

JOINT NOTE BY PROF. RAJ KRISHNA AND SHRI H. N. RAY  
ON COMPENSATION TO STATES FOR THE LOSS OF REVENUE  
CONSEQUENT ON THE PROGRESSIVE INTRODUCTION OF  
PROHIBITION.

1. The Finance Commission has projected the revenues from State excise duties under the head '039' at a static level from 1979-80 onwards during the forecast period on the basis of such decisions for the progressive introduction of prohibition as they have actually implemented during 1978-79 and about which the Commission has information. However, we have not been able to agree with the recommendations of our other distinguished colleagues for meeting the loss of excise revenue consequent on the progressive introduction of prohibition during the forecast period. Our understanding is that besides the compensation already agreed to by the Government of India, and computed on the basis of 50 per cent of the established loss of excise revenue each year, treating the actual excise revenue of 1977-78 as the base, our colleagues have recommended in the majority report that the Government of India should also make good to each State Government annually the balance of the loss of excise revenue consequent on the progressive introduction of prohibition. The following paragraphs explain our point of view and give the reasons for our not being able to go along with the majority of the Commission.

2. Though the Finance Commission was in session, the Government of India have communicated their decisions regarding compensation to the States for loss of excise revenue pursuant to the implementation of the prohibition policy / vide their letter No. 11012/18/78-PR(Vol. III) dated the 3rd August, 1978 / . In this communication, they have made it clear that the compensation will be limited to 50 per cent of the established loss of revenue each year and have also indicated with some degree of precision how the established loss is to be computed. The States have been expressly informed that they would be expected to devise ways and means of meeting the balance loss. It is our view that the present Finance Commission is not called upon by its terms of reference, to suggest any modification of the decision of the Government of India with regard to these compensatory payments. This view is re-inforced by the wording of paragraph 4 of the communication of the 3rd of August, 1978 where the Government of India presumes that the States would have projected their revenues to the Finance Commission on the basis of the national policy which envisages complete prohibition within a period of four years. The communication thereafter adds that it would be for the Commission to take a view on the question of devolution of funds with reference to the resources position disclosed in the forecasts and other relevant factors. It seems clear, therefore, that the Finance Commission was not expected to make good loss of excise revenue fully in all cases and it was left to it to take a view having regard to the overall financial position of each State and of the Government of India and all other relevant factors. The same position has been re-affirmed in letter No. P. 11012/18/78-PR dated 4th of August from the Department of Social Welfare addressed to the Member-Secretary of the Seventh Finance Commission. It has been reiterated in letter No. PF/R-9(50)74/Vol. V dated 16th of September, 1978 from the Finance Secretary, Government of India to the Member-Secretary, Finance Commission that the State Governments were expected to devise ways and means to recoup the likely loss of the balance of excise revenue by other measures. This communication clarifies that the Government of India have been guided by the consideration that it should be possible for the States to make up the balance (after 50 per cent has been compensated by the Government of India) through higher realisation of revenue from some of the existing taxes like sales tax and entertainment tax. The introduction of prohibition was expected to divert some purchasing power from expenditure on liquor to expenditure on other goods and on entertainment, some of which are subject to State taxation.

3. The prohibition policy is implemented in pursuance of the Directive Principles of State Policy incorporated in Article 47 of the Constitution. The duty is cast upon "the State" to bring about prohibition of the consumption of intoxicating drinks, and is thus an obligation not only of the Government of India but also of the Government of each State and of all local and other authorities in India (vide Articles 36 and 12 of the Constitution defining "the State"). Duties of excise on alcoholic liquors etc. for human consumption figure in Entry 51 of List II to the Seventh Schedule and this excise is solely a State subject. All decisions regarding prohibition have to be implemented by the State Governments themselves within their respective territories. The costs involved and the benefits accruing from the implementation of prohibition, which is an accepted national policy should, therefore, be shared jointly by both the Central Government and by all the State Governments concerned.

4. Though the Finance Commission have projected receipts from State excise duties at a static level from 1979-80 onwards for all the States, the actual receipts under this head will depend largely upon the decisions taken by the concerned State Governments for implementing the prohibition policy and upon the phasing of the programme adopted. The Government of India is committed to compensate the States only to the extent of 50 per cent of the established loss and it is expected that the State Governments would be able to mop up through other tax and non-tax sources a part of the income that would otherwise have been spent on the purchase of liquor. The balance left after taking credit for the Government of India's compensation of 50 per cent may or may not be made good by these measures and by the partial diversion of alcohol (which would otherwise have been consumed as liquor) to industrial and transportation uses. Some States may experience financial difficulty with the progressive introduction of prohibition, since we have projected excise revenues from potable liquor under head 039 at a static level from 1979-80 onwards. This is likely because the loss occasioned by prohibition would only be partially compensated by the Government of India and the balance of the loss remaining uncovered may result in strain for the weaker States. It may be in conformity with the provisions of Article 275 to make additional grants to this category of States. For this purpose, the Government of India may keep the position under review, and make suitable additional grants, depending upon the pace at which prohibition is introduced and the actual loss of revenue sustained below the static level projected by us for a particular State.

5. But this consideration may not apply to States which are left by the recommended scheme of devolution of taxes etc. with a sizeable surplus even after meeting their non-Plan revenue needs. The surpluses left under this scheme are indeed substantial in the cases of Maharashtra (Rs.3005 crores), Punjab (Rs.817 crores), and Haryana (Rs.678 crores), having regard to their size.\* To us, it appears adequate that the Centre should have agreed to compensate those States which are thus favourably circumstanced to the extent of only 50 per cent of the established loss incurred for implementing an accepted national prohibition policy for which they share joint responsibility with the Centre. We see no valid reason why additional Central funds should be expended for the purpose of maintaining their surpluses inviolate, and insulting them from the effects of implementing a prohibition policy which ex-hypothesi will benefit their citizens. It is recognised that in such a situation, implementation of the prohibition policy may result in a smaller balance from current revenues becoming available for financing the State Plan, but this factor should not, in our view, justify the payment of additional compensation by the Government of India over and above 50 per cent of the established loss already promised.

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\* These are also large but different under the scheme of Prof. Raj Krishna.

They could take various measures to offset this loss even if the additional purchasing power released by prohibition does not bring substitute revenue e. g. mobilise additional resources, or curtail non-priority expenditure.

6. According to the scheme of devolution and grants-in-aid adopted in the majority report of the Commission, while all States will be left with a surplus, in some cases, these surpluses will be marginal whereas in other cases they will be substantial. In order to make the figures comparable, we have computed the per capita surpluses taking into account transfers under the heads (i) income tax, (ii) basic excise other than electricity duty, (iii) Central excise on electricity generation, (iv) additional excise in lieu of sales tax, (v) grants in lieu of railway fares, and (vi) grants under Article 275 including provisions for upgradation of administration. The per capita surpluses range from Rs. 14.73 in the case of Orissa to Rs. 678 in the case of Haryana. We have considered the level of the per capita surplus at which a State may be deemed to be in a relatively strong financial position. We are of the view that this cut-off point may be a per capita surplus of Rs. 300/- after taking the above mentioned transfer into account. On this basis, the following States would be entitled to compensation over and above the already promised level of 50 per cent for loss of excise revenue occasioned by progressive introduction of prohibition in order to allow them some flexibility for financing their plans:-

1. Andhra Pradesh
2. Assam
3. Bihar
4. Himachal Pradesh
5. Jammu & Kashmir
6. Kerala
7. Madhya Pradesh
8. Manipur
9. Meghalaya
10. Nagaland
11. Orissa
12. Rajasthan
13. Sikkim
14. Tripura
15. Uttar Pradesh
16. West Bengal

On the other hand, the following States would be compensated only to the extent of 50 per cent of the established loss of excise revenue occasioned by the introduction of prohibition, as the Government of India have already agreed to:-

1. Haryana
2. Karnataka
3. Maharashtra
4. Punjab

The two remaining States of Gujarat and Tamil Nadu introduced prohibition long ago and are not covered by the scheme. The arrangement we have proposed is not very different in outcome from what the Commission has unanimously adopted to determine the eligibility of States for upgradation grants.

7. The Centre's resources together with those of the States constitute a common pool for financing not only non-Plan expenditure but also the Central and State Plans. Implementation of the prohibition policy necessarily means forgoing revenue in the short run and has been deliberately adopted for the overall good of the people. In all fairness, therefore, the entire financial burden for the implementation of the policy should not be borne by the Centre alone as would be the result in practice of accepting the majority recommendation of the Finance Commission. This burden is by no means negligible as the present State excise revenues are of the order of Rs. 505 crores per annum (figure for 1976-77) and at a static level would amount to about Rs. 2,500 crores over a 5-year period. It is our view that those States which are favourably circumstanced and are in a position to bear a part of the loss resulting from the implementation of the prohibition policy should do so. Casting almost entire financial burden of implementing the prohibition policy upon the Government of India, as envisaged in the recommendations of the majority of the Commission, may result in inadequate transfer of funds to those States which necessarily rely upon Central assistance for their efficient functioning and development. It was perhaps because of these considerations that the Government of India agreed to bear only 50 per cent of the established loss. It is our view that the present Commission need not in equity recommend that the existing commitment of 50 per cent of the established loss be raised to 100 per cent in respect of all States whether resourceful or not.

8. It is worth referring to a side issue in this connection. The Government of India have informed the Commission that neither the Government of Gujarat nor the Government of Tamil Nadu which have implemented the policy of prohibition long ago would receive any grants-in-aid on this account (Letter No. P. 110012/18/78-PR dated 4th August, 1978). Both these Governments in their Memoranda to the Finance Commission have strongly urged that they should be compensated for their loss of excise revenue. These demands we have not accepted. These Governments were pioneers in the field of prohibition and implemented the Directive Principles with little, if any, assistance from the Centre. Their sense of grievance will not be assuaged if those States which now implement the prohibition policy long after Tamil Nadu and Gujarat have done so, are compensated to the extent of 100 per cent of their loss, while the latter States get nothing on this account.

9. It has been argued that if full provision for loss of revenue occasioned by prohibition is not made, the Finance Commission will lay itself open to the charge of coming in the way of prohibition. But in our view, this argument is untenable because the Central Government itself has stipulated that it would compensate the States only to the extent of 50 per cent of the established loss. The Finance Commission is in no way expected to provide more Central assistance than this stipulation except to otherwise weak States. It has also been argued that it will be difficult to justify any decision which draws a distinction between strong and weak States in the matter of prohibition assistance. But inter-State disparities are a reality and condition to some extent all devolution decisions by all Commissions. We see no reason, therefore, why States with large surpluses should not bear a part of the loss of excise revenue entailed by the prohibition policy.

Raj Krishna  
25.10.1978

H.N.Ray  
25.10.1978

OBSERVATIONS ON THE JOINT NOTE OF  
PROF. RAJ KRISHNA AND SHRI H.N. RAY

The basic question is whether any distinction should be made between States which are left with a revenue surplus as a result of our scheme of transfer of resources from the Centre, and those which are not. The majority of us believe that all the States need to be treated equally in respect of entitlement to Central assistance to cover loss of excise revenue from potable liquor resulting from steps taken by the States to enforce complete prohibition in accordance with the national policy. The surpluses we have left should be wholly available as Plan resources. These surpluses are the result of a scheme of devolution of taxes on principles applied uniformly to all the States. In our view, to make distinctions, as envisaged by Prof. Raj Krishna and Shri H.N. Ray, will be to detract from this uniform and impartial treatment of all States. We should also note that in our recommendation in regard to Central assistance to cover losses of excise revenue we have left out of account losses of revenue which would occur under the heads Sales tax and other taxes. These losses would have to be borne by the States concerned. We would also point out that the introduction of prohibition would mean loss of resources for the Plan of a larger order than would appear from the projections of excise revenue which we have adopted, i. e. at a static level.

It seems to us that the cut off point of per capita surplus of Rs. 300, adopted by Prof. Raj Krishna and Shri H.N. Ray in paragraph 6 of their note is arbitrary. Incidentally, since the surpluses referred to are for the period 1979-80 to 1983-84, one should take the projected population of those years for calculating the per capita surplus. If one takes the projected population for 1981, the per capita surplus of Karnataka would be Rs. 283, and not more than Rs. 300 as taken by Prof. Raj Krishna and Shri H.N. Ray.

J. M. Shelat

C. H. Hanumantha Rao

V. B. Eswaran

New Delhi,  
October 28, 1978

NOTE OF DISSENT BY PROF. RAJ KRISHNA ENTITLED  
"A MORE EQUITABLE DISTRIBUTION OF RESOURCES"

I. Introduction and summary

The Seventh Finance Commission has unanimously made major progressive innovations in many aspects of the traditional scheme of resource transfer to the States. It has recommended a record amount of overall devolution from the Centre to the States. It has doubled the proportion of shareable excise revenue given to the States. Thus the total devolution is more than twice the devolution by the Sixth Commission. It has for the first time left significant surpluses with all States. And it has liberalised and rationalised general expenditure forecasts and earmarked provisions on account of relief expenditure, debt relief, increases in the emoluments of State Government employees and upgradation of the standards of public services.

2. But with regard to the distribution of the total transfer among different States, I have felt constrained, with utmost respect, to differ from my most distinguished colleagues. In my view the distribution should be more progressive so that larger resources are transferred to the most poverty-stricken States, hill States and specially handicapped States.

3. Therefore I have devised a formula, different from that of my colleagues, which does allocate more resources for these more deprived States.

4. The overall transfer in my scheme (Rs. 21862 crores) is larger only by about 5 per cent than the transfer under the majority scheme (Rs. 20843 crores)@. (See Table 1). The difference is mainly due to the fact that my projection of Central excise revenue in the next five years is higher by Rs. 1400 crores. (Table A. 3.) (The basis for this higher projection of Central excise revenue is explained in the Annex.) I also provide extra grants totalling Rs. 366 crores to eight hill States and two handicapped States. (Table A. 1)

5. Except the devolution of excise revenues and extra grants all components of the total transfer are exactly the same in the majority scheme and mine. The real difference between the two schemes lies in the amounts and shares allocated for different States.

6. Under my scheme, eight States with a large share of India's poverty population (West Bengal, Bihar and Orissa in Eastern India, Kerala and Tamil Nadu in Southern India, Uttar Pradesh and Madhya Pradesh in Central India and Rajasthan in Western India) get an extra total allocation of Rs. 2013 crores than under the majority scheme. (See Table 1.)

7. Eight hill States viz. Assam, Himachal Pradesh, Jammu and Kashmir, Manipur, Meghalaya, Nagaland, Sikkim and Tripura\* also get an extra transfer, amounting to Rs. 113 crores, under my scheme. (See Table 1.)

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@. In rounded figures. These figures exclude the provisions for natural calamity relief and for prohibition loss compensation. They also exclude the sum of Rs. 64 crores (the estate duty share) for its inter-State allocation is not available at present.

\* Tripura is only partly a hill State but because of its special feature it is conveniently placed in the hill group

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