

Chapter 6

Conclusion

Fiscal decentralization is considered a major issue in the literature of fiscal federalism in the recent decades. The classic argument for decentralization is one of allocative efficiency. As argued by the first and second generation theories of fiscal federalism, local governments can efficiently provide public services to the people according to their tastes and preferences. In a decentralized system central government should transfer funds, functions and functionaries to the lower level governments for the efficient allocation of local public goods and services. But the transferred functions can be carried out only with adequate funds and with fiscal autonomy. Many countries have initiated decentralization transferring administrative and functional responsibilities to local governments without devolving sufficient financial resources. The case is no different in India. After the 73rd and 74th constitutional amendments, central government gave discretionary powers to the state governments to take decisions on the transfer of responsibilities and funds. Indian states followed different strategies and implementation of decentralisation was not uniform across the states.

Among the Indian states the experience of Kerala is unique in terms of the design and implementation of fiscal decentralization. In Kerala, the local governments are bestowed with diverse functions and large funds. A discussion on the revenue capacity and revenue efforts of the local governments is important in this context. Researchers have paid much attention to Kerala because of its large scale functional and financial devolution and have found it to be one of the successful Indian states implementing fiscal decentralization. Our study has focused on the Gram Panchayats of Kerala because in the three-tier structure, Gram Panchayat has been devolved large number of functions and has revenue powers. Major studies on fiscal decentralization have focused on the own revenue mobilization of the Gram Panchayats and have observed large variation in it. So far the previous studies have explained the variation in own source revenue in terms of tax effort only, and the methodology adopted has been too limiting. The point of departure of the present

study consists in explaining the variations in own source revenue of Gram Panchayats in terms of both tax base and tax effort by applying a different approach and in exploring the issues in the methodology of estimating tax effort.

The main problem with the existing studies was the method of estimation of tax effort. The aggregate regression method adopted did not allow for taking into account the tax base and tax system. We have put forth a different approach: on the substantive plane, we have moved from the aggregate regression method to disaggregated in the process bringing to the fore the tax base and the system of taxation; on the regression method plane, we have moved from ordinary least squares to robust regression to obviate the effect of influential variables.

The objectives have been taken up in the following order: tax base; variations in own source revenue; relationship between tax base and own source revenue; exploration of the effect of the system of taxation; and development and testing of a model of property tax. An exploration of the tax base of the Gram Panchayats has been taken up in the third chapter after setting out the structure, functions and finances of the rural local bodies. Since the bulk of the own source revenue originates from property tax and profession tax, the analysis taken up is of their respective tax bases. The major finding is that there exists large variation in the tax base across Gram Panchayats, especially in the case of non residential buildings. The chapter has provided an essential understanding of the tax capacities of Gram Panchayats in mobilising own source revenue.

An analysis of the own source revenue of Gram Panchayats across the districts and within the districts (carried out in the fourth chapter) has shown that a sizable number of them mobilize large resources. The large variations in own source revenue leading to the wide difference between mean and median of per-capita own source revenue in many districts suggest the presence of influential Gram Panchayats (outliers). But the proportion of influential Gram Panchayats varies across the districts. Turning to the relationship between the own source revenue and the tax base of Gram Panchayats, a systematic analysis is severely limited by the non-

availability of data. Analysis carried out for three districts of the state has shown that the relationship is fairly strong: Gram Panchayats with larger tax base mobilize larger own revenue. However, the large variation in own source revenue at any given level of tax base of the Gram Panchayats may be suggesting their lack of efficiency in mobilising revenues.

An exploration of the methodologies of measuring tax effort (carried out in the fifth chapter) reveals the flaw of aggregate regression method and the need for adopting the representative tax system approach. As conventional regression analysis does not take in to account the effect of influential observations, estimation of tax effort using ordinary least squares could be flawed. We have adopted a different approach applying robust regression techniques to obviate the influence of outlier observations. A comparison of the ordinary least square estimates with the robust regression estimates has shown that the differences are indeed large. Exploration of methodological issues in the estimation of tax effort has revealed the role of taxation system in mobilising tax revenue. The estimation of tax effort would then necessitate netting out the effect of the system of taxation.

Unlike many previous studies, we have included non-residential buildings as an explanatory variable for property tax mobilisation and the results show that it explains a large part of the variation. This is an important finding pointing to the fact that more diversified Gram Panchayats mobilise more property tax. It further points to the aptness of moving from aggregate regression to representative tax system approach and of running regressions of individual taxes on relevant tax bases. Overall, the explorations of the methodological issues and the development of the property tax model in Chapter 5 lead to the inference that the estimation of tax effort is a challenging task, especially of a local government.

The existing studies of own revenue mobilisation and tax effort of Gram Panchayats in Kerala lack a proper discussion of methodology. This study clarifies the major methodological complexities in measuring tax effort and moves away from the prior studies in three distinct directions: from aggregate regression to representative tax

system approach; from conventional ordinary least square regression to robust regression technique; and incorporating the effect of taxation system. Our analysis in Chapters 3 & 5 has shown that there is large variation in the number of non-residential buildings across Gram Panchayats and that a large part of the variation in own source revenue is explained by it. We have questioned the conventional way of estimating tax effort without incorporating the specificities of the system of taxation and have argued that its incorporation makes a difference in the regression estimates, which in turn would have a bearing on the estimation of tax effort. The significant results from the methodological innovations made in this thesis show us some future directions to be pursued in the estimation of tax effort. However, the study also points to the complexities involved in estimating tax effort and how it is not appropriate to make an index for the sake of simplistic comparisons. Overall, the study confirms Bird's (1978) view that simplistic comparisons without taking relevant tax capacity variables will lead to wrong inferences.

Although our explorations of the methodological issues in the measurement of tax effort have yielded significant results, we have not been able to pursue the goal of estimation of tax effort. This is mainly due to the poor database of the local governments. A fairly good database would go a long way towards giving more definitive results. Among the major limitations of our analysis is the assumption of the homogeneity of non-residential buildings and taking per-capita profession tax as a proxy for it. This calls for further refinement as per-capita profession tax would only represent the buildings housing formal institutions. A similar issue arises regarding the commercial buildings and the use of rent as a proxy for it. Is it a good proxy? We do not have a clear answer. The insignificant coefficients of rent from buildings raise some doubts. These limitations call for further refinements in the selection of variables and proxies.