

# CESS TAXES IN INDIA: A RIGHTS BASED ANALYSIS OF EARMARKING

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## I: INTRODUCTION

Taxes are compulsory contributions collected by governments to contribute to their coffers. Proceeds from taxes are meant to be used for the common good of the public and thus, no individual taxpayer has the entitlement to ask for a specific reciprocal benefit out of the same.<sup>1</sup> Governments can choose to apply the proceeds from taxes for any public purpose as deemed fit. Taxes are understood as an inherent attribute of sovereignty which grants governments' larger latitude in matters of taxation.<sup>2</sup>

Tax systems of most countries compose a varied mix of direct and indirect taxes. The Indian tax regime is no different.<sup>3</sup> However, a closer study reveals that under the umbrella of the direct and indirect taxes there are some specialized levies termed surcharges and cesses. A surcharge is an increase in the rate of a tax and the proceeds from such a levy is to be used exclusively for purposes of the Union Government.<sup>4</sup>

A cess has been described under Article 270<sup>5</sup> of the Indian Constitution as a levy for a 'specific purpose'. Judicial precedents have stated that a cess may bear the features of a tax or a fee.<sup>6</sup> A fee connotes the payment by an individual for a *quid pro quo* facility or service from the government.<sup>7</sup> The amount spent by the government towards rendering the service or facility must be broadly proportional to the amount paid by the individual.<sup>8</sup>

A cess tax is a term coined to identify a cess in the nature of a tax. If a cess is in the nature of a tax, one would then ask, what is the difference between a cess tax and a tax? The answer is that a cess is a levy collecting proceeds for a 'specific purpose' or in other words, an earmarked tax, unlike a tax which does not entail earmarking. The difference between a cess tax and a fee also needs to be understood. The contributor of a cess tax is not entitled to a *quid pro quo* while a fee payer is entitled to it. The common feature of a cess tax and a fee is that the collected sums are not to be merged in the general coffers, but kept aside for the special purpose or identified service, respectively.<sup>9</sup>

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<sup>1</sup> *The Commissioner, Hindu Religious Endowments, Madras v Sri Lakshmindra Thirtha Swamiar of Sri Shirur Mutt*, AIR 1954 SC 282, paras 45, 49-50 citing Latham CJ of the High Court of Australia in *Matthews v Chicory Marketing Board* (1938) 60 CLR 263, 276.

<sup>2</sup> *Jindal Stainless Ltd. v. State of Haryana* Civil Appeal No.3453/2002, para 14; *Commissioner of Income Tax, Udaipur, Rajasthan v. McDowell and Co. Ltd.* (2009) 10 SCC 755.

<sup>3</sup> See Ministry of Finance, Government of India, 'Tax Revenue' in Receipts Budget 2016 – 2017 (New Delhi, 2016).

<sup>4</sup> Article 271 of the Constitution read with *Sarojini Tea Co. (P) Ltd. v. Collector of Dibrugarh* [1992]1SCR371, para 17.

<sup>5</sup> Article 270(1): 'All taxes and duties referred to in the Union List, except the duties and taxes referred to in articles 268, 269 and 269A, respectively, surcharge on taxes and duties referred to in Article 271 and any cess levied for specific purposes under any law made by Parliament shall be levied and collected by the Government of India and shall be distributed between the Union and the States in the manner provided in clause (2).'

<sup>6</sup> *Hingir-Rampur Coal Co Ltd v The State of Orissa*, AIR 1961 SC 459, para 9.

<sup>7</sup> *Nagar Mahapalika, Varanasi v Durga Das* AIR 1968 SC 1119, para 21; *State of Andhra Pradesh v Hindustan Machine Tools* AIR 1975 SC 2037, para 22 –23.

<sup>8</sup> *Indian Mica Micanite Industries v The State of Bihar and Ors.* AIR 1971 SC 1182, para 11.

<sup>9</sup> *Shri Krishna Rubber Works v Union of India* (1971) 73 BOMLR 496, para 15.

In that sense, the cess tax-payers are entitled to utilization of cess taxes for the ‘specific purpose’ for which it is levied. Thus, while there is no entitlement of *quid pro quo* there is certainly an entitlement of ensuring that the levy, maintenance and utilization of the cess tax is for the ‘specific purpose’. Conceptualizing cess taxes in this light, the general taxes and fee form two extremes of the spectrum whereas cess taxes form a separate category in the middle. It is this rights-based perspective of cess taxes and the various questions it raises, that we propose to highlight in the paper.

India has a quasi-federal structure. Cesses may be imposed by the Union Government and the State Governments. The general rule is that collections from Union taxes are shared with State Governments. However, some exceptions have been carved out to this rule under Article 270(1)<sup>10</sup>. One such exception is in respect of Union cess taxes. The proceeds from a cess tax imposed by the Union Government are not shared with State Governments. This language though, was inserted in the Constitution only with effect from 1996, pursuant to the recommendations of the Tenth Finance Commission.<sup>11</sup> Even before 1996, the proceeds of Union cess taxes were not shared with State Governments on account of recommendations of successive Finance Commissions. For example, the Fourth Finance Commission opined that sharing proceeds with State Governments would be undesirable as a purpose had already been earmarked.<sup>12</sup>

One of the authors carried out a historical study of Union cess taxes levied between 1950 and November 2016 in an earlier paper. The study showed how proceeds from various cess taxes are lying unutilized including a case where proceeds were diverted for adjusting the fiscal deficit of the Government. In general there has been lack of accountability and transparency with respect to the appropriation and utilization of amounts collected from Union cess taxes. Cess taxes have also found to be economically inefficient in some cases which has led to repeal of various cess taxes.<sup>13</sup>

There appear to be two primary reasons as to why cess taxes have been levied by successive Union Governments. Firstly, amounts raised by the Union Government in the form of cess taxes need not be shared with State Governments. Secondly, through the route of cess taxes, Union Governments have been imposing these levies on tax bases in the Union List but for purposes in the State List which has enabled them to enter the domain exclusively reserved for the State Governments.<sup>14</sup>

As the earmarking requirement is central to the differential treatment of Union cess taxes under the Indian Constitution, a deeper enquiry into the same is necessitated. This paper is meant to be a follow on inquiry into the concept of earmarking and the legal implication of the findings from the data collection. The modest attempt of this paper is to continue the conversation by seeking answers to the following questions: What is the concept of earmarking? What is the meaning of the phrase ‘*specific purpose*’ in Article 270(1) of the Constitution? What are the implications in law of the various practical findings relating to dilution of purpose, non-utilization and diversion of earmarked proceeds? What has been the response of the Indian judiciary to challenges concerning cess taxes? Does the act of earmarking impose some obligations on the Government and in turn, some rights on the tax payer?

While cess taxes have been and are being imposed also by State Governments, this paper is confined to cess taxes imposed by the Union Government. It may perhaps be possible to extend the same

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<sup>10</sup> Supra note 5.

<sup>11</sup> ‘Devolution: An Alternative Scheme’, Chapter XIII in Tenth Finance Commission: Report (Finance Commission) (New Delhi, 1994) 59 – 61.

<sup>12</sup> ‘Union Excise Duties’, Chapter VI in Fourth Finance Commission: Report (Finance Commission) (New Delhi, 1965) 24, para 48.

<sup>13</sup> Ashrita Kotha, Cesses in the Indian Tax Regime: A Historical Analysis, Chapter 17 in *Studies in the History of Tax Law*, Volume 8 (2017), 483-511.

<sup>14</sup> Ashrita Kotha, Cesses in the Indian Tax Regime: A Historical Analysis, Chapter 17 in *Studies in the History of Tax Law*, Volume 8 (2017), 483-511.

study to levies imposed by the State Governments. The paper draws from observations by authors who have studied the phenomenon of earmarking abroad but the legal analysis here is restricted to the Indian context and experience. The absence of any study on the legal implications of the Indian experience relating to cess taxes constitutes the literature gap that the paper seeks to address.

## II: EARMARKING OF TAXES

### What is earmarking?

Earmarking has been defined to be the act of allocating specific tax revenues to fund a specific public service within fiscal systems collecting multiple taxes applied for varied purposes.<sup>15</sup> The specific purpose is made known to the taxpayer through the charging legislation, even before the taxes have been paid. This is the most important characteristic of an earmarked tax.<sup>16</sup> Earmarking operates like a ‘*spending promise*’ from the Government.<sup>17</sup>

The Tax Foundation’s 1955 report states that earmarking can happen in two ways: one scenario where legislative control is retained through the intervention of enacting appropriation acts and the other where earmarking happens directly without the need for any Parliamentary approval by way of appropriation acts.<sup>18</sup>

In India, the process of earmarking entails Parliamentary intervention. Once the Parliament passes a legislation charging a cess for an earmarked purpose, the proceeds are credited into the Government’s exchequer termed as the Consolidated Fund of India.<sup>19</sup> For withdrawing funds from the Consolidated Fund of India to be able to spend for the earmarked purpose, an Appropriation Act needs to be passed in the Parliament.<sup>20</sup> Such Appropriation Acts are money bills which must be introduced in the Lower House of the Parliament. The Upper House of the Parliament must return the bill within fourteen days and its recommendations are not binding in nature.<sup>21</sup>

### Merits and demerits of earmarking

Available literature points to certain merits and demerits of the practice of earmarking. Economists and lawyers have been divided in their opinion on the efficacy of earmarked taxes.

Earmarking has certain positive outcomes. Firstly, the act of earmarking safeguards support for some chosen purposes in the face of any financial exigencies (internal or external), change in Government,

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<sup>15</sup> James Buchanan, The Economics of Earmarked Taxes, Journal of Political Economy, Vol. 71, No. 5 (Oct., 1963), pp. 457- 469 at 457-458.

<sup>16</sup> Susannah Camic, Earmarking: The Potential Benefits, 4 Pitt. Tax Rev. 55 (2006) at 60.

<sup>17</sup> Susannah Camic Tahk, Public Choice Theory & Earmarked Taxes, University of Wisconsin Legal Studies Research Paper Series Paper No.1231, at p.14.

<sup>18</sup> Tax Foundation, Earmarked State Taxes, 1955 (New York) at p. 4.

<sup>19</sup> Article 266(1), Constitution of India. The Consolidated Fund of India is the fund where all tax monies are deposited and maintained. On the other hand, a Public Account is maintained for all public monies that the Government holds as a beneficiary, on behalf of the public, as per Article 266(2). The Public Account is used for sums such as Provident Fund, etc.

<sup>20</sup> Article 114, Constitution of India.

<sup>21</sup> Article 110, Constitution of India.

coalition politics, etc.<sup>22</sup> Also, earmarking results in Governments promising to fund such purposes for years to come even in the absence of a strict legal obligation on account of symbolic and institutional reasons.<sup>23</sup>

Secondly, in countries where tax compliance is poor on account of lack of credibility, earmarked taxes can help change this perception. If the Government can demonstrate that the tax collected will be spent for pledged purposes, there are better chances that the community will pay for the said taxes.<sup>24</sup> It is relatively easier for the Government to correlate collection and expenditure when there is a targeted contributor base and set of beneficiaries.<sup>25</sup> This could lead to increased revenues for the Government.<sup>26</sup>

Thirdly, some believe that earmarking is justified because it applies the benefits principle.<sup>27</sup> The benefits principle connotes that the set of contributors is also the beneficiary of the tax collections.

Fourthly, earmarked taxes provide better information on the amounts collected and spent which could help policy makers design and monitor tax systems better and advocacy groups to hold the Government responsible for the earmarking.<sup>28</sup>

On the flip side, earmarking also has some cons.

Firstly, it has been observed that the practice impedes legislative control as no appropriation bills are passed by the Parliament for usage of the earmarked funds. It must be remembered that this criticism does not apply in the Indian context as for each earmarked tax, the Parliament needs to pass Appropriation Acts to withdraw funds from the treasury.

Secondly, the exercise of earmarking entails setting aside an indefinite amount of money unlike budgetary allocation where specific sums of money are allocated based on needs. The pledging of funds in advance, precludes the opportunity of adjusting allocations depending on needs, as and when they arise. Further, when there are any pressing needs, due to the lack of availability of the earmarked funds, there is pressure on whatever sources remain.<sup>29</sup>

Thirdly, even for the earmarked purposes, considering the earmarked funds are pledged in advance, the sums have not been adjusted to current levels of inflation, which means that the Government may still have to depend on additional budgetary allocations (apart from the earmarked funds).<sup>30</sup>

Fourthly, the act of locking-in funds for specific purposes leads to '*misallocation of resources*'; some purposes receive excessively disproportionate amounts while others do not get the necessary attention and support.<sup>31</sup>

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<sup>22</sup> Ranjit S Teja, The Case for Earmarked Taxes, Staff Papers (International Monetary Fund), Vol. 35, No. 3 (Sep., 1988), pp. 523-533 at p.531; William McCleary, The Earmarking of Government Revenue: A Review of Some World Bank Experience, The World Bank Research Observer, Vol. 6, No. 1 (Jan., 1991), pp. 81-104 at p.85.

<sup>23</sup> Susannah Camic, Earmarking: The Potential Benefits, 4 Pitt. Tax Rev. 55 (2006) at pp.63-77.

<sup>24</sup> Ranjit S Teja, The Case for Earmarked Taxes, Staff Papers (International Monetary Fund), Vol. 35, No. 3 (Sep., 1988), pp. 523-533 at p.531; William McCleary, The Earmarking of Government Revenue: A Review of Some World Bank Experience, The World Bank Research Observer, Vol. 6, No. 1 (Jan., 1991), pp. 81-104 at p.85.

<sup>25</sup> Ashrita Prasad Kotha, Indian Cess Taxes: A Call for Accountability, available at <https://www.taxjustice.net/2017/12/11/indian-cess-taxes-call-accountability-guest-blog/>.

<sup>26</sup> Susannah Camic, Earmarking: The Potential Benefits, 4 Pitt. Tax Rev. 55 (2006) at p.78.

<sup>27</sup> Deran, Elizabeth, "Earmarking and Expenditures: A Survey and a New Test", National Tax Journal Vol. 18, No.4, (December 1965) pp. 354-361 at 357.

<sup>28</sup> Susannah Camic, Earmarking: The Potential Benefits, 4 Pitt. Tax Rev. 55 (2006) at p.59.

<sup>29</sup> Tax Foundation. Earmarked State Taxes. New York, 1955 at p. 20.

<sup>30</sup> William McCleary, The Earmarking of Government Revenue: A Review of Some World Bank Experience, The World Bank Research Observer, Vol. 6, No. 1 (Jan., 1991), pp. 81-104 at p.90.

<sup>31</sup> Deran, Elizabeth, "Earmarking and Expenditures: A Survey and a New Test", National Tax Journal Vol. 18, No. 4, (December 1965) pp. 354-361 at 357.

Fifthly, even though earmarking has been supported on the basis of benefits theory, practically, this is far from true.<sup>32</sup>

Sixthly, in practice, these provisions appear to remain on the statute books even after the purpose ceases to remain a pressing concern.<sup>33</sup>

### **Kinds of earmarked taxes**

Existing literature has classified earmarked taxes into four categories. The categorization is based on the tax base and the specific purpose chosen in the earmarked tax.

McCleary has classified earmarked taxes based on whether it has a narrow or broad tax base and narrow or broad purpose. The first category constitutes taxes with a narrow base and narrow purpose. The contributors are also the beneficiaries of the earmarked tax which he described to be a case of '*strong earmarking*'. Other three categories are where a narrow base is applied towards a broad purpose, broad base is applied towards a narrow purpose and broad base is applied towards a broad purpose. These categories reveal '*weaker earmarking*' as the objective of setting aside fixed revenues is mixed with that of redistribution and social welfare. Also, the benefits principle is lacking in the latter three models.<sup>34</sup>

Camic has classified earmarked taxes using the matrix of how concentrated or diffused the cost and benefit of the tax is. The cost looks at the tax base while the benefit looks at those who stand to gain from the collections of the tax. The four categories are as follows: taxes with diffused costs and diffused benefits, taxes with diffused costs and concentrated benefits, taxes with concentrated costs and diffused benefits and lastly, taxes with concentrated costs and concentrated benefits.

Both authors classify earmarked taxes along similar lines. The first factor of tax base is common to both. The second matrix is also related. McCleary's use of purpose is akin to Camic's use of beneficiaries as the breadth of the purpose dictates how diffused or concentrated the beneficiaries are.

Earmarked taxes have been in vogue well before India became independent and adopted its own Constitution. There have been a wide range and number of earmarked taxes levied since 1950, when adopted its own Constitution.

Now, to look at the kinds of tax base and specific purposes used. The tax base adopted for most earmarked taxes has been excise duty which is an indirect tax applied on the taxable event of manufacture of goods. Only many decades later, beginning from the early 2000s, the choice of tax base was extended to other indirect taxes such as service tax and customs duty and direct taxes such as income tax and corporation tax. The earmarked purposes could be studied to fall under three categories: promoting a particular trade / industry, labour welfare within a particular industry and other broad-based / general causes.<sup>35</sup>

One can attempt to use the classification by McCleary and Camic in the Indian context as well. Unlike the American context which was studied by Camic, the study at hand, only looks at earmarked taxes

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<sup>32</sup> William McCleary, The Earmarking of Government Revenue: A Review of Some World Bank Experience, The World Bank Research Observer, Vol. 6, No. 1 (Jan., 1991), pp. 81-104 at p.101.

<sup>33</sup> Deran, Elizabeth, "Earmarking and Expenditures: A Survey and a New Test", National Tax Journal Vol. 18, No. 4, (December 1965) pp. 354-361 at 357.

<sup>34</sup> William McCleary, The Earmarking of Government Revenue: A Review of Some World Bank Experience, The World Bank Research Observer, Vol. 6, No. 1 (Jan., 1991), pp. 81-104 at p. 82-84.

<sup>35</sup> Ashrita Kotha, Cesses in the Indian Tax Regime: A Historical Analysis, Chapter 17 in Studies in the History of Tax Law, Volume 8 (2017), 483-511.

imposed by the Union Government. At first thus, it seems that all costs are diffused because of the relatively bigger spread formed by the tax base.

However, if one were to study the cost and benefit in relative terms, it would be possible to identify earmarked taxes with concentrated costs and benefits as being the cesses that were imposed on specific industries for promoting the trade of that particular industry. For example, rubber cess, tea cess, sugar cess, to name a few. These would constitute the category of '*strong earmarking*' in the language of McCleary.

On the other end of the spectrum, taxes with diffused costs and benefits can be identified as the new age cesses such as Swachh Bharat Cess<sup>36</sup>, Krishi Kalyan Cess<sup>37</sup> and Infrastructure Cess<sup>38</sup> which have been imposed on all taxable services for broad purposes such as promotion of hygiene and sanitation, agriculture and farmer welfare and infrastructure, respectively. The description of the purposes has also been done in a wide and open-ended manner which lends more weight to the understanding that the benefits are diffused. Even the primary education<sup>39</sup> and secondary and higher education cess<sup>40</sup> appears to fall under this category as the levy was collected across various tax bases (such as service tax, income tax, customs duty) and the purpose extends to facilitation of education across the country.

Cesses with concentrated costs and diffused benefits consist of the labour welfare cesses which were typically collected from the owners of the mines and the proceeds therefrom were to be spent for welfare of labourers within the specific mining industry. This classification is based on the understanding that the number of labourers outnumber the number of owners. If on the other hand, data reveals numbers to the contrary, this category may fall under taxes with diffused costs and concentrated benefits. The redistributive aspect in both instances shows '*weaker earmarking*', as described by McCleary.

Finding other examples for the category with diffused costs and concentrated benefits seems the toughest in the Indian system. The reason being the adoption of broad purpose clauses and the practice of using broad tax bases (such as all income earners, all service recipients).

One anomalous cess tax is the Goods and Services Tax Compensation Cess<sup>41</sup> levied over and above the newly introduced Goods and Services Tax. Here the beneficiary is not the tax payer but the State Governments. This makes it look more like a revenue raising measure rather than an earmarked tax. The so called specific purpose is to compensate State Governments for compensating them for any losses occurring in the first five years of implementing the Goods and Services Tax.<sup>42</sup> Hence, in McCleary's language, this looks more like a '*general tax*' for raising revenues. There is no earmarking nexus that can be established here. One thus, questions whether this levy constitutes a cess to begin with.

### **III: EARMARKED TAXES UNDER THE INDIAN CONSTITUTION**

The power to tax is an inherent attribute of the sovereign. Undoubtedly, the sovereign has the prerogative to choose the class of persons to be taxed, the tax base and tax rate. In the case of a cess tax,

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<sup>36</sup> Section 119, Finance Act, 2015.

<sup>37</sup> Section 161, Finance Act, 2016.

<sup>38</sup> Section 162, Finance Act, 2016.

<sup>39</sup> Finance Act, 2004.

<sup>40</sup> Finance Act, 2007.

<sup>41</sup> Section 8, Goods and Services (Compensation to States) Act, 2017.

<sup>42</sup> Section 8, Goods and Services (Compensation to States) Act, 2017.

the sovereign also has the privilege of identifying the earmarked purpose. As a tax can only be brought in through the means of a legislation<sup>43</sup>, the law must be valid in the eyes of law.

Every tax law must (a) be within the legislative competence of the relevant legislature<sup>44</sup>, (b) not be violative of any fundamental rights contained in Part III of the Constitution<sup>45</sup> and (c) not be expressly prohibited under any other tax specific articles of the Constitution<sup>46</sup>.

The constitutional validity of any tax legislation can be challenged on three primary grounds: (a) violation of any specific provisions of the Constitution, (b) violation of fundamental rights and (c) legislative competence.

### **Cess taxes must confirm to Article 270**

The general rule under the Constitution is that the proceeds from the taxes levied by the Union Government are shared with the State Governments, as was contained in Article 270. This provision underwent an amendment through the Eightieth Constitution Amendment Act, 2000 based on the recommendation of the Tenth Financial Commission<sup>47</sup>. The amended Article 270 provides that cess taxes levied for '*specific purpose*' is an exception to the scheme of sharing between the Union and the State Governments.

The Eightieth Constitution Amendment Act, 2000 was enacted for ensuring utilization of the cess proceeds by the Union alone for effective implementation of the purpose for which the cess was levied. Making cess tax as an exception to the revenue sharing structure mandated by the Constitution based on the principle of co-operative federalism has a great bearing on the Center State relations in the country. The lack of financial resources impedes the financial autonomy of the States. No wonder, State Governments have been protesting against the increasing share of cess taxes in the Union revenue.<sup>48</sup>

Until the Eightieth Constitution Amendment Act, 2000 the only reference to cess in the Constitution was in Art 277<sup>49</sup> which was to save pre-Constitution legislation passed by State Governments or local authorities that imposed cesses now covered within the competence of the Union Parliament until a contrary legislation is passed by the Parliament.

The absence of a specific mention of cess taxes other than in Article 277 prior to the Eightieth Amendment Act, 2000 does not change the understanding of a cess tax as the Supreme Court<sup>50</sup> had consistently held since 1967 that a cess is a tax levied for a specific administrative expense.

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<sup>43</sup> Constitution, Art 265.

<sup>44</sup> Constitution, Art 246 read with the 7th Schedule.

<sup>45</sup> Constitution, Art 13.

<sup>46</sup> For example, Constitution, Arts 276(2), 285, 286 and 304(a).

<sup>47</sup> 'Devolution: An Alternative Scheme', Chapter XIII in Tenth Finance Commission: Report (Finance Commission) (New Delhi, 1994) 59 – 61.

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<sup>49</sup> '*Any taxes, duties, cesses or fees which, immediately before the commencement of this Constitution, were being lawfully levied by the Government of any State or by any municipality or other local authority or body for the purposes of the State, municipality, district or other local area may, notwithstanding that those taxes, duties, cesses or fees are mentioned in the Union List, continue to be levied and to be applied to the same purposes until provision to the contrary is made by Parliament by law.*'

<sup>50</sup> Hon'ble Justice Hidayatullah expressed in his dissenting opinions rendered in the matter of *Shinde Bros v Dy Commissioner Raichur & Ors.* AIR 1967 SC 1512 para 39 and *Guruswamy & Co v State of Mysore* [1967] 1 SCR 548 para 57. The dissenting views were adopted by the majority in *India Cement Ltd. v State Of Tamil Nadu* AIR 1990 SC 85 paras 19 and 20.

### ***Understanding ‘specific purpose’ by contrasting cess and surcharge***

Proceeds from cess as well as surcharge are exempted from sharing with the States under Art. 270 of the Constitution. Proceeds from both need not be shared by the Union Government with the State Governments. However, there are substantial differences between the two.

Cesses may be levied by the Union or State Governments. The operative phrase in understanding a cess tax is ‘*specific purpose*’; the earmarked purpose for which it is levied. Cesses are typically named after such earmarked purpose; the purpose itself must be certain and for public good.

On the other hand, a surcharge is an increase in duties or taxes ‘*for the purposes of the Union*’ as described in Article 271 of the Constitution. The nature of a surcharge and its characteristic features have been explained in similar terms by the Supreme Court in *Sarojini Tea Co. (P) Ltd. v. Collector of Dibrugarh*.<sup>51</sup>

An example of the latter is individuals earning more than INR 10,000,000 annually being required to pay an extra sum amounting to fifteen percent on their income tax<sup>52</sup>. As can be seen the provision does not point to any earmarked purpose as proceeds are exclusively at the disposal of the Union Government and can be used for any purpose, as may be deemed fit.

Keeping cesses and surcharges outside the divisible pool of revenues was recommended by the Tenth Finance Commission as it was in national interest to allow the Union Government to have sufficient flexibility for meeting its exclusive needs.<sup>53</sup>

The Constitution itself makes a distinction by identifying them as two distinct levies. Hence, any contrary interpretation would mar the Constitutional intent in maintaining a distinction between a tax, a cess tax and a surcharge.

### ***Specific Purpose: Condition precedent for levy, maintenance and utilization of cess***

The very reason for treating cess taxes as an exception to the model of co-operative federalism was to give due weight and meaning to the phrase ‘*specific purpose*’. Thus, in respect of cess taxes, all steps in its life cycle, beginning from conception, levy, collection, maintenance and utilization of proceeds must confirm to fulfilling the threshold spelt out by ‘*specific purpose*’.

A cess tax must be accompanied by the ‘*specific purpose*’ which must not be vague and uncertain. Unfortunately the trend of recent cess tax legislations has been to give a very brief description of the earmarked purpose. For example, Section 119 of Finance Act, 2015 which has imposed the Swachh Bharat Cess describes the purpose as being to ‘*promote and finance Swachh Bharat initiatives and any related purpose thereto*’. Similarly, Sections 162 of Finance Act, 2016 which levied Infrastructure Cess merely states that the purpose of the cess is to *promote and finance infrastructure projects*.

However, a RTI response received from the Ministry of Finance stated that the purpose is to finance infrastructure projects in view of the pollution and traffic situation in Indian cities. This is not in conformity with the text of Section 162 and is an example of the Indian executive traversing beyond the legislature’s intention by supplying its own meaning. Such an instance also highlights the dangers of having such brief clauses describing the purpose.

Cess taxes should not be general revenue raising measures. A cess tax is levied over and above an existing tax. Tax monies are already available for being utilized for all public purposes. Moreover, cess

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<sup>51</sup> [1992] 1 SCR 371 para 17.

<sup>52</sup> Section 3(a), Finance Act, 2017.

<sup>53</sup> Para 6, Statement of Objects and Reasons, Constitution (Eightieth Amendment) Act, 2000.



taxes are an exception to the general rule under which all Union taxes have to be shared with State Governments<sup>54</sup>. Hence, it is expected that while creating a charge for an additional tax, the Union Government should justify the necessity and/or exigency for such levy and that the resort to cess taxes must be made cautiously.

The purpose sought to be funded from cesses must be for some special object, for which existing tax monies are not sufficient. Even Hidaytullah J. referred to cess as a levy for a '*special administrative expense*'. Similar analogy was used by the Supreme Court when considering the legal validity of a toll tax. The Supreme Court observed that when the building of bridges and roads was already within the statutory duty of the municipality, there was no justification to levy an additional toll tax for such purpose.<sup>55</sup>

Proceeds from cess taxes are to be earmarked in the financial accounts as well as utilized for the earmarked purpose. The Constitution provides that all cess tax proceeds must be deposited into the Consolidated Fund of India.<sup>56</sup> However, to uphold the true spirit of earmarking, monies from cess taxes must be segregated within the Consolidated Fund of India, by not only using separate accounting codes but also creating dedicated funds.

If the cess is levied, maintained or utilized contrary to the '*specific purpose*' condition, it would amount to a fraud on the Constitution. As a consequence of such act, the quintessential feature not being met with, it could be argued that a cess tax loses its character of a cess and becomes a tax.

The rate of cess to be levied must be based upon the specific funding requirement for which the cess is being levied. There cannot be a mathematical equivalence between the funding required and cess proceeds raised, however, it is expected that the rate of cess percentage should be based on some calculation revealing the funding requirement for the specific purpose.

#### ***Legislative dilution of utilization of cess proceeds de hors 'specific purpose'***

In order to uphold the spirit of '*specific purpose*' the legislations charging cess taxes must mandate that the entire proceeds from the cess, minus amounts spent in collecting the cess, are utilized only for the earmarked purpose.

However, certain legislations introducing cess leave the utilization of cess tax for specific purpose upon the discretion of the Parliament.

Such wide discretion is nothing but colourable exercise of power in as much as what cannot be done directly i.e. having undivided revenue receipts of general nature can never be done indirectly, i.e. by levying cess for specific purpose but permitting use for general purposes.<sup>57</sup>

#### **Legislative competence of cess legislations**

The power to enact legislations is demarcated among the different spheres of Government through the Union List, State List and Concurrent List in the Seventh Schedule to the Constitution. The Parliament has the power to introduce legislations on subjects mentioned in the Union List and Concurrent List.<sup>58</sup> For

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<sup>54</sup> Constitution, Art. 270.

<sup>55</sup> *Kamaljeet Singh v. Municipal Board* AIR 1987 SC 56, para 1.

<sup>56</sup> Article 266(1), Constitution of India.

<sup>57</sup> See Section 4, Research and Development Cess Act, 1986, Section 4, Central Road Fund Act 2000, Section 12(7), Rubber Act, 1947, Section 3(a) Beedi Workers Welfare Fund Act 1974.

<sup>58</sup> Articles 245 read with Article 254, Constitution of India.

a tax legislation, the concerned Government must rely on a tax specific entry therein. Hence, while the Union Government can make a law on any entry in the Union List, it can only introduce a tax legislation on a tax specific entry therein. Additionally, the Union Government has the power to introduce a tax not mentioned in the State List or Concurrent List on account of the residuary power<sup>59</sup> vested in it.

Cess taxes provide an interesting case study for legislative competence because there are two elements at play here – the tax base and the earmarked purpose. When the Union Government is enacting a cess legislation, is it enough that the tax base is covered in the Union List but the purpose is in another List? It appears not. Owing to the constitutional protection, once a cess tax is imposed by the Union Government the proceeds are to be retained and spent exclusively by it. The Union Government only has power to spend for purposes contained in the Union List. When the purpose is not in the Union List and on the contrary, in the State List, the Union Government can neither legislate in case of cess taxes, nor incur expenses on such purposes. Hence, if the purpose is mentioned elsewhere that would lead to an anomalous situation.

The next question is whether the residuary power of the Union Government empowers it to impose not just taxes *simpliciter* but also cess taxes. It appears that the power can be exercised in the former case but cannot be extended to the latter instance of cess taxes. In the case of taxes *simpliciter*, all proceeds are to be shared with the State Governments based on recommendations of the Finance Commission. Such monies will then be applied for purposes based on the respective competence of the Union and State Governments.

However, in respect of cess taxes imposed by the Union Government, owing to the fact that the monies are also to be at the exclusive disposal and utilized by the Union Government, it would be anomalous if the purpose has been enshrined in the State List. Where the purpose is completely absent from the Seventh Schedule, the cess legislation may still be tenable.

Several cess taxes are being levied by the Parliament on tax bases contained in the Union List but for specific purposes which relate to entries provided for, in the State List. This is extremely dangerous scenario as it leads to a vulnerable situation and unprecedented financial dependency of the States on the Union. An instance is the Swachh Bharat Cess<sup>60</sup> which was imposed as an addition to the existing service tax base for the earmarked purpose of promoting and financing Swach Bharat (Clean India) initiatives. The earmarked purpose here can be read into entry 6 of the State List. Likewise, in the case of the Krishi Kalyan Cess the purpose of agriculture and farmer welfare is also mentioned in the State List.

Proceeds amounting to approximately INR 16,425 crores<sup>61</sup> from the Swachh Bharat Cess are being allotted by the Union Government to different State Governments in its absolute discretion. This is problematic because if this were a tax instead, the distribution of proceeds would be governed by the recommendations of the Finance Commission. The Finance Commission has been envisaged to be an independent body and thus, entrusted with recommending the vertical and horizontal distribution of tax revenues between the Union Government and the various State Governments. Here, the distribution is happening contrary to the spirit of a cess tax and without any rational and independent basis, as would have been the case with the Finance Commission.

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<sup>59</sup> Entry 97, Union List, Seventh Schedule, Constitution of India.

<sup>60</sup> Section 119, Finance Act, 2015.

<sup>61</sup> Ministry of Finance, Government of India, 'Tax Revenue' in 2015 – 2016 Receipts Budget (New Delhi, 2015) and Ministry of Finance, Government of India, 'Tax Revenue' in 2016 – 2017 Receipts Budget (New Delhi, 2016).

Hence, legislations enacting cess taxes such as the Swachh Bharat Cess and the Krishi Kalyan Cess amount to encroaching on the powers of the States and are in flagrant breach of the Indian federal structure, which is a basic structure of the Constitution.

#### IV: JUDICIAL RESPONSE TO EARMARKED TAXES IN INDIA

Having understood what the Constitution provides in relation to cess taxes, it is important to see what the understanding of the Judiciary has been, in relation to the concept of a cess tax as well as legal issues pertaining thereto.

##### *Features of a cess tax*

The early decisions on cess taxes state that the term may be still in vogue in Ireland<sup>62</sup> and may have meant ‘*a rate levied by a local authority and for local purposes*’ in England but now the word cess has been replaced by rate<sup>63</sup>. A cess has been described as a tax for a specific object<sup>64</sup> or special administrative expense, as identified in the name. The examples quoted are those of health cess, education cess, etc.<sup>65</sup>

While these decisions refer to a cess as being a tax, it must not be forgotten that a cess may bear the characteristics of either a tax or a fee. Whether it would constitute a tax or a fee would depend ultimately on the facts at hand. For example, if a cess in the nature of a tax, the proceeds must form a part of the Consolidated Fund of India. On the other hand, if a cess is a fee, the funds are kept separately for rendering the service to the fee payer.<sup>66</sup>

The Court studied the nature of the rubber cess introduced under Section 12, Rubber Act, 1947 and stated it to be in the nature of a tax. The cess was described as a duty of excise, imposed on articles manufactured in India. The funds from the cess were to be used for research, training of students, providing technical advice to growers, etc. The ‘*pith and substance and dominant purpose*’ of the levy was to develop the rubber industry which connotes a public purpose rather than a specific facility to a person. The funds were to be first credited into the Consolidated Fund of India and then appropriated for the identified purpose into an earmarked fund. All these factors demonstrated that the levy bore the characteristics of a tax and not a fee.<sup>67</sup>

On the other hand, the cess levied under the Orissa Mining Areas Development Fund Act, 1952, was held to be a fee as the monies were not part of the Consolidated Fund of India. There was a correlation between the cess and the purpose for which it was levied. The cess was levied against the persons owning mines in the notified area and the funds were to be used to render specific services to the said class by developing the notified area.<sup>68</sup>

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<sup>62</sup> *Shinde Bros v Dy Commissioner Raichur & Ors.* AIR 1967 SC 1512 para 39 and *Guruswamy & Co v State of Mysore* [1967] 1 SCR 548.

<sup>63</sup> *Daulat Ram v Municipal Committee* AIR 1941 Lah 40, para 9.

<sup>64</sup> *Daulat Ram v Municipal Committee* AIR 1941 Lah 40, para 9.

<sup>65</sup> This was the view of Justice Hidaytullah expressed in his dissenting opinions rendered in the matter of *Shinde Bros v Dy Commissioner Raichur & Ors.* AIR 1967 SC 1512 para 39 and *Guruswamy & Co v State of Mysore* [1967] 1 SCR 548, para 57. In *India Cement Ltd. v State Of Tamil Nadu* AIR 1990 SC 85, paras 19 and 20 the dissenting views of Hidaytullah J. were adopted by the majority noting that there was no disagreement among the Judges on this aspect.

<sup>66</sup> *Hingir-Rampur Coal Co Ltd. v The State of Orissa*, AIR 1961 SC 459, para 9. In *N Balaraju* the Andhra Pradesh High Court spoke of cess and tax interchangeably. However, that appears to be an error in light of the Supreme Court precedents quoted here.

<sup>67</sup> *Shri Krishna Rubber Works v Union of India* (1971) 73 BOMLR 496.

<sup>68</sup> *Hingir-Rampur Coal Co Ltd. v The State of Orissa*, AIR 1961 SC 459, para 18.

### ***Specific purpose***

A cess may be a tax or a fee but most importantly, it must be for a specific purpose. This feature makes it different from a tax or a fee *simpliciter*.

The earmarked purpose of a cess tax must be for the benefit of the public.<sup>69</sup> There is no need for identifying a *quid pro quo* to the contributor. However, this does mean that the funds must be used for the collective good of the society by spending for the promised earmarked purpose.

The purpose in a statute imposing a cess must not be vague or uncertain, as it could lead to a claim of excessive delegation of power. The purpose of the Iron Ore mines Labour Welfare cess was to fund measures for *inter alia* improvement of standard of living including housing and nutrition, public health and sanitation, provision of water supplies, education, etc.<sup>70</sup> The Supreme Court held that the purpose was specific in nature.<sup>71</sup>

Some cess tax statutes employ confusing language. Section 91 of the Finance Act, 2004 states that ‘*there shall be levied ...as surcharge for the purposes of the Union, a cess to be called the education cess, to fulfil the commitment of the Government to provide and finance universalized quality basic education.*’

The Supreme Court in *SRD Nutrients Private Limited v Commissioner of Central Excise, Guwahati* observed that primary education and higher education cess are surcharges. The Court was not called upon to decide the nature of the levy; the limited question was in respect of a manufacturer’s eligibility for refund of primary education cess and secondary and higher education cess paid during clearance of goods. The issue of refund could have been decided just by interpreting the applicable sections of the Finance Act, 2004 which say that the education cess is payable on aggregate duties of excise. If no duties of excise are payable, the cess amount would also be nil. Considering the remarks of the judges were not central to deciding the question at hand, one can argue that the comments are *obiter dicta*.

The remarks are problematic as there are more legislations containing such language which leads to a danger that subsequent cases would rely on these statements. Another example is Section 184(2) of Finance Act, 2016 pertaining to Income Disclosure Scheme which imposed a tax of thirty percent and ‘*a surcharge, for the purposes of the Union, to be called the Krishi Kalyan Cess on tax calculated at the rate of twenty-five per cent of such tax so as to fulfil the commitment of the Government for the welfare of the farmers*’.

### ***Earmarking of proceeds***

Once the proceeds are collected it must be credited into the Consolidated Fund of India<sup>72</sup>. However, the proceeds must be earmarked within the Consolidated Fund of India. The proceeds must not be merged with the other monies in the Consolidated Fund of India as that would render the legislation unconstitutional.<sup>73</sup> If the earmarking exercise is not done, the cess tax would cease to be a cess tax and become a tax *simpliciter*.<sup>74</sup>

The earmarking of proceeds must also be accompanied by generating reports and accounts which demonstrates transparency in maintenance of funds.<sup>75</sup> Such reports and accounts must be available in the public domain.

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<sup>69</sup> *Shree Krishna Rubber Works*;

<sup>70</sup> Section 3, Iron Ore Mines Labour Welfare Cess Act, 1961.

<sup>71</sup> *V Nagappa v Iron Ore Mines Cess Commissioner* AIR 1973 SC 1374

<sup>72</sup> Constitution, Art 266(1).

<sup>73</sup> *Sharma Sports v State of Karnataka* reported in 2005 (1) Kar LJ 539, more particularly in paragraph 19, 24, 25 and 28

<sup>74</sup> *Gwalior Sugar Co. Ltd. v State of Madhya Bharat* reported in AIR 1954 MB 196, more particularly paragraphs 17 and 19

<sup>75</sup> *V Nagappa v Iron Ore Mines Cess Commissioner* AIR 1973 SC 1374

In order to withdraw the proceeds from the Consolidated Fund of India to spend for the earmarked purpose, an Appropriation Act must be passed.<sup>76</sup> This ensures parliamentary involvement and scrutiny in the administration of the cess proceeds.

The Supreme Court has also observed that a cess tax contains an inherent check as it should be possible to correlate the collected amount with the amount required for the specific purpose.<sup>77</sup> This means that prior to the imposition of the cess tax, there must be calculation of the amount required to be raised. Such forethought would also mean that the cess would not be imposed for an arbitrary or indefinite period.

### ***Non-appropriation / utilization of proceeds***

In *Vijayalakshmi Rice Mills v Commercial Tax Officers*<sup>78</sup> the Supreme Court explained a cess to be a special kind of tax as proceeds have to be used for the specific purpose. By way of illustration, the Court explains that a health cess must be used for building hospitals, giving medicines to the poor, etc. Proceeds must thus be used for earmarked purpose and not diverted for any other purpose.<sup>79</sup>

In another instance, the Supreme Court had to consider a situation where over INR 270,000 million collected as building and other construction workers welfare cess had been lying unutilized. The Court passed a series of orders where it observed that less than 10 per cent money had been spent but that was also for purposes other than worker welfare.<sup>80</sup> The Court took strong objection to this state of affairs. The Court admonished the Government by stating that ‘*it would be perhaps more appropriate not to collect this money since it is not being utilized for the benefit of the persons for whom it is collected, but for other purposes.*’ The Supreme Court asked the Delhi Government, which had spent money on advertisements, to refund the same as it had nothing to do with worker welfare.<sup>81</sup> When it also found that money collected was not being transferred to the earmarked welfare board set up under the legislation, it ordered transfer of funds within a prescribed time frame.<sup>82</sup>

The cess in question has been determined to be a cess fee. The common feature between a cess fee and a cess tax is that the proceeds ought to be utilized for a specific purpose. Hence, it can be argued that the analysis applies equally to a cess tax.

On the other hand, the Karnataka High Court has observed that the proceeds of a cess in the nature of a tax may be used for any public purpose including the earmarked purpose as it is part of the Consolidated Fund of India.<sup>83</sup> Such conclusion is contrary to the spirit of a cess tax and confuses the concept of a cess tax and a tax.

The Kerala High Court held that when considering the constitutional validity of a cess statute it would be ‘inappropriate and indeed illegitimate’ to enquire into whether the application of proceeds

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<sup>76</sup> Article 114, Constitution of India.

<sup>77</sup> *V Nagappa v Iron Ore Mines Cess Commissioner* AIR 1973 SC 1374, para 16.

<sup>78</sup> (2006) 6 SCC 763, para 13.

<sup>79</sup> *Vyapar Mandal v. The Municipal Board*, 1989 (87) ALJ 1372, para 47 and 50.

<sup>80</sup> *National Campaign Committ., C. L., Labour v. Union of India*, Conmt. Pet. (C) No. 52/2013 in Writ Petition (C) No. 318/2006, order dated 30th October 2017.

<sup>81</sup> *National Campaign Committ., C. L., Labour v. Union of India*, Conmt. Pet. (C) No. 52/2013 in Writ Petition (C) No. 318/2006, order dated 21 August, 2015.

<sup>82</sup> *National Campaign Committ., C. L., Labour v. Union of India*, Conmt. Pet. (C) No. 52/2013 in Writ Petition (C) No. 318/2006, order dated 8 May 2017 and 2 August 2017.

<sup>83</sup> *Commissioner of Central Excise, Customs and Service Tax v. Shree Renuka Sugars Ltd.*, 2014 (302) ELT 33 (Kar.), para 26.

collected under the legislation confirm to the provisions of the Constitution.<sup>84</sup> This reading is problematic as non-utilization for specific purpose should lead to violation of Article 270 of the Constitution.

## V: CONCLUDING THOUGHTS: NEED FOR A RIGHTS BASED ANALYSIS

Rights are entitlements (not) to perform certain actions, or (not) to be in certain states; or entitlements that others (not) perform certain actions or (not) be in certain states.<sup>85</sup> Hohfeldian analysis of rights includes the two primary incidents of claim and privilege; *claim* attaches an obligation on some party to do or not to do something, *privilege* on the other hand does not attach such an obligation.<sup>86</sup> An example of a claim is the right to vote and the corollary duty is the duty of the State to ensure no person is prevented from voting. Thus, every claim has a correlative duty. An example of a privilege is the right to take an empty seat in a bus, however there is no corollary duty arising from the privilege.

Claims are enforceable rights whereas privileges are not enforceable. Some jurists have proposed that rights are based in human interests, whereas the rights justify the duties. However, often times, the limitations on the power are in the nature of obligations on the Government while exercising the power, create corollary claim rights in people to not exercise the power beyond the limitation.

The rights based perspective to different fields of study aims to look at the issue with rights at the core. The right based approach is central to the conceptualization of a cess. A cess cannot be looked upon as a general levy like a tax *simpliciter* or surcharge owing to its distinctive nature of requiring earmarking.

For instance in the case of cess taxes, the rights based perspective helps us look at the issue from the perspective of rights of tax-payers to pay cess tax only on the condition that the same is levied, maintained and utilized for a '*specific purpose*' and by competent legislature.

Using entitlements to understand fee, tax and cess taxes, one could say that the fee-payer has a claim to the reciprocal benefit of the utilization of the fee, the tax-payer has a privilege to enjoy the benefits of well-maintained roads, town-planning, water-supply, drainage and other developmental activities provided by the local bodies from the tax pool generated, whereas the cess-tax payer has a lesser right than a claim for reciprocal benefit but a higher right than an unenforceable privilege. A cess tax-payer would have a claim to transparency and accountability in levy, maintenance and utilization of cess taxes for the '*specific purpose*' that justifies the exception under Art.270 of the Constitution.

Thinking from this rights based perspective, the validity of cess legislations enacted by Parliament for '*specific purpose*' which relate to entries in the State List, is under a cloud of doubt. Similarly, all the cess taxes which are not levied, maintained or utilized for a '*specific purpose*' would stand vitiated based on the right-based perspective.

The rights in the tax payer impose a number of corollary obligations on the Government.

There must be separate legislations detailing the earmarked purpose and charging the cess tax. There must be a statement of objects and reasons justifying why a cess tax is necessitated along with enumerating the mechanism for collection and maintenance of the proceeds in separate funds. The legislations must mandate utilization of all proceeds minus the sums spent towards administering the cess tax.

Transparency must also be built through revealing a detailed blue-print for utilization of the cess proceeds including Government schemes that would be funded by the cess tax proceeds. The cess statutes

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<sup>84</sup> *Raja Oil Mills Chovva, Cannanore v. Union of India*, MANU/KE/0260/1968, para 6.

<sup>85</sup> Stanford Encyclopaedia on Philosophy, 2005, p. 21

<sup>86</sup> Hohfeld, W., 1919, *Fundamental Legal Conceptions*, W. Cook (ed.), New Haven: Yale University Press.

must mandate annual publication of collection and expenditure data. The Government's obligation to undertake periodic reviews of the levy can be achieved by inserting sunset clauses in the legislations.

An analysis of the jurisprudence developed by the various High Courts and Supreme Court decisions in respect of cess legislations shows that the rights-based approach is already taking root in this context, however, many questions remain to be answered clearly. The legislature and executive have neglected some aspects whereas the same have also not been in issue before the judiciary to give a clear finding in light of the right-based approach.

Cess taxes being an exception to the revenue sharing structure of co-operative federalism, has a great bearing on the relations between the Union Government and State Governments. The lack of financial resources impedes the financial autonomy of the States. No wonder, State Governments have been protesting against the increasing share of cess taxes in the Union revenue.<sup>87</sup> Taxes which are not shared with the States like cesses and surcharges are therefore expected to be an exception and not as a norm. However, this is far from true.

Another important policy question is that in the Indian context most earmarked taxes are consumption based taxes which means they are regressive. In a country where the proportion of indirect taxes outweighs the direct taxes and has been criticized for exacerbating inequality, existing cess taxes add fuel to fire. It is thus, time to conceptualize cess taxes in a manner that suits the Indian context.