

CHAPTER 7

ADDITIONAL DUTIES OF EXCISE IN LIEU OF SALES TAX ON SUGAR, TOBACCO AND TEXTILES

61. Paragraph 4(d) of the Order of the President requires us to examine the present distribution scheme in regard to the proceeds of additional duties of excise in lieu of sales tax on cotton fabrics, silk fabrics, rayon or artificial silk fabrics, woollen fabrics, sugar and tobacco (including manufactured tobacco) and to recommend changes, if any, in the principles of distribution. We have however, to ensure that whatever distribution scheme we suggest does guarantee to each State an amount, in each of the financial years 1966-67 to 1970-71, which shall not be less than the revenue realized from the levy of sales tax on these items in the financial year 1956-57 in that State.

62. Before going into the principles of distribution, we would like to state briefly the background and the rationale of the scheme of additional excises. This is important because several non-official organizations and individuals have urged that we should on our own recommend an extension of the scheme of substitution of sales taxes by additional duties of excise to several other commodities, important ones being paper and related items, rubber goods, glass and glass ware, steel products and mineral oils and related items.

63. 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 extending to a larger number of commodities the scope of the present agreement that the Union Government would levy additional duties of excise in lieu of State sales tax.

64. The present arrangement, under which the State Governments do not levy any sales tax on textile, sugar, and tobacco owes its origin to the consensus of opinion that emerged at a meeting of the National Development Council held in December 1956. In anticipation of the Council's decision being implemented by an Act of Parliament, the President asked the Second Finance Commission to make recommendations as to the principles which should govern the distribution among the States of the net proceeds of the additional duties and

the amounts which should be assured to each one of them as the income derived by them from such taxes during the financial year 1956-57. The Council's decision and the recommendations of the Second Finance Commission were implemented through the Additional Duties of Excise (Goods of Special Importance) Act, 1957. The first schedule of the Act prescribed the rates of additional duties of excise and the second the scheme of the distribution of the net proceeds among the States. The Act does not state that the States shall not levy sales taxes on the specified commodities, but merely provides that if in any year any State levies and collects a tax on the sale or purchase of such commodities, no sums shall be paid to that State in that year by way of share out of the net proceeds of the additional duties of excise, unless the Central Government by special order otherwise directs.

65. A scheme of centrally levied additional duties of excise in replacement of States' sales taxes combined with a distribution scheme is essentially in the nature of a tax rental agreement. It can come into operation or be expanded in coverage only if the Union and the States agree amongst themselves. The Finance Commission comes into the picture only for the purpose of determining the principles of distribution of the net proceeds. The present scheme has been in operation for almost eight years. During this period certain merits and disadvantages of the scheme have come to light. At present, on the one hand there is a demand from the trade and other interests that the scheme be expanded so as to cover some additional items and on the other almost all the States have argued before us that the operation of the scheme has not benefited them to the extent they initially hoped and that they would be disinclined to get the scheme expanded in coverage unless certain safeguards are provided to protect not only their existing revenues but also the prospective increases in their revenues. Some States have second thoughts even about the continuance of the existing arrangements. We deal with these aspects later in this Chapter.

66. The rationale behind the currently operative scheme of additional excises in lieu of sales taxes is that if the tax is levied at the first point, the chances of evasion would be minimized and that a uniform levy at the point of production of such mass consumption items as sugar, tobacco and textiles would be welcome to the trade, industry, and the consumer as it would save them from the administrative complexities involved in the collection and payment of sales

consumption, particularly consumption of commodities subject to Union excise duties.

56. The proposal for devising the distribution scheme entirely on the basis of 'population' is supported on the ground that population of a State represents the 'needs' of the State and since the sharing of excises with the States is not compulsory under the Constitution and is only permissive, the proceeds of excises should be so distributed between the States that each gets according to its needs. It may also be argued that in the case of some commodities, population is a rough index of total consumption. There is some substance in both these arguments but we do not agree with the view that population is the only index of the needs of a State. There are other factors which are equally relevant. In our view while population should be the major factor for determining the distribution, relative economic and social backwardness of States should also be taken into account.

57. Before we go to define the factors that we have taken into account for determining the relative backwardness of each State, we would like to deal with the suggestion of certain States that following the lead given by the last Finance Commission, we should also take into account the factor of relative financial weakness as measured in terms of revenue deficits. We have stated at the very beginning of our Report that we do not think that it is proper to bring in the element of grant into the distribution scheme of divisible taxes. In our view such non-plan revenue deficits as are left in certain States, after taking into account the share of central taxes on the basis of general and uniform principles applicable to all States, should be covered by explicit grants under article 275 rather than by adjustments in the formulae for distribution of taxes. Another point on which we wish to clarify our stand is that we distinguish between economic and social backwardness of a State and its financial weakness. 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. There are States of this type. In the distribution of proceeds of excise duties we have not taken financial weakness but have taken economic and social backwardness as indicated by the following factors:

- (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.

58. We consider that it would be adequate if the factor of relative economic backwardness is given weight equivalent to 20 per cent. For the other factor, namely population, we would recommend weight equivalent to 80 per cent. We have worked out a schedule of distribution on this basis, which is set out in the following paragraph.

59. We recommend that under Article 272 of the Constitution, in each of the years 1966-67 to 1970-71, a sum equal to 20 per cent of the net proceeds of the 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, should be paid out of the Consolidated Fund of India to the States and distributed among them in the following proportion:

SCHEDULE OF DISTRIBUTION

<i>States</i>	<i>Percentage</i>
1. Andhra Pradesh	7.77
2. Assam	3.32
3. Bihar	10.03
4. Gujarat	4.80
5. Jammu and Kashmir	2.26
6. Kerala	4.16
7. Madhya Pradesh	7.40
8. Madras	7.18
9. Maharashtra	8.23
10. Mysore	5.41
11. Nagaland	2.21
12. Orissa	4.82
13. Punjab	4.86
14. Rajasthan	5.06
15. Uttar Pradesh	14.98
16. West Bengal	7.51
TOTAL ..	100.00

60. We deal in a later Chapter with the topic covered by para. 4(e) of the Order of the President. The scheme of distribution outlined in this Chapter is in consonance with our views expressed there.

tax. It was recognized from the very beginning that no State should suffer because of the centralization of the levy, and hence each State was assured that it would continue to get annually from the Centre, by way of its share out of the proceeds of additional duties of excise, at least that amount which it raised in 1956-57 in the form of sales tax on commodities brought within the scheme of additional duties of excise. Our terms of reference as well as those of the Second and the Third Finance Commissions refer specifically to this assurance.

67. It has been suggested to us that the assurance of the guaranteed amounts is an indirect recognition of the logic that in the distribution of the net proceeds, the accent should be on compensating each State for the loss that it has suffered in its revenue by surrendering its right to levy sales tax on certain commodities. The distribution formula should be so devised that each State gets almost the same amount as it would have got, had sales taxes on these commodities been in operation with the same order of incidence as the additional excise duties. Wider considerations such as needs of the States, relative economic and social backwardness and population, it has been emphasized, have absolutely no relevance so far as the determination of a distribution scheme relating to proceeds of additional duties of excise is concerned.

68. We first deal with the question of guaranteed amounts. In our terms of reference, it has been clearly stated that the share accruing to each State shall not be less than the revenue realized by that State in the year 1956-57 from the levy of the sales tax on the commodities which are currently subject to these additional duties of excise. We have thus to estimate the yield in each State in 1956-57 on such commodities.

69. The Second Finance Commission adopted an elaborate procedure for working out estimates of yield for the year 1956-57. It obtained from each State figures of collection of sales taxes for the years 1954-55 to 1956-57 in respect of the commodities brought within the additional excise scheme. It also explored the possibility of working out the estimates from the consumption data as available from the Fourth Round of the National Sample Survey, the estimates prepared by the Textile Commissioner, the statistics of the clearance or off-take of sugar prepared by the Sugar and Vanaspati Directorate and the statistics of consumption of tobacco contained in the report on the marketing of tobacco prepared by the Agricultural Marketing

Directorate of Government of India. Taking all the relevant statistics into account, that Commission worked out its own estimates of the likely revenue. These were primarily based on consumption estimates but a corrective on the basis of population was also applied. It was the view of that Commission that the figures taken by it, which were a mixture of consumption-based yield and population, were the nearest possible approximation to the income of each State from sales taxes on the relevant commodities during the financial year 1956-57. The Third Finance Commission accepted the estimates worked out by the Second Finance Commission but added to the figure of each State marginal sums representing the estimated yield in 1956-57 on account of sales taxes on silk fabrics.* We have not attempted to work out a fresh set of estimates for the year 1956-57, as we feel that because of lapse of time a task of this nature will be even more difficult now than it was at the time when the Second Finance Commission framed its estimates. We, therefore, accept the estimates worked out by the Second Finance Commission, and later adjusted by the Third Finance Commission to take into account the bifurcation of the old Bombay State as also imposition of additional excise duty on silk fabrics.

70. We examined the issue whether out of the net proceeds of additional duties of excise, the total of the guaranteed amounts should first be set apart and then the balance be distributed in a certain manner, or the entire net proceeds should first be distributed in a particular manner and then the question of guaranteed amounts brought in. We feel that the latter procedure might create difficulties inasmuch as under certain circumstances it might happen that some States' share may fall short of the guaranteed amount. We have taken the view that the appropriate course would be the first and the more direct one, namely that of giving to each State the guaranteed amount first and then distributing the balance between different States on the basis of certain uniform principles.

71. In regard to the principles for the distribution of the balance of the net proceeds over the total of the guaranteed amounts, the Third Finance Commission considered that it would be equitable to distribute the excess collections partly on the basis of the percentage increase in the collection of sales tax in each State since the year 1957-58 when the additional excise duties were imposed and partly on the basis of

* On silk fabrics the substitution of sales taxes by additional duties of excise was made in 1961.

population. There is no indication as to the relative weightage given to these factors. In our opinion, figures for collections of all sales taxes in a State are a more direct indicator of the contribution made by each State to the divisible surplus than population. Therefore, we recommend that the distribution of the balance over the total of guaranteed amounts may be made on the basis of the proportion of sales tax revenue realised in each State to the total sales tax collections in all the States taken together. For the purpose of determining the proportion for each State, we have utilized the data relating to actual collections of sales taxes over the years 1961-62 to 1963-64.

72. During the year 1956-57 the State of Jammu and Kashmir did not have any sales tax and, therefore, the question of giving any guaranteed amount to that State does not arise. The Second Finance Commission had taken the view that since the incidence of the additional duties of excise would fall as much on the people of this State as on the people of other States, Jammu and Kashmir should be given a share out of the net proceeds. That Commission had fixed the share of Jammu and Kashmir at $1\frac{1}{4}$ per cent of the net proceeds. The Third Finance Commission increased it to $1\frac{1}{2}$ per cent. We do not consider it necessary to change the Third Finance Commission's figure.

73. Both the Second and the Third Finance Commissions had taken the view that an appropriate share of the total net proceeds should be retained by the Union Government as being attributable to Union territories, the figure recommended by both the Commissions being 1 per cent. With the establishment of Nagaland as a separate State, the President by an Order made under Section 23 of the State of Nagaland Act, 1962, assigned for the year 1964-65 and thereafter 0.05 per cent. of the net proceeds to that State. Since this percentage was taken out of the share of 1.00 per cent attributable to Union territories, in effect the share attributable to Union territories has got reduced to 0.95 per cent. We are of the view that the amount attributable to Union territories may be taken at 1.00 per cent of the total net proceeds.

74. On the basis of the principles outlined above, we recommend that in each of the years 1966-67 to 1970-71, the net proceeds of additional duties of excise on cotton fabrics, silk fabrics, rayon or artificial silk fabrics, woollen fabrics, sugar and tobacco including manufactured

tobacco, may be distributed among the States on the following basis:

- (i) A sum equal to 1.00 per cent of the net proceeds of these duties in any year may be deemed as being attributable to Union territories and may, therefore, be retained by the Centre;
- (ii) A sum equal to 1.50 per cent of the net proceeds in any year be paid to the State of Jammu and Kashmir;
- (iii) A sum equal to 0.05 per cent of the net proceeds in any year may be paid to the State of Nagaland as its share;
- (iv) Out of the remaining 97.45 per cent of the net proceeds, the following sums representing the revenue realised in 1956-57 by each respective State on account of sales taxes on the six commodities be first paid annually to the following States:—

<i>States</i>	<i>(Rs. in lakhs)</i>
Andhra Pradesh	235.24
Assam	85.08
Bihar	130.16
Gujarat	323.45
Kerala	95.08
Madhya Pradesh	155.17
Madras	285.34
Maharashtra	637.77
Mysore	100.10
Orissa	85.10
Punjab	175.19
Rajasthan	90.10
Uttar Pradesh	575.81
West Bengal	280.41
Total:	3,254.00

and (v) the difference between 97.45 per cent. of the net proceeds in any year and the total guaranteed amount of Rs. 3,254 lakhs would constitute the balance which may be distributed

among 14 States, namely all States other than Jammu and Kashmir and Nagaland, as follows:—

States	Percentage
Andhra Pradesh	7.42
Assam	1.98
Bihar	6.17
Gujarat	7.43
Kerala	5.65
Madhya Pradesh	4.62
Madras	11.13
Maharashtra	19.87
Mysore	5.21
Orissa	2.58
Punjab	5.01
Rajasthan	3.17
Uttar Pradesh	7.83
West Bengal	11.93
Total	100.00

75. Before we leave this subject, we would like to mention that the States in their representations to us have been critical of the way that the scheme of substitution of sales tax by additional duties of excise has so far been operated. Their main point of criticism is that whereas over the period 1957-58 to 1965-66, the rates of basic duties of excise on some of the items brought within the scheme have been raised, and even special duties of excise introduced, the rates of additional duties of excise have remained unchanged. If the substitution had not taken place, so runs the argument, the States would have had the opportunity of raising sales tax rates on these items and would have also benefited from the rise in prices, sales tax being an *ad valorem* levy. It is further argued that over the past eight years, sales tax revenues have shown a much higher rate of growth than the yield from the additional duties of excise and that if the scheme had not been introduced, the rate of increase in sales tax revenues from these items would have been closer to the rate for sales tax revenue on other items.

76. As against the above views of the States, it has been pointed out to us that over the period 1958-59 to 1965-66, the yield from additional duties has increased by as much as 45 per cent, the increase

in the yield from basic duties of excise on these commodities (excluding the yield from special duties of excise which fall in a distinct category) being hardly 21 per cent. The items covered under the scheme of additional duties of excise are essential consumer items; and it is not as if the States could have just gone on increasing the rates. Indeed on items of comparable nature like matches, kerosene, coal and vegetable products, the sales tax rates between 1958-59 and 1963-64 have either remained altogether unchanged or shown very little increase. An important reason why the Union Government had not revised the additional duties of excise rates with every change in basic rates is that sugar and textiles are items in the case of which often downward adjustments had to be made and the Union Government did not want that the States' revenues should be adversely affected by these downward adjustments. It is only in the case of tobacco that basic duties have been increased and never lowered. The increase in sales tax revenue in the States is *inter alia* due to enhancement of rates in the case of luxury and semi-luxury items and coverage of new items. It is argued that it would therefore not be correct to assume that the States would have managed to realize the same rate of increase in the sales tax revenue from these items as they have realized in the case of the total sales tax yield.

77. We have not thought it necessary to go into the validity of the arguments for or against the manner of the implementation of the scheme by the Union Government. We feel that if some sort of institutional arrangement existed and both the Union and the State Governments had the opportunity of explaining each others views, the implementation of the scheme would have been considerably better and misunderstandings less.

CHAPTER 8

COORDINATION BETWEEN SALES TAXES AND UNION
EXCISE DUTIES

78. This Chapter deals with paragraph 4(e) of the Order of the President in which we have been asked to make recommendations in regard to (a) the effect of the combined incidence of a State's sales tax and Union duties of excise on the production, consumption or export of commodities or products, the duties on which are sharable with the States, and (b) the adjustments, if any, to be made in the State's share of Union excise duties, if the sales tax rates levied by the State exceed certain specified ceilings.

79. This term of reference involves the determination of two issues:

- (i) Measurement of the impact of the two levies on production, consumption or export of various commodities and a finding as to the cases in which the combined incidence has an inhibiting effect on consumption, production or export; and
- (ii) in the light of the finding on (i), construction of an adjustment formula under which the share of the States out of Union Duties of excise could be reduced if the States exceeded certain specified ceilings in regard to sales tax rates.

The first issue concerns economic aspects of commodity taxation, while the second concerns devolution of taxes from the Union to the States.

80. Before going into the problems of measurement of the incidence of these two levies and their economic consequences, it may be useful to explain briefly the nature and import of these levies. Both the Union duties of excise and the sales taxes levied by the States are taxes on commodities. Although from the point of view of the incidence on the consumer, there is no essential difference between the two levies, the two taxes are not identical or interchangeable. An excise is a levy at the production point whereas a sales tax touches a commodity at one or more points of sale or purchase between the stages of production and final consumption. For

each given commodity, there can be only one stage at which the commodity completes the production process, and so an excise levy should theoretically be only at one point. Since, however, the component parts might themselves have been the subject of excise levy, an excise duty on the final product may in practice involve multiple duty on the components unless the duty is based on the value added by manufacture, as is done in some countries. In the case of sales, however, the same commodity may pass through different stages of sales, thereby exposing itself for taxation at more than one point, depending upon the system of the sales tax levy. An excise levy ends at the production point and does not take into account, even indirectly, elements of cost that are incurred after the production stage, e.g. freight, insurance, distribution charges, etc. whereas a sales tax is on a more comprehensive concept of cost and touches not merely the cost at the production point, but also subsequent elements, including profits and the excise duty itself. An excise duty in India, being a Union levy, does not differentiate between one region and another and is uniform throughout the country. On the other hand the sales tax system and the rates of sales tax differ from State to State. Again, while most of the excise duties are specific, sales taxes are *ad valorem* levies. In a phase of rising prices, other things remaining the same, the sales tax yield automatically goes up.

81. In some countries where excise duties are exclusively reserved for the Centre, the levy of sales tax by States has been held to be unconstitutional on the ground that they are substantially the same as excise duties. Similarly the question has been raised whether *ad valorem* excise duties are not really sales-taxes. But the point that needs to be noted is that although on the surface sales taxes and excises may appear to be similar in nature, they have distinguishing features. Both have a positive place in a comprehensive system of taxation and are expressly mentioned in our Constitution.

82. In the wake of developmental planning and the search for resources over the last fifteen years, both Union excise and sales tax systems have expanded considerably, in depth as well as range. In 1950-51, the aggregate yield from the two levies was roughly Rs. 128 crores, representing 1.3 per cent of the national income in that year. By 1963-64, the level had risen to Rs. 998 crores, accounting for 5.8 per cent of the national income. On the basis of 1965-66 budget estimates, the total of the receipts comes to Rs. 1135 crores.