

CHAPTER III INCOME-TAX

Taxes on income, other than agricultural income, though levied and collected by the Government of India, are compulsorily shareable between the Union and the States under Article 270(1) of the Constitution. The proceeds attributable to Union Territories and taxes payable in respect of Union emoluments, as also any surcharge which may be levied for purposes of the Union are kept out of the divisible pool by virtue of the provisions contained in Articles 270(2), 270(3), 270(4), and Article 271 of the Constitution. These Articles, when read with Article 280(3) of the Constitution, cast the following responsibilities on the Finance Commissions :—

- (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) Fixation of the shares of each of the States in the divisible pool.
- (iii) Assessment of the percentage of the net proceeds which the Union should be allowed to retain with itself as proceeds attributable to Union Territories.

2. The assignment of the net proceeds of income-tax to the States, which was fixed by the First Finance Commission at 55 per cent, was enlarged progressively by the succeeding Commissions and placed at 75 per cent by the Fourth Finance Commission. The Fifth Finance Commission retained the States' share of the net proceeds of income-tax at 75 per cent, despite the request of many State Governments for further enhancement. The Commission refrained from recommending upward revision of States' shares, among other things, on the ground that for the period covered by their award, the proceeds of the income-tax distributable among the States would for the first time be inclusive of advance tax collections and that this change would have the effect of augmenting the divisible pool.

3. Almost all the States have again pleaded before us for a significant increase in the divisible pool of income-tax. Some of the States—Andhra Pradesh, Orissa and Punjab—have argued that the entire net proceeds of income-tax should be divided among the States. Kerala proposed an increase in the share of the States to 95 per cent. Other States have also pressed for augmentation of the divisible pool ranging from 80 per cent to 90 per cent. In justification of a

further increase in the States' share of income-tax, the States have put forward two main arguments :—

- (i) The continuance, almost on a permanent basis, of Union surcharge and its recent enhancement have in effect enlarged the Centre's share of the net proceeds of the income-tax at the expense of the States.
- (ii) While in terms of the provisions of Article 271 of the Constitution, the Centre is entitled to levy a surcharge exclusively for purposes of the Union, the levy of such a surcharge should be only a transitory phenomenon. In their view, 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.

4. The State Governments have also contended that the exclusion of income-tax paid by Companies from the divisible pool since 1959-60 has deprived them of a source of revenue that is bound to be far more elastic than income-tax. The income-tax paid by Companies just before its exclusion in 1959-60 from the divisible pool stood at Rs. 68.81 crores. But for the changes made in pursuance of the Finance Act of 1959, it would have risen to Rs. 232.5 crores by 1969-70. Almost all the State Governments have gone a step further and argued that the Commission should recommend that Corporation tax should also be brought within the divisible pool through an amendment of the Constitution. They pointed out that in 1950-51 when the Constitution came into force, the yield from Corporation tax was only Rs. 40 crores as against Rs. 133 crores from income-tax, whereas in 1973-74 Corporation tax is estimated to yield Rs. 608 crores as against Rs. 650 crores from income-tax. State Governments have argued that if the framers of the Constitution had anticipated these trends in the relative rates of growth of income-tax and Corporation tax, it is extremely unlikely that they would have kept the Corporation tax out of the divisible pool.

5. In view of the explicit provisions of the Constitution, we are precluded from recommending the inclusion of the surcharge on income-tax for Union purposes and the Corporation tax in the divisible pool. But having regard to the near unanimity in the views expressed by the State Governments, we would suggest that the question of bringing Corporation tax within the divisible pool be brought up for examination before the National Development Council. There is no reason to apprehend that the inclusion of Corporation tax in the list of shareable taxes would *ipso facto* upset seriously the relative balance between Central

and State resources. The States' share of the combined divisible pool of income tax and Corporation tax could be fixed at a suitably lower level that takes note of the essential needs of the Centre.

6. As regards the States' share of the net proceeds of income tax, we agree with the earlier Commissions that the Centre which is responsible for the levy and collection of the income tax should continue to have a significant interest in it. But there are also certain other factors which should be taken into account. The Union surcharge was raised from 10 to 15 per cent in 1971-72. The addition of advance tax collections to the divisible pool, including a sum of Rs. 270 crores representing the unadjusted balances of advance tax collections up to 1966-67, had resulted in a very appreciable increase in the resources accruing to the States from their share of the income tax during the period covered by the award of the Fifth Commission. The arrear element due to advance tax collection of earlier years has now disappeared. Having regard to these and other considerations, we feel that there is a good case for a modest increase in the States' share of the divisible pool of income tax. We, therefore, recommend that the States' share of the net proceeds of income tax be raised from 75 to 80 per cent during the period covered by our award.

7. As regards the manner of distribution among the States of the percentage of the net proceeds of income tax assigned to them, the views of the States are understandably divergent. While some of the relatively advanced States such as Gujarat, Maharashtra, Tamil Nadu and West Bengal have pressed for a higher weightage for the factor of contribution ranging from 40 per cent to 50 per cent against 10 per cent at present, the other States have urged that the net proceeds of income tax should be distributed wholly on the basis of population. Some of the States have also suggested weightage for other factors such as area, proportion of Scheduled Castes and Scheduled Tribes population. Uttar Pradesh has urged that while 75 per cent of the proceeds may be distributed on the basis of population, the balance of 25 per cent should be distributed only among those States whose per capita income is below the per capita national average.

8. All the successive Finance Commissions so far have recognised population and contribution to be the only two relevant factors in the distribution of the proceeds of income tax among the States, though they have differed on the relative weightage to be accorded to these two factors. None of them has taken into account other considerations such as economic backwardness, area and proportion of Scheduled Castes and Scheduled Tribes population. We endorse this approach of the earlier Commissions both because there are advantages in our complex federal system in maintaining a reasonable measure of stability in the principles of distribution of shareable taxes and also because we are seeking to mitigate the economic disabilities of some of the States through weightage for relative economic backwardness in the distribution of

Union excise duties and through grants-in-aid for up-gradation of standards of administrative and social services.

9. We have given careful consideration to the relative weightage to be accorded to population and contribution. 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. At the same time, particularly after the exclusion of income tax paid by the Companies from the divisible pool, it cannot be denied that a small, but not clearly identifiable, percentage of personal incomes should be deemed to have purely local origin. In respect of income tax ascribable to such local incomes at least, the States can lay a claim based on contribution. Bearing all these considerations in mind, we have decided that 10 per cent of the net proceeds of income tax should be distributed on the basis of contribution.

10. Another important point which arises for consideration in this context is how precisely the factor of contribution should be measured. The Fifth Finance Commission considered assessment as a more reliable index than collection of the contribution of the different States. The reasons adduced by them were :—

- (i) Collections did not make due allowance for incomes originating outside the State.
- (ii) Large amounts of deduction of tax at source on dividends, interest payments and in other cases gave undue benefit to States having metropolitan and industrial centres, in so far as such deductions relate to assessee's residing in other States. On the other hand, any refunds made to such assessee's would reduce still further the figures of collection of the States where they reside.
- (iii) The figures of collection might include large over-payments or under-payments which were adjusted only on assessment.

We feel that these considerations still hold good. In determining the States' share of the net proceeds of income tax we have, therefore, taken assessment as the measure of contribution.

11. Accordingly, we consider that during the period covered by our award, namely 1974-75 to 1978-79, 90 per cent of the States' share of the divisible pool of income tax should be distributed among them 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 rectification. All the previous Commissions have prescribed the respective shares of States worked out on the principles enunciated by them in terms of fixed percentages. For the sake of administrative convenience, we propose to continue this practice. In arriving at the percentage

share of each State, we have taken the figures of population according to 1971 census and the average of the assessments made during the five years ending with 1972-73, which are the latest years for which firm figures are available, after adjustment for reduction on account of factors such as appellate orders, revisions and refunds during the same period.

12. We further recommend that 1.79 per cent of the net proceeds of income tax may be taken to be the portion of such proceeds attributable to Union Territories. We have worked out this figure by allocating to Union Territories as at present constituted the share which would have accrued to them on the principles of distribution prescribed by us for the States, if the Union Territories had collectively been entitled to share of income tax.

13. We accordingly make the following recommendations in respect of the distribution of the net proceeds of income tax in each of the financial years from 1974-75 to 1978-79 :—

- (1) Out of the net proceeds of taxes on income in each financial year, a sum equal to 1.79 per cent thereof be deemed to represent the proceeds attributable to Union Territories.
- (2) The percentage of the net proceeds of taxes on income, except the portion representing the proceeds attributable to Union Territories, to be assigned to the States, should be eighty.

(3) The distribution among the States *inter se* of the share assigned to the States in respect of each financial year should be on the basis of the following percentages :—

States	Percentage
1. Andhra Pradesh	7.76
2. Assam	2.54
3. Bihar	9.61
4. Gujarat	5.55
5. Haryana	1.77
6. Himachal Pradesh	0.60
7. Jammu & Kashmir	0.81
*8. Karnataka	5.33
9. Kerala	3.92
10. Madhya Pradesh	7.30
11. Maharashtra	11.05
‡12. Manipur	0.18
13. Meghalaya	0.18
14. Nagaland	0.09
15. Orissa	3.73
16. Punjab	2.75
17. Rajasthan	4.50
18. Tamil Nadu	7.94
19. Tripura	0.27
20. Uttar Pradesh	15.23
21. West Bengal	8.89
TOTAL	100.00

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CHAPTER IV UNION EXCISE DUTIES

Under paragraph 4(a) of the President's Order, we are required to make recommendations on "the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them under Chapter I of Part XII of the Constitution and the allocation between the States of the respective shares of such proceeds". Under Article 272 of the Constitution, Union excise duties may be divided between the Union and the States, if Parliament by law so provides. Though sharing of the excise duties is of a permissive nature, no satisfactory scheme of fiscal transfers from the Union to the States through tax sharing can be devised, unless Union excise duties are also kept within the ambit of devolution.

2. The participation of States in Union excise revenues started on a rather modest scale with the award of the First Finance Commission which recommended sharing in respect of only three of the major commodities then subject to Union excise duties. In pursuance of the recommendations of successive Finance Commissions, the share of the States in Union excise duties has been progressively enlarged. By the time the Fifth Finance Commission was set up, the States were already sharing the proceeds of all Union excise duties excepting only special excise duties, regulatory duties of excise and cesses on commodities. The Fifth Finance Commission saw no justification for the exclusion of special duties of excise from the divisible pool and recommended that they should also be brought within the scheme of sharing from 1972-73 onwards. The regulatory duties, however, still remained outside the shareable pool. It should, however, be noted that the yield from regulatory duties was nil in 1970-71. No credit was also taken under this head in the budget estimates for 1971-72. But, in the new situation created by large influx of refugees from Bangladesh and hostilities with Pakistan, Government of India invoked the powers available to them under section 12 of the Finance Act of 1971 to levy regulatory duties of excise on certain products such as steel, iron and steel products, copper, zinc, aluminium and unmanufactured tobacco. The yield from these regulatory duties amounted to Rs. 22.88 crores in 1971-72 and was placed at Rs. 80.37 crores in 1972-73 (Revised Estimate).

3. The levy of regulatory duties of excise has been replaced under the Finance Act of 1973 by auxiliary duties on excisable goods. The Finance Act specifically lays down that these auxiliary duties have been levied for purposes of the Union and that the proceeds therefrom shall not be distributed among the States. In his budget speech, the Finance Minister observed that "for certain reasons it is not possible to incorporate the provision in rate tariffs, or make

them part of taxation statutes and they would, therefore, have to be revived from year to year for the present". The States have argued that auxiliary duties are, in pith and substance, indistinguishable from basic duties of excise. They also apprehend that continuance of auxiliary duties as a separate entity may encourage the Centre to raise additional revenues increasingly through enhancement of rates and coverage of auxiliary duties of excise rather than of basic duties. On the basis of existing coverage and rates, the estimated revenue from auxiliary duties of excise over the next five years is of the order of Rs. 720 crores. We recognise that under certain special circumstances the Centre may have to resort to levy of excise duties in a form not shareable with the States, particularly as the Constitution does not, unlike in the case of Income-tax, envisage a surcharge exclusively for purposes of the Union. Nevertheless, we feel that levy of excise duties on a non-shareable basis should be confined to short periods of two or three years at the most to meet the large demands on national exchequer that may unexpectedly arise. We therefore recommend that revenue from auxiliary duties should be brought within the divisible pool from 1976-77 onwards. This will enable the Centre to meet its pressing needs in the immediate future and at the same time allay the apprehensions of the States that auxiliary duties of excise may be resorted to on a larger scale in order to deprive them of their legitimate share in the growth of revenues from Union excise duties.

4. As the buoyancy of Union excise duties in recent years has been significantly higher than that of income-tax, it is understandable that all the States—except Assam—should have pressed for augmentation of the divisible pool of Union excise duties. It is significant that this plea has been made by advanced and backward States alike. Some of the States—Andhra Pradesh, Kerala, Punjab, Tamil Nadu, Uttar Pradesh and West Bengal—have suggested enhancement of the States' share of Union excise duties from the present level of 20 per cent to 50 per cent. Others have urged increases ranging from a minimum of 33 1/3 per cent to 40 per cent. In the course of our discussions with some of the socially and economically backward States that were likely to qualify for grants under Article 275 of the Constitution, we specifically posed the question whether they would not prefer the divisible pool to be kept at a lower level so that the Centre may have larger resources for helping them in their developmental programmes. We also drew their attention to the possibility of increase in revenues accruing to them from increased share of Union excise duties being off-set by corresponding reduction in grants under Article 275. Even such States distinctively demand larger devolution through share of excise duties with a more pronounced weightage

