**CHAPTER VIII**

**DEVOLOPMENT OF REVENUE : TAXES**

**Purpose**

In the past, the mechanism of 'revenue-devolution' has been employed to lure the regional governments into a federal union. The devolution thus ensured, would have to have a nexus with the revenue loss sustained by the regional governments as a result of joining the federation. However, in the modern era of cooperative federalism, the object of devolution of revenue is to bring about harmony between needs and resources of the two governments, the central and regional, and to help them in the attainment of economic equilibrium.

In a federation, the economy of constituent units has to be viewed as a part of the national economy. For the development of national economic programmes, the units are required to provide to their residents certain economic and social services which are considered to be of vital public importance. It is, however, conditioned by the ability of the units to discharge their financial responsibilities adequately and efficiently. Since the levels of public services provided by the unit governments are likely to show significant variance, the needy units are to be helped to raise the standard of these public services to the levels prevailing in the more affluent parts of the federation. It is with the object of reducing the disparities in the levels and standards of social services and augmenting the resources of the units in an equitable manner and to enable them to meet their growing needs that fiscal transfers are considered desirable. The revenue-devolution so provided, has to take full cognizance of the requirements of fiscal equity, federal integrity and of securing a more balanced correspondence between fiscal needs and resources of the units that are at different levels of development.

---

In India, the scheme of the distribution of taxing powers between the Union and the States, was drawn with the initial presumption that by and large the revenues which could be raised by the use of the allotted taxing powers would reasonably match the requirements of the respective Governments having regard to the functions and responsibilities assigned to them by the Constitution. This initial presumption was, however, conditioned by expediency rather than scientific principles of federal finance. For that, taxes like income-tax, corporation tax, excise duties, and customs, which have a national and inter-State base and which have to be levied on the basis of uniformity, have been placed with the Centre, while the States are left with taxes which have a local base. It was recognised at the very outset that the yield from the taxes assigned to the States would not be enough, in the case of most of them, to enable them to discharge their responsibilities. To meet this situation, the Constitution-makers incorporated a scheme of revenue devolution as a balancing factor. Thus the avowed object for embodying this scheme was to give to each State according to its need and for that purpose, 'fiscal need' was accepted as 'the bed-rock of the adjustments'. The task of determining, from time to time, the fiscal needs of the States, as already mentioned, has been left to the Finance Commission.

It has been seen that the fiscal transfers made on the recommendations of the Finance Commission, do not cover the totality of revenue transfers from the Centre to the States. Rather they constitute a small portion of the total transfers, the major portion of which is made on the recommendations of the Planning Commission. In addition to the transfers made by these two Commissions, a sizeable part of Central payment is made over to the States at the discretion of the various Ministries of the Central Government.

4. See Chapter VII, supra.
5. See Chapter IX, infra.
confined to the devolution of revenue made under the recommendations of the Finance Commission.

**Approach of the Finance Commission**

The financial transfers to the States made on the recommendations of the Finance Commission mainly include: assignment to the States of the entire net proceeds from "taxes and duties mentioned in Article 269"; obligatory sharing of revenue from "taxes on incomes other than agricultural incomes" and permissive sharing of "excise revenue" with the Centre. Having received tax devolution, if some States are still in need of additional assistance, the Commission recommends an appropriate amount to them by way of grants-in-aid.

'Revenue devolution' from the Centre to the States has been regarded by the Successive Finance Commissions, as a means to supplement the revenues of the State Governments which have, invariably, been found unable to discharge their financial responsibilities. The Commissions have made use of both 'tax-devolution' and grants-in-aid' to bridge the gap between the resources and expenditure incurred by the States. However, in this exercise their main emphasis has been on 'tax-devolution', and 'grants-in-aid' have been treated as a residuary form of financial assistance, for the latter are meant only for the States adjudged to be in need of additional assistance.  

In the matters of 'tax-sharing' the task of the Finance Commission includes the fixation of the entire 'divisible pool' of the States in divisible taxes and duties and further, to determine the principles for the distribution of the 'divisible pool' among the States inter se. It covers the transfers by way of obligatory sharing of revenue from taxes on incomes other

---

than agricultural incomes and the permissive sharing of excise duties levied by the Union. In the case of 'estate duty on property other than agricultural land', the Commission's job is to determine the principles for the distribution of the entire net proceeds among the States *inter se*. It has, however, to assign to the Centre, a share in their proceeds which is attributable to the Union Territories levying the duty. The size of *ad hoc* grant in lieu of the repealed 'tax on railway fares' is determined by the Union Government in consultation with the Railway Convention Committee. The entire proceeds thereof are distributed among the States. Similarly, the net proceeds of the 'additional excise duties' in lieu of States' sales taxes are to be distributed by the Commission among the States themselves. In the case of the latter three 'taxes and duties', the work of the Finance Commission is, thus, confined only to the laying down of the principles of State-wise distribution.

The First Finance Commission laid down some guidelines for federal fiscal transfers under the Indian Constitution. The Commission observed:

In drawing up the scheme of assistance we have kept three main considerations in view. Firstly, the additional transfer of resources from the Centre must be such as the Centre could bear without undue strain on its resources, taking into account its responsibility for such vital matters as the defence of the country and the stability of its economy. Secondly, the principles for the distribution of revenues between the States and the determination of grants-in-aid must be uniformly applied to all the States. Lastly, the scheme of distribution should attempt to lessen the inequalities between States.

These guidelines have been, generally, kept in mind by the Successive Finance Commissions while making their recommendations on the devolution of revenue from the Centre to the States. In the whole scheme, 'fiscal needs' of the States has

8. See infra.
been taken to be the relevant principle by the successive Commissions to attain the object of federal equilibrium. This object calls for greater magnitude of resource flow to less developed States to keep pace with the more developed ones. Taking account of the principle of fiscal needs of the States, Justice R. Kaushalendra Rao, a member of the First Finance Commission observed:  

In federal finance the theory of contribution is yielding ground to the theory of equalisation. The federal government is raising taxes from territories where there is ability to pay and is appropriating the proceeds more and more to uses in territories where they are needed.

To the same effect, the Fifth Finance Commission maintained: "In considering this question of distribution among the States, it is necessary to keep in mind the main purpose of devolution, which is to augment the resources of the States in an equitable manner to enable them to meet their growing needs."  

The Sixth Commission spelt out: "The objective of rectifying, to the extent possible, regional imbalances, should be recognised as a distinct criterion in determining the principles of fiscal transfers in any federation."  

Taking note of the widening disparities in the levels of development among the States the Seventh Finance Commission observed: "In our view the role of a Finance Commission should not be negative, of filling in the revenue gaps only, but positive in that its scheme of devolution gives a better start for developmental outlay."  

Thus the approach of the successive Finance Commissions towards 'revenue devolution' has been influenced by objective of placing as many of the less affluent States as possible in surplus on the revenue account. The object being that the States which are less favourably placed in regard to their resource potential should be

specially helped in order to place them in a position where they
can also take steps more readily for the betterment of the people
living in those States. In the following pages, the approach of
the successive Finance Commissions towards the distribution of
specific taxes and duties has been analysed.

Indian Constitution incorporates several devices for the
devolution of revenues from the Centre to the States. There are:

(a) **Assignment of revenue from several taxes** - These include
the taxes which are levied and collected by the Union but
entirely assigned to the States like succession and estate duties
on non-agricultural property, terminal taxes, taxes on railway
fares and freights.\(^{13}\) This category also includes taxes which
are levied by the Union but collected and appropriated by the
States like stamp duties on bills of exchange, cheques, etc.,
and Union duties of excise on medicinal and toilet preparations.\(^{14}\)

(b) **Compulsory sharing of taxes** - These represent taxes which
are levied and collected by the Union but the net proceeds
thereof are distributed between the Union and the States. This
class includes taxes on incomes other than agricultural income.\(^{15}\)

(c) **Permissive sharing of taxes** - These are taxes which are
levied and collected by the Union and if the Parliament by law so
provides, may be shared with the States.\(^{16}\)

(d) **Grants-in-aid to the needy States.**\(^{17}\)

(e) **Discretionary grants and loans.**\(^{18}\) - The above scheme
illustrates that the Constitution confers the major role of tax
collection on the Union Government which collects them not merely

---

\(^{13}\) Article 269.

\(^{14}\) Article 268.

\(^{15}\) Article 270.

\(^{16}\) Article 272.

\(^{17}\) See Chapter IX, *infra*.

\(^{18}\) See *infra* Chapters IX & X.
for itself but also for the States. As a consequence, the scheme requires devolution of revenues from the Centre to the States. It, thus, constitutes the "backbone of the Union-State fiscal relations" under the Indian Constitution. The Constitution itself indicates the taxes which are compulsorily and permissively divisible between the Centre and the States. The role of the Finance Commission is confined to the fixation of the collective share of the States in the divisible pool and laying down the principles for its distribution among the States inter se.

A question here arises: Can the Finance Commission extend the scope of the divisible pool and thus go beyond their terms of reference while making their recommendations? Theoretically speaking, the Commission cannot extend the list of shareable taxes which is beyond their powers. For instance, the Second and the Third Finance Commissions expressed their incompetence to include corporation tax in the divisible pool when suggested by some States in their memoranda to the Commissions. But more than once, the Commissions have not held themselves bound by this limitation. It so happened when the First Finance Commission recommended, on their own, a share for the States in some of the Union excise duties, which is permissible only under a Parliamentary Law. Again, the Fifth Finance Commission, while making their recommendations, included the revenues from special excise duties (hitherto non-shared) in the shareable pool, though it was not so required by their terms of reference. The Sixth Finance Commission, on being pressed by the States, recommended that the auxiliary duties on goods imposed under the

22. Article 272 permits such levy by Parliament for Union purposes.
23. The special excise duties were levied in 1963, in view of the National emergency arising from Chinese aggression. The proceeds of this duty were not shared with the States. Under the Fifth Commission's recommendations, 1969, these were made shareable from March 31, 1972.
Finance Act of 1973, should also be brought into the common pool.\footnote{Report, Sixth Finance Commission, 14, 1973.}

With respect to the taxes and duties,\footnote{Those include estate duty on property other than agricultural land; additional excise duties in lieu of States' sales taxes and grants in lieu of the repealed tax on railway fare. See also infra.} which are levied and collected by the Union but the net proceeds of which are entirely\footnote{The share attributable to the Union Territories is assigned to the Central Government.} assigned to the States, the function of the Finance Commission is only to evolve the principles of distribution among the States \textit{inter se}. The need for the fixation of aggregate share of the States arises only in the case of income tax and union excise duties. The share of the States jointly, in these taxes and duties is reviewed every time a new Finance Commission is appointed. It may be seen from the recommendations of the successive Finance Commissions that there has been a progressive increase in the proportionate share of the States in revenues from these divisible taxes and duties. Earlier to the First Commission the States were receiving 50 per cent of the net proceeds\footnote{As calculated after deducting the cost of collection of the tax; the share of the Part-C States (which was retained by the Centre) and surcharge on income-tax which was not shareable with the States.} of income-tax\footnote{This percentage was fixed by Sir Otto Niemeyer in 1936 and was kept up under the Deshmukh Award 1949, which remained operative until the First Finance Commission made their recommendations in 1952.}. The First Finance Commission increased it to 55 per cent, which was revised upward to 60 per cent by the Second Finance Commission. The Third and Fourth Commissions raised it to 66.6 per cent and 75 per cent respectively. The Fifth Commission thought it proper to keep the proportionate share unchanged. But they increased the size of the divisible pool of the tax by including the hitherto excluded advance tax.
payments into the shareable items. The share was increased to 80 per cent by the Sixth Commission and the Seventh Commission raised it to 85 per cent.\footnote{29}

It so happened with respect to the Union Excise Duties also. Prior to 1952, the States were not receiving any share in these duties. The First Finance Commission broke new ground when, for the first time, they recommended that 40 per cent of the revenue from excise duties on three commodities be made over to the States. The Second Commission reduced this percentage to 25 but extended the number of shareable commodities from three to eight, thus adding to the bulk of shareable pool. The Third Commission further extended the list to 35 items and reduced the percentage to 20. The Fourth Commission went a long way in this regard. They did not change the percentage shareable but under their recommendations, revenue from all the commodities on which duty was levied in 1965 was shared by the States. By the time the Fifth Finance Commission was set up, the States were sharing the revenue from excise duty on all the commodities, with the exception of special excise duties and regulatory duties of excise and cesses on commodities. The Fifth Commission, while leaving the proportionate share unchanged to 20 per cent, brought the special duties of excise in the divisible pool.\footnote{30} As a result of the recommendations of the Sixth Commission, revenue from auxiliary duties\footnote{31} on excisable goods was added to the shareable pool, but the proportionate share remained unchanged at 20 per cent. The Seventh Finance Commission did not make any change in the existing divisible pool of Union excise duties but like the First Commission, raised the proportionate share to 40 per cent.\footnote{32}

\footnote{29. For details see infra.}
\footnote{30. In case, the special duties continued after March 1972. As the duties were continued to be levied even after March 1972, the States started sharing in the proceeds on the same basis as applies to basic duties of excise.}
\footnote{31. The auxiliary duties were levied in place of regulatory duties of excise under the Finance Act of 1973.}
\footnote{32. For details see infra.}
There has, thus, been a general trend in the direction of increasing the divisible pool through a greater coverage.

The foregoing analysis brings out that the share of the States in revenue proceeds from Income-tax and Union excise duties has progressively increased as a result of the recommendations of the successive Finance Commissions. But the shares thus determined appear to be essentially arbitrary. The Commissions have not been placing before the public the relevant details and particulars they have been taking into account while fixing a particular proportionate share for the States in the divisible pool. This failure on their part has led the researchers to suspect that they have been trying to avoid criticism of their arbitrary assumptions, estimations, methods and calculations by hiding them from the public. However, as the working of the successive Finance Commissions depicts, they appear to have been taking a general view of the requirements of the States, in fixing their proportionate share in income-tax proceeds. Taking for example, the reasons expressed by the First Finance Commission for increasing the share from 50 to 55 per cent. The Commission observed that such increase was justified because of the shrinkage of the size of the divisible pool and increase in the number of claimant States. The need to transfer larger resources to the States, though an important consideration was not cited by the Commission as an expressed reason for such increase. Much less the same approach has been followed by the subsequent Finance Commissions in this matter.

This brings us to the most important problem of fixing the bases for the distribution of the divisible share from income-tax and union excises among the States inter se. Different bases

33. The reasons of such shrinkage being that the Commission had recommended a higher share for the Union Territories (Part C - States as they were known at that time) i.e., 2.75 per cent as against 1 per cent previously given. Also because of a proportion of cost of collection had been apportioned to the income-tax vis-a-vis the corporation tax. See Report, First Finance Commission, 70-77.

34. As a result of the inclusion of Part B States (former Princely States) the number of claimant States increased from nine to sixteen. Report, 70-71, 1952.

35. For example, the Second Finance Commission justified some increase in States' share in income-tax proceeds in view of unanimous desire of the States. Report, 39, 1957.
have been continually suggested by the States, individuals and
certain organisations and committees, some of which are:

(a) Basis of population
(b) Basis of collection
(c) Basis of residence
(d) Basis of origin
(e) Basis of relative per capita income
(f) Basis of relative wealth indices
(g) Basis of relative economic backwardness of the States.

The working of the successive Finance Commissions brings out two important facts regarding the distribution of divisible revenues inter se. The first is that 'tax-sharing' has been mainly governed by two objectives, namely, the principle of need and the principle of compensation. The principle of equalisation is followed to a marginal extent, that too in case of basic excise duties only. Secondly, these principles have not been uniformly applied in distributing all the shared revenue and different taxes have been treated separately. The principles have been combined in different ways for distributing revenues from each of the shared taxes. For example, population representing the need principle and contribution expressing compensation have been the only two relevant factors in the distribution of the proceeds of income-tax. Whereas the factor of population is completely missing from the formula adopted in the distribution of revenues from additional duties of excise levied in lieu of sales taxes and in the case of grant made in lieu of tax on railway fares. On the other hand, principle of contribution is completely missing from the formula applied for distributing revenues from basic excise duties. In the following pages, the recommendations of the successive Finance Commissions as far the calculation of the divisible revenues and their distribution among States, are analysed.

36. For details, see infra.
I  Assigned Taxes And Duties

A. Taxes and Duties Enumerated in Article 269.

Article 269 provides for the assignment to the States of the net proceeds of seven types of taxes levied and collected by the Union. These are called assigned taxes and the question of the States' share as a whole, does not arise as the entire net tax proceeds are to be distributed among the States. The task of the Finance Commission in their case is to evolve the formula for their distribution inter se.

The Finance Commissions have taken the view that these "taxes and duties" are, in fact, States' taxes, which have been included in the Union List in the interest of uniformity of treatment and convenience of collection.\(^{37}\) They, therefore, decided to distribute the net proceeds from these taxes in such a manner as to give to each State, approximately, 'the amounts which it would have itself collected if it had the power to levy and collect such tax or duty'.\(^{38}\)

Out of the seven taxes mentioned in Article 269, five are insignificant and therefore these have not been tried so far. The remaining two taxes, namely, tax on railway fare\(^{39}\) and estate duty\(^{40}\) levied in 1957 and 1953 respectively, are of concern.

39. The tax was imposed under the Railway Passenger Fares Tax Act, 1957.
40. The duty was levied under the Estate Duty Act, 1953, which defined the term 'Estate Duty' as a duty payable on the principal value of all properties, movable and immovable, agricultural or non-agricultural, real or personal, settled or non-settled, passing on the death of a person. Under the Act of 1953, the duty is made leviable on agricultural land also by an agreement between the State Legislatures entered into under Article 252. But Article 269 is concerned with estate duty on non-agricultural property only.
for the Finance Commission to determine their State-wise distribution.

The distribution of the tax proceeds from the estate duty on non-agricultural property and the tax on railway passenger fares, was, for the first time, referred to the Second Finance Commission in 1957. The States pleaded for different criteria like area, population, backwardness, collection etc., depending upon their respective interests. But the Commission approached the question in a manner that each State should receive, broadly, the amounts which it would have raised if it had the power to levy and collect these taxes. Accordingly, the Commission applied 'contribution' as the appropriate principle of distribution for estate duty and tax on railway passenger fares as well.  

(a) **Estate Duty**

In the case of estate duty, the location of the dutiable property was taken to provide an ideal measure of each State's contribution to the total revenues produced by it. But this ideal principle could not be suitably applied in the case of the movable property part of the estate. For this part the Second Finance Commission adopted the basis of population as most proper. Therefore, the Commission recommended that the net proceeds of estate duty attributable to immovable property be distributed on the basis of State-wise location of such property (calculated on the basis of the gross value of immovable property assessed within their precincts), while those apportioned to movable property be distributed on the basis of population.  

The recommendations of the Second Finance Commission were:

1. that out of the net proceeds of the duty in any financial year, a sum equal to one per cent be retained by the Union as proceeds attributed to Union Territories;

---

42. *Id.* at 51.
(2) the balance be apportioned between immovable property and other property in the ratio of the gross value of all such properties brought into assessment in that year;

(3) the sum thus apportioned to immovable property be distributed among the States in proportion to the gross value of the immovable property located in each State;

(4) the sum apportioned to property other than immovable property be distributed among the States in proportion to their population.

The subsequent Finance Commissions did not suggest any change in the above formulation with a difference that the proceeds attributable to Union Territories were raised from 1 to 3 per cent. The Seventh Finance Commission, however, made a minor deviation from the above recommendations as regards estate duty. The Commission held that it would be incorrect to determine the shares of the States in proportion to the collections of the duty in each State, since collections may take place in a State on account of duty assessed on properties situated in other States. As regards the determination of location of properties other than immovable property subjected to estate duty, they maintained that "the rules framed under the Estate Duty Act for the purpose of determining location of properties other than immovable property, which are held abroad, can equally be applied for the determination of the location of such properties in India". Accordingly the Commission recommended:

(1) The net proceeds of Estate Duty in respect of property other than agricultural land attributable to Union Territories in each of the years 1979-80 to 1983-84 should be determined in the same manner and on the same principles as for the determination of the shares of each State, taking the Union Territories as one unit for the purpose.

46. Id. at 92.
The balance of the net proceeds of Estate duty in each year should be distributed among the States in proportion to the gross value of the immovable property and property other than immovable property taken together located in each State and brought into assessment. For this purpose property located abroad should be deemed to be located in the State where it is brought to assessment.

Sikkim will also be entitled to a share in the net proceeds of the duty, calculated in the same manner as for the other States, as from the date the duty may become leviable in that State in the period from 1979-80 to 1983-84.

It may be observed that distribution of the net proceeds from estate duty, on population basis, conforms to the principle of contribution only under the assumption that movable property is uniformly distributed among the States. But it is far from reality. In a country where the States have significant disparities in terms of income and wealth of their residents, the criterion of per capita distribution of a tax goes, by and large, in favour of the relatively poor but populous States. It does not conform to the principle of contribution enunciated by the successive Finance Commissions for the purpose of distribution of taxes and duties under Article 269. The Seventh Finance Commission has thus rejected population altogether as the criteria for the distribution of this duty and has recommended the location of dutiable property, immovable or others, as a measure to determine each State's contribution to total revenue from this duty.

(b) Grant in lieu of Tax on Railway Fares

In the matter of the distribution of proceeds from tax on railway fares, the approach of the Second Finance Commission was influenced by the same factor as in the case of estate duty. The Commission observed that the proceeds of this tax should be distributed inter se on the principle that each State gets, as nearly as possible, the share of the net proceeds on account of
the actual passengers travel on railways within its limits. Keeping this principle in view, the Commission recommended that each State should be allocated on the basis of the passenger earnings from non-suburban services for each gauge of each railway zone separately among the States covered by it according to the route length falling within each State. Thus the break-up of the tax collected on each ticket according to the mileage of the routes lying in each State, formed the basis for distribution. Since only figures of ticket values issued by origin of travel were available, the estimates of the earnings of each zonal railway allocated by rough mileage located in each State separately for each gauge were used to find out passenger travel in terms of passenger earnings and the tax proceeds recommended to be distributed in the ratio of these earnings. While so doing, the Commission recommended steps to investigate whether Statewise statistics of route mileage, traffic and earnings could be maintained without undue cost to facilitate the adoption of better methods of distribution of this tax.

The recommendations of the Second Finance Commission as to the distribution of tax on railway fares were accepted by the Government of India. But in April 1961, this tax was abolished by the Repeal of the Railway Passenger Fares Tax Act 1957 and the tax was merged in the basic fare with effect from April 1, 1961. The Government of India decided to make an ad hoc grant of Rs. 12.5 crores a year to States in lieu of the tax for a period of five years from 1961-62 to 1965-66. This grant continued and its amount was successively raised.

The Third, Fourth and Fifth Commissions, which were asked to deal with the distribution of this ad hoc grant

48. Id. at 65.
49. This step was taken by the Government of India in pursuance of the recommendations of the Railway Convention Committee which was persuaded by the Railway Board's contention that the levy of the passenger fare tax had limited the scope for raising passenger fares. Report, Seventh Finance Commission, 52, 1978.
50. The grant was raised to Rs. 16.25 crores from 1966-67. It was done at the suggestion of the Railway Board, made in view of the growth in passenger traffic from 1960-61 to 1964-65.
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. The criterion adopted by these Commissions was the route mileage within each State with suitable adjustments for different gauges to accommodate differences in density of traffic. This distribution could not satisfy the States which were deficient in railway facilities. Their contention before the Sixth Finance Commission was that lack of adequate railway facilities in a State and the consequential expenditure on roads to meet the demand of traffic should form one of the criteria for determining the *inter se* distribution of the grant. Some States suggested that the distribution should be made on the basis of track mileage in each State as against purely route mileage, as the former afforded better index of intensity of traffic. Some other States demanded that while 80 per cent of the grant might be distributed on the basis of the existing criterion, the balance of 20 per cent should be distributed among the States whose railway mileage in terms of area was below the all-India average, in proportion to the shortfall from such average multiplied by the area of the State concerned. States like Meghalaya, which had no railway line, claimed that a minimum sum out of the total grant should be set apart for distribution among them. Manipur which also had no railway line urged that criterion of population should be uniformly applied in the distribution of the grant among States which had no railway lines. Jammu and Kashmir would like its share to be fixed at a higher figure and increased in the same proportion as the increase in the length of railways in the State.

But the Sixth Finance Commission, after carefully considering the pros and cons of the various suggestions put forward by the State Governments, did not think proper to recommend any change in the existing distribution of the grant. Rejecting the States' contentions, the Commission stated that since the principle of distribution of *ad hoc* grant in lieu of the repealed tax should be so designed as to place the States on more or less...
the same footing as they were when the tax was in force, State in which there were no railway lines could have no claim on this grant.\textsuperscript{53} In the continuing absence of statistics on passenger earnings in each State on account of actual travel within its limits, the Sixth Commission worked out the percentage shares of the different States on the basis of the statistics of gauge-wise route lengths of railways in each State and the actual passenger earnings from non-suburban traffic for each zonal railway for the four years ending 1971-72.\textsuperscript{54} The Seventh Finance Commission also took into consideration this distribution. The Commission was in agreement with the views held by the earlier Commissions that the States' share in the grant in lieu of the tax should be determined in the same manner as if the levy and collection of the tax had continued. Accordingly, the Commission recommended that the most appropriate distribution of the grant would be in proportion to the non-suburban passenger earnings from traffic originating in each State.\textsuperscript{55}

The foregoing analysis brings out that the approach of the successive Finance Commissions as regards the distribution of the proceeds of 'estate duty' and 'grant in lieu of tax on railway fares', has remained virtually unchanged. The principles evolved by the Second Commission for the distribution of this revenue among the States continued to govern except the minor changes introduced by the Seventh Commission. However, the assumption made by all the Commissions as to the nature of the taxes and duties enumerated under Article 269, viz., that they, in fact, are the taxes of the States, can be challenged on more than one count. Firstly, it is the Union Government who is exclusively empowered by Article 269 to levy these taxes. Whether a tax is to be levied or not, is for the Union Government to decide. So far, only two taxes were tried out of a list of seven and one of these was discontinued after a trial of three years. The unilateral repeal of the tax on railway fares by\textsuperscript{56}

\textsuperscript{53. Ibid.}
\textsuperscript{54. Ibid. at 23.}
\textsuperscript{55. Report, Seventh Finance Commission, 53, 1978.}
\textsuperscript{56. Report, Seventh Finance Commission, 53, 1978.}
Central Government proves the above hypothesis. Secondly, which is almost a corollary of the first, is that only the Centre has the right to fix the rates of these taxes. The Finance Commissions have justified this exercise by the Centre, as to ensure uniformity of rates in all the States. But this uniformity for a tax (which essentially belongs to the States) could have been ensured through a consultative mechanism between the Centre and the States. Further, taking this interpretation given by the successive Commissions as correct, how far it justify the adoption of the factor of contribution as an index of compensation when it is more likely that, had the States themselves levied these taxes, their rates would have differed among the different States. It thus appears that the interpretation and recommendations made by the Commissions are somewhat arbitrary. 56

B. Additional Duties of Excise in Lieu of Sales Taxes

Under the Constitution, the power to levy Union excise duties is vested in the Union Government and that to levy tax on the sale or purchase of goods except those in the course of inter-State trade and newspapers, in the State Governments. There is however, no bar in the Constitution to the Union and the States entering into agreements for the levy of additional duties of excise in lieu of States' levy of sales tax.

With a view to providing convenience to trade and minimize the chances of tax evasion, the National Development Council in its meeting of December 1956, proposed the levy of special duties of excise on certain commodities of nation-wide importance in lieu of the States' Sales Taxes on them. To give effect to this proposal, the Additional Duties of Excise (Goods of Special Importance) Act was enacted in 1957, empowering the Union to impose additional duties of excise on mill-made textiles, sugar and tobacco. The net proceeds from these duties under the Act are wholly assignable to the States.

This arrangement has been treated by all the Finance Commissions as a "tax-rental agreement" between the Central and

56. Grewal, 93-94.
State Governments. Under the agreement, the entire net proceeds from these duties are to be distributed among the States with the guarantee that each State must receive at least the amount which it collected through the foregone sales tax in 1956-57.57 Though the States still have the constitutional right to re-impose sales tax on these goods subject only to the possible forfeiture of their share of revenues from additional excise duties on these commodities. Besides the declaration of these goods as "goods of special importance" by Section 14 of the Central Sales Tax Act,1956,58 acts as an effective deterrent against the States' reverting to the old pattern of levy of sales tax. The effect of this legislative provision is to restrict the levy of sales tax on these goods to the limit specified therein (currently 4 per cent). Again, sales tax on these commodities can be levied at only one stage and the local sales tax is to be refunded if such goods subsequently became subject to inter-State sales tax. State Governments are, therefore, effectively prevented from imposing sales tax on these commodities, though their constitutional right to levy sales tax remains unimpaired.59

The Second Finance Commission was the first to deal with these duties and their distribution among the States inter se. The terms of reference of the Commission, in this regard, were somewhat clear. The Commission was required to recommend not only the principles of distribution of the net proceeds, but also to specify the amounts which should be assured to each State as being the 'present income' derived from them in 1956-57 by the levy of sales tax on these commodities.60 The term 'present income' was more widely interpreted by some States, by putting their claim on the likely increases from enhancement of tax rates already sanctioned or about to be passed, for allowance for the prospective yield in a full year of the Centrally levied inter-State sales tax which came into force on July 1, 1957, as well as

58. See Article 286(3) of the Constitution.
60. These were mill-mace textiles, sugar and tobacco (including manufactured tobacco). Report, Second Finance Commission,59, 1957.
for the better yield from reduction in evasion and improvement in the machinery of collection. But the Second Commission rejected all these claims and interpreted the term 'present income' to mean only "the income from the level of the sales tax on these commodities in 1956-57." Compensation was accepted as the main basis of distribution of these duties because this was a case of voluntary surrender of tax powers by the States. After the guaranteed amounts were distributed, the Commission recommended the remaining proceeds (if any) to be allocated on the basis of consumption. Since the States could not supply accurate figures of consumption of these commodities, the Second Finance Commission used consumption statistics (as furnished by the States which contained a margin of error) corrected by population factor as the percentage formulae for the distribution of the above said balance. The Commission also recommended one per cent of the net proceeds from these additional duties for distribution among Union Territories and 1/4 per cent of the same for the State of Jammu and Kashmir.

The State Governments repeated their claims for revising the guaranteed amounts before the Third Finance Commission. They requested the Commission to take into account the losses sustained by them from the surrender of sales tax on these commodities and their likely increases in rates effected under the Central Sales Tax Act 1956. But the Commission like their predecessors, rejected their plea on the grounds of their impracticability arising from lack of statistical data then available, as well as, their being outside the scope of their terms of reference. As regards, the balance proceeds, in excess of the guaranteed amounts, the Third Commission considered that it would be equitable to distribute it, partly on the basis of percentage increase in the collection of sales tax (in each State since 1957-58) and

61. *Id.* at 59-60.
62. *Ibid*.
63. *Id.* at 61-62.
64. Report, Third Finance Commission, 26, 1961. The only revision in the guaranteed amount was made on account of the additional excise duty on silk fabrics levied in April 1961. See *Ibid*.
partly on the basis of population. But the criterion appears to be artificial in as much as the sales tax revenue from a different set of items could not reasonably be taken to represent the potential yield of sales tax on goods subjected to additional excise duties. There is also no indication as to the relative weightage given to these two factors of "percentage increase in the collection of sales tax" and "population" adopted by the Third Commission. The Fourth Commission upheld the plea raised by the States to the extent that they abandoned population as a relevant factor and vested their scheme of distribution of the balance over the total of guaranteed amount, wholly on the basis of the realization of sales tax revenue in each State, determined by proportion of sales tax revenues realised in each State to the all-India sales tax collections. The criterion so adopted was likely to favour those States which had high concentration of luxurious and semi-luxurious items usually with high rates of sales tax and thus cannot be held to be equitable one. The Commission, however, continued the practice of setting apart the guaranteed amounts. The Fifth Finance Commission did not change the basic approach in the matter of distribution of additional excise duties, however, in regard to the principle for distribution of the balance of the net proceeds from additional excise duties after excluding the guaranteed amounts, the Commission held the view that the best formula would be to give equal weightage to both, sales tax collection and population as evolved by the Third Commission. Accordingly, the Commission recommended that 50 per cent of the balance (after excluding the guaranteed amounts) be distributed on the basis of sales tax collection and 50 per cent on the basis of population.

65. Id. at 27.  
66. Dr. Diwan, 90.  
69. Id. at 44.
The Sixth Finance Commission evolved new criteria for the distribution of proceeds from these duties. The Commission departed from the earlier approach in two ways. Firstly, the practice of providing for "guaranteed amounts" was given up and the entire net amount was thrown into the divisible pool. Secondly, while theoretically conceding State-wise consumption of goods subjected to these duties as an "uncontrovertible" basis of distribution inter se, on account of non-availability of requisite statistics, they, like their predecessors, adopted 'some reliable indicators' of the level of consumption of these commodities, as the basis of distribution. The Commission held that population and the average of State Domestic Product for the three years 1967-68 to 1969-70, should be taken together as providing reasonable basis for assessment of the level of consumption, population being given considerably higher weightage. They observed that sales tax yield from items other than those subjected to these duties did not provide a good indication of what the sales tax yield would have been had these commodities been levied sales tax. The Commission calculated the estimated yield from these duties for the five-year period to Rs. 1037 crores as against the guaranteed amount of Rs.162 crores. They thus recommended that the most equitable basis for the distribution of the net proceeds from these duties would be to allocate the proceeds on the basis of population, State Domestic Product at State current prices and production, in the ratio of 70 : 20 : 10.

The Seventh Finance Commission did not find favour with the approach taken by the earlier Commissions as to the distribution of revenues from additional excise duties. These Commissions, except the Sixth Commission, had been giving undue weight to the question of the likely proceeds from commodities, had they been subjected to States' sales tax. It may be because

70. Report, Sixth Finance Commission, 20-21, 1973. In the opinion of the Commission, population was a major indicator of consumption of these commodities in the States.

71. Id. at 20.

72. Id. at 22. The manner of assigning weightage to the factor of State Domestic Product is not known.
of the fact that by the terms of reference, the Commissions were being asked to guarantee their historical incomes to the States. But, when the States agree to give up their power to levy varying rates, with the hope that centralisation would lead to more efficient collection and also prove more advantageous to economy, consideration of compensation as a basis for the distribution of the yield from these duties does not appear to be a sound principle.\textsuperscript{73} The Seventh Commission, thus, did not attach any importance to the approach followed by their predecessors and held that there was no need to set apart any guaranteed amounts to the States out of the net proceeds of additional duties of excise, as in their view, "there is no risk of the share of any State falling short of the revenue realised in the financial year 1956-57 in a State from the levy of the salt tax on the commodities subject to additional duties of excise."\textsuperscript{74} In order to avoid any doubt as to the entitlement of a State in its share of the proceeds of the duties, the Commission specifically recommended the shares of each State separately in the net proceeds for additional excise duties on sugar, textiles and or tobacco. In the case of duties on sugar, the Commission received from the Government of India's Food Department, statistics of despatches of sugar to each State and the Union Territories during the last few years ending with 1976-77 and used these despatches as a fair approximation of consumption of sugar in each State and Union Territory. The Commission then recomended the share of the Union Territories and of each State in proportion of the total of the average despatches in the three years ending 1976-77, to all the States. In the case of textiles and tobacco, the Commission was unable to find a similar method as in the case of sugar for estimating consumption in each State. For this purpose, the Commission

\textsuperscript{74} \textit{Report}, Seventh Finance Commission, 92, 1975.
\textsuperscript{75} Id. at 48.
obtained from the Central Statistical Organisation, a comparable series of per capita State Domestic Product at state current prices for each state for the years 1970-71 to 1975-76. The average per capita State Domestic Product of each state for the three years ending 1975-76 were multiplied by the population of the State according to 1971 census and the Commission worked out the percentage shares of this product of each State in the corresponding all States' total figure. The proceeds attributable to the Union Territories were worked out in the same manner. Sikkim was also given a share in the net proceeds of these duties except the duties on textiles on which the State levied sales tax.76

The scheme to impose additional excise duties in lieu of sales tax is in force for the last 25 years and the trade has welcomed it.77 But some states have been expressing their dissatisfaction with the inadequate exploitation of this source of revenue. This led the Union Government to enjoin the Fifth Finance Commission, to investigate and report on the desirability or otherwise of continuing the scheme. The entire question was examined by a group consisting of the representatives of the Union and State Governments in the light of the Report made by the Fifth Commission. The proposals made by the group were discussed in the meeting of the National Development Council held on December 28, 1970. The Council decided to continue the present arrangements subject to certain conditions. The main condition was that the incidence of the duty should be raised up to 10.8 per cent of the value of the clearance within a period of two or three years. These recommendations of the Council were accepted by the Union Government and had been implemented through the successive Finance Acts.78 It is evident from the memoranda of the states to the Sixth and Seventh Finance Commissions that they were satisfied with the new measures. Thus, it seems that the duty is going to stay.

76. Id. at 49.
C. Grant on Account of Wealth Tax on Agricultural Property

Wealth tax is not one of those taxes or duties which, under the Constitution, are to be shared with the States either on an obligatory or permissive basis. Nor is it a tax levied and collected by the Centre and assigned to the States, as is the case with estate duty on property other than agricultural land. However, when in 1969, agricultural land held by individuals and Hindu undivided families was made liable to wealth tax subject to certain limits, the Central Government decided *suo moto* that the net proceeds of the tax on agricultural land would be made over to the States as grants-in-aid. The decision to subject agricultural land to this tax was taken by the Union Government with a view to bring about equality of treatment as between persons having investments in non-agricultural property and those having investments in agricultural property.\(^79\) It was done by the Finance Act of 1969 which amended the Wealth Tax Act 1957\(^80\) so as to extend the levy to agricultural property (except such property situated in Jammu and Kashmir), with effect from the assessment year 1970-71. No tax is payable if the net wealth is less than rupees one lac, both in the case of an individual and a Hindu undivided family. The rate of the levy is fixed at 5 per cent of the amount by which the net wealth exceeds the limit of rupees one lac.

The Sixth Finance Commission was, for the first time, required to make recommendations regarding the principles governing the distribution, among the States, of the grant to be made available to them on account of wealth tax on agricultural property for the five years from 1974-75 to 1978-79. The different principles suggested by the State Governments to the Commission were: distribution on the basis of location of property; distribution on the basis of population; on the basis of collection; distribution on the same basis as adopted in the case of income-tax; distribution partly on the basis of population and partly on the basis of backwardness; distribution in proportion of the rural population living below the subsistence level to the total of such population.

---


\(^{80}\) This Act had exempted agricultural property from the levy of Wealth Tax.
of all States taken together, and in such a manner as to make available more funds to agriculturally less developed States in comparison to those which are highly developed. One State specifically suggested that the grant should be distributed in proportion to the gross value of agricultural wealth located in each State, in the same way as estate duty is distributed in proportion to the gross value of immovable property located in each State. Another suggestion was that each State should get the amount which it would itself have collected if it had the power to levy and collect the tax itself. It was also suggested that in case data were not available for distribution of the grant in proportion to the gross value of agricultural land located in each State and brought into assessment in each year, the distribution would preferably be made according to the respective population of the States.

The Sixth Commission considered the relative merits of the above suggestions. The Commission considered the tax as being comparable in its incidence to estate duty in so far as the latter related to immovable property. They thus observed that the location of the property brought to assessment would be clearly identifiable in each case and would provide a reliable basis for the distribution of the proceeds among the States. They recommended, accordingly, that the grant should be distributed in proportion to the value of agricultural property situated in each State and brought to assessment in each year. Population in their opinion, would not seem to be a suitable basis, since it had no bearing on the extent or value of agricultural property brought within the tax net. Collection as a basis, the Commission told, would not be appropriate, for the tax collected in one State might in some cases relate to property located outside the State. It would, therefore, provide a sound basis. Backwardness or need of a State for development would not be a relevant criterion, the Commission, opined, for the distribution of the grant. The Commission took the amount of

82. Ibid.
grant as equivalent to the net collections of wealth tax on agricultural property reduced by the net collections attributable to the Union Territories and recommended its distribution among the States in proportion to the value of agricultural property located in each State and brought to assessment in that year.

The Seventh Finance Commission considered the question of distribution of this grant in the light of various factors. In the implementation of the Sixth Commission's recommendations, the Central Board of Direct Taxes had found that the available statistics of wealth tax assessments would not enable it to ascertain the value of agricultural property located in each State and brought to assessment in a year without taking upon itself considerable amount of additional work. The Union Ministry of Finance had also expressed the difficulties in the compilation of the statistics. Besides, the Commission noted that receipts on account of wealth tax on agricultural property in the years 1979-80 to 1983-84 projected in line with the departmental figure of Rs. 0.91 crores for 1975-76, would be very small and shares therein would make no material difference to the States. In these circumstances, the Seventh Commission recommended that the share of each State in the grant in each of the years from 1979-80 to 1983-84 should be an amount equivalent to the net collection in that State in each year. Sikkim was also held entitled to a share in accordance with this recommendation, if and when the levy of the tax is extended to that State.83

In the foregoing analysis, the approach of the successive Finance Commissions as regards the "assigned taxes and duties" and devolution of the proceeds therefrom is discussed. It may be mentioned that the magnitude of devolution under the aforementioned taxes and duties is only of minor importance for the most substantial chunk of transfers to the States is their share in income tax and Union excise duties. To illustrate the fact, during 1971-72, the States received an amount of Rs.830 crores as their share in income-tax and excise duties, whereas the total

sum they got from assigned taxes (namely estate duty, grant in lieu of railway fares, additional excise duties) amounted to only Rs. 130.5 crores.84 During 1979-80 to 1983-84, according to the recommendations of the Seventh Finance Commission, the States were estimated to receive Rs. 16138 crores as their share in income tax and Central excises, while the total amount to devolve from estate duty, additional excises and railway fare compensation, was estimated to be Rs. 2012 crores.85 Further, in regard to these assigned taxes and duties, the job of the Finance Commission is only to determine the principles of Statewise distribution, while in the case of income tax and Union excise duties, the Commission is to fix the aggregate share of the States in their proceeds and then to devise the principles for their distribution among the States inter se. Moreover, it is only in regard to these two taxes that the Finance Commission is, in fact, free to determine the principles of sharing. It is here that the Commission is expected to play the role of a wise man, a judge, between the conflicting claims of the States, on the one hand and the Centre on the other. The principles actually recommended by the successive Commissions for the distribution of proceeds from Union excise duties and income-tax are discussed in the following paragraphs and it is to be seen as to how far the Commissions have been able to live up to the expectations.

II. Compulsorily Shareable Tax: Income Tax

Income-tax transfers is one of the main items under which the States get a part of revenue accruing to the Union Government.

84. See Explanatory Memorandum on the Central Budget 1972-73, Statement IV at 36.

85. Grant on account of wealth tax on agricultural property constituted a very small amount. Report, Seventh Finance Commission, 57, 1978. See also Table A-1, id. at 118.
Article 270 makes it mandatory for the Union Government to distribute the proceeds of 'taxes on income other than agricultural income', between the Union and the States. The proceeds of such tax as attributable to Union Territories and taxes payable in respect of Union emoluments do not form part of the divisible pool of revenue arising from taxes on income. The expression "taxes on income", however, do not include corporation tax and any surcharge which may be levied by the Central Government for its own purposes. 87

86. Article 270: (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, 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 those States in such 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 -
   (i) until a Finance Commission has been constituted prescribed by the President by order, and
   (ii) after a Finance 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.

87. See supra Chapter IV.
While the Constitution has provided for the devolution of taxes, the fixation of divisible pool and its distribution among the States inter se, is entirely left to the Finance Commission. Article 280 enjoins the Finance Commission, inter alia, to make recommendations to the President as to how and in what proportion the proceeds of taxes on income are to be distributed between the Union and the States and among the States inter se. The task of the Finance Commission in this regard thus extends to:

(i) determination of the percentage of the net proceeds of income-tax (exclusive of corporation tax, proceeds attributable to Union territories and taxes payable in respect of Union emoluments) to be assigned to the States;

(ii) assessment of the percentage of the net proceeds which the Union should be allowed to keep with itself as proceeds attributable to Union Territories; and

(iii) fixation of share of each State in the divisible pool.

In presenting their case before the Finance Commission, the States have been demanding larger share of the divisible pool to enable them to finance their expanding social and developmental services. It has been seen that as a result of the recommendations of the succeeding Finance Commissions, the States' proportionate share in the divisible pool of income tax has progressively increased. To begin with it was 55 per cent as recommended by the First Finance Commission, which was enlarged by the succeeding Commissions and placed at 75 per cent by the Fourth Commission. It rose to 85 per cent under the recommendations of the Seventh Finance Commission, the last to report in the matter. With the increased share in the tax proceeds, the volume of this transfer has also considerably increased. Thus the income tax amount assigned to the States which was Rs.537 crores in 1951-52, went up to Rs.359.1 crores in 1970-71 and rose to Rs.921.11 crores under the budget of 1978-79.
Distribution of income-tax proceeds among the States inter se, has been the most controversial issue before each of the Finance Commissions. It requires the Commission to formulate the principles according to which the divisible pool from this tax is distributed among the States. In this task the Commissions have paid more deference to the 'need' of the States for additional resources. In this context, the First Commission observed: "He consider that only a broad measure of need such as is given by the respective populations of the States is suitable for application in the distribution of the proceeds of a shared tax." This has remained the main consideration with the subsequent Commissions also as regards the distribution of income-tax divisible pool.

It will be interesting to see how the successive Finance Commissions have dealt with the right of the States to share in the divisible pool of income-tax. In this matter the First Commission was faced with a variety of proposals made by the State Governments in their representations to the Commission. There was a general demand from them for raising their share in the divisible pool from the 50 per cent hitherto allowed. While some States suggested an increase at least to 60 per cent, some others urged it to be raised to 70 per cent. Some others proposed that the divisible pool should include the proceeds of corporation tax as well. The Commission considered these proposals in the light of other prevailing circumstances. At the very outset, the Commission made it clear that it would be undesirable to concentrate on income tax as a balancing factor in the adjustment of resources between the Centre and the Units. They thought that an

86. This was also the consideration with Sir Otto Niemeyer in 1936, See supra Chapter III.


90. The analysis of the awards of successive Finance Commissions made here, would reveal the growing needs of the States for financial resources and the attempts made by the Commissions to meet them by recommending larger percentage to the States from the divisible pool of this tax.
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. While the number of the States participating in the divisible pool increased from nine to sixteen, there was likely reduction in the revenue from this tax owing to the concession given in regard to the application of the full rates of income-tax for a transitional period in some Part-B States. Besides, increased number of Part-C States demanded somewhat higher percentage to be allocated to them. Moreover, the increased cost of collection was likely, to some extent, to reduce the amount of divisible pool. Taking into account these circumstances, the Commission concluded that some increase in the share assignable to the States was justified but not of the order suggested by the majority of the State Governments. Accordingly, the Commission recommended that the percentage of the net proceeds of income-tax to be allocated to the States be raised from 50 per cent to 55.91

While there was a general demand for raising the States' share in the divisible pool of the tax, there was hardly any unanimity or even similarity in the representations made by the States on the mode of its distribution among themselves. One and all, they had advanced principles which would benefit them best individually. There did not appear any attempt to give a balanced view in the matter. The various bases for the distribution of divisible pool inter se the States suggested to the Commission were:92

(i) Collection of income-tax in various States.
(ii) Amount of tax realised in respect of incomes, wherever earned of individuals, resident in the different States.
(iii) Collection of income-tax in various States adjusted with reference to the origin of income.
(iv) Relative population of each State.
(v) Relative volume of industrial labour in each State.
(vi) Needs of different States according to various criteria, e.g., area, sparseness of population, economic backwardness or the inverse relative per capita income of each State.

92. Id. at 65-67, 73.
The Government of Bombay argued that contribution made by each State should be the main basis for allocation. It suggested that the States' share be distributed in the proportion: 25 per cent on the basis of collection, 25 per cent on the basis of industrial labour and 10 per cent on the basis of other considerations such as need and backwardness, etc. Alternatively, the State was prepared to accept the formula for distribution recommended by the Expert Committee on the Financial Provisions of the Constitution.

The Government of West Bengal went even further. It raised a legal issue as to the distribution of revenues. It argued that the principles of distribution should distinguish between a tax which had to be compulsorily shared and other forms of Central assistance. It held that the phraseology of Article 270 required that after retaining the Central share, the President had no option but to place the balance in the hands of the Governments, in whose respective territories the tax had been levied or to whom it was attributable. The State made reference to the manner of attributability applicable in case of Part-C States. Though the Government of West Bengal agreed to the adjustments which could be made on consideration of economic allegiance, it contended that money raised in one State could not be made available to another State.

93. The Government of Bombay had suggested the increase in the States share from existing 50 per cent to 60 per cent, which 60 per cent be distributed inter se in the proportion of 25:25:10. Ibid.

94. The Committee (known as Sarkar Committee 1947) had recommended that the States' share should be 60 per cent of the net income-tax proceeds. Of the States share 33-1/3 per cent should be distributed on the basis of population, 58-1/3 per cent on the basis of collection and the remaining 8-1/3 per cent be used to help the States facing hardship because of this distribution. Report, Expert Committee, 1947, III Select Documents, 276, 1967. See supra Chapter IV also.

95. Report, First Finance Commission, 65-66, 1952. Between them the States of Bombay and West Bengal accounted for nearly three quarters of the total collection of income tax in the country. Id. at 73.
The Government of Assam, on the other hand, suggested that of the 60 per cent to be assigned to the States, 35 per cent should be distributed on the basis of population, adjusted for area or density; 20 per cent on the basis of origin and 5 per cent to be used for removing any hardships. The State of Bihar proposed the distribution of 80 per cent of the States' share on the basis of population and the balance to be distributed on consideration of other factors such as backwardness, the special responsibilities of a State and general financial management of different States. The Government of Madhya Pradesh suggested distribution entirely on the basis of population with a weightage for the backward classes and scheduled castes and the tribes living in a State. The State of Uttar Pradesh suggested that population should be the only factor in the distribution of States' share in income-tax. These were the States where the incidence of collection was small, as compared with the States of Bombay and West Bengal. Certain other suggestions were moved by other States. The Government of Punjab held the view that the need of a State, not its population or collections in it, should be the determining factor. The Government of Orissa suggested that 50 per cent of the States' share should be distributed on the basis of the inverse ratio of per capita income, 35 per cent on the basis of population and 15 per cent on the basis of area.

The construction placed upon the language of Article 270 by the Government of West Bengal was not sustained by the Commission. Referring to the phrase "within which the tax is leviable" appearing in Article 270, the First Finance Commission observed that it only meant that "a State in which the tax was not leviable had no right to a share at all". This phrase, the Commission said had been taken from the text of the corresponding provision in the Government of India Act 1935, which meant to exclude from the distribution, the Princely States which had not till then introduced legislation corresponding to the Indian

---

96. Id. at 66.
97. Ibid.
98. Section 138.
Chanda further explains that "the purpose in retaining the phraseology was to safeguard the interests of the States where the tax was levied." The Commission illustrated the point taking the case of the State of Jammu and Kashmir. The Income Tax Act had not been extended to that State at the time of the commencement of the Indian Constitution and the State had retained a measure of freedom in this field. For that reason, the State was not entitled to any share of income tax levied by the Government of India under Article 270.

The First Commission also dismissed the contention made by the Government of West Bengal that "manner of distribution" involved merely the process of returning to each State a proportion of the revenue collected in its area and that it was only the manner in which the money was to be returned, that meant the mode of payment that was left to the determination of the Commission. The Commission felt that the Constitution did not recognise that any State had a right to income-tax collected or even arising in its area, the right accrued only after the manner of distribution had been prescribed by the President. The Commission, therefore, did not think it proper to distribute the tax-proceeds on the basis of returning to a particular State the whole or part of the collections in that area or on the basis of the States having a notional right to the concurrent levy of income tax.

The State of Bombay, another industrial State, urged the Commission not to introduce in the distribution of taxes, considerations which should apply in making grants-in-aid. It advocated that the contribution a State made to the collection of a particular tax, should be the determining factor. It was not an accident, the State argued, that the bulk of the collections

1. Federalism in India, 235.
3. Ibid.
4. Id. at 72.
5. Ibid.
was made in the industrially advanced States. Rather this position had been built up by the capital and enterprise of the citizens of the State. Besides, the existence of big industries and the presence of a large and concentrated population of industrial labour, the Government of Bombay argued, had created special problems for these States in regard to law and order and placed demands on the resources of the States in providing welfare and other amenities and social and educational facilities. Pointing to these specific considerations, the State of Bombay, claimed a fair share of the revenue from income-tax.  

The Commission acknowledged the relevance of the factor of 'contribution' in the distribution of a shared tax, however, it held that 'collection' by itself was not an adequate index of contribution. To bring it out, the Commission pointed out that nearly three-quarters of the total collections of income-tax in the country were made in the two States of Bombay and West Bengal and again, 75 per cent of these collections was contributed by the two cities of Bombay and Calcutta. This high collections of tax in these cities, the Commission observed did not arise mainly on account of economic activities confined to the limits of these two regions. Rather, it was due, in a large measure, to these all-India cities being "in a sense interports of the country's import and export trade and to the concentration within their confines of the head offices of companies and other concerns operating all over the country."  

It could hardly be doubted that a substantial part of the tax receipts in these big port-cities, in fact, accrued in respect of incomes originating beyond the boundaries of the respective States. On the basis of a study of the information collected from some of the larger concerns, the Commission observed that "the bases of income-creation were far more diversified and widely spread

6. *Id.* at 65.
7. *Id.* at 73-74.
over the country than what collection would suggest.\(^8\)

The bases of 'residence' or 'origin', the First Finance Commission held, might be conveniently adopted for providing relief from double taxation as between two sovereign States, but it might not give proper results in the allocation of the proceeds of a Central tax like income tax among the States of a country. Besides, the income earned in a State in a federation was largely conditioned by federal economic policies pursued in the national interest and these federal policies, in their opinion, might confer unequal benefits and impose unequal burdens on different States. Further, these policies had a bearing on the pattern of development of large-scale enterprise in industry and trade which were important contributory sources of income tax.\(^9\) This led the Commission to observe: "Since the benefits which result in the growth of enterprise flow from policies pursued on the ground of national interest, there is every reason why national considerations should in a large measure influence the sharing of the proceeds of taxes on such enterprise."\(^10\)

The Commission, then, examined another argument, raised in favour of giving collection some importance in the distribution of income-tax proceeds. It was that the industrial States had to spend more in looking after the problems of law and order and welfare in respect of the concentration of industrial labour in those States. The Commission rejected the contention on the ground that these States also had more lucrative sources of revenue such as increased receipts from stamps, sales-taxes and entertainment duties, which directly benefitted the State.

---

8. Ibid. Take for example, the Tata Iron and Steel Co. Ltd., the biggest steel works in India, paying about a crore of rupees as taxes on income. It is well known that their production works are located in Bihar, they obtain their mineral ores from Bihar, Orissa and Madhya Pradesh, while their registered office is in Bombay and their products are sold throughout the country. B.N. Bhargava, Theory and Working of Union Finance in India, 129-30, Chaitanya Publishing House, Allahabad, 2nd ed. 1967.


10. Id. at 74-75.
It was further argued that the volume of industrial labour in a State reflected both the contribution of a State to the tax-yielding incomes and the State's needs in the way of larger administrative and welfare services. But, the Commission held it merely a partial index of either contribution or needs.\(^\text{11}\)

The criterion of per capita income suggested by the Government of Orissa, was discarded by the Commission on the ground of the non-availability of the statistics for individual States. The Commission emphasised that they attached utmost importance to the factors which could be related to definite unambiguous and authoritative data.\(^\text{12}\)

Having critically examined the suggested bases, the First Finance Commission proceeded to enunciate their conception of federal devolution to the States. In their opinion "a proper scheme of distribution should not overlook the broad purpose of the devolution of revenues to the States, which is to make larger funds available to them to meet their expanding responsibilities in respect of the welfare of their population."\(^\text{13}\) The Commission distinguished between assistance given to the States by devolution and that given by grants-in-aid of revenues. The former, in their opinion, should be designed to provide governmental services to the people and to raise the standard of administration, whereas, the latter should be diverted to meet special and particular needs arising out of sparseness of population, economic backwardness, etc.\(^\text{14}\)

The Commission thus recommended that needs of the States should form the main criteria of distribution and observed: "Only a broad measure of need such as is given by the respective

\(^{11}\) Ibid.

\(^{12}\) Ibid.

\(^{13}\) Ibid.

\(^{14}\) Ibid.

\(^{15}\) Ibid.
populations of the States is suitable for application in the
distribution of the proceeds of a shared tax." Population,
therefore, reflected the general needs of a State and the
Commission held it to be the major if not the only determining
factor. At the same time, the Commission maintained that it would
be justified to give a moderate weight to the factor of
cortribution also in the scheme of distribution. The Commission
recognised that "there is all over the country a core of incomes-
particularly in the range of personal and small business incomes-
which could be treated as of local origin." Having regard to
the essential postulate of definiteness in the factor so chosen,
the Commission adopted the figures of collection of income tax
revenue as the measure of the contribution of individual States
to the divisible pool, although such figures were held to provide
only an inadequate and partial measure of contribution.

After the detailed and critical analysis of the whole
matter, the First Finance Commission suggested that the proceeds
of income tax divisible pool be distributed, 80 per cent
according to relative population (as shown under the 1951 census)
and 20 per cent according to relative tax collections. On this
basis, the Commission recommended a set of fixed percentage
shares for the States to govern payments until the question
was reviewed by the next Finance Commission. The shares of the
States calculated on this basis are given in Table V(1).

The distribution of income tax was reviewed by the Second
Finance Commission in 1957. The Commission was faced with a
similar controversy regarding both the quantum of the share of
the States and the basis of its distribution inter se. The States,

16. Ibid.
17. Id. at 76.
18. Ibid.
19. The Commission added together the two shares on the basis
of population and collection and expressed a single
percentage of the share assigned to the States.
<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>States</th>
<th>States share</th>
<th>Sr. No.</th>
<th>States</th>
<th>States share</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Assam</td>
<td>2.25</td>
<td>9</td>
<td>Orissa</td>
<td>3.50</td>
</tr>
<tr>
<td>2</td>
<td>Bihar</td>
<td>9.75</td>
<td>10</td>
<td>Pepsu</td>
<td>0.75</td>
</tr>
<tr>
<td>3</td>
<td>Bombay</td>
<td>17.50</td>
<td>11</td>
<td>Punjab</td>
<td>3.25</td>
</tr>
<tr>
<td>4</td>
<td>Hyderabad</td>
<td>4.50</td>
<td>12</td>
<td>Rajasthan</td>
<td>3.50</td>
</tr>
<tr>
<td>5</td>
<td>Madhya Bharat</td>
<td>1.75</td>
<td>13</td>
<td>Saurashtra</td>
<td>1.60</td>
</tr>
<tr>
<td>6</td>
<td>Madhya Pradesh</td>
<td>5.25</td>
<td>14</td>
<td>Travancore Cochin</td>
<td>2.50</td>
</tr>
<tr>
<td>7</td>
<td>Madras</td>
<td>15.25</td>
<td>15</td>
<td>Uttar Pradesh</td>
<td>15.75</td>
</tr>
<tr>
<td>8</td>
<td>Mysore</td>
<td>2.25</td>
<td>16</td>
<td>West Bengal</td>
<td>11.25</td>
</tr>
</tbody>
</table>


On their part, took up identical arguments and made similar demands. Under the changed pattern of Union taxation when income-tax ceased to be an expanding source of revenue as it once was, some of the States claimed the inclusion of corporation tax, the tax on Union emoluments and the surcharge on income-tax levied for Union purposes, in the divisible pool. But these claims were outrightly dismissed by the Second Commission as being against the provisions of the Constitution.²⁰

The Second Commission then proceeded to determine the share of the net proceeds of the tax to be assigned to the States. In this exercise, the Commission attempted a careful review of the matter in all its aspects. After analysing the trend of this tax and its future possibilities in the resources of the Union, the Commission concluded that it had ceased to be an expanding source of revenue as it once was. Though expanding economic activity and the steps taken for plugging tax evasion, might improve the yield but it would not be substantial. In the changing context, the Commission observed

that Income Tax would not be a major factor in the devolution of further revenues to the States. With this understanding and in view of the unanimous desire of the States, the Commission held that some increase in the States' share of this tax was justified and, in fact, raised it from 55 per cent, hitherto allowed, to sixty per cent. 21

The Second Commission then considered de novo the claims put forward by the States for the distribution of their share inter se. In this matter, the Commission was in substantial agreement with the observations made by the First Commission that factors such as proportion of scheduled castes and tribes and backward classes in the population, the area of the State, its relative backwardness, etc., were not relevant and took population and collection as the only principles admitting consideration on the basis of which the States' share in the divisible pool was to be distributed among them inter se. 22

'Population' as a basis, the Commission observed, had found the widest measure of support among the States, while 'collection' had been advocated, mainly by the two industrially advanced States of Bombay and West Bengal. 23 Though collection had been given some weight in the scheme of distribution adopted earlier to the First Commission, but it had been reduced in favour of population, a move in the right direction, the Second Commission observed. To justify this change, the Commission went back to the years when income-tax was, for the first, made a divisible

21. *Ibid.* Asok Chanda, however, records that the conclusion so drawn by the Commission was not justified by the growth of income tax in the later years. It increased from Rs. 1,630 millions in 1957-58 to Rs. 1,720 millions in 1958-59 and would have further improved at the annual rate of 5 per cent but for a reclassification of this tax. The rationale of the principle of yield of a particular tax as a determining consideration for its distribution was also questioned by him. *Federalism in India*, 239.


23. Id. at 39-40. This was also the case before the First Commission. See *supra*. 
head of revenue. During that period the agricultural Provinces had a substantial income from, and an expanding source in land revenue, which had to be balanced by giving a large share of income tax to the industrial and commercial Provinces. This position no longer prevailed and land revenue, over the period of years, had ceased to be a significant source of revenue and its incidence in the finances of the States gradually declined. Whereas, revenue from sales taxes, the tax on motor vehicles, entertainments and passenger taxes, duty on consumption of electricity, had been progressively developing and adding largely to the revenues of the more urbanised and industrially developed States than to the agricultural ones. The agricultural States, therefore, under the changed situation, faced double disadvantages, viz., reduced yield from land revenue and smaller receipts from indirect taxes. This, in turn, requires a basic change in the scheme of distribution of income-tax, if financial equilibrium and parity between agricultural and industrial States were to be achieved.

The Second Commission gave one more justification. They considered that income-tax, which was paid by an infinitesimal portion of population, the bulk of it was generated by business activities in the country. In the context of the economic integration of the country and the abolition of inter-State trade barriers, the Commission stated, business incomes were deemed to have been derived from the country as a whole and not from a particular State. 'Collection', in their opinion, would no longer be considered as equitable basis of distribution. Weightage had been given to 'collection' by the First Finance Commission, but that too in the restricted field of personal income tax. The Second Commission could find no logic in retaining even that moderate weightage for collection. It, therefore, took

24. It was introduced by the Government of India Act 1935, under Section 133 and given practical shape by Sir Otto Niemeyer in his Award of 1936. See supra Chapter III.
26. Ibid.
a more extreme position and recommended its complete abandonment in favour of population as the basis of inter se distribution. The resultant loss to a few States, where collections were concentrated was to be made good by taking into account the overall devolution.27

However, the Second Commission did not wish to cause a sudden break in the continuity. It, therefore, proposed the elimination of 'collection' as a factor in the distribution, in more than one stages and recommended the reduction of its weightage from the previous 20 to 10 per cent.28

In terms of its recommendations, the Second Finance Commission proposed 60 per cent of the net yield of income tax to be allocated as the share of the States, the distribution of which among States inter se being, 90 per cent on the basis of population and 10 per cent on the basis of collection. For the purpose of convenience, as was done by the First Commission, the amount of share of each State was expressed as a single percentage of the distributable pool,29 given in Table V(2).

**Table V(2)**

State-wise distribution of Income Tax divisible pool

<table>
<thead>
<tr>
<th>States</th>
<th>States share</th>
<th>States</th>
<th>States share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Andhra Pradesh</td>
<td>8.12</td>
<td>Mysore</td>
<td>5.14</td>
</tr>
<tr>
<td>Assam</td>
<td>2.44</td>
<td>Orissa</td>
<td>3.73</td>
</tr>
<tr>
<td>Bihar</td>
<td>9.94</td>
<td>Punjab</td>
<td>4.24</td>
</tr>
<tr>
<td>Bombay</td>
<td>15.97</td>
<td>Rajasthan</td>
<td>4.09</td>
</tr>
<tr>
<td>Kerala</td>
<td>3.64</td>
<td>Uttar Pradesh</td>
<td>16.36</td>
</tr>
<tr>
<td>Madhya Pradesh</td>
<td>6.72</td>
<td>West Bengal</td>
<td>10.08</td>
</tr>
<tr>
<td>Madras</td>
<td>8.40</td>
<td>Jammu &amp; Kashmir</td>
<td>1.13</td>
</tr>
</tbody>
</table>

(Source: Report, Second Finance Commission, 72, 1957)

27. Ibid.
28. Id. at 40.
29. Id. at 41.
By the time the Third Finance Commission was constituted, the question of distribution of income-tax became more significant in the context of the reform introduced in company taxation. As a result of the reform, from the financial year 1960-61, the income-tax paid by companies had been reclassified as corporation tax,\(^{30}\) and thus excluded from the divisible pool under Article 270.

All the States joined in representing to the Third Commission and made further demands for an increase in their share of income tax revenue, especially arguing that the reclassification of taxes had deprived them of an expanding part of tax-revenue to which they had a constitutional right. Some of them contended that this amounted to violation of the provision of the Constitution, if not in law at least in spirit. It was further said that this reclassification had been made not with the avowed object of rationalizing the law but with the purpose of depriving the States of their legitimate share in tax-revenue with respect to which the Constitution provided obligatory sharing.\(^ {31}\)

Though the States did not take the issue of legality of the change to the Court, they, however, agitated it before the Commission with all their emphasis. On this ground, they renewed their claim for including in the divisible pool, if not the whole of 'corporation tax', at least such part of it as was attributable to the yield denied to them by the recent change.\(^ {32}\) They also suggested that surcharge on income-tax which had been in force for over 15 years should be merged in the basic rates, so as to abate partly the impact of loss caused to them.\(^ {33}\)

The Third Commission was impressed by the demands made by the States, but signified their inability to consider matters outside the Constitutional provisions and not forming part of their terms of reference. However, the Commission expressed

\(^{30}\) See Government of India, Finance Act 1959.

\(^{31}\) See Chanda, 240-241. Chanda was the Chairman of the Third Finance Commission.


\(^{33}\) Ibid.
that other measures were available to take account of the shrinkage in the divisible pool. This led the States to put forward their demand for substantial increase in their share and some of them even laid claim to the entire yield of income tax. But the Commission pointed out:

In the case of a divisible tax in which there was obligatory participation between the Union and the States, a sound maxim to adopt would be that all participating Governments, more particularly the one responsible for levy and collection, should have a significant continuing interest in the yield of the tax.

Propounding this principle, which was taken to be a warning note by the subsequent Commissions also, the Third Commission considered that a distribution of two-thirds of the net proceeds of the tax to the States and one-third to the Union would be justified to meet the changed situation.

With regard to the determination of the share of each State, the Third Commission accepted the conclusions drawn by their predecessors that 'collection' and 'population' should be the two determining factors of distribution. They could not, however, appreciate the recommendations of the Second Commission in regard to eliminating the factor of collection altogether. They maintained that there was a great deal of force in the observation made by the First Commission in regard to the factor of contribution when the latter stated that "it is pertinent to bear in mind the fact that there is all over the country a core of incomes - particularly in the range of business incomes - which could be treated as of local origin." The Commission further stated that the exclusion of taxes on income paid by the companies from the income tax divisible pool had largely removed incomes of all-India origin from the residual amount, and that on this reclassification,

34. Id. at 17.
35. Ibid.
36. Id. at 18.
a higher percentage of the yield of the tax now (after the reclassification of the tax) represented tax driven from incomes of local origin. This fact, they pointed out, had strengthened the case for awarding a larger percentage on the basis of collection.\footnote{Ibid.} The Commission felt impressed by the argument, which had been dismissed by their predecessors, that the industrial States having larger collections had problems of their own. "Large concentration of population, more particularly of industrial labour, creates problems of law and order and gives rise to an increased demand for the administrative and social services. Further, the unit cost of providing these services is larger in such areas than elsewhere more particularly in the non-urbanised parts."\footnote{See supra, where the First Commission had rejected the argument raised by the state of Bombay on the pretext that industrial states had more lucrative sources of revenues such as receipts from stamps, sales taxes, entertainment duties, etc.} Taking all these considerations into account, the Third Commission, not only reversed the trend set by the Second Commission, but also restored the formula evolved by the First.\footnote{Asok Chanda, the Chairman of the Third Commission, writing in 1965 supported the move, but observed that "the Commission lacked the courage of its intention". For, it would have been more justified to allocate 40 per cent of the yield as attributable to income of local incidence. \textit{Federalism in India,} 242.} Accordingly, the Commission recommended the distribution of divisible pool of income tax revenue as 80 per cent on the basis of population and 20 per cent on the basis of collection.

The Third Commission, in making their recommendations, thus raised the share of the States from 60 per cent to 66-2/3 per cent of the net proceeds. Of these 2.5 per cent was fixed as share attributable to the Union Territories and the remaining was recommended to be divided between the States inter se, according to 80:20 formula, the respective proportions, in single figure, are given in the Table V(3).

\footnote{Report, Third Finance Commission, 18, 1961.}
### Table V(3)

State-wise distribution of Income Tax divisible pool

(Figures in percentages)

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>States</th>
<th>States share</th>
<th>Sr. No.</th>
<th>States</th>
<th>States share</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Andhra Pradesh</td>
<td>7.71</td>
<td>8.</td>
<td>Maharashtra</td>
<td>13.41</td>
</tr>
<tr>
<td>5.</td>
<td>Jammu &amp; Kashmir</td>
<td>0.70</td>
<td>12.</td>
<td>Rajasthan</td>
<td>3.97</td>
</tr>
</tbody>
</table>

(Source: Report of the Third Finance Commission, 19, 1961)

It may be noticed that the 'core of income' argument was used by the First and Third Commissions for justifying the consideration given to the factor of 'contribution' in the distribution of States' share inter se. However, it did not justify the adoption of the principle of contribution, rather, it only provided for the adoption of collection figures as a measure of contribution. In fact, none of the Commissions had made an a priori case for the adoption of the principle of contribution.

Sastri holds that the records of the three Commissions, in this respect, had been "nothing but a see-saw, giving more weight alternately to population or collection, without any attempt at rationally analysing the full implications of the cocktail formula of population-collection and satisfactorily explaining the basic considerations that led to its adoption."

As usual, the States repeated before the Fourth Finance Commission, their arguments for enhancing their share in the proceeds of income-tax revenue. Practically, all the States pointed out that as a result of re-classification of the income-tax paid

---

42. Federal-State Fiscal Relations in India, 80.
by companies brought about by the Finance Act, 1959, the rate of
growth of the divisible pool had been adversely affected. They
argued that what the framers of Constitution had intended to be
a flexible and expanding source of revenue to the States had
ceased to have the significance that was once contemplated. The
proceeds from corporation tax were increasing at a much rapid rate
than those from income tax.43 Some States reiterated the views
placed by them before the previous Commissions for the merger
of surcharge on income-tax with the basic rates of the tax.
They argued that though the Government of India could under
Article 271 levy any surcharge wholly for the purposes of the
Union, such a levy in the very nature of things, was intended to
be a temporary measure to serve a particular situation. They,
therefore, urged that a surcharge levied during normal times,
there being no need for doing so, should as a matter of course,
be merged with the basic rates after a period of three years.
Various other suggestions were made by the States for a
substantial increase in their share in the divisible pool. One
view was that 50 per cent of the proceeds of both the income-tax
and corporation tax should be assigned to the States. Another
was to amend the Constitution so as to provide for inclusion
of the proceeds from corporation tax in the divisible pool with
an alternative for the Centre to make good to the States the loss
on account of such non-inclusion, by way of grants. Above all,
there was a general demand for finding a permanent solution
to the shrinkage of States' share in the divisible pool.44

The Fourth Commission, first, endorsed the principle
propounded by the Third Commission that "in the case of a divisible
tax in which there was obligatory participation between the
Union and the States, a sound maxim to observe would be that all
participating Governments, more particularly the one responsible
for levy and collection should have a significant interest in

43. They stated that while the collections from Corporation tax
had increased by well over 600 per cent in the course of the
last 12 years, the corresponding growth in the divisible
pool of income-tax was less than 50 per cent. Report, Fourth

44. Id. at 17-18.
the yield of that tax." At the same time, the Commission took due note of the States' representation about the need for abating the loss sustained by them as a result of reclassification of income-tax paid by the companies. They, therefore, opined that the fixation of States' share should take into account the then existing level of yield of this source of revenue, and its likely future rate of growth. Taking these facts into consideration, the Fourth Commission recommended that the States' share in the divisible pool of income-tax should be raised to 75 per cent.

The Commission proceeded, thereafter, to lay down the principles of distribution of the States' share. However, the two factors considered relevant by the Commission were population and contribution. The Commission accepted that contribution was not synonymous with collection, but in the absence of reliable statistics on contribution, they held that collection must be taken as the only available indication of contribution. As regards the relative proportion of these two factors too, the States were not unanimous. The Commission discussed various proportions, but ultimately confirmed the principle recommended by their immediate predecessor. Realising the wisdom of sticking to the old formulae they observed: "We are eventually impressed by the fact that a sense of certainty and stability as regards the principles to be adopted in the distribution of income-tax should prevail. It is not desirable that every time a new Finance Commission is appointed there should be reopening of the basis of distribution."

45. The Commission meant income-tax paid by Companies.
46. For this purpose the Commission accepted the forecasts supplied to them by the Union Ministry of Finance. Report, Fourth Finance Commission, 18, 1965.
47. Ibid.
48. Various basis suggested by the States were: population, collection, area, backwardness, financial weakness, population of Scheduled Castes and tribes. Id. at 18-19.
49. Report, Fourth Finance Commission, 19, 1965. The point was also made by Dr. P. V. Rajamannar, the Chairman of the Commission, in his supplemental note where he explained: "In respect of
collection formula with weights of 80 per cent and 20 per cent respectively. For the purpose of convenience, the share of each State was expressed in fixed percentage. The Commission took the average of the collections of the three years ending with 1963-64 and the population figures according to the 1961 census and fixed the percentage share of each State as given in the Table V(4). The Union Territories were given 2.5 per cent and the balance 97.5 per cent of the States' share was recommended to be divided among the States inter se according as given in the following Table.

Table V(4)

<table>
<thead>
<tr>
<th>States</th>
<th>States share</th>
<th>States</th>
<th>States share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sr. No.</td>
<td>Sr. No.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Bihar</td>
<td>9.04</td>
<td>11. Nagaland</td>
<td>0.07</td>
</tr>
<tr>
<td>5. Jammu &amp; Kashmir</td>
<td>0.73</td>
<td>13. Punjab</td>
<td>4.36</td>
</tr>
<tr>
<td>8. Madras</td>
<td>8.34</td>
<td>16. West Bengal</td>
<td>10.91</td>
</tr>
</tbody>
</table>

(Source: Report, Fourth Finance Commission, 20, 1965)

The Fifth Finance Commission was faced with a new, rather technical question. The State Governments, apart from their old demands for raising their share in the net-proceeds of income tax, represented to the Commission that the advance tax collections should form part of the divisible pool in the same year in which they were collected and that their distribution should not be deferred till the completion of assessments. This led the Commission such an important matter as the determination of the resources which will be available to each State as a result of a scheme of devolution, there should not be a gamble on the personal views of five persons, or a majority of them". Id. at 93.
to take up the matter with the Comptroller and Auditor-General of India and the Central Government. On the examination of the question, the Commission was enjoined, in the supplementary reference made by the President, to make recommendations regarding the distribution of advance tax already collected and not included in the net proceeds of the years up to 1966-67, and also to suggest changes, if any, in the distribution of income tax collected during 1967-68 to 1968-69, in the event the Comptroller and Auditor-General of India certifying the net proceeds of those years after taking into account the advance tax collected in the respective years. The Commission was also to make recommendations regarding the distribution of the net proceeds of income tax including the advance tax, for the years 1969-70 to 1973-74.\footnote{50}

The Fifth Commission ascertained from the Comptroller and Auditor-General of India that the total unadjusted amount of advance tax outstanding at the end of the financial year 1966-67 was Rs. 387.74 crores, out of which Rs. 16.62 crores calculated, were relating to the Union surcharges. This left an amount of Rs. 371.12 crores to be distributed between the Union and the States. The question which the Commission was to consider first related to the determination of the percentage of this amount to be assigned to the States after excluding the proceeds attributable to Union Territories. Various suggestions were moved by the State Governments and claims between 50 to 75 per cent on different bases were made by them. However, the Commission considered it proper and equitable to fix the percentage at 75. As regards its distribution among the States \textit{inter se}, the Commission recommended the same basis that was applicable to the distribution of the States' share of the net proceeds of income tax in the year 1967-68.\footnote{51} The payment of the whole of the States' share of unadjusted balance of advance tax collections in a single year would have strained the ways

\footnote{50} \textit{Report, Fifth Finance Commission, 19-20, 1969.} \\
\footnote{51} As recommended by the Fourth Commission, viz., 80 per cent on the basis of population and 20 per cent on the basis of collections.
and means position of the Central Government. For that reason, its payment was spread over to years 1967-68 to 1970-71, to be made by way of annual instalments.  

The Fifth Commission proceeded to determine the States' share in the net proceeds of income-tax in the years 1967-68 and 1968-69. The Comptroller and Auditor-General was to certify the net proceeds of the income-tax in these years after taking into account the advance tax collected in the respective years. On such certification, the Commission recommended that the net proceeds of the tax in these years should be distributed between the Union and the States on the basis as recommended by the Fourth Finance Commission, thus allocating 75 per cent to the States. Here the payment to the States of balance of the net proceeds of income tax in 1967-68 and 1968-69 was to be made in the years 1969-70 and 1970-71 respectively.

The Commission then considered the distribution of the net proceeds of the tax for the years 1969-70 to 1973-74. The State Governments presented their views for the increase in the percentage to be assigned to them, varying from 80 per cent to 100 per cent of the net proceeds. Some of them suggested that the divisible pool of income-tax should include a part or the whole of the proceeds of corporation tax and the surcharge on income-tax or alternatively the Union surcharge should be merged with the basic rates of the tax.

Considering the States' claims, the Commission observed that the shrinkage of the divisible pool due to the reclassification in 1959 of income tax paid by the companies, had been taken note of by the Third and Fourth Finance Commissions and that they had raised the States' share in the divisible pool on this count, to 75 per cent. No further increase on this ground, was therefore, considered necessary by them.

---

53. *Id.* at 23-24.
54. Similar views were expressed by the States before the earlier Commissions. See * supra*.
The Fifth Commission pointed to the grievances expressed by the States in regard to the continuance of surcharge, which in the latter's view had the effect of reducing the percentage share of income tax assigned to them. Referring to the specific provision of Article 271 empowering the Union to levy surcharge for its own purposes, the Commission observed that it was not correct to say that the quantum of surcharge was such as to reduce the scope of the divisible pool unduly. Nor the language of Article 271 warranted the assumption made by the States as to its temporary nature. The Commission, therefore, signified their inability to consider the matter, being outside their purview and held that the grievance expressed by the States could be considered by the Government of India.

In view of the greater and growing needs of the States, the Commission appreciated their demand for increased share of income tax receipts. They, however, accepted the logic in the principle propounded by the Third Commission and endorsed by the Fourth Commission, according to which the Centre, invested with the levy and collection of income tax was to have a significant interest in the yield of that tax. With this maxim in view, the Fifth Commission pointed out "that any further increase in the States' share should be considered only if there was sufficiently strong justification therefor having regard to the scheme of devolution of taxes as a whole." So far as the period of five years under their review was concerned, they stated that as a result of the revised basis for determining the proceeds of income tax including advance tax collections, the size of the divisible pool had already been raised. For these reasons, any further increase in the States' share of the net proceeds of income tax was not considered necessary by them. The States' share in the divisible pool of the tax was thus left at 75 per cent, as was the case under the recommendations of the Fourth Finance Commission.

56. Ibid.
57. Id. at 26.
58. Ibid.
Regarding the bases of determination of shares of each State, the Fifth Commission reopened the question. They found it difficult to agree with the observation of the Fourth Commission as to the desirability of giving certainty and stability to the principles adopted in the distribution of income tax. Considerable changes might take place during the period between the appointment of two Finance Commissions, in the economic and fiscal situation and the relative needs and resources of the States. Appointment of a new Commission, the Fifth Commission emphasized, should provide an opportunity for a fresh consideration of various problems which might crop up due to the changed circumstances. The Commission thus found nothing wrong in principle, in reviewing the question and considered the matter de novo.59

The Fifth Commission, therefore, reviewed the recommendations of the earlier Commissions and discussed the conclusions drawn by them. They, then, proceeded to consider the contentions placed before it by the State Governments and noticed a sharp divergence of opinion regarding the weightage given to the factor of contribution or collection. The more developed States suggested that the factor should be given greater weightage than it received under the recommendations of the earlier Commissions. On the other hand, the less developed States wanted the altogether elimination of the factor of collection. Taking note of the arguments for and against 'contribution' being taken as a factor, the Commission found its relevance in the scheme of distribution, but on novel footing. The justification advanced by them was that while the agricultural States could levy a tax on agricultural income and the proceeds therefrom were not shareable with the Centre, the industrial States needed to be compensated on this account. The Commission observed: "this manner of allocation to the States of a part of taxes on non-agricultural income contributed by them can, in a sense, be regarded as the counterpart in the non-agricultural sector of the taxes on agricultural income which under the Constitution can be levied by the States themselves."60

59. Id. at 27.
60. Id. at 28.
The Fifth Commission was also influenced by the increasing economic unity of the country, and the inter-dependence of different regions and the growing impact of development undertaken through National Plans. The increasing needs of the States arising from committed expenditure related to Plan schemes and other like factors had been affecting the country as a whole. This required greater weightage for the factor of population, which in the opinion of the Commission was a general measure of need. The Commission also pointed to the enhanced divisible pool, resulted from the inclusion of advance tax collections, in the proceeds of the same financial year, which in their opinion justified some modification in the weightage to contribution.

The Commission took into account the above considerations. Having regard to the broader considerations of equity viewed in the light of the main purpose of devolution, which according to them, was to secure a more balanced correspondence between needs and resources, the Fifth Commission held that 20 per cent weightage to contribution, which resulted in marked disparities between more and less developed States, should be reduced. Therefore, the Commission restored the formula of the Second Commission, viz., that the weightage given to the factor of contribution fixed at 10 per cent and the weightage to population increased to 90 per cent.

Having laid the distribution formula, the Fifth Commission considered the measurement of the factor of contribution, which had been found difficult in the absence of reliable statistics. Like the earlier Commissions, the Fifth Commission recognised that the criterion of collection as a measure of contribution, was inadequate and unsatisfactory. The Commission gave their own reasons for it being so. Collection, in their opinion, did not make any allowance for income originating outside the State. Secondly, the large amounts of deduction of tax at

61. Ibid.
62. Ibid.
63. The place of collection is determined by convenience of the assesses without reference to origin of incomes, while the industrialists and persons with high personal incomes derive profits from activities spread all over the country.
source on dividends, interest payments and in other cases, gave undue benefit of larger collection to States having metropolitan and industrial centres insofar as the collection related to assesses residing in other States. Whereas, any refunds payable in respect of such assesses, had the effect of reducing the figures of collections of those States where they resided. In addition, the figures of collections might include larger overpayments or under-payments which could be adjusted only on regular assessments. They, therefore, considered the whole matter carefully and opined that the statistics of assessments in different States, would provide a more reliable basis to measure the factor of contribution. Due allowance for reductions on account of appellate orders, references, revisions, rectification, etc., was to be made in making the assessments more reliable. Accordingly, the Commission adopted assessments instead of collections, as the basis for determining the contributions of each State.

On the basis of the above considerations, the Fifth Finance Commission recommended that during the quinquennium from 1969-70 to 1973-74, 90 per cent of the States' share in the divisible pool of income-tax should be distributed among them on the basis of population and the remaining 10 per cent on the basis of the figures of assessments after allowing for reductions on account of appellate orders, references, revisions, rectifications, etc. The Commission recommended further that 2.6 per cent of the net proceeds of the tax should be deemed to be the portion of such proceeds attributable to Union Territories. The respective share of each State, in terms of fixed percentages came to be determined as given in Table V(5).

The distribution of income-tax between the Centre and the States was reviewed by the Sixth Finance Commission in 1973. The Commission was faced with a similar set of diverse demands by the State Governments for a significant increase in their divisible income-tax.
Table V(5)

State-wise distribution of Income tax divisible pool

(Figures in percentages)

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>States</th>
<th>States share</th>
<th>Sr. No.</th>
<th>States</th>
<th>States share</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Andhra Pradesh</td>
<td>8.01</td>
<td>9.</td>
<td>Maharashtra</td>
<td>11.34</td>
</tr>
<tr>
<td>2.</td>
<td>Assam</td>
<td>2.67</td>
<td>10.</td>
<td>Mysore</td>
<td>5.40</td>
</tr>
<tr>
<td>3.</td>
<td>Bihar</td>
<td>9.99</td>
<td>11.</td>
<td>Megalnd</td>
<td>0.08</td>
</tr>
<tr>
<td>5.</td>
<td>Haryana</td>
<td>1.73</td>
<td>13.</td>
<td>Punjab</td>
<td>2.55</td>
</tr>
<tr>
<td>6.</td>
<td>Jammu &amp; Kashmir</td>
<td>0.79</td>
<td>14.</td>
<td>Rajasthan</td>
<td>4.34</td>
</tr>
<tr>
<td>7.</td>
<td>Kerala</td>
<td>3.63</td>
<td>15.</td>
<td>Tamil Nadu</td>
<td>8.18</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>17.</td>
<td>West Bengal</td>
<td>9.11</td>
</tr>
</tbody>
</table>


In justification of a further increase in their share, the States put forward two main arguments. One was that "the continuance, almost on a permanent basis, of Union surcharge and its recent enhancement" had in effect enlarged the Centre's share of the net proceeds of the income-tax "at the expense of the States". Secondly, while in terms of the provision of Article 271, the Centre was entitled to levy a surcharge, exclusively for purposes of the Union, the levy of such a surcharge, the States argued, "should be only a transitory phenomenon". In their opinion the continuance of surcharge, as a permanent element of the income-tax rate structure, was against the spirit, if not the letter, of the provisions of the Constitution. 66

The State Governments also contended that the exclusion of income-tax paid by companies from the divisible pool since 1959-60, had deprived them of a source of revenue that was bound to be far more flexible and expanding than income-tax. They went a step further and urged that corporation tax should be brought

within the divisible pool through an amendment of the Constitution. They pointed out that on the commencement of the Constitution the yield from corporation tax was only Rs.40 crores as against Rs.133 crores from income-tax, whereas in 1973-74 corporation tax was estimated to yield Rs.608 crores as against Rs.650 crores the estimated yield from income tax. The States thereon, argued that had the framers of the Constitution anticipated these trends in the relative rates of growth of these two taxes, they would not have kept the corporation tax out of the divisible pool.67

The Sixth Commission could find substance in the arguments made by the States, but in view of the explicit provisions of the Constitution, they pleaded their incompetence for recommending the inclusion of the surcharge on income-tax and the corporation tax in the divisible pool. However, taking note of the near unanimity in the views expressed by the State Governments, the Commission suggested that the question be brought up for examination before the National Development Council. The Commission also expressed the view that there was no reason to apprehend that the inclusion of corporation tax in the divisible pool would ipso facto upset seriously the relative balance between Central and State resources, because in the combined divisible pool, the States' share could be fixed at a suitably lower level.68

On the question of the distribution of income tax proceeds between the Centre and the States, the Sixth Commission willingly endorsed the maxim adopted by the earlier Commissions that "the Central Government which levied and collected the income tax should continue to have a significant interest in it." With this rider, the Commission considered certain other factors relevant for making their recommendations. They pointed out that the Union surcharge had been raised from 10 to 15 per cent in 1971-72, which had indirectly limited the scope of States' share in the net

67. Ibid.
68. Id. at 11-12.
proceeds of income tax. The arrear element due to advance tax collections (which had resulted in an appreciable increase in the State's share in the income tax proceeds during the period covered by the award of the Fifth Commission) had by then disappeared. Therefore, the Commission found a good case for a modest increase in the State's share of the divisible pool of income tax and, in fact, recommended it to be raised from 75 per cent to 80 per cent.

The Commission was further to recommend the mode of distribution of divisible pool among the States inter se. On the question, the Commission endorsed the approach of the earlier Commissions recognising population and contribution to be the only relevant factors. This was justified by the Commission for the advantages in maintaining a reasonable measure of stability in the principles of distribution of shareable taxes. Economic disabilities of some of the States had been sought to be mitigated through weightage for relative economic backwardness given by the Commission, in the distribution of Union excise duties and up-grading of standards of administrative and social services had to be done through grants-in-aid.

The Sixth Commission proceeded, thereafter, to give careful consideration to the relative weightage to be accorded to population and contribution. The approach of the Commission, on this question, was identical with that taken by the earlier Commission. The Commission pointed out that in view of the increasing integration of national economy and the influence of Central policies on the location and development of industrial and tertiary sectors, it was difficult to assign the factor of contribution, weightage higher than it had earlier received. Any increase in its weightage, they felt, would further aggravate regional imbalances. At the same time, the Commission took note of certain personal incomes purely of local origin which had resulted on the exclusion of income tax paid by the companies from the divisible pool. In respect of income tax ascribable

69. Ibid.
70. Ibid.
to such local incomes at least they maintained that the States could lay a claim based on contribution. As a result, the Commission decided that 10 per cent of the States' share in the net proceeds of income-tax should be distributed on the basis of contribution and the remaining 90 per cent on the basis of population. In this respect, the Sixth Commission concurred with the Second Finance Commission.

The next important question considered by the Sixth Commission related to the measurement of the factor of contribution. Accepting the views expressed by and the reasons for doing so adduced by the Fifth Commission, the Sixth Commission felt that assessment would provide a more reliable index than collection, of the contributions of the different States.

Accordingly, the Commission recommended that the States' share in the net proceeds of income-tax should be 80 per cent during the period covered by their award namely 1974-75 to 1978-79. Out of the net proceeds of income tax, 1.79 per cent was recommended to represent the proceeds attributable to Union Territories. Distribution among the States inter se would be 90 per cent on the basis of population according to 1971 Census, and the remaining 10 per cent on the basis of figures of assessment, after allowing for reductions on account of appellate orders, revisions, refunds and rectifications. The respective shares of the States were worked out in terms of fixed percentages are given in Table V(6).

During the review by the Seventh Finance Commission of the distribution of income tax, the States, as usual, represented for the size of divisible pool of the tax being raised from the level of 80 per cent determined by the Sixth Commission. In support, they referred to the fact that the Central Government had raised the Union surcharge to 15 per cent from the earlier level of 10 per cent simply as a revenue measure rather than for meeting any specific Union purposes. This step, according to them, had the effect of

71. Ibid.
72. Ibid.
Table V(6)

State-wise distribution of Income tax divisible pool

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>States</th>
<th>States share</th>
<th>Sr. No.</th>
<th>States</th>
<th>States share</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Andhra Pradesh</td>
<td>7.76</td>
<td>11</td>
<td>Maharashtra</td>
<td>11.05</td>
</tr>
<tr>
<td>2</td>
<td>Assam</td>
<td>2.54</td>
<td>12</td>
<td>Manipur</td>
<td>0.18</td>
</tr>
<tr>
<td>3</td>
<td>Bihar</td>
<td>9.61</td>
<td>13</td>
<td>Meghalaya</td>
<td>0.18</td>
</tr>
<tr>
<td>4</td>
<td>Gujarat</td>
<td>5.55</td>
<td>14</td>
<td>Meghalaya</td>
<td>0.09</td>
</tr>
<tr>
<td>5</td>
<td>Haryana</td>
<td>1.77</td>
<td>15</td>
<td>Orissa</td>
<td>3.73</td>
</tr>
<tr>
<td>6</td>
<td>Himachal Pradesh</td>
<td>0.60</td>
<td>16</td>
<td>Punjab</td>
<td>2.75</td>
</tr>
<tr>
<td>7</td>
<td>Jammu &amp; Kashmir</td>
<td>9.81</td>
<td>17</td>
<td>Rajasthan</td>
<td>4.50</td>
</tr>
<tr>
<td>8</td>
<td>Karnataka*</td>
<td>5.33</td>
<td>18</td>
<td>Tamil Nadu</td>
<td>7.94</td>
</tr>
<tr>
<td>9</td>
<td>Kerala</td>
<td>3.92</td>
<td>19</td>
<td>Tripura</td>
<td>0.27</td>
</tr>
<tr>
<td>10</td>
<td>Mysore Pradesh</td>
<td>7.30</td>
<td>20</td>
<td>Uttar Pradesh</td>
<td>15.23</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>21</td>
<td>West Bengal</td>
<td>8.89</td>
</tr>
</tbody>
</table>

* Mysore was named as Karnataka w.e.f. 1.11.1973


depriving the States of a share in the increased revenue from income tax and surcharge taken together. The States based their contention on the belief that basic tax and surcharge were substitutable.73

The Seventh Commission appears to have been impressed by the arguments made by the State Governments. They felt that though Article 271 laid down no requirement of a specific purpose for levying the surcharge, there was, however, an underlying assumption that a surcharge should only be levied for meeting the requirements of some unexpected events and that it should be levied only for the period during which the requirements persisted. They maintained that a surcharge continued indefinitely could well be called an 'additional income-tax'.74 But in view

74. Ibid.
of the express constitutional provision, the Commission refrained from suggesting such a course. Yet, they considered necessary and proper to give weight to the strong feelings of the State Governments on this subject by increasing the size of the divisible pool. They, therefore, recommended the raising of the States' share from 60 per cent to 85 per cent of the net proceeds of income tax, excepting so far as those proceeds represented proceeds attributable to Union Territories or to taxes payable in respect of Union emoluments. Sikkim, where the tax was not leasible, did not qualify to share the divisible pool.

The Seventh Commission was in general agreement with the conclusions drawn by their predecessors that a weightage should be given to contribution in the distribution of the devolution pool of income tax among the States inter se. It had rather been a tradition with the Finance Commissions that a weight had been given to this factor. That after the amendment of the Income tax law in 1959, what might be termed incomes of local origin in each State has contributed significantly towards the income tax revenue from that State. The Seventh Commission added that the same could be said about the income tax on emoluments of State employees. Taking these considerations into account, they recommended 10 per cent weightage for the factor of contribution. In this regard, the Commission did not disturb the position taken by the Fifth and Sixth Commissions. Keeping the weightage for contribution to 10 per cent, the Commission admitted that a proportion smaller than this would not be acceptable to the States and a larger proportion would have the effect of reversing the trend. As the bulk of the collection of income tax revenue came from the advanced States, larger weightage to contribution in its distribution would also have gone against the objective proposed by them for the fiscal transfer scheme.

75. Ibid.
76. The objective was to place the financially weaker States in a position from where they could get a better start than had been the case in the past, for their development. See Report, Seventh Finance Commission, 62-63, 1978.
For the purpose of determining the proportions of the contribution of the States to the income tax revenue, the Seventh Commission adopted the State-wise proportions of net assessments, taking the years 1972-73 to 1976-77 for calculating average assessments. In recommending the distribution of the remaining 90 per cent of the divisible pool on the traditional basis of population, the Commission acknowledged the approach of the First Commission that population was a broad measure of the needs of the States. Speaking in the context of the relations between the Centre and the States, the Commission signified their inability to discount the factor of population, which in their view was difficult to be replaced.77

On the bases recommended above, the Seventh Finance Commission worked out the shares of the States in the net proceeds of income-tax, including and excluding Sikkim, for the latter was held entitled to a share only when the levy of tax was extended to the State. For the period covered by their report, the Commission's recommendations were: "(a) out of the net proceeds of taxes on income in each financial year, a sum equal to 2.19 per cent should be deemed to represent the proceeds attributable to Union Territories and in the remaining, the States' share should be 85 per cent. (b) The bases of the distribution inter se the States should be the same as recommended by the earlier Commissions, namely 10 per cent on the basis of contributions represented by average assessments and 90 per cent on the basis of population."78 The devolution recommended is given in the following Table.

77. *Ibid.* at 64.
### Table V(7)

**State-wise distribution of Income tax divisible pool**

(Figures in percentages)

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>States</th>
<th>States share</th>
<th>States share</th>
<th>Sr. No.</th>
<th>States</th>
<th>States share</th>
<th>States share</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Andhra Pradesh</td>
<td>8.023</td>
<td>8.021</td>
<td>12</td>
<td>Manipur</td>
<td>0.188</td>
<td>0.188</td>
</tr>
<tr>
<td>2</td>
<td>Assam</td>
<td>2.522</td>
<td>2.521</td>
<td>13</td>
<td>Meghalaya</td>
<td>0.178</td>
<td>0.178</td>
</tr>
<tr>
<td>3</td>
<td>Bihar</td>
<td>9.540</td>
<td>9.536</td>
<td>14</td>
<td>Nagaland</td>
<td>0.085</td>
<td>0.085</td>
</tr>
<tr>
<td>4</td>
<td>Gujarat</td>
<td>5.959</td>
<td>5.957</td>
<td>15</td>
<td>Orissa</td>
<td>3.739</td>
<td>3.738</td>
</tr>
<tr>
<td>5</td>
<td>Haryana</td>
<td>1.819</td>
<td>1.619</td>
<td>16</td>
<td>Punjab</td>
<td>2.714</td>
<td>2.713</td>
</tr>
<tr>
<td>6</td>
<td>Himachal Pradesh</td>
<td>0.595</td>
<td>0.595</td>
<td>17</td>
<td>Rajasthan</td>
<td>4.364</td>
<td>4.362</td>
</tr>
<tr>
<td>7</td>
<td>Jammu &amp; Kashmir</td>
<td>8.818</td>
<td>0.818</td>
<td>18</td>
<td>Sikkim</td>
<td>-</td>
<td>0.035</td>
</tr>
<tr>
<td>8</td>
<td>Karnataka</td>
<td>5.442</td>
<td>5.440</td>
<td>19</td>
<td>Tamil Nadu</td>
<td>8.050</td>
<td>8.048</td>
</tr>
<tr>
<td>9</td>
<td>Kerala</td>
<td>3.950</td>
<td>3.948</td>
<td>20</td>
<td>Tripura</td>
<td>0.258</td>
<td>0.258</td>
</tr>
<tr>
<td>10</td>
<td>Madhya Pradesh</td>
<td>7.356</td>
<td>7.354</td>
<td>21</td>
<td>Uttar Pradesh</td>
<td>15.429</td>
<td>15.422</td>
</tr>
<tr>
<td>11</td>
<td>Maharashtra</td>
<td>10.953</td>
<td>10.949</td>
<td>22</td>
<td>West Bengal</td>
<td>8.018</td>
<td>8.015</td>
</tr>
</tbody>
</table>

(Source: Report, Seventh Finance Commission, 64, 1978)

Note: (i) Col.(3) represents States' share without Sikkim.

(ii) Col.(4) represents States' share with Sikkim.

**Evaluation**

The successive Finance Commissions have taken note of the fact of increasing needs of the States, as also the fact of a restrictive effect on the divisible pool by a change in income tax law in 1959, and accordingly the percentage share of the proceeds to be assigned to the States has been increased. The First Finance Commission considered it "undesirable to concentrate on income-tax as a balancing factor in the adjustment of resources between the Centre and the Units."\(^{79}\) The Commission thought that "an increase...

in the States' share of this tax should not be used as a major factor in the devolution of further resources to the States. But since there were factors working towards a reduction in the States' share, the Commission came to the conclusion that "some increase in the share assignable to the States was justified" and, therefore, raised the share of the States from 50 per cent to 55 per cent. While the Second Finance Commission raised it to 60 per cent, the Third Commission, being faced with the special plea regarding the enlargement of corporation tax at the cost of income tax, raised it to 66-2/3 per cent. The pressure of the States, of course, still persisted and along the same lines. They pleaded that in view of their ever-increasing financial needs and in view of raised surcharge on income tax and enlarged coverage of corporation tax it was necessary that there should be a constitutional amendment whereby both the surcharge and corporation tax were included in the divisible pool. Such a recommendation was not within the terms of reference of the Finance Commissions. They, however, recognised the substance in the States' case. Expressing their inability, in view of the express Constitutional provision, they met the demand made by the States by enhancing their share in the divisible pool of income tax, which at present stands at 85 per cent.

The States had also been pleading for the inclusion of advance tax collections in the divisible pool. The Fifth Finance Commission after consultations with the Comptroller and Auditor General of India, included the advance income tax collections in the divisible pool and since then it continues to be so.

It may of course be remembered that the question of recommending a specified proportion of income tax proceeds as the States' share is not an isolated one and has to be viewed in an overall context. This aspect of the matter would be considered in Chapter XI as an integrated question of devolution of resources.

The intricate and vexing question relates to the distribution of resources among the States inter se. The

80. Ibid.
different States have been pressing for different criteria as it suits to their need. In short, the States have been propagating purely a subjective criteria. These criteria, however, are the product of two opposite approaches, namely, those of 'need' and 'contribution' and various degrees of compromise between them. While some States would like the distribution to be based upon fiscal needs and make them play a redistributive role as between different parts of the country, States like Maharashtra would like to interpret the Constitutional provisions so as to maintain that in the devolution of taxes, considerations of need, equity or development have no relevance. Besides, application of each criterion has its own conceptual and practical difficulties. For example, it is not easy to determine relative fiscal needs of the States and the successive Finance Commissions have been forced to take almost arbitrary decisions in this regard. To them population has been the best criteria for determining the fiscal needs, though some States wanted it to be adjusted by some corrective factor. Thus, Rajasthan, the sparsely populated State, has been pleading that a thinly spread population implies a large per capita expenditure for providing the same economic and social services as would be the case in a densely populated State. It has, therefore, been pressing for adjusting the population figures by area and proportion of scheduled tribes population in the total. While industrial States like Maharashtra want more funds because the existence of an industrial labour force necessitates higher per capita expenditure on account of law and order and other services, and, therefore, would like that urbanization should be applied as a corrective factor. Similarly, in the 'contribution' approach, conceptual difficulties involve choosing from one or more of the criteria like collection and assessment of income tax, or origin of the taxed income. The three criteria obviously yield different results and cannot be taken as equivalent to each other.
Each Finance Commission has chosen population and collection (or assessment) as the two criteria and the respective weights have been as shown in Table V(8).

**Table V(8)**

<table>
<thead>
<tr>
<th>Bases for Determining the Relative Shares of States in Income-Tax Proceeds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Weight assigned to</td>
</tr>
<tr>
<td>Population</td>
</tr>
<tr>
<td>First Finance Commission</td>
</tr>
<tr>
<td>Second Finance Commission</td>
</tr>
<tr>
<td>Third Finance Commission</td>
</tr>
<tr>
<td>Fourth Finance Commission</td>
</tr>
<tr>
<td>Fifth Finance Commission</td>
</tr>
<tr>
<td>Sixth Finance Commission</td>
</tr>
<tr>
<td>Seventh Finance Commission</td>
</tr>
</tbody>
</table>

The Second Commission asserted that the entire income-tax proceeds should be distributed only on the basis of population and like the First Finance Commission, believed that "such considerations as the proportion of the scheduled castes and tribes and backward classes in the population, the area of the States, the backwardness etc., are not relevant to a scheme for the redistribution of a tax." 81 However, in order not to cause a sudden disruption, the Second Commission raised the percentage weight for population from 80 to 90 with the hope that in due course it would be raised to 100. The Third Commission, however, lowered it again to 80 per cent which was kept unchanged by the Fourth Commission. The percentage figures were again raised to 90 by the Fifth and the Sixth Commissions which were not disturbed by the Seventh Commission. Thus the successive Finance Commissions have accepted population as an index of general need and assigned marginal weight to collection/contribution in the distribution of income tax pool among the States inter se. In doing so the Sixth

Finance Commission observed:

In view of the increasing integration of our national economy and the influence of Central policies on the location and development of industrial and tertiary sectors, it is difficult to assign the factor of contribution any higher weightage than at present in the distribution of income tax. Also such enhanced weightage will further aggravate regional imbalances.

Spelling out their objective of "placing as many of the less affluent States as possible in surplus on the revenue account" and keeping the "contribution" figure to 10 per cent in the distribution of income tax pool, the Seventh Finance Commission observed that "a larger proportion would set a trend in the wrong direction."

It may be observed with the Sixth Commission that "resources belong to the nation and they should be applied at points where they are most needed."

III. Voluntarily Shareable Tax: Union Excise Duties

In terms of the distribution of resources, excise duties, with the exception of that levied on alcoholic liquors, opium, Indian hemp and narcotics, are Central revenues. Article 272 of the Constitution, however, empowers Parliament to provide by legislation the distribution to the States of the whole or a part of the net proceeds of the Union duties of excise on specified commodities, prescribing at the same time, the principle on which the distribution should be made among the States inter se. Thus, it was left to the Parliament to decide

84. Id. at 63.
86. Entry 84 Union List, Seventh Schedule, Constitution of India, 1950.
whenever any of these duties is to be shared with the States and the extent of such sharing. The States' share is to be distributed among them in accordance with such principles as may be formulated by the Parliament. This permissive provision was embodied in the Constitution to provide for additional financial assistance to the States, should the necessity arise to augment sums which could be made available, under other provisions of the Constitution. This enabling provision was not acted upon until 1952 and the proceeds of this levy were not brought into distribution, but were retained wholly by the Centre. It was only when the First Finance Commission took up the question, on their own, that the States became vocal and represented for a share of excise duties levied by the Union. These duties, at one time, were a negligible source of revenue, but as a result of an expansion of coverage and increase in rates, they have now become the dominant element in the Centre's resources.

Having been influenced by the growing needs of the State in fulfilling a complementary role in the development of the national economy and the provision of a higher level of social services, the successive Finance Commissions have considered desirable to widen the field of devolution by having more than one divisible tax "so as to secure a balanced scheme of devolution under which the different buoyancy of each tax may not affect the scheme unduly, and on the whole a more even distribution may prevail over a period of years." It was also felt that

87. This was the position under the Government of India Act 1935 also. See Section 140 of the Act, supra Chapter III. Despite the considered views of the various economic experts on this permissive provision of the Act, excise revenues were wholly retained by the Centre from 1935 till the First Finance Commission reported in 1952. The Expert Committee on the Financial Provisions of the Constitution recommended no change in the position as embodied in the Act 1935 but suggested that one half of the net proceeds of the duty on tobacco should be assigned to the Provinces and distributed on the basis of estimated consumption. See supra, Chapter IV.

income tax which is compulsorily divisible under the provisions of Article 270, had been left with a limited scope for expansion, while the requirements of the States for expenditure were growing at an increasing pace particularly due to the implementation of National Plans of development. It was, therefore, considered necessary to provide for increased devolution to the States by a share of Union excise duties under the enabling provision of Article 272.

With a modest beginning under the recommendations of the First Finance Commission, there has been a general trend in the direction of increasing the size of devolution under Union excise duties. It has so happened that in every budget, either the Union Government has brought new items under this duty or has raised the rates of levy and sometimes it has done both, thus adding appreciably to the share of the States in the yield of these duties. Though there is no constitutional compulsion for sharing these proceeds, but revenue from this levy has come to stay as the main vehicle of the tax devolution from the Union to the States. The factual position is that ever since 1952-53 the States have been getting a share out of Union excise proceeds.

When the First Finance Commission took up the matter with the States, exorbitant demands were made by them for a share in the proceeds of Union excises. The majority of States suggested the distribution of all excise duties on a 50:50 basis, others limited the claim to the major levies but demanded a larger share. The Commission, however, felt that, right at the outset, the sharing of excise duties should be done on a somewhat modest and a selective basis and that the principle of such sharing should be cautiously applied. As the yield from some of the excises was relatively small, they thought it undesirable to bring all the excises into the scheme of distribution. Secondly, they concluded that the principle should be to select commodities which were of common and widespread consumption and which yield a sizeable sum of revenue for distribution. There should also be reasonable stability of yield and that only those commodities which were immune from...
fluctuations due to changes in tariff rates, should be taken for distribution. Taking all these factors into account, the First Commission concluded that duties on tobacco including cigars and cigarettes, matches and vegetable products should be the most suitable for distribution and recommended that 40 per cent of their proceeds should be allocated to the States, keeping in view the scheme of devolution as a whole, under their report. 89

On the question of the determination of the mode of distribution inter se, the First Commission felt that the scheme they evolve should be balanced and equitable as a whole. For the period covered by their report, the Commission believed that these objectives could be achieved by recommending the distribution on a per capita basis. They, therefore, suggested that the States share of the excise duties (specified in their report) should be distributed on the basis of population. 90

In their representations, some of the States had suggested that consumption should be adopted as the basis of distribution of the excises among them inter se. The First Commission did endorse the suggestion and accepted though indirectly, consumptions as being the correct basis of distribution, but with a note of regret, dropped it because the State-wise consumption figures were not available by then. They, therefore, recommended that steps should be taken to collect and maintain statistics of consumption of all major commodities that might be subject to excise levies from time to time, so that the data might be available to the future Commissions. At the same time, they recognised that meticulous accuracy in regard to these figures might not be possible. They, however, advised against any subsequent adjustment being made in their recommendations in case reliable consumption statistics became available meanwhile. Since the devolution proposed by them was an integrated one, the Commission desired that it should not be disturbed by piecemeal adjustments. 91

90. Ibid.
91. Id. at 82-83.
basis of distribution the First Commission observed: "Only a broad measure of need such as is given by the respective population of the States is suitable for application in the distribution of the proceeds of a shared tax." Having so said, the Commission recommended the distribution of the entire share of States in excise proceeds on the basis of population as decided on per capita basis. Table V(9) below shows the State-wise distribution of Union excise duties.

**Table V(9)**

State-wise distribution of divisible pool of Union Excises

(Figures in percentages)

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>States</th>
<th>States share</th>
<th>Sr. No.</th>
<th>States</th>
<th>States share</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Assam</td>
<td>2.61</td>
<td>9.</td>
<td>Orissa</td>
<td>4.22</td>
</tr>
<tr>
<td>2.</td>
<td>Bihar</td>
<td>11.60</td>
<td>10.</td>
<td>Pepsu</td>
<td>1.00</td>
</tr>
<tr>
<td>4.</td>
<td>Hyderabad</td>
<td>5.39</td>
<td>12.</td>
<td>Rajasthan</td>
<td>4.41</td>
</tr>
<tr>
<td>5.</td>
<td>Madhya Bharat</td>
<td>2.29</td>
<td>13.</td>
<td>Saurashtra</td>
<td>1.19</td>
</tr>
<tr>
<td>7.</td>
<td>Mysore</td>
<td>2.62</td>
<td>15.</td>
<td>Uttar Pradesh</td>
<td>18.23</td>
</tr>
</tbody>
</table>

(Source: Report, First Finance Commission, 83, 1952)

The recommendations of the First Commission on the subject were accepted by the Central Government. Since these could be given effect to only by an Act of Parliament, the Union Duties of Excise (Distribution) Act, 1953, was accordingly enacted providing for the distribution to the States, of 40 per cent of the net proceeds of excise duties on tobacco, matches and vegetable products, on the basis of their respective population.

92. Id. at 75.
The Act broke new ground in giving to the States a share in a growing and expanding source of revenue earlier denied to them.

The First Commission having blazed the trail, the Second Commission had, of necessity, to consider the distribution of Union excises. In the intervening period, the coverage and yield of these duties had been considerably expanded. While in 1952-53, the excise duties were levied on thirteen commodities giving a net yield of Rs. 83.03 crores, the number of commodities had risen in 1957-58 to twenty-nine with a total net yield of Rs. 259.57 crores in the budget for 1957-58.  

The devolution made by the First Commission had whetted the appetite of the State Governments. When asked for their suggestions by the Second Commission, they demanded an increase in the number of commodities the duties on which should be shared. Many of them demanded that all excises should be included in the distribution scheme. The share suggested by them varied between a minimum of 50 to a maximum of 70 per cent.

The Second Commission considered that with taxes on income ceasing to be an expanding source of revenue, any further substantial devolution of revenue to the States by sharing of taxes, would have to come from Union excises. They, therefore, opined that a larger share of excise duties should be given to the States. But they found it neither necessary nor expedient at that time, to make a sweeping change by providing for the distribution of all excises. The Commission felt that they would be meeting the general wish of the States if they widen the range by increasing the number of duties to be shared. Accordingly, the Second Commission recommended that the duties on sugar, tea, coffee, paper and vegetable non-essential oil should be added to the existing three, making a total of eight. Having regard to the overall scheme of devolution they had in view, the Second Commission reduced the States' share to 25 per cent. The reduction in the percentage was more than made good by widening the range of

The distribution of the States' share of the divisible excises presented the same difficulties as experienced by the First Commission. There were almost as many suggestions for distribution inter se, as the number of States. While in accordance with the recommendations of the First Commission, statistics of consumption commodity-wise had been compiled, but they were no more reliable than those made available to the former Commission. In this matter, the Second Commission was in no better position than their predecessors.

Referring to the choice of population as the basis for distribution, the Second Commission took the view that their predecessors had used population as "indicating the nearest measure of consumption" in the absence of reliable data on consumption. They further considered that while it was possible to hold that consumption would provide a suitable basis of distribution, its adoption would, according to them, operate in favour of the more urbanised States, which were also in a position to raise substantial revenue from sales taxes on such consumption. They, therefore, favoured the retention of the per capita distribution adopted by the First Commission.

The Commission was inclined, in any case, to take population as the sole basis of distribution. But they found that the distribution on the basis of population alone would have the practical effect of leaving some of the States in an unfavourable position. They decided, therefore, to use a small corrective

94. Id. at 43.

95. It is because of the fact that consumption of suitable articles has been higher in the Urban States than that in others.

96. It may be noticed that the Second Commission had advocated that federal financial assistance to the States, in whatever manner it was afforded, should be made on the determination of relative needs of the States. In the compulsorily shareable income tax also, the Commission had favoured such distribution and recommended population as the basis.
in favour of these States. The Commission recommended that 90 per cent of the States' share in the excise proceeds should be distributed on the basis of population and the remaining 10 per cent be used for making other adjustments to even out the distribution. But the Commission did not disclose how these adjustments were made and on what basis. It is also not visible from the following table showing the State-wise distribution of the excises.

Table V(10)

State-wise distribution of divisible pool of Union Excises

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>States</th>
<th>States share</th>
<th>Sr. No.</th>
<th>States</th>
<th>States share</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Andhra Pradesh</td>
<td>9.38</td>
<td>9</td>
<td>Orissa</td>
<td>4.46</td>
</tr>
<tr>
<td>2</td>
<td>Assam</td>
<td>3.46</td>
<td>10</td>
<td>Punjab</td>
<td>4.59</td>
</tr>
<tr>
<td>3</td>
<td>Bihar</td>
<td>10.57</td>
<td>11</td>
<td>Rajasthan</td>
<td>4.71</td>
</tr>
<tr>
<td>4</td>
<td>Bombay</td>
<td>12.17</td>
<td>12</td>
<td>Uttar Pradesh</td>
<td>15.94</td>
</tr>
<tr>
<td>5</td>
<td>Kerala</td>
<td>3.84</td>
<td>13</td>
<td>West Bengal</td>
<td>7.59</td>
</tr>
<tr>
<td>6</td>
<td>Madhya Pradesh</td>
<td>7.46</td>
<td>14</td>
<td>Jammu &amp; Kashmir</td>
<td>1.75</td>
</tr>
<tr>
<td>7</td>
<td>Madras</td>
<td>7.56</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Mysore</td>
<td>6.52</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(Source: Report, Second Finance Commission, 44, 1957)

The States which were benefitted by these corrections effected by the Second Commission were, of course, the poor States of Andhra Pradesh, Assam, Mysore, Orissa, Rajasthan and Jammu and Kashmir. Yet, some other poor States, notably, Bihar, Madhya Pradesh and Uttar Pradesh had to suffer on this account as they got less than what they would have received had population been taken as the sole basis of distribution of Union excises.

The Third Commission which reviewed the distribution of Union excises had a problem of their own. In their representations to the Commission, the States had claimed with justification that a substantial increase should be made in their share of income

tax. This claim was made on account of the shrinkage in the
divisible pool of income-tax resulting from the reclassification
of income tax paid by the companies as corporation tax affected in
the Finance Act 1959. The States could not be compensated for
the loss sustained unless the bulk, if not the whole, of the
net proceeds of income tax were to be transferred to them. The
Commission could not favour this solution but assured the States
that there were other avenues open to them to make amends.\textsuperscript{98}
This implied that the Commission would make a much larger
devolution of the yield of excise duties to take account of this
loss. Even otherwise, there was the need for enlarging the
scope of devolution to provide assistance needed for filling up
the revenue gaps caused by the impact of the committed expenditure
of the successive plans. The Commission thus considered to give
the distribution of Union excises a greater importance in their
scheme of overall devolution. This the Commission thought was not
only justified but was even necessary.\textsuperscript{99}

The majority of the States had demanded that the entire
net proceeds of Union excises should be made divisible. Their
claim rested on two considerations. First was that the expansion
of coverage and the increasing incidence of the duty had an
impact on the levy and collection of sales tax. This inter-
dependence, the States argued itself provided enough justification
for making the entire net proceeds of excises divisible.
Additionally they adduced that sales tax constituted the only
significant flexible source of revenue available to them and this
flexibility was subjected to restraint by the excise policy of the
Union Government. Further, the rates of duty on some of the
articles of common consumption were variable and admitted
adjustments from time to time. If a broader base was adopted, the
States argued that the buoyancy of duty on some articles would make
good the shortfall on others, thus maintaining a steady flow of
assistance to them.\textsuperscript{1}

\textsuperscript{98}. See supra.
1. Id. at 20-21.
The Third Commission were greatly impressed by the logic of this approach. They further considered that the inadequacy of resources of the States was largely the result of the planning process and this inadequacy was likely to become more pronounced with the completion of each successive plan. The best way to secure the viability of the States was to assure them a larger devolution of the Union excise duties. This, according to the Commission, should be effected by providing for the participation of the States, by convention, in the proceeds of all Union excises. This, they said would give a great deal of psychological satisfaction to the States and would dissipate any suspicion that the Union was pursuing a policy of excessive centralisation of resources. The Commission, therefore, decided to provide for the participation of the States in the proceeds of all excises levied up to 1960-61 excluding those on which the yield was below Rs. 50 lakhs a year.²

Rejecting the other two alternatives canvassed before them, namely the distribution of the proceeds of Union excise duties on (i) articles of common consumption, and (ii) on consumer goods only, the Third Commission held that there was no particular virtue or advantage in their adoption. They could hardly find any logic in the selection of one commodity in preference to another. Limiting the devolution to articles of common use, such as cotton textiles, sugar etc., would not have, in that situation, assured the States of a stable yield. Accordingly, the Commission recommended that 20 per cent of the net proceeds of Union duties of excise on all commodities listed should be deemed to be the share of the States. Motor spirit was not included in the list as they had separately provided for the distribution of the duty collected on motor spirit, as a special purpose grant to the backward States for the maintenance and improvement of communications.³

². With the exception of silk fabrics, the duty on which was to be shared.
As regards the distribution of the States' share of the divisible excises among the States inter se, the Third Commission made a significant departure from the criteria adopted by their predecessors, which favoured 'consumption' as the basis of distribution and in the absence of the availability of relevant data on consumption, regarded 'population as the measure of consumption'. The Commission observed that the former Commissions were considering a limited range of commodities which could be classified as consumer goods. As they proposed to include, in devolution scheme, goods and intermediaries also, the Third Commission opined that consumption would not be the correct criterion to apply for distribution. They were of the view that in the permissive participation of the Union excises, "an attempt should be made to bring all the States, as far as possible, to a comparable level of financial balance,\(^4\) Taking into account the considerations of inter-State equalisation, the Commission devised that population should continue to be the major factor of distribution, while, the relative financial weakness of the States, the disparities in the levels of development reached, the percentage of scheduled castes and tribes and backward classes in their population, should also be taken as relevant considerations for the purpose.\(^5\) The Commission, while recommending population as the criterion for distribution of States' share in excises inter se, therefore, gave weightage to these factors also. But the manner in which these additional factors were considered and respective weightage given to them was not made known by the Commission. It was somewhat an arbitrary conclusion but it definitely aimed at establishing the use of excise duties as a balancing factor for the time to come. The recommendations so made by the Third Commission are shown in the Table given below:

\(^4\) Id. at 22.
\(^5\) Ibid.
Table V(ll)

State-wise distribution of divisible pool of Union Excises

(Figures in percentages)

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>States</th>
<th>States share</th>
<th>Sr. No.</th>
<th>States</th>
<th>States share</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Andhra Pradesh</td>
<td>8.23</td>
<td>7.</td>
<td>Madhya Pradesh</td>
<td>8.46</td>
</tr>
<tr>
<td>2.</td>
<td>Assam</td>
<td>4.73</td>
<td>8.</td>
<td>Madras</td>
<td>5.82</td>
</tr>
<tr>
<td>5.</td>
<td>Jammu &amp; Kashmir</td>
<td>2.02</td>
<td>11.</td>
<td>Rajasthan</td>
<td>5.93</td>
</tr>
<tr>
<td>6.</td>
<td>Kerala</td>
<td>5.46</td>
<td>12.</td>
<td>Uttar Pradesh</td>
<td>10.68</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>13.</td>
<td>West Bengal</td>
<td>5.07</td>
</tr>
</tbody>
</table>

(Source: Report, Third Finance Commission, 24, 1961)

By the time the Fourth Finance Commission was appointed, excise had become the major element in the devolution of resources to the States. The Third Commission had accepted, in principle, the reasonableness of the demand made by the States for participation in the proceeds of all Union excises but they had limited the sharing of the proceeds only from the commodities on which duties were levied until 1960-61 and which yielded an amount of Rs. 50 lakhs or more. In their representation to the Fourth Commission, the State Governments argued for widening the scope of the sharing and removing whatever reservations the Third Commission had left in this respect. The States urged that they should have and continue to have a substantial interest in the collection and levy of Union excises, which would lead to a coordination between the excise policy of the Union Government and the Sales Tax policies pursued in the States. As fluctuations in the yield of certain items of excise could be neutralised by fluctuations in the yield of some other items, they argued that larger number of commodities should be brought within the divisible pool. This would also result in the greater evenness in the flow of resources to the States. Since the States requirements were growing, an elastic source of revenue like a
share in excise on all commodities would go to strengthen their position. Commodities covered by the Union excise duties being of country-wide consumption, there was no justification for selecting only a few of them for sharing. The State Governments added further arguments in support of their demand. Under the prevailing system, any reduction or abolition or substitution of excise duty on a shared commodity was to go to the disadvantage of the States. Further, in any economy, where industry was getting diversified new lines of production would emerge continuously and any formula for the sharing of excise duties, the States demanded, should cover such new products.6

The Fourth Commission found considerable force in the above arguments and therefore recommended that all Union excise duties currently levied and also those that might be levied thereafter during the quinquennium covered by their report, should be shared between the Centre and the States. The Commission, however, did not bring within the scheme of sharing certain categories of excise duties, namely, cesses levied on certain goods under special Acts, regulatory duties of excise levied under the Finance Acts, and the special duties of excise on certain articles which were being levied from 1963 in the form of surcharges on basic duties on those items.7

On the question of the percentage of the proceeds of distributable excises, the Fourth Commission took the view that the overall share of the States should be determined, taking into account the requirements of the States on the one hand and the needs of the Union Government on the other. Having considered the issue in this light and keeping in mind the estimates of the yield from the excise duties in the quinquennium under their report, the Commission concluded that the States' share out of the distributable excises might be fixed at 20 per cent of the net proceeds. Stressing the financial significance of this figure, the Commission visualised that had they confined the sharing to the 35 commodities (as was the case under the Third

---

7. Ibid. These duties were introduced for the first time by the Finance Act 1963 in the context of National Emergency.
Commission's recommendations) they had to fix the proportion at around 30 per cent to keep the transfer to the States at about the same level as provided in their scheme. There was, therefore, a substantial increase in the overall share of the States in the proceeds of Union excises under the recommendations of the Fourth Commission.

The Fourth Commission then took into consideration the distribution of the States' share as between different States. Various bases were suggested by the State Governments. In support of consumption as a basis, it was said that such a distribution would be in accordance with the 'contribution' that each State had made to the total proceeds. Further, that if ever a large scale substitution of sales taxes by Union excises were to take place, the resistance from the States to that substitution would be less if the distribution of excises took into account the 'contribution' factor. But the Commission could find no case for the adoption of 'contribution' as the sole criterion. Though this factor could be combined with other factors like population and economic and social backwardness, but in the absence of reliable State-wise data of consumption of excisable commodities, the Commission expressed their inability in taking 'consumption' or 'contribution' as a factor in the distribution scheme. The factors such as the ratio of urban and rural population, were also rejected. The Commission thought it to be desirable to devise the distribution scheme on the basis of ascertainable factors than on the basis of such uncertain indicators. The basis of population was supported on the ground that population of a State represented the 'needs' of the State. Since the sharing of excises was not compulsory under the Constitution and was only permissive, the proceeds of excise should be so distributed that each State got according to its needs. It was also argued that population might, in case of some commodities, be a rough index of total consumption. The Commission did find some substance in these arguments but they did not agree with the view that population could be the only index of the needs of a State. There were other factors which were equally relevant. The Commission, therefore, expressed

8. Id. at 26-27.
the view that in determining the distribution, while population should be the major factor, relative economic and social backwardness should also be taken into account. In determining the relative backwardness of each State, the Fourth Commission made a slight departure from the approach adopted by the earlier Commission. The Commission distinguished between economic and social backwardness of a State and its financial weakness. The Commission observed: "It is possible that a State may be economically backward and poor in social services and yet it may have fairly comfortable position on revenue account." They, therefore, evolved their own index of economic and social backwardness of the States. For the purpose the Commission used the following seven factors as determinants:

(i) **Per capita** gross value of agricultural production;

(ii) **Per capita** value added by manufacture;

(iii) Percentage of workers (as defined in the census) to the total population;

(iv) Percentage of enrolment in classes I to V to the population in age group 6-11;

(v) Population per hospital bed;

(vi) Percentage of rural population to total population; and

(vii) Percentage of the population of scheduled castes and tribes to total population.

The Fourth Commission, for the first time, considered it adequate to give a specific weightage to the factor of relative economic backwardness. They accordingly recommended that 20 per cent of the States' share in the excise proceeds should be distributed on the basis of this index and the remaining 80 per cent was to be distributed on the basis of population. The Commission recognised the need of giving some weightage to contribution, but in the absence of reliable statistics they could not consider the possibility of combining 'consumption' or 'contribution' factor with that of population and economic and social backwardness. On the recommendations

9. Id. at 28.
10. Ibid.
11. Id. at 28-29.
of the Fourth Commission, 20 per cent of the net proceeds of Union duties of excise on all articles levied and collected in that particular year, excepting regulatory duties, special excises and duties and cesses earmarked for special purposes, was to be distributed among the States in the following proportions:

**Table V(12)**

State-wise distribution of divisible pool of Union Excises

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>States</th>
<th>States share</th>
<th>Sr. No.</th>
<th>States</th>
<th>States share</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Andhra Pradesh</td>
<td>7.77</td>
<td>9.</td>
<td>Maharashtra</td>
<td>8.23</td>
</tr>
<tr>
<td>2.</td>
<td>Assam</td>
<td>3.32</td>
<td>10.</td>
<td>Mysore</td>
<td>5.41</td>
</tr>
<tr>
<td>3.</td>
<td>Bihar</td>
<td>10.03</td>
<td>11.</td>
<td>Nagaland</td>
<td>2.21</td>
</tr>
<tr>
<td>4.</td>
<td>Gujarat</td>
<td>4.80</td>
<td>12.</td>
<td>Orissa</td>
<td>4.82</td>
</tr>
<tr>
<td>6.</td>
<td>Kerala</td>
<td>4.16</td>
<td>14.</td>
<td>Rajasthan</td>
<td>5.06</td>
</tr>
<tr>
<td>8.</td>
<td>Madras</td>
<td>7.18</td>
<td>16.</td>
<td>West Bengal</td>
<td>7.51</td>
</tr>
</tbody>
</table>

(Source: Report, Fourth Finance Commission, 29, 1965)

The question of sharing special excise duties was raised before the Fourth Commission also, but they on practical consideration thought it desirable to keep them outside the sharing scheme. These duties were renewed on a year to year basis and were not on the same footing as the basic duties of excise under the Central Excises and Salt Act, 1944. The Fourth Commission, therefore, suggested that the resort by the Union Government to special excises should not be the rule but the exception. 12

The special excise duties having been introduced for the first time in March 1963 were continued to be levied under the subsequent Finance Acts. When the question of their sharing

with the States was discussed before the Fifth Commission, the Government of India represented that the need for such duties had not disappeared. They referred to the essential requirements of the Union arising from the increased defence expenditure, the necessity of subsidising exports and the cost of the Central Police Force. They urged that the percentage share of the States in the excises, whether or not including the special excises, should be so fixed as not to cut into the essential needs of the Union.

The Fifth Finance Commission concurred with their immediate predecessors that the special excises should not be the rule but the exception. However, the Commission opined that if these duties were continued on a long term basis it would be desirable to include them along with other duties in the divisible pool. This would, according to the Fifth Commission, fulfil the main purpose of securing a common interest of the Union and the States in the whole field of excise taxation which had been kept in view by the Third and Fourth Commissions while making their recommendations in this regard. The Fifth Commission, therefore, considered desirable, in principle, the inclusion of special excises in the divisible pool. However, in view of the inclusion of advance tax into the distributable proceeds of income-tax on the revised basis, which resulted in substantial increase in States share in income tax proceeds, the Commission deferred the inclusion of special excises in the divisible pool until 1972-73. They recommended that if such special duties were continued till that year, they should be included in the divisible pool from the year 1972-73. Taking account of the resources and expenditure of both the Government of India and the States and the estimated yield from excise duties, the Fifth Commission did not disturb the States share of 20 per cent in the divisible proceeds of the Union excises.¹³

As regards the distribution of the States' share inter se, the approach of the Fifth Commission was somewhat, similar to

their immediate predecessors. However, the Commission contended that the purpose of devolution was to augment the resources of States in the equitable manner to enable them to meet their growing needs. Such needs depended mainly on the size of the States' population, their relative income and resources and their levels of economic development. Keeping this in mind the Commission considered the principle of contribution, as inappropriate, in the distribution among States inter se, of a tax that was shared on a discretionary basis, which was a case with Union excise duties. They concurred with the Second Commission that the factor of consumption, in the matter, would operate to the disadvantage of less-urbanised States which were not in a position to raise revenues from sales tax to the same extent as more urbanised States. The Commission, therefore, did not favour the consumption factor. Instead, they observed that the distribution should be based mainly on population basis and of the remaining 20 per cent on the basis of economic and social backwardness of the States. Though, the Commission adhered to the Fourth Commission's ratio formula, but their construction of the index of social and economic backwardness of the States differed from that evolved by the latter. The Fifth Commission took the following six factors, in equal weight, to construct the index of social and economic backwardness:

(i) Scheduled tribes population;
(ii) Number of factory workers per lakh population;
(iii) Net irrigated area per cultivator;
(iv) Length of railways and surfaced roads per 100 square kilometers;
(v) Shortfall in number of school-going children as compared to those of a school going age; and
(vi) Number of hospital beds per 1,000 population.

The Commission recommended that out of the total share of the States in the proceeds from Union excise duties:

(1) 80 per cent should be distributed on the basis of population of respective States;

---

14. Id. at 35.
15. Id. at 36.
16. Ibid.
(ii) The remaining 20 per cent be distributed in the following manner:

(a) Two-third should be distributed among States whose per capita income was below the average per capita income of all States, in proportion to the shortfall of the State's per capita income from all States' average multiplied by population of the respective State.

(b) One-third should be distributed among all the States according to the integrated index of backwardness on the basis of the criteria given above.

The share of each State was worked out in accordance with the above formulae. The Fifth Commission used the inverse of the second, third and the fourth indicators after applying some moderation in the case of States where an indicator was less than one-third or more than three times of the average of all the States and combined them with equal weightage to each along with the remaining indicators. But the manner of bringing into the States' share the moderating element was not made known by the Commission. In the table below is shown the share of the individual States in the divisible revenues from Union excise duties under the recommendations of the Fifth Commission.

**Table V(13)**

State-wise distribution of divisible pool of Union Excises

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>States</th>
<th>States share</th>
<th>Sr. No.</th>
<th>States</th>
<th>States share</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Andhra Pradesh</td>
<td>7.15</td>
<td>9</td>
<td>Maharashtra</td>
<td>7.93</td>
</tr>
<tr>
<td>2</td>
<td>Assam</td>
<td>2.51</td>
<td>10</td>
<td>Mysore</td>
<td>4.65</td>
</tr>
<tr>
<td>3</td>
<td>Bihar</td>
<td>13.61</td>
<td>11</td>
<td>Nagaland</td>
<td>0.08</td>
</tr>
<tr>
<td>4</td>
<td>Gujarat</td>
<td>4.17</td>
<td>12</td>
<td>Orissa</td>
<td>4.72</td>
</tr>
<tr>
<td>5</td>
<td>Haryana</td>
<td>1.49</td>
<td>13</td>
<td>Punjab</td>
<td>2.17</td>
</tr>
<tr>
<td>6</td>
<td>Jammu &amp; Kashmir</td>
<td>1.12</td>
<td>14</td>
<td>Rajasthan</td>
<td>5.28</td>
</tr>
<tr>
<td>7</td>
<td>Kerala</td>
<td>4.28</td>
<td>15</td>
<td>Tamil Nadu</td>
<td>6.50</td>
</tr>
<tr>
<td>8</td>
<td>Madhya Pradesh</td>
<td>8.48</td>
<td>16</td>
<td>Uttar Pradesh</td>
<td>18.82</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>17</td>
<td>West Bengal</td>
<td>6.84</td>
</tr>
</tbody>
</table>

(Source: Report, Fifth Finance Commission, 37, 1969)
The Fifth Finance Commission, though, enlarged the States' divisible pool of Union excises by the addition of special duties of excise but the regulatory duties were kept outside the scheme of sharing. One reason for this exclusion might be the meagre yield from these duties which was nil in 1970-71. But the influx of refugees from Bangladesh and hostilities with Pakistan created a new situation in 1971. To meet the increased expenditure, the Government of India invoked section 12 of the Finance Act of 1971 and levied regulatory duties of excise on certain products such as steel, iron and steel products, copper, zinc, aluminium and unmanufactured tobacco. These duties were replaced by auxiliary duties on excisable goods under the Finance Act of 1973. The Act specifically provided that the duties were levied for the purpose of the Union and the proceeds therefrom would not be distributed among the States.

In their representations to the Sixth Commission, the State Governments argued that, in pith and substance, auxiliary duties were indistinguishable from basic duties of excise. They apprehended that the separate entity of these duties might encourage the Centre to continue with them and raise additional revenues through increasing rates and coverage of these duties rather than the basic duties of excise. The Commission also recognised the logic of their contention. The Commission observed that the Centre might levy excise duties in a form not shareable with the States, but resort to such practice should be justified only under certain special circumstances. Limiting such eventuality to two or three years at the most, the Commission recommended that if the duties were continued, the revenue from them should be brought within the divisible pool from 1976-77 onwards. This the Commission said

17. The duties could be levied under the Finance Acts. The purpose of the provision being to give to the Executive, powers to vary rates of duties on any item within certain limits.
19. The provision empowered the Union Government to levy the duty.
would enable the Centre to meet their pressing needs in the immediate future and at the same time would allay the States' apprehension that the auxiliary duties were resorted to, to deprive them of their legitimate share in the growing revenue from Union excise duties.

The State Governments, as usual, pressed for augmentation of the divisible pool of the Union excise duties, particularly in view of the higher buoyancy of the excises in comparison to income tax. In this demand, even the backward States, which could get more revenue in the form of grants under Article 275, had the divisible pool been kept at a lower level, joined the advanced States and preferred larger devolution through share of excise duties.

The Sixth Commission took note of the demands made by the States and the needs of the Centre. They had to strike a balance between the two. The Commission also realised that enlargement of the divisible pool had further widened the gulf between the 'surplus' and 'deficit', States, for it conferred disproportionately larger benefits on surplus States than on the deficit States. It had largely been due to inter se allocation continued to have been undertaken predominantly on population basis. To ensure equity in the aggregate transfer of resources as between the 'surplus' and 'deficit' States, and taking into account other relevant considerations, the Commission recommended no increase in the States' share of Union excises and retained it at 20 per cent as recommended by their immediate predecessors. In addition, the Commission recommended that 20 per cent of the net proceeds of auxiliary duties of excise should be shared with the States from 1976-77 onwards. Revenues from cesses on excisable commodities levied under special enactments was still kept outside the shareable pool.  

The distribution of the States' share in the excise divisible pool among the States inter se, presented the same difficulties as experience by the earlier Commissions. There was wide divergences in the approach taken by the States and each was inclined to put forward a formula that favoured it the most. Weightage for relative economic backwardness had by then come to be accepted as a legitimate criterion in the distribution of States' share of the excises. But some of the States vigorously argued that such a factor could not be a relevant considerations in the distribution of Central taxes. These States were of the view that the distribution of excises should be related exclusively to non-discriminatory criteria such as population or consumption and any special help that might be considered necessary should be extended to the backward States through the mechanism of grants-in-aid. But the Commission rejected this point of view and observed that "the objective of rectifying, to the extent possible, regional imbalances should be recognised as a distinct criterion in determining the principles of fiscal transfers in any federation."21 They thus addressed themselves to evolve a scheme of devolution which, though, might not completely redress regional imbalances but, could make a modest contribution to the process of elimination of existing disparities.

The Commission, having laid down the fundamentals of their approach, considered a number of indicators for the measurement of relative economic backwardness of the States. The assignment of weightage among the different indicators was an intractable issue. The Commission considered, however, that per capita income could be the best possible yardstick for the measurement of the levels of development in the States. They, therefore, took it as the sole indicator in assessing the relative economic position of the different States.22 The Commission also abandoned the 'cumulative index' of economic poverty used by the Fifth Commission for the distribution of excise revenue

21. Ibid.
22. Id. at 16.
The Fifth Commission had categorised the States into two classes, namely, the advanced and the backward. This classification adversely affected those States whose per capita income happened to be just above the dividing line. The Sixth Commission also did not favour the allocation of a portion of the proceeds of Union excises, exclusively to the backward States as was the case under the Fifth Commission's recommendations. Instead, they recommended a new formula. According to this formula, 25 per cent of divisible revenue from excises was allocated on the basis of weighed per capita incomes inversely related to the gap between the highest per capita State income and that of the State in question, multiplied by the latter's population (according to 1971 census). The balance of 75 per cent was recommended to be distributed on the basis of population.

The recommendations of the Sixth Commission may be summed up. A sum equivalent to 20 per cent of the net proceeds of Union duties of excise on all articles levied and collected in each year under their report, excluding auxiliary duties and cesses levied under Special Acts and earmarked for special purposes, were to be paid to the States during the years 1974-75 and 1975-76; during the years 1976-77 to 1978-79, the States were to receive 20 per cent of the net proceeds including auxiliaries duties also; among the States, inter se, the amount was to be distributed in accordance with the proportion given in Table V(14).

23. Id. at 17.
### Table V(14)

State-wise distribution of divisible pool of Union Excises

(Figures in percentages)

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>States</th>
<th>States share</th>
<th>Sr. No.</th>
<th>States</th>
<th>States share</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Andhra Pradesh</td>
<td>8.16</td>
<td>11</td>
<td>Maharashtra</td>
<td>8.58</td>
</tr>
<tr>
<td>2</td>
<td>Assam</td>
<td>2.71</td>
<td>12</td>
<td>Manipur</td>
<td>0.21</td>
</tr>
<tr>
<td>3</td>
<td>Bihar</td>
<td>11.47</td>
<td>13</td>
<td>Meghalaya</td>
<td>0.19</td>
</tr>
<tr>
<td>4</td>
<td>Gujarat</td>
<td>4.57</td>
<td>14</td>
<td>Nagaland</td>
<td>0.11</td>
</tr>
<tr>
<td>5</td>
<td>Haryana</td>
<td>1.53</td>
<td>15</td>
<td>Orissa</td>
<td>4.06</td>
</tr>
<tr>
<td>6</td>
<td>Himachal Pradesh</td>
<td>0.63</td>
<td>16</td>
<td>Punjab</td>
<td>1.87</td>
</tr>
<tr>
<td>7</td>
<td>Jammu &amp; Kashmir</td>
<td>0.90</td>
<td>17</td>
<td>Rajasthan</td>
<td>5.00</td>
</tr>
<tr>
<td>8</td>
<td>Karnataka</td>
<td>5.45</td>
<td>18</td>
<td>Tamil Nadu</td>
<td>7.43</td>
</tr>
<tr>
<td>9</td>
<td>Kerala</td>
<td>3.86</td>
<td>19</td>
<td>Tripura</td>
<td>0.30</td>
</tr>
<tr>
<td>10</td>
<td>Madhya Pradesh</td>
<td>8.15</td>
<td>20</td>
<td>Uttar Pradesh</td>
<td>17.03</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>21</td>
<td>West Bengal</td>
<td>7.79</td>
</tr>
</tbody>
</table>


The Sixth Commission, thus, gave larger weightage to the relative poverty of States - 25 per cent as against 20 per cent recommended by their predecessors. The formula enunciated by the Sixth Commission also contained a better element of equalisation. But the Commission did not succeed in their attempt of eliminating existing disparities. It is evident from the Table V(15) given at page 408 that several States, though backward by any criterion, got a reduced share in comparison to what they received under the Fifth Commission's recommendations. The State of Bihar lost nearly two and a half per cent under the new formula. The State of Uttar Pradesh, another poor State, lost nearly two per cent. Other poorer States, which also were affected under the Sixth Commission's recommendations were Jammu and Kashmir, Madhya Pradesh, Orissa and Rajasthan. Instead, this formula benefitted several richer States. Of the eight States having per capita income higher than the all-India average, Gujarat, Haryana, Maharashtra, Tamil Nadu and West Bengal received larger shares than what they got under the Report of Fifth Commission.
**Table V(15)**

Percentage share of the States in Union Excise Duties under the Fifth and Sixth Finance Commissions

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>States</th>
<th>As recommended by Fifth F.C.</th>
<th>As recommended by Sixth F.C.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Andhra Pradesh</td>
<td>7.15</td>
<td>8.16</td>
</tr>
<tr>
<td>2.</td>
<td>Assam</td>
<td>2.51</td>
<td>2.71</td>
</tr>
<tr>
<td>3.</td>
<td>Bihar</td>
<td>13.81</td>
<td>11.47</td>
</tr>
<tr>
<td>4.</td>
<td>Gujarat</td>
<td>4.17</td>
<td>4.57</td>
</tr>
<tr>
<td>5.</td>
<td>Haryana</td>
<td>1.49</td>
<td>1.53</td>
</tr>
<tr>
<td>6.</td>
<td>Himachal Pradesh</td>
<td>-</td>
<td>0.63</td>
</tr>
<tr>
<td>7.</td>
<td>Jammu and Kashmir</td>
<td>1.12</td>
<td>0.90</td>
</tr>
<tr>
<td>8.</td>
<td>Karnataka</td>
<td>4.65</td>
<td>5.45</td>
</tr>
<tr>
<td>9.</td>
<td>Kerala</td>
<td>4.28</td>
<td>3.86</td>
</tr>
<tr>
<td>10.</td>
<td>Madhya Pradesh</td>
<td>8.48</td>
<td>8.15</td>
</tr>
<tr>
<td>11.</td>
<td>Maharashtra</td>
<td>7.93</td>
<td>8.56</td>
</tr>
<tr>
<td>12.</td>
<td>Manipur</td>
<td>-</td>
<td>0.21</td>
</tr>
<tr>
<td>13.</td>
<td>Meghalaya</td>
<td>-</td>
<td>0.19</td>
</tr>
<tr>
<td>14.</td>
<td>Nagaland</td>
<td>0.08</td>
<td>0.11</td>
</tr>
<tr>
<td>15.</td>
<td>Orissa</td>
<td>4.72</td>
<td>4.06</td>
</tr>
<tr>
<td>16.</td>
<td>Punjab</td>
<td>2.17</td>
<td>1.87</td>
</tr>
<tr>
<td>17.</td>
<td>Rajasthan</td>
<td>2.17</td>
<td>1.87</td>
</tr>
<tr>
<td>18.</td>
<td>Tamil Nadu</td>
<td>6.50</td>
<td>7.43</td>
</tr>
<tr>
<td>19.</td>
<td>Tripura</td>
<td>-</td>
<td>0.30</td>
</tr>
<tr>
<td>20.</td>
<td>Uttar Pradesh</td>
<td>18.82</td>
<td>17.03</td>
</tr>
<tr>
<td>21.</td>
<td>West Bengal</td>
<td>6.84</td>
<td>7.79</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td>100.00</td>
<td>100.00</td>
</tr>
</tbody>
</table>
The Seventh Commission attached special importance to the role of Union excise duties in the scheme of transfer of financial resources to the States. Their whole approach was based on the proposition that 'tax-sharing' should constitute the bulk of the fiscal transfers to the States, reducing the element of grants-in-aid under Article 275 to a residual position. They also attempted to ensure that after the fiscal transfers the Commission recommended, "the Centre should be left in a sufficiently comfortable position to meet all the demands on its resources". The Commission cast their attention to the existing methods of financing the Plan, which included not only transfers to the States by way of Central assistance for their Plans, but also the possible requirements for budget support to the Centres own Plans and that of the Union Territories. The Commission also took note of the transfer to the States, of the entire non-shareable portion of the net proceeds of the excise duty on generation of electricity with effect from 1st April, 1979. Keeping these considerations in mind, the Seventh Commission enlarged the divisible pool of Union excises to 40 per cent of the net proceeds of duties levied on all the commodities. The net proceeds of the excise duties which were made shareable were to include excise duties levied on all the commodities and other excise duties whether they were designated as special or regulatory or by any other name. But these were to exclude the duty levied on the generation of electricity and additional duties in lieu of sales tax for which the Commission provided separately. The cesses levied under special Acts and earmarked for special purposes were still kept outside the divisible scheme.

The Commission then took up the question of the distribution of the excise divisible pool among the States inter se. In this respect, they referred to the growing concern in the country over the widening economic disparities between the States. The earlier

25. The duty was levied under the Finance Act 1978. Under the pressing demand made by the States the Central Government was moved to transfer the entire net proceeds of the duty to the States. Report, Seventh Finance Commission, 65, 1978.
26. These duties have been dealt with separately. See supra.
Commissions had been distributing the excise proceeds with the avowed purpose of reducing the imbalance among the States. They had done this by distributing some part of the excise proceeds on the basis of relative backwardness of the States, but their contribution in this regard had been only modest. The Seventh Commission indicated their aim to do more in this direction. They recorded that the reasons for such inter-State imbalance could be found not only in the weakness of the financial strength of the States but also in cultural and institutional factors which could facilitate or retard economic growth. The potential for mobilising financial resources, which could have a decisive influence in favour of growth, was not the same in States with different levels of development and domestic products. The Commission recognised that "the States which were less favourably placed in regard to their resource potential should be specially helped in order to place them in a position where they could also take steps more readily for the betterment of the people living in those States". They, therefore, proposed to realise the basic objective of their scheme of fiscal transfer by a combination of different and appropriate factors.

The Commission considered various factors to be built into the scheme of distribution of divisible pool of Union excises among the States inter se. Population as a determinant of the share of States, they held, was merely a scale factor and therefore could not be the sole determinant. For the reason, the Commission thought it desirable to adopt the overall indicators of backwardness such as per capita income and the population of people below the poverty line, instead of partial indicators such as the level of schooling, health services and road mileage, etc. They focussed their attention to the poverty problem of some of the States and decided to give some weight to this factor. Another factor the Commission considered appropriate was the revenue-raising potential of the States.  

28. Ibid.
Having based their approach on these considerations, the Seventh Commission proposed that the share of the States in the divisible pool should be determined giving equal weight to population factor, the inverse of the per capita State Domestic Product, the percentage of the poor in each State and a formula for revenue equalisation. In accordance with the principle so adopted, the Commission worked out the relative share of all the States in terms of percentages.

The Commission, finally, recommended that the entire net proceeds of the Union excise duty on generation of electricity should be made over to the States in proportion to the amount equal to the collection in or attributable to that State. Further, that 40 per cent of the balance of the net proceeds of excise duties levied and collected on all other articles should be distributed among the States on the basis of the percentages given in Table V(16). The cesses levied under special Acts and earmarked for special purposes were still kept outside the divisible scheme.

It may be noticed from the totals in Table V(16) that the Seventh Commission has been able to level up the disparities among the States in their scheme of distribution of Union excise duties. The States with relatively low per capita income (e.g. Uttar Pradesh, Bihar, Rajasthan, Orissa, Madhya Pradesh) received greater percentage share than what they received under the formula evolved by the Sixth Commission, while the percentage share of States with higher per capita income (e.g. Maharashtra,

29. It was determined according to the method evolved by Prof. Raj Krishna, a member of the Commission.
30. To work out this formula, the Commission computed the per capita revenue potential of each State with reference to the average per capita SDP for the triennium 1973-76. The per capita average revenue of each State (tax and non-tax both) for 1975-76 and 1976-77, were regressed on the average per capita income excluding the five atypical States of Manipur, Meghalaya, Nagaland, Sikkim and Tripura. The per capita revenue was thus derived and its distance for each State from the highest per capita revenue that of Punjab - was multiplied by population of the State (1976) to come to the formula.
<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>States</th>
<th>Share of the State Excluding Sikkim</th>
<th>Including Sikkim</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Andhra Pradesh</td>
<td>7.696</td>
<td>7.691</td>
</tr>
<tr>
<td>2</td>
<td>Assam</td>
<td>2.793</td>
<td>2.793</td>
</tr>
<tr>
<td>3</td>
<td>Bihar</td>
<td>13.025</td>
<td>13.021</td>
</tr>
<tr>
<td>4</td>
<td>Gujarat</td>
<td>4.103</td>
<td>4.101</td>
</tr>
<tr>
<td>5</td>
<td>Haryana</td>
<td>1.177</td>
<td>1.177</td>
</tr>
<tr>
<td>6</td>
<td>Himachal Pradesh</td>
<td>0.521</td>
<td>0.521</td>
</tr>
<tr>
<td>7</td>
<td>Jammu &amp; Kashmir</td>
<td>0.839</td>
<td>0.839</td>
</tr>
<tr>
<td>8</td>
<td>Karnataka</td>
<td>4.877</td>
<td>4.876</td>
</tr>
<tr>
<td>9</td>
<td>Kerala</td>
<td>4.036</td>
<td>4.035</td>
</tr>
<tr>
<td>10</td>
<td>Madhya Pradesh</td>
<td>8.727</td>
<td>8.725</td>
</tr>
<tr>
<td>11</td>
<td>Maharashtra</td>
<td>6.633</td>
<td>6.632</td>
</tr>
<tr>
<td>12</td>
<td>Manipur</td>
<td>0.218</td>
<td>0.218</td>
</tr>
<tr>
<td>13</td>
<td>Meghalaya</td>
<td>0.200</td>
<td>0.200</td>
</tr>
<tr>
<td>14</td>
<td>Nagaland</td>
<td>0.097</td>
<td>0.097</td>
</tr>
<tr>
<td>15</td>
<td>Orissa</td>
<td>4.682</td>
<td>4.682</td>
</tr>
<tr>
<td>16</td>
<td>Punjab</td>
<td>1.226</td>
<td>1.226</td>
</tr>
<tr>
<td>17</td>
<td>Rajasthan</td>
<td>4.813</td>
<td>4.813</td>
</tr>
<tr>
<td>18</td>
<td>Sikkim</td>
<td>-</td>
<td>0.028</td>
</tr>
<tr>
<td>19</td>
<td>Tamil Nadu</td>
<td>7.641</td>
<td>7.637</td>
</tr>
<tr>
<td>20</td>
<td>Tripura</td>
<td>0.373</td>
<td>0.373</td>
</tr>
<tr>
<td>21</td>
<td>Uttar Pradesh</td>
<td>18.293</td>
<td>18.290</td>
</tr>
<tr>
<td>22</td>
<td>West Bengal</td>
<td>8.028</td>
<td>8.025</td>
</tr>
</tbody>
</table>

Total 100.000 100.000

Revenue from Union excise duties has come to stay as the major vehicle of the tax devolution from the Union to the States in India. Factors backing the dominance of excise duties in the Central tax structure are too obvious to be gone into here. In a developing economy it could not have been otherwise. From the point of view of federal fiscal readjustment, Union excise duties assume a double significance. One is the buoyancy of this source of finance and thus fixed percentage shares come to be associated with quantitative shares, the growth rates in which are greater than would be true for any other shareable tax. Secondly, and apart from allocation of the proceeds of "assigned taxes"as between Income tax and Union excise duty, the Finance Commissions have picked up the latter for their experimentation with equalisation.

It is submitted that there has been an element of vagueness as regards the basis on which excise duties should be shared between the Centre and the States as also in the determination of States' share inter se. Element of fiscal need has been an important factor in assigning the States a share in the proceeds from this duty. At the same time, the Finance Commissions have not been very generous in recommending large shares to the States. Though the successive Finance Commissions widened the coverage of duties to be shared, the percentage of proceeds going to the States was not increased. The Seventh Finance Commission, however, attached special importance to the role of Union excise duties in the scheme of transfer of resources to the States. The Commission believed that 'tax-sharing' should constitute the bulk of the fiscal transfers to the States, thus reducing the element of grants-in-aid to a residual position. It thus raised the States' share in the excise proceeds from 20 to 40 per cent. While determining the relative shares of the States, population has been an important proxy for most of the criteria - for example, both for 'fiscal need' and 'contribution'. Successive Finance Commissions have also shifted their stand regarding the choice
between fiscal need and backwardness as the appropriate basis
for division of the excise proceeds, the determinants of
economic backwardness and the relative weightage to be assigned
to different components thereof.

Conclusion

It has been generally assumed that the object of a
Finance Commission is to evolve a scheme of transfer of financial
resources from the Centre to the States, so designed as to place
each State in a position where it can be expected to maintain
financial equilibrium during the period covered by the report of
the Commission. The successive Finance Commissions have asserted
that the distribution of resources should be so made as to reduce
imbalances among the States and proclaimed that they directed
their special attention to ironing out disparities. But on the
basis of the above analysis of the working of the Finance
Commissions, it can be concluded that equalisation has not
figured predominantly in their approach to the distribution of
divisible pool of shared taxes and duties. Population has been
used the main criterion in the allocation of net proceeds of the
shared taxes among the States inter se. By itself, population is
only an imperfect measure of fiscal needs of the States and
is neutral so far as inter-State equalisation is concerned. It
is, at best, a basis which can prevent increase in disparities.
It is sometimes argued that if the revenue collected through a
progressive tax on incomes is distributed among the States on the
basis of population, the resulting distribution automatically
contains an element of equalisation, the poorer States will be
receiving per capita share equal to that of the richer States
though the latter have contributed more to the Central fisc.
But, such a distribution has an equalisation bias only when compared
with the principle of contribution and when viewed against the
principle of fiscal need, the population factor ceases to be an
equaliser. Again, distribution on the basis of population would
lose its desired redistributive effect because some of the
relatively developed States are also more populous. For instance, the Fifth Finance Commission fixed the percentage share of Maharashtra and West Bengal in the divisible pool of income tax to 11.34 and 9.11 respectively as against 9.99 of Bihar and 7.09 of Madhya Pradesh. The outcome of having population as the main criterion has been described by Prof. U.K. Hicks, an International authority on Public Finance as:

The allocation recommended by the Indian Finance Commissions tend to be disequalising. Relatively rich States such as West Bengal, Maharashtra, Gujarat and Madras receive the biggest slice in the share out, while poor States such as Bihar and Orissa are low down the list. This distribution is presumably due to continued use of the idea of derivation and to the high weightage given to crude population. If instead attention were paid to per capita incomes the result would be very different.

Collection base is a criterion which contributes to the perpetuation rather than correction of disparities and does not seem to have any major force of argument behind it except the bargaining position of the States with larger contribution to the Central revenue. It amounts to some reward to the better off States and punishment to States with low tax base. Thus, if the satisfaction of fiscal need has been the objective, the Commissions have failed to come up to the expectations.

'Fiscal needs' is a relative concept and has always to be considered in relation to the availability of finances of different State Governments. Low income States, because of their smaller tax base will have to levy higher per capita taxes to maintain their public services at a level equal to that obtaining in the higher income States. This being so, the principle of 'fiscal needs' demands that the low income States should be given higher per capita shares of Central transfers. It may, therefore,

be suggested that a criterion like population share of a State weighed by relative distances of State's *per capita* income, made applicable to the larger part of the devolution of resources by the Finance Commission, particularly in the distribution of the net proceeds of income tax and Union excise duties, may prove more effective in the direction of reducing disparities in the levels of living and development among different States.