

# **Tax Rental Arrangement: Replacement of Sales Tax by Additional Duties of Excise**

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## **I**

The Constitution which has laid down an elaborate scheme for the division of financial resources between the Union and states does not, however, prohibit them from agreeing to a "tax rental agreement" by which the states rent out their exclusive powers of taxation to the Union in return for some form of compensatory payments. This tax rental agreement has been employed in India in respect of certain selected commodities whereby the states have surrendered their powers to levy sales tax on them in lieu of the share of additional duties of excise levied by the Union. The present arrangement under which the states do not levy any sales tax on sugar, tobacco, cotton (excluding handloom), woollen and rayon or artificial silk fabrics was introduced by the Additional Duties of Excise (Goods of Special Importance) Act, 1957, which was enacted in pursuance of the decision of the National Development Council in December 1956.

Sales tax from its inception in India has been a constant source of harassment and inconvenience to traders. Though the incidence of the tax falls on the consumer yet it is incumbent on the dealer to comply with the law. The majority of the dealers in India are small tradesmen without much education. The difficulties of maintaining complicated accounts, assessment of liability on the basis of those accounts, understanding the statute and keeping pace with the frequent amendments of the statute and the rules thereunder present difficulties which are often more burdensome than the tax itself. Further, the administration of tax collection equally with that of checking of tax evasion has been a problem for the government. From the angle of interstate trade, diversity in the tax rates on the same commodity in the central and state tax laws tends to cause unnecessary movement of goods from one state to another. The multiple taxation of the same commodity under different tax laws and diversity in the rates of tax may also give rise to the problem of interstate trade barriers. Because of the difference in rates, the incidence of the tax on consumers varies from place

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to place. Further, when there is a great divergence in rates, particularly in contiguous states, there is danger of smuggling of goods from one state to another.<sup>1</sup>

Because of the difficulties involved in the levy, assessment and administration, and adverse impact on the national economy, there have been constant demands for the abolition of sales tax and its replacement by duties of excise imposed by the Centre. The National Development Council had recommended abolition of sales tax on the commodities mentioned above because of the several benefits flowing from it. The general elections of 1977 have added a new dimension to the question of replacement of sales tax by additional duties of excise, as the Janata Party manifesto had made a promise to that effect. It also promised that along with the abolition of sales tax, a formula would be worked out which ensures that the states derive steadily increasing shares from the collections, thus maintaining the element of elasticity which sales tax has.

## II

The decision of the National Development Council in 1956 required that a formula be evolved to compensate the states for their loss of revenue. The matter was consequently referred by the Union Government to the Second Finance Commission. The Commission recommended that the share of each state should not be less than the revenue realised from the levy of sales tax on these items for the financial year 1956-57 in that state. On working out the estimates of receipts of sales tax for the relevant year, the Commission arrived at guaranteed shares for each state, plus different percentages for different states if the proceeds exceeded certain amount. The Commission adopted consumption as the main basis for the distribution of the proceeds but as there was considerable margin of error in the figures of consumption, it also used population as a corrective in arriving at the figures for distribution of the proceeds among the states.<sup>2</sup>

The principles recommended by the Second Finance Commission were incorporated in the Additional Duties of Excise Act which was enacted by Parliament. In order to make the states amenable to the scheme, the commodities were named as "declared goods" so that the power of the states to levy tax on their sales was limited to a maximum of 3 per cent.

Silk fabrics were covered by the scheme through the Finance Act, 1961, and the item was put in the categories of declared goods. However, in 1968 it was withdrawn from the category of declared goods, and in 1970 the

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1. Indian Law Institute, *Interstate Trade Barriers and Sales Tax Laws in India* 79 (Bombay, Tripathi, 1962).

2. *The Report of the Finance Commission (Second)* 59-63 (1957).

states were left free to levy sales tax on silk fabrics without losing the payment on account of additional duties. This, thus put an end to the scheme in relation to the silk fabrics. Presumably this was because the yield from the additional excise duty on silk fabrics was small being estimated at Rs. 4 lakhs annually.<sup>3</sup>

The rates of excise duties are fixed on a sort of weighted average of the sales tax rates of all the states.

All the states accepted the scheme relating to the above mentioned commodities. The advantages are: (i) The traders welcomed the schemes as it eliminated considerable inconvenience experienced by the commercial community previously; (ii) the states' share of revenue increased due to checking of tax evasion; (iii) by doing away with sales tax the scheme was beneficial from the point of view of interstate trade and commerce.

In spite of the substantial gain from the scheme, a general extension of it to other commodities does not appear to be feasible. One obvious limitation is that administratively speaking excise is difficult to collect when there are innumerable producers with small units of production. When excise is levied on the mass of commodities, administrative problems are no less than under the sales tax. Excise duty has advantage over sales tax only when the production is on a large scale and concentrated in a few hands. Apart from its limited usefulness from the point of view of administration, there is the difficulty that the states will lose the advantage of flexibility which sales tax gives them. Under sales tax, the states can change the rates to suit the changing fiscal and trade conditions in their respective areas. Such adjustments are not possible when the Central Government is levying additional excise duty in lieu of sales tax, for the Central Government will need the consent of all the states, and then a change in the rate of excise will affect not only that state which desires the change but also other states. Sales tax can also be varied in relation to different grades of consumers in accordance with the needs of a particular state, but this is not possible in the case of an excise levy by the Central Government.<sup>4</sup>

If additional duties of excise were substituted in place of sales tax the states' dependence on the Centre for revenue would increase to a very great extent. In the course of *Lok Sabha* debates on the Additional Duties of Excise Bill, it was suggested that the Act be extended to other commodities.

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3. *The Report of the Finance Commission (Third)* 26 (1961).

4. *Supra* note 1 at 81-82.

The then Finance Minister, T.T. Krishnamachari observed:

It [the Bill] detracts from the responsibility of the States to their own people to some extent, because they can always say that the Centre has done it. If tomorrow something goes wrong, say, in regard to any particular provision in this particular Bill, it is easy for the people to say, well, it is the Centre that has done it, and we are not responsible. Even in the Taxation Enquiry Commission...I did mention this fact that the centralization of sales tax altogether would not be a correct thing because if the power of taxation is shifted to the Centre, there is no responsibility left so far as the States are concerned. So, we have also to keep the number of commodities that will come within the purview of Central taxation, however, beneficial it might be, to be restricted rather than enlarged, though, I do not, for one moment, say that there is no room for enlarging the present list.<sup>5</sup>

Extension of additional duties of excise does not seem to be a feasible device for use on a large scale.

The states themselves seem to have reservations about continuing the scheme. By the time the Third Finance Commission was appointed, many states had felt that the amount of compensatory revenue they received as per recommendations of the Second Finance Commission was far less than what they could have raised by increasing the rates of sales tax in the growing sale and hence consumption of these commodities. Therefore, "the States urged that the guaranteed amounts should be revised to take account of increases in rates of sales tax effected by them after the amounts guaranteed had been determined. They also complained that as a result of the surrender of sales tax, they lost over a period of years and that they should be insulated against further future losses." But the Third Finance Commission decided that "the Second Commission had rejected the suggestion that not only the revenues currently derived but prospective revenues should also be taken into account in determining the guaranteed amounts. So must we also dismiss the suggestion that we should make an estimate of possible losses sustained and refix the amounts of guarantees. For one thing, such an examination would be outside the terms of reference, and for another, such a determination would be impracticable on statistical material now available."<sup>6</sup> Consequently, the Commission recommended the distribution of the net yield from additional Union excise duties on the same basis as was recommended by the Second Finance Commission,

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5. L.S.D. 2nd series, vol. X (1957) p. 6215.

6. *Supra* note 3.

except that it recommended that the balance (over the guaranteed amount) be distributed partly on the basis of population (proportion of state population to the total population of the country) and partly on the basis of percentage increase in the collection of sales tax in each state since 1957-58.

The states reiterated their old grievance against this scheme before the Fourth Finance Commission also. The Commission made a departure from the recommendations of the earlier commissions with regard to the distribution of balance of the net proceeds left after distributing the guaranteed amount. The balance was to be distributed entirely on the basis of the proportion of sales tax revenue realized in each state to the total sales tax collected in all the states taken together.<sup>7</sup>

To counter the arguments of the states, it was pointed out by the Union that the items covered under this scheme were essential consumer items and that the states could not have increased the rates indiscriminately. In fact on similar items such as matches, kerosene, coal and vegetable products, the sales tax rates between 1958-59 and 1963-64 have either remained unchanged or shown very little increase. In fact on sugar and textiles, the Union Government did not revise additional duties of excise because on these items the basic duties of excise had to be decreased at times and the Union did not want that the state revenues (in respect of additional excise duties) should be affected by such decreases. It is only on tobacco that the basic duties have been increased and not lowered. Further, increase in the sales tax revenue in the states is due to increase of rates of luxury and semi-luxury goods. The Commission did not go into the validity of states' claims and the counter-claims of the Union. However, it observed:

We feel that if some sort of constitutional arrangement existed and both the Union and the state governments had the opportunity of explaining each other's views the implementation of the scheme would have been considerably better and misunderstandings less.<sup>8</sup>

The chairman of the Commission, P.V. Rajamannar, however, in a personal note appended to the Report felt that the objection of the states to the scheme

may... be met by giving the states a larger share of the receipts from the basic excise duties and any special duties of excise or surcharges on the duties. A view has been expressed that if it were possible to make a constitutional amendment, placing the yield of excise duties on the same footing as income tax, there might be just a possibility of the states agreeing to the merger of sales taxes and excise duties.<sup>9</sup>

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7. *The Report of the Finance Commission (Fourth)* 30-37 (1965).

8. *Id.* at 37.

9. *Id.* at 93.

By the time the Fifth Finance Commission was constituted, the complaint of the states as regards this scheme reached a high pitch. About half the number of states urged that the scheme should be discontinued. Others wanted suitable modifications. The reasons were: First, the states received compensatory grants only to the extent of their own collection of revenue from sales tax on these commodities in 1957-58. Though the actual yield exceeded the guaranteed amount, the Finance Commissions recommended the balance to be distributed partly on population or "general need" basis and partly on the growth of sales tax yield in the states. This mode of distribution, the states felt, was unjustified because they were constitutionally entitled to the entire yield on compensation or derivation principle. The Finance Commission could not do justice because of its inability to work out the derivation basis of the net proceeds. Second, the fixing of the guaranteed amount to the rates of sales tax prevailing in 1956-57 was considered unjust because of the lower rates prevailing then in some states. Further, the Union Government increased its own basic excise duty rates on similar commodities but kept the rates of additional excise duties constant on the basis of preventing inflation. Third, the states increased their rates of sales tax on other comparable commodities after 1957-58 whereas the rates on these rented commodities remained constant and the Finance Commissions refused to increase the guaranteed amount to the extent of actual net proceeds from these duties having regard to the growth of sales tax revenue in the states and the growth of consumption. This attitude of the Finance Commissions caused resentment among the states and some wanted to terminate the arrangement.

The Fifth Finance Commission was sympathetic to the views of the states. The Commission found that between 1957-58 and 1967-68 the revenue from basic and special Union excise duties on the commodities covered by the tax rental agreement increased by more than 70 per cent, whereas the revenue from additional Union excise duties on these commodities increased by only 45 per cent. The Commission also found that the rates of sales tax levied by some states on comparable commodities were generally higher than those of the additional Union excise duties. Consequently, the Commission felt that if the states were free to levy sale tax on these commodities, they would be realising much more revenue from them than they have been receiving as compensatory payments. However, the Commission agreed with the rationale and advantages of the tax rental scheme. But in view of the opposition of the states to the scheme, the Commission felt that it would not be desirable to continue the scheme, unless the Union Government in consultation with the state governments would arrive at a more satisfactory agreement with suitable modifications to the existing scheme. In view of this suggestion, the Commission did not recognise the extension of the existing agreement to cover other commodi-

ties. To reduce the grievances of states the Commission recommended that the rates of duties may be made *ad valorem* as far as possible and may be revised periodically to keep them at par with the rates of sales tax on similar items levied by the states. As regards the principles for distribution of net proceeds, the Commission recommended that the guaranteed amount may be paid on the basis of the old method and the balance may be distributed partly on the basis of sales tax collection (excluding interstate sales tax) during 1965-66 to 1967-68 and partly on the basis of population.<sup>10</sup>

Consequent on the recommendations of the Fifth Finance Commission that the scheme may have to be revised, some states wanted the discontinuance of the scheme. For instance, Andhra Pradesh and Tamil Nadu submitted their memoranda to the Union Government to this effect. So the Union Government referred the issue to the National Development Council, which in turn appointed a committee to examine the issue and to recommend the future course of action. The committee recommended the continuation of the scheme but suggested for the increase in the incidence of the duties by 10.8 per cent within a period of two or three years. These recommendations were reluctantly accepted by the states. The Union Government accepted these recommendations and implemented them through successive Finance Acts.<sup>11</sup>

By the time the Sixth Finance Commission submitted its report (1973), the yield from the additional duties of excise which amounted to only Rs. 52.68 crores in 1968-69 rose to about Rs. 168.78 crores in 1973-74. Most of the states by then were satisfied with the manner of implementation of the scheme by the Union government and did not want any material change. However, Andhra Pradesh wanted the scheme to be given up and it be allowed to levy sales tax. West Bengal also had reservations about the continuance of the scheme. Since the continuance or otherwise of the scheme was a policy decision, the Commission did not go into it. After soliciting the views of the state governments on the manner of distribution of the net proceeds, it laid down the principles.

It departed from the views of the previous commissions in that it expressed the view that there is no need to set apart any guaranteed amounts to the states because there is no risk of the share of any state in the net proceeds of such duties falling short of the revenue realised from the levy of sales tax on the commodities subject to additional duties of excise for the financial year 1956-57. The commission while examining afresh the

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10. *The Report of the Finance Commission (Fifth)* 38-39 (1969).

11. *The Report of the Finance Commission (Sixth)* 18 (1973); see also Thimmaiah, *Federal Fiscal Systems of Australia and India* 133 (New Delhi, Associated Publishing House, 1976).

principles for allocation of proceeds among the states recommended that the entire yield should be distributed 70 per cent in proportion to population of each state in the total population of the country, 20 per cent in proportion to the income of each state in the total income of all states and 10 per cent in proportion to the production of each commodity in the state.<sup>12</sup> These recommendations were implemented in 1974 and the system of providing a guaranteed amount for payment to the states was done away with.

### III

Pursuant to the manifesto of the Janata Party, the Union Finance Minister, on behalf of the Union government, had been having a series of talks with the state Chief Ministers and Finance Ministers to gauge their opinion on this important issue. On the whole the states are not happy to give up sales tax, their elastic source of income because it would have considerable bearing on their resources. The sales tax yield accounts for 55 per cent of the states' revenue and amounted roughly to Rs. 2,500 crores in 1975-76. Thus, sales tax has emerged as an effective tool in the mobilisation of state resources during the last two decades.

Those states where the Janata Party is in power are agreeable to the abolition of sales tax not because they would like it to happen but because of their election pledge to the people. In fact the Delhi Metropolitan Council passed a resolution seeking to abolish sales tax in the Union territory.<sup>13</sup> But those states such as West Bengal, Tripura, Tamil Nadu, Orissa and Kerala, where other parties are in power, have categorically opposed this scheme on the basis that it would constitute an inroad into their financial autonomy.<sup>14</sup> Further, the Jha Committee Report on indirect Taxes has by implication suggested that states should not be required to give up sales tax, a tax with great elasticity, because they are expected to mobilise increasing resources under successive Plans, and that the proposed

12. *The Report of the Finance Commission (Sixth)* 18-21 (1973); see also Alice Jacob, "The Finance Commission: Its Role in Adjustment of Union-State Financial Relations," in Alice Jacob (ed.) *Constitutional Developments since Independence* 317 at 324-25 (Bombay, Tripathi, 1975).

13. The resolution said: "This House resolves that the sales tax being levied in the Union territory of Delhi under the local and Central Sales tax laws be abolished. In its place alternative avenues, including an appropriate additional excise duty, be explored by the Central Government.

This House further resolves that the Central Government be moved to make allocations to the Union territory of Delhi to commensurate with its present collection and the increased collection which it would have made in future had the sales tax not been abolished, in order to safeguard Delhi's interests." See *Times of India*, 28.12.1977.

14. See Kerala Chief Minister's Reaction in *Patriot*, 3.2.1978; Orissa Government's Response in *Indian Express (Sunday Standard)* 26.2.1978; see generally, "Hurdles in Way of Sale Tax Abolition" *Patriot*, 28.1.1978.



substitution would accentuate the dependence of the states on the Centre.<sup>15</sup> This is reflected in the Union Finance Minister's Budget speech. He observed:

The total revenue from sales tax is of the order of Rs. 2,500 crores and it is growing steadily. It constitutes the main source of revenue of the States. The Chief Ministers of the States have generally showed a lack of enthusiasm for the abolition of the sales tax. In view of the attitude of the States and since sales tax is a State subject the task of persuading the States to give up sales tax calls for persistence and patience. It certainly cannot be regarded as something which can be accomplished in the immediate future<sup>16</sup>

Thus, the reluctance of the states to forego sales tax has made the Union go slow in the implementation of its election manifesto.

All in all it does not seem to be a feasible proposition to use the device of additional excise duties to replace sales tax on an extensive scale.

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15. See Editorial "Indirect Taxes" in *Statesman*, 22.1.1978; Jagannathan, "Economic Notebook: The Running Battle Goes On", *Statesman*, 3.2.1978.

16. See *Statesman*, 1.3.1978.

