

CHAPTER VI

UNION DUTIES OF EXCISE

6.1 The distribution between the Union and the States of Union excise duties is governed by Article 272 of the Constitution. That Article vests power in the Government of India to levy and collect duties of excise, other than those on medicinal and toilet preparations as are mentioned in the Union List. But, if Parliament by law so provides, there shall be paid out of the Consolidated Fund of India to the States to which the law imposing the duty extends, sums equivalent to the whole or any part of the net proceeds of that duty, and those sums shall be distributed among those States in accordance with such principles of distribution as may be formulated by such law. By para 4(a) of the President's order, we are required to make recommendations on this matter.

6.2 The First Finance Commission recommended that Union excise duties on three commodities, namely, tobacco (including cigarettes, cigars, etc.), matches and vegetable products, should, be shared between the Centre and the States. These commodities were selected on the consideration that they were articles of common consumption, and the excise duties levied thereon would yield a sizeable and reasonably stable source of revenue for distribution. The share of the States was fixed at 40 per cent.

The Second Finance Commission enlarged the list to include duties on sugar, tea, coffee, paper and vegetable non-essential oils. With this increased coverage, it felt that the States' share could be reduced to 25 per cent.

The amendments in the Income Tax Act in 1959 made a large portion of the tax on companies non-shareable by treating it as corporation tax. This resulted in a shrinkage of the divisible pool of income tax. The Third Finance Commission, therefore, thought that a further addition to the list of excisable goods, the duties on which should be shared with the States, was necessary. It also felt that the States needed greater assistance to fill up their larger revenue gaps caused by the impact of expenditure on two successive plans. The Commission, therefore, included in the divisible pool excise duties from all commodities, excluding those on which the yield was less than Rs. 50 lakhs a year. The States' share was fixed at 20 per cent. However, the Commission excluded from its computation the duty on motor spirit as they separately proposed that a sum of Rs. 36 crores, being about 20 per cent of its yield, should be utilised for the maintenance and improvement of communications, and distributed as a special purpose grant.

The Fourth Finance Commission considered the demand of the States for the sharing of the excise duties realisable on all commodities as perfectly reasonable. That Commission fixed the States' share at 20 per cent of this enlarged divisible pool.

The Fifth Finance Commission went a step further and recommended that States should also receive a share from the proceeds of special excise duties from 1972-73. Firstly, it felt that the resort by Union Government to special duties of excise should not be the rule but an exception. It further said 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. And, secondly, that in the last two years of its award period, namely 1972-73 and 1973-74, the divisible pool of income tax would shrink, as it would no longer include any arrears of advance tax collections pertaining to the previous years. It thought that the sharing of special excise duties from 1972-73 would provide some stability to the States' revenues by securing to the States some increases in the last two years. The States' share was fixed by them at 20 per cent.

Like its predecessor, the Sixth Finance Commission also felt that the levy of excise duties which are, under the law, not shareable with the States, should be confined to short periods of two or three years at the most, to meet the unexpected demands on the national exchequer. It, therefore, recommended that the revenue from auxiliary duties on excisable goods levied in replacement of regulatory duties under the Finance Act of 1973, should be brought within the divisible pool from 1976-77 onwards.

5.31 On the basis of the recommendations in para 5.19 and 5.30, the composite percentage shares of each State have been determined and shown in the table below para 5.32. Income tax has not yet been extended to Sikkim. We have worked out the State-wise composite shares in income tax amongst the States including Sikkim as well as without Sikkim on the consideration that in case income tax is extended to that State, the basis of its distribution amongst the States may pose no problem.

5.32 To sum up, we recommend that in the distribution of the net proceeds of income tax in each of the years 1984-85 to 1988-89 :-

- (a) Out of the net proceeds in each financial year, a sum equal to 1.792 per cent thereof shall be deemed to represent the proceeds attributable to Union territories,
- (b) The share of net income tax proceeds, except the portion representing the proceeds attributable to Union territories and Union emoluments, to be assigned to the States should be 85 per cent; and
- (c) The distribution amongst the States inter se of the share assigned to the States in respect of each financial year should be on the basis of the percentages shown in the Table below:

State	Percentage with Sikkim	Percentage without Sikkim	State	Percentage with Sikkim	Percentage without Sikkim
1. Andhra Pradesh	8.187	8.190	12. Manipur	0.220	0.220
2. Assam	2.789	2.789	13. Meghalaya	0.184	0.184
3. Bihar	12.080	12.085	14. Nagaland	0.088	0.088
4. Gujarat	4.409	4.410	15. Orissa	4.202	4.203
5. Haryana	1.074	1.074	16. Punjab	1.744	1.744
6. Himachal Pradesh	0.555	0.555	17. Rajasthan	4.545	4.547
7. Jammu & Kashmir	0.838	0.838	18. Sikkim	0.035	-
8. Karnataka	4.979	4.981	19. Tamil Nadu	7.565	7.567
9. Kerala	3.760	3.761	20. Tripura	0.269	0.269
10. Madhya Pradesh	8.378	8.382	21. Uttar Pradesh	17.907	17.914
11. Maharashtra	8.392	8.396	22. West Bengal	7.800	7.803
			Total:	100.000	100.000

5.33 Shri A.R. Shirali feels that in order to give the Centre a little more incentive in the collection of income tax and in view of the constraint of revenue resources at the Centre, the States' share would need to be brought down from the present level of 85 per cent. Considering, however, the progressive formula recommended for distribution of the States' share among the States, he suggests that for the present the share be brought down from 85 per cent to 80 per cent only. This he considers can be given effect to from 1985-86.

As for 1984-85, in view of the fact that the Plan size of most States has already been finalised and in order not to disturb the resource calculations already made, he is of the view that the States' share in 1984-85 be retained at 85 per cent and continue to be distributed according to the existing formula as recommended in the Commission's Interim Report submitted in November, 1983 i. e. according to the percentages recommended by the Seventh Finance Commission. His Note of Dissent is appended.

That Commission, however, recommended that revenues from cesses on excisable commodities, levied under special enactments and reserved for special purposes, should not be included in the divisible pool. It also took the view that an enlargement of the States' share would confer disproportionately large benefits on surplus States than on the deficit States. On these and other considerations, it recommended that the States' share should be 20 per cent of all the basic excise duties. It also recommended that 20 per cent of the net proceeds of auxiliary duties of excise be shared from 1976-77 onwards.

6.3 The stated objective of the Seventh Finance Commission was that its scheme of fiscal transfers should leave as many of the less affluent States as possible with a surplus on revenue account. It thought that the bulk of fiscal transfers should be by way of tax shares and grants-in-aid should have a residual role. That Commission, therefore, recommended that the States' share of excise duties (excluding duty on electricity, in respect of which it made a separate recommendation) should be 40 per cent. It clarified that the net proceeds of excise duties would include proceeds from all Union excise duties, by whatever name called, but exclude proceeds from the additional excise duties levied in lieu of sales tax and cesses earmarked for special purposes and the additional duties of excise on certain textiles and textile articles, which, under law, are not to be distributed among the States.

6.4 To decide upon the recommendations we should make, we have to consider the following questions:-

- (i) Should any kind of excise duty be left exclusively to the Union and remain unshared with the States?
- (ii) What should be the share of the States in excise duties?
- (iii) On what principles should shares be allocated amongst the States?

We shall deal with these and allied questions seriatim.

6.5 The first question is as to the kinds of duties which should be shared by the Union with the States. In their Memoranda Bihar, Gujarat, Haryana, Karnataka, Kerala, Madhya Pradesh, Punjab, Rajasthan and West Bengal have expressly demanded that all kinds of excise duties should be made shareable with the States, including the cesses levied under special Acts and the additional excise duties levied on textiles under the Additional Excise Duties (Textiles and Textile Articles) Act, 1978.

A perusal of the revised estimates of 1983-84 of the Central budget shows that out of the total receipt of Rs. 10,125 crores of excise duties, about Rs. 1,186 crores (i.e. about 11 per cent) of cesses and duties stand earmarked for special purposes. The laws, under which these duties and cesses are levied, earmark them for specific purposes. We obviously cannot ignore those laws and recommend the diversion of moneys to different purposes. We would, however, like to say that the earmarking of certain levies of excise duties for specific purposes should be kept to the minimum as it causes grievances amongst the States.

6.6 In view of what we have stated, we recommend that the States should be paid a share out of the net proceeds of all excise duties, other than those collected under the provisions of the Additional Excise Duties (Textiles and Textile Articles) Act, 1978 and the cesses earmarked by law for special purposes.

6.7 Before turning to the other two questions, we would like to dispose of the point regarding the excise duty on electricity before we deal with the excise duty on other articles. An excise duty on electricity was first levied from 1st March, 1978 as a part of the budget proposals of the Centre for the financial year 1978-79. The net proceeds of this new duty were shared with, and, amongst the States in 1978-79 in the same manner that the net proceeds of other excise duties were being shared at that time in accordance with the recommendations of the Sixth Finance Commission.

6.8 Subsequently, the Central Government intimated to the Seventh Finance Commission, which was then sitting, that the Centre had, of its volition, decided to transfer to the States the entire non-shareable portion of the net proceeds of this new duty with effect from the 1st April, 1979 subject to the condition that the duty continued to be levied beyond that date. The Union Finance Ministry wrote three letters dated 13th, 19th and 23rd October, 1978 to the Member-Secretary of the Finance Commission which have been reproduced in Annexure VI-1. In these circumstances, that Commission recommended that the entire net proceeds of Union excise duty on generation of electricity realised from States should be paid to the States. Each State was to get an amount equal to the collection in or attributable to that State.

6.9 There has now been another development. In the course of his speech presenting the Budget for the year 1984-85, the Union Finance Minister has proposed to abolish the excise duty on electricity, leaving it to the States to tap this source to whatever extent, and in whatever manner they like. In order to give the States time to take appropriate action, this proposal would be made effective from 1st October, 1984.

6.10 We have examined the implication of this proposal. As the date with effect from which this change is intended to come into effect falls outside the financial year 1983-84, which we have used as the base year for making projections for the forecast period, we have made our calculations as if no change was contemplated in regard to this levy. This will not affect the revenue resource position of the States. No doubt the States will not receive anything as a share of excise duty in electricity if the Central Government abolishes this levy from 1st October, 1984, but, in that event, we would naturally assume that the States would make good the loss by recovering an equal amount by way of electricity duty on consumption, which they have the power to levy. In other words, the loss on account of devolution from the Centre can be made good by the States themselves. As far as the Centre is concerned, our decision will not affect its revenue surplus as the transfer to the States by way of devolution would have been equal to the receipts from this duty.

6.11 As regards the formula for distribution, continuance of the principle of allocation of Union excise duty on electricity recommended by the Seventh Finance Commission is advocated by the States of Haryana and Maharashtra. However, Himachal Pradesh is strongly opposed to it, and feels that it has wrought great injustice. It maintains that the only right principle for allocation of this duty among the States is that the proceeds should be shared by the States in proportion to the power generated within their territory. Meghalaya supports this principle. Gujarat has suggested that the allocation should be on the basis of consumption in each State. No other State has offered any comments.

6.12 We think that in deciding what principle to apply for allocating excise duty on electricity among the States, it is necessary to remember the background. As we have mentioned earlier, the Finance Ministry wrote to the Seventh Finance Commission saying that the Union Government had agreed to transfer to the States the entire non-shareable portion of the excise duty on electricity. This was done because the States had made representations that they were entitled to the proceeds of the duty, and the Union Government had acceded to the demand. The effect of this decision was that the entire proceeds of excise duty on electricity were made transferable to the States. The principle on the basis of which the Union intended to allocate the non-shareable portion of this duty among the States was explained in the letter dated 13th October, 1978 written by the Finance Ministry to the Seventh Finance Commission. It said that the entire non-shareable portion of the duty would be transferred to the States 'in proportion to the revenues realised from each State on this account'. The Seventh Finance Commission obviously concurred with that principle and applied it to the States' share of this duty also. That is why they recommended that the entire proceeds of this duty should be transferred to the States, and each State should be paid an amount 'equal to the collection in or attributable to the State'. In these circumstances this was obviously the right thing to do, and, we propose to do the same. Accordingly, we recommend that, during the forecast period, the entire excise duty on electricity will be distributed among the States so that each State gets an amount equal to the collection in or attributable to that State.

6.13 In order to make an estimate of the likely State-wise receipts of the Union excise duty on electricity during each of the five years or the forecast period ending with the financial year 1988-89, we requested the Central Electricity Authority to provide us with their estimates of such receipts. We have accepted the estimates sent by them and have made our calculations on that basis. The estimated receipts State-wise are shown in Annexure VI-2.

6.14 We next come to the question as to what should be the share of the States in the net proceeds of excise duties.

6.15 Himachal Pradesh, Manipur, Meghalaya, Nagaland and Sikkim are the only States which have stated that the States' share should be kept at 40 per cent, as fixed by the last Finance Commission. They apprehend that if the share is further enlarged, a relatively larger portion might go to the developed States, which will further accentuate the existing inter-State imbalances. These States prefer to leave the Centre with larger resources with which it can help the less developed States. Other States have suggested larger share for the States, varying from 50 per cent to 75 per cent. West Bengal has not specifically stated what it thinks should be the States' share, though the tenor of its Memorandum undoubtedly suggests that it is in favour of a larger share for the States. The main plea

of the States in support of their demand for a larger share is that their requirements for resources have increased rapidly with the expanding size of their developmental plans, the unforeseen commitments in respect of increases in dearness allowances and larger expenditure on office contingencies due to increase in prices. They also feel that the Centre can bear a greater transfer as it has exclusive access to other large source of funds.

6.16 It is patent that we have to carefully balance many diverse considerations. There can be no doubt that the Centre has a greater capacity to bear financial burdens than the States. Revenue deficits of States have also increased since the Report of the Seventh Finance Commission. As will appear in Chapter III, sixteen States have a total deficit of Rs. 18,485 crores without taking into account any transfer of resources from the Centre. We think the transfer of resources to the States should leave as many of them as possible with surpluses on revenue account so that they are able to have a better start in the implementation of the next Five Year Plan. At the same time, we have also to keep in view the amount of surplus with the Centre as reassessed by us. Having regard to these, and all other relevant considerations, we have come to the conclusion that during the forecast period, the share of the States in the net proceeds of excise duties, other than the duty on electricity, should be increased from 40 per cent fixed by the Seventh Finance Commission to 45 per cent, and, we recommend accordingly.

6.17 There remains the question as to the allocation of excise duty among the States. Widely divergent views have been expressed by them. We think it would be worthwhile to summarise the views.

6.18 Assam, Tripura and Sikkim favour the continuation of the scheme of distribution adopted by the Seventh Finance Commission except that Tripura is in favour of special weightage being given to the population of Scheduled Tribes in the State, and Sikkim wants weightage to the criterion of poverty increased by 5 per cent with a corresponding reduction in the weightage to population. Haryana and Punjab have advocated that the entire proceeds should be distributed solely on the basis of population. While making this suggestion, the Government of Punjab has emphasised that factors like financial weakness and relative economic backwardness are extraneous to the purpose of inter se distribution of shareable taxes and duties, and are relevant only for assessing the needs of grants under Article 275 of the Constitution. On the other extreme, Karnataka does not want to assign any weightage at all to population. Instead, it has suggested that 60 per cent be distributed on the basis of relative development of each State measured by a composite index of development, and the remaining 40 per cent be distributed on the basis of an index of revenue mobilisation effort.

6.19 Gujarat has preferred a weightage of 75 per cent to be given to population, the remaining 25 per cent being left for distribution on the basis of the proportion of sales tax collection in each State to the total collections of sales tax in all States. It has also suggested that excise duty recovered from sick industrial units taken over by State Governments be fully paid back to the concerned States to enable them to meet a part of their financial commitments of such take-over. Maharashtra would like 60 per cent of the States' share to be distributed on the basis of population (giving a weightage of 70 per cent to rural population and 30 per cent to urban population), 20 per cent on the basis of economic backwardness as reflected by the per capita incomes, using the method adopted by the Sixth Finance Commission, 10 per cent on the basis of the performance of States in the population control programme, and the remaining 10 per cent on the basis of the mobilisation of small savings.

6.20 Both Bihar and Uttar Pradesh have advocated that 30 per cent and 25 per cent, respectively, of the States' share should be exclusively distributed among those States the per capita income of which is below the all States' average, the inter se distribution being based in proportion to such distance multiplied by population. While Bihar wants the entire balance of 70 per cent to be distributed on the basis of population, Uttar Pradesh wants only 50 per cent out of the balance of 75 per cent to be distributed on this basis and the remaining 25 per cent to be distributed on the basis of inverse of the per capita income. Bihar has also added that, in the alternative, the scheme of distribution of the Seventh Finance Commission may be adopted.

6.21 Madhya Pradesh is in favour of the formula adopted by the Seventh Finance Commission, except that it wishes to reduce the weightage to population from 25 per cent to 10 per cent, and advocates that the balance of 15 per cent be distributed on the basis of the area of the States. Rajasthan has favoured distribution on two criteria, i.e., 50 per cent on the basis of population weighted for area and 50 per cent on the basis of an index of infrastructure. Orissa has suggested that the practice of bridging the revenue gap by grants under Article 275 be discontinued. Instead, the deficits of all States that remain after devolution, except of basic Union excise duties, should first be met by a share from Union excise

duties, and the balance may be distributed among States on the basis of weightage of 25 per cent each to population, percentage of Scheduled Castes/Scheduled Tribes population, the per capita SDP, and inverse ratio of per capita household consumption.

6.22 Tamil Nadu would like 25 per cent to be distributed on the basis of population, after giving urban population a weightage of 50 per cent; 50 per cent on the basis of revenue equalisation, 12½ per cent each on the basis of poverty ratio and unemployment ratio. Andhra Pradesh has suggested a weightage of 50 per cent each to population and per capita SDP. Kerala has proposed a weightage of 25 per cent each to population and per capita income and distribution of the remaining 50 per cent in proportion of the non-Plan expenditure on social and community services to the total non-Plan expenditure of States. West Bengal has not suggested any formula of distribution.

6.23 Himachal Pradesh and Nagaland want a weightage of 25 per cent to population. Both States are in favour of 25 per cent being reserved for providing an equal percentage of surplus to the revenue deficit backward States and to allocate another 40 per cent to all backward States. The remaining 10 per cent is recommended to be distributed only among hill States to ensure reasonable surpluses to them. Jammu & Kashmir has suggested that the per capita SDP and revenue equalisation should be given a weightage of 25 per cent each, and backwardness the remaining 50 per cent. The proposal of Manipur is similar except that the 50 per cent, which Jammu & Kashmir wants earmarked for backwardness, Manipur would wish to be distributed to the extent of 40 per cent on the basis of poverty ratio and the balance of 10 per cent to be earmarked for the hill States exclusively. Meghalaya wants the pre-emption of 50 per cent of the States' share to ensure that all States get a surplus on revenue account. It wants the remaining 50 per cent to be divided into three equal parts; one part to be distributed on the basis of population, another on the basis of backwardness and the third to be reserved exclusively for the hill States for distribution on the basis of population.

6.24 It is obvious from this narration of the views of the States that each of them has given preference to the formula which benefits it most. There are merits and demerits in each of them. Ultimately, in deciding the criteria which we should apply for allocating shares of excise duty among the States, we have been guided by three over-riding considerations which were emphasised by all the experts and the disinterested observers we met. These considerations are: (i) that the formula should be progressive in the sense that it should allocate a larger share to those States which have a relatively lower per capita incomes, or, which are otherwise backward and financially weak; and (ii) the formula should be simple; and (iii) firm and reliable data should be available for applying the formula.

6.25 It is too late in the day for anyone to argue that backwardness should not be a factor in allocating resources between the States. From the Third Finance Commission onwards every Commission has given weightage to backwardness in one form or other, though in varying proportions. It is impossible to argue that backward States, which are members of a federation, should be left to fend for themselves. Even many of the richer States did not dispute this proposition. We are happy to record that some of them freely conceded that in the larger national interest they would have to make sacrifices to help the backward States. Since excise duties form a major portion of the moneys which are transferred to the States by way of devolution it follows that backwardness in some form or other must be given a large weightage, otherwise it will be impossible to correct fiscal imbalances.

6.26 We now proceed to examine some of the particular points made by the States. Bihar and Uttar Pradesh have suggested that to do justice to backward States, 30 per cent and 25 per cent respectively of the States' share should be distributed only among States whose per capita income is below the all-India average. We think that the same objective could be served even if every State is allowed a share from a progressive formula of distribution, provided a substantial proportion of excise duties is distributed on the basis of such a formula.

6.27 Madhya Pradesh has suggested assigning a weightage of 15 per cent to area while Rajasthan has suggested that the population factor should be weighted with area. In the course of discussions we were informed that States having large areas with sparse population, living in isolated villages, have to incur larger costs in providing services like schools, hospitals, roads, etc. They, therefore, pleaded that some special consideration should be given to this factor in the formula of distribution. We are not unaware of these disabilities suffered by some States. We may point out, however, that all costs being incurred on this account have already been taken into account while projecting the revenue expenditure for the forecast period. The needs of these States would be assessed on that basis. That apart, we notice that distribution of resources on the criterion of area of States benefits only a few States, but, mainly at the cost of other States which are equally backward, and whose backwardness is probably attributable to their high density of population. Thus the area factor cannot have general acceptance for use in distributing resources among the States.

6.28 Many States have said that it would be unrealistic to take into account the 1971 population for the distribution of resources when the results of the 1981 census are available. A few States have suggested that a portion of the States' share of excise duties should be distributed among the States on the basis of the efforts made by them to control the growth of population. However, para 7 of the President's Order is clear on the subject. It is in accordance with the policy announcement contained in para 8 of 'Family Welfare Programme - A Statement of Policy' (June 29, 1977) issued by the Ministry of Health and Family Welfare, Government of India, the relevant portion of which is reproduced in Annexure VI-3. That shows that a decision was taken at the national level that in all cases, where population is a factor for the transfer of resources from the Centre to the States, the population figures of 1971 would continue to be used till the year 2001.

6.29 As regards the proposal made by some States to give special weightage to urban population, we think that both the revenue receipts and revenue expenditure of States as well as their per capita incomes reflect this position, and hence, a separate weightage is not necessary.

6.30 We would now like to consider the three criteria of distribution, other than population, adopted by the Seventh Finance Commission.

6.31 The first was the States' population weighted by the inverse of the average per capita State Domestic Product of States for the triennium 1973-74 to 1975-76. This produces progressive results in as much as States with a lower average per capita State Domestic Product would receive a relatively larger share and vice versa. On a similar basis, the Planning Commission has distributed among the States a portion of the Central assistance during the Sixth Plan period. The share of a State is determined by its 'Income Adjusted Total Population' as a percentage of the aggregate of all States' Income Adjusted Total Population. We note that State Governments have not generally objected to this principle adopted by the Seventh Finance Commission.

6.32 The second criterion used by the Seventh Finance Commission was the percentage of the poor in each State measured by a method which Prof. Raj Krishna, Member of that Commission, had evolved. The methodology adopted for this purpose is outlined in Appendix 4.9 of the Report of the Seventh Finance Commission.

6.33 We have scrutinised the estimates of the poor in each State by using the formula of the Seventh Finance Commission, and those made by the Planning Commission for the purposes of the 1980-85 Plan. A peculiar feature of these estimates is that in the hill States and States like Rajasthan, which are undoubtedly poor and backward, the percentage of poor is relatively small. To what extent the policies of the State Governments resulting in maldistribution of incomes are responsible for accentuation of poverty conditions, particularly in the case of States which have a high per capita income, is another important question which is to be considered in this connection. More important is the fact that the estimates of the poor can vary depending on the concept of poverty used. It is, therefore, not surprising that many States have expressed doubts about the reliability of data and the methodology used for the estimation of these poverty ratios.

6.34 With these limitations, use of poverty ratio as a factor of distribution may not be advisable. In fact, as many as 15 States, including some which are undoubtedly backward and poor, have not favoured the use of this criterion. The object of transferring relatively larger resources to States which are more backward and poor can still be achieved by linking distribution to the per capita incomes of States. Therefore, in the circumstances described above, we have no other option except to choose other criteria which are more reliable, and whose data base is not likely to be called into question by States.

6.35 The third criterion used by the Seventh Finance Commission was the revenue equalisation factor. A shortcoming in the application of this criterion, as used by the Seventh Finance Commission, was brought to our notice by the Government of Maharashtra. It pointed out that with a linear equation, when only one independent variable, viz. per capita income has been used (as would appear from the gist of the formula in the Report of the Seventh Finance Commission), that formula did not amount to anything different from allocating shares in revenues to States based on the distance of the per capita income of the State from the highest per capita income of any State.

6.36 This criticism is, no doubt, valid but it does not detract from the utility of this criterion for assessing the capacity of States to raise resources. It is true that a more sophisticated formula of revenue equalisation could be evolved using multiple factors as independent variables to estimate tax effort. In fact, the National Institute of Public Finance and Policy has given us a study entitled "Relative Taxable Capacity & Tax Effort of States in India", which we had commissioned, with the intention of working out a refined formula for revenue equalisation. On examination, we found that a

comprehensive formula of revenue equalisation would be quite complicated. We also thought that some of the assumptions that might be made for evolving that formula might also be called into question by States. On balance, therefore, we considered that it would be worthwhile to opt for a less complicated formula. We are of the view that the distance of per capita income of States from the highest per capita income of any State, which is a well accepted indicator of the relative backwardness of States, would also be a good indicator of the capacity of States to raise resources. Such a formula was used by the Sixth Finance Commission as an alternative to the criteria suggested to it by States for measuring backwardness.

6.37 Before we proceed to explain the basis we have adopted for the distribution of excise duties amongst the States, we would like to highlight two important considerations which have influenced our decisions.

The first is the striking imbalances between the States. Our re-assessment of States' forecasts shows that there are six States which have a surplus of Rs. 8,064 crores, while the remaining States have a total deficit of Rs. 18,485 crores on revenue account, before devolution from the Centre. The percentage of revenue expenditure which is met by a State's own revenue receipts (i.e. excluding Central transfers) is another indicator of the imbalance. We notice that the percentage of own revenue receipts to revenue expenditure in 1982-83 varied between 42.6 in the case of Orissa to 107.2 in the case of Maharashtra among the 15 non-hill States. Amongst hill States, the corresponding percentage is as low as 9.3 for Manipur. We think, that it should be the endeavour of a Finance Commission to minimise, to the extent possible, these imbalances without, however, hindering the progress of developed States.

The second consideration is that the recommendations made by the earlier Finance Commissions regarding distribution of taxes and duties among States used to leave deficits in the revenue account of a number of States. These were then covered by grants under Article 275. Notwithstanding that the last Finance Commission raised the States' share of excise duties from 20 per cent to 40 per cent, eight States still had deficits. This included the seven hill States of Himachal Pradesh, Jammu & Kashmir, Manipur, Meghalaya, Nagaland, Sikkim and Tripura. That Commission estimated that these States would receive Rs. 421.80 crores as their share of devolution, which would still leave them with a deficit of Rs. 1036.20 crores. This was made good by recommending grants-in-aid under Article 275. We are of the view that this pattern of distribution as between the amounts received as shares of taxes and as grants needs to be corrected, so that the dependence on an inelastic source of revenue like the grant-in-aid is minimised.

Having considered the problem in all its aspects, we are of the view that, if our scheme of devolution has to serve the aforesaid purposes, it should not only be based on a progressive and simple formula of distribution among the States, but, it should also make a special provision to deal with the revenue deficits of States.

6.38 As regards backwardness, various factors have been suggested to determine it. We have found it difficult to choose a set of indicators which would adequately represent and reflect fully the economic and social conditions of the States in our country, and to assign appropriate weightages to them so that an index of backwardness could be prepared. We, however, feel that per capita income is a more appropriate composite criterion than any other suggested to us, which reflects the level of backwardness of States as well as their capacities to raise revenues. The merit of this criterion is that it suffers least from data deficiency and it is generally accepted by all States.

6.39 For this purpose, we prefer to use the average per capita income for at least three years so that annual fluctuations are smoothened out. Details of State-wise per capita income upto 1979-80 are available. A perusal of the data relating to 1979-80 shows that as the country's economy suffered a serious setback in that year owing to exceptionally bad weather, the per capita incomes of all States have generally been affected. We, therefore, thought that it would not be proper to base our recommendations on the basis of the average per capita incomes for the triennium ending with 1979-80. The 1980-81 data has not yet been made available to us. We have, therefore, considered it proper to take the average per capita income of States of the three years ending with 1978-79 only. We have worked out the simple average of the per capita incomes of States for the years 1976-77, 1977-78 and 1978-79, as furnished to us by the Central Statistical Organisation of the Government of India as shown in Annexure VI-4.

6.40 We have assigned a weightage of 25 per cent to population as we consider it to be a primary criterion for determining, in general terms, the needs of all States. The population on the basis of 1971 census has been used for this purpose as required by para 7 of the President's Order. The share

of each State is given by the percentage share of its population in the aggregate all-States' population.

6.41 Consideration to backwardness is given in two ways by using the average per capita income for the triennium 1976-77 to 1978-79 in constructing the formula of distribution:-

(a) Firstly, the 1971 population of the States has been weighted with the inverse of the aforesaid average per capita income to get an Income Adjusted Total Population. The share of a State is determined by percentage of the income adjusted total population of that State to the aggregate of the income adjusted total population of all States. We have assigned a 25 per cent weightage to this factor in the distribution.

(b) Secondly, we have assigned a 50 per cent weightage to the distance of the average per capita income of any State during the triennium 1976-77 to 1978-79 from that of the State which has the highest average per capita income, which is Punjab.

6.42 It would be obvious that if the principle mentioned in sub-para (b) of the previous para is adopted without any further modification, Punjab would not be eligible to receive any share from excise duties under this criterion. This is what happened when the Sixth Finance Commission distributed 25 per cent of the States' share of Union excise duties to States on the basis of 'distance' method without making such adjustment. This was also the result when the Seventh Finance Commission assigned a weightage of 25 per cent to the revenue equalisation factor in its formula of distribution. As we are assigning a weightage of 50 per cent to this factor, we have considered it necessary to ensure that all States get a share under this principle. Therefore, while in the case of all States, except Punjab, the distance between their average per capita income for the triennium 1976-77 to 1978-79 from the corresponding average per capita income of Punjab has been multiplied by their 1971 population, in the case of Punjab we have used a special device to obtain such a product. The product in the case of Punjab has been arrived at by multiplying its 1971 population with a notional distance factor equal to the distance of the average per capita income of Punjab from that of the State which has the second highest per capita income i. e. Haryana. In other words, the income distances in the case of Punjab and Haryana have, for this purpose, been treated as equal.

The share of each State will be determined by the product of that State arrived at in the manner indicated above as a percentage of the aggregate of the similar products for all the 22 States.

6.43 We would like to mention here that we have tried a large number of alternative combinations, and we find that to impart progressivity to the inter se distribution in a significant measure, with due regard to the capacity of States to raise resources, it is necessary to give a weightage of 50 per cent to per capita income on the basis of the 'distance method'.

6.44 The special arrangement that we are making to help the deficit States is to set aside a certain portion of the States' share of excise duties, which will be distributed only among those States which have deficits on revenue account. The manner in which this amount is being distributed is explained in the next paragraph.

6.45 It will be recalled that we have fixed the States' share at 45 per cent of the net proceeds of shareable excise duties excluding that on electricity. We recommend that this be distributed amongst the States on the following basis:-

(a) 40 per cent of the net proceeds of shareable excise duties excluding that on electricity, be distributed during each year of the forecast period among all States in the following manner:-

(i) $\frac{1}{4}$ th of this amount (i.e. 25 per cent) should be distributed among the States on the basis of the 1971 population, as indicated in para 6.40.

(ii) Another $\frac{1}{4}$ th (i. e. 25 per cent) should be distributed to States on the basis of inverse of per capita income, as indicated in sub-para (a) of para 6.41.

(iii) The remaining 50 per cent should be distributed on the basis of the distance of per capita income, as indicated in sub-para (b) of para 6.41 and para 6.42.

(b) The remaining 5 per cent of the net proceeds of excise duties excluding that on electricity, be set aside and distributed to those States which have deficits after taking into account their shares from the devolution of all taxes and duties, including their shares of excise duties, under clause (a) above and grants in lieu of the repealed tax on railway passenger fares, but excluding their shares of estate duty and grants on account of wealth tax on agricultural property. This distribution should be based on the proportion of the deficit of each State to the total of the deficits of all States as estimated by us, worked out separately for each year of the forecast.

6.46 The percentage share of each State in 40 per cent of the net proceeds of shareable excise duties excluding that on electricity has been worked out and shown in the table below:—

Table 1 : Percentage Share of States in 40 per cent of the net proceeds of excise duties for the years 1984-89

Name of State	Percentage Share in 40 per cent of the net proceeds of excise duties for the years 1984-89	Name of State	Percentage Share in 40 per cent of the net proceeds of excise duties for the years 1984-89
1. Andhra Pradesh	8.587	12. Manipur	0.233
2. Assam	2.977	13. Meghalaya	0.194
3. Bihar	13.202	14. Nagaland	0.096
4. Gujarat	3.506	15. Orissa	4.592
5. Haryana	1.017	16. Punjab	1.317
6. Himachal Pradesh	0.589	17. Rajasthan	4.695
7. Jammu & Kashmir	0.856	18. Sikkim	0.039
8. Karnataka	5.077	19. Tamil Nadu	7.317
9. Kerala	3.800	20. Tripura	0.292
10. Madhya Pradesh	8.852	21. Uttar Pradesh	19.097
11. Maharashtra	6.216	22. West Bengal	7.449
		Total:	100.000

The percentage share of the deficit States in the 5 per cent of the net proceeds of the shareable excise duties excluding that on electricity has been worked out by us for each of the 5 years commencing from 1st April, 1984 and these percentages are shown in the following table:—

Table 2 : Shares of Deficit States in 5 per cent of the net Proceeds of Excise Duties

Name of the State	Share in 5 per cent to Deficit States				
	1984-85	1985-86	1986-87	1987-88	1988-89
1. Assam	12.728	12.578	12.713	13.418	12.023
2. Himachal Pradesh	10.340	11.528	12.914	14.098	16.475
3. Jammu & Kashmir	15.457	16.661	17.818	18.560	20.254
4. Manipur	6.969	7.742	8.722	9.545	11.217
5. Meghalaya	5.575	6.180	6.944	7.570	8.863
6. Nagaland	8.837	9.944	11.240	12.371	14.482
7. Orissa	9.214	8.154	5.457	3.109	0.598
8. Rajasthan	1.940	-	-	-	-
9. Sikkim	1.659	1.836	2.051	2.232	2.593
10. Tripura	8.200	9.104	10.207	11.162	12.956
11. West Bengal	19.081	16.273	11.934	7.935	0.539
Total:	100.000	100.000	100.000	100.000	100.000

6.47 Shri A.R. Shirali, for reasons explained in Chapter V, Income Tax, feels that for 1984-85 the States' share of shareable Union excise duties (excluding that on electricity) may continue to remain at 40% and be distributed according to the recommendations of this Commission in its Interim Report submitted in November, 1983 i. e. according to the percentages recommended by the Seventh Finance Commission.

6.48 As for the period 1985-89, Shri A.R. Shirali feels that regard must be had to the difficult revenue position of the Central Government as well as the wide disparities in the levels of surpluses of the different States that would result if the share of Union excise duties (excluding that on electricity) for all States is maintained at 40% with another 5% for deficit States only. Taking both these considerations into account, he is of the opinion that a modest reduction in the share meant for all States would be justified. On this basis, he suggests that the total States' share of Union excise duties (excluding that on electricity) be maintained at 40% comprising 35% for all States and 5% for the deficit States only. As regards the distribution of the States' share among the States, he agrees with the recommendation of the majority. His Note of Dissent is appended.