

Chapter 1

Introduction

1.1 Introduction

Decentralisation as a paradigm shift to participatory development from top-down to bottom-up, from centralised standardisation to local diversity (Kannan and Pillai 2005), has gained currency in recent years. From the standpoint of politics, decentralisation is typically viewed as an important element of participatory democracy that allows citizens to have an opportunity to communicate their preferences and views to elected officials who are subsequently rendered accountable for their performance to citizens (Bhardhan and Mookherjee 2007). The approach to decentralisation from the bottom up generally stresses political values – improved governance in the sense of local responsiveness and political participation, for example – as well as allocative efficiency in terms of improving welfare (Bird and Vaillancourt 1998). In the decentralised governance, local bodies are empowered to function as local development institutions of self-government, and constitute an autonomous and hence ideal means of targeting and tackling development issues through co-operation and collective action (Kannan and Pillai 2005).

Decentralised governance is a meaningful march towards participatory democracy, which has intrinsic value and instrumental importance. There are three commonly used meanings of decentralization; deconcentration, delegation and devolution (Martinez-Vazquez, McLure, and Vaillancourt 2006). Deconcentration gives regional or local offices of the central government decision-making power. Delegation makes sub-national governments responsible for delivering services and devolution transfers responsibilities for service delivery from central government to sub-national governments. The 73rd and 74th constitutional amendments heralded decentralised governance in India. They made mandatory provisions for the creation of local governments and transfer of funds, powers and functions to the local governments. Following the constitutional amendments, Indian state governments passed the enabling legislations.

Kerala is one of the states which implemented decentralisation successfully compared to other states (Rao 2007, Sharma 2006). Kerala had a well acclaimed development experience in social sector achieved through what is generally accepted as the Kerala model of development. Kerala's success in decentralisation is achieved through the large devolution of funds and functions (Oommen 2004). The context of the present study is the revolutionary turnaround of the fiscal domains of rural local bodies in the process of decentralisation started in 1996. Kerala government transferred all the functions mentioned in the 11th schedule of the constitution and devolved 35 to 40 % of the budget outlay to the Local Self Governments. In the light of expanded functional domain of local governments, the present study focuses on the own source revenue (OSR) of Gram Panchayats (GPs), the key constituent of rural local governments. Since local governments are self governing institutions they should have own revenues to meet their functions (Second Generation Theory) and transfers should be incentivised to mobilise own revenue. In this context, discussion of own source revenue of Gram Panchayats is important.

1.2 Rationale for Fiscal Decentralisation

The last two decades of the twentieth century witnessed a significant rise in the scope of local democracy throughout the developing world, with increasing devolution of political, economic, and administrative authority to local governments. The classic argument for decentralisation is that different states have different demands for types and levels of public goods and services. This variation may simply come from personal preferences of the residents themselves, perhaps arising from cultural differences or other sources of heterogeneity across states. The presumption of the Oates (1972) decentralisation theorem is that central provisions will tend to be uniform, so that efficiency could be improved if regional communities were allowed to provide their own local public goods and services to cater to local preferences and need (Broadway and Shah 2009). Thus traditional theory or First Generation Theory (FGT) (Musgrave 1969, Oates 1972) justifies decentralisation on grounds of allocative efficiency. This strand of literature suggests a system in which sub-national governments, even if they have substantial control over expenditures will levy few taxes (Bird 2010). They viewed sub-national governments as little more than decentralised service providers with the allocative role of providing local public goods. The underlying assumption of FGT is that state will act as an optimiser of

social welfare. Here central government is deciding what is good for local governments and transferring funds to lower level of governments. It is this prescriptive role of the state which has come under criticism from the Second Generation Theory.

In the Second Generation Theory (SGT) (Weingast 2006), states as complex systems have their own objectives to maximise. Local governments are also governments which have stakeholders. So, they need their own incomes to function. Recent authors note that if fiscal decentralisation is to be a reality, sub-national governments must control their own source of revenue (Martinez-Vazquez, Mclure, and Vaillancourt 2006). The argument is that regional governments are more likely and able to allocate and control their expenditures efficiently and effectively if they also control their own revenues (Bird 2010).

When the expenditure devolved to sub-national governments exceeds their capacity to raise revenues from own sources, they have to depend on inter-governmental transfers to close the fiscal gap. Even if they have significant taxing power, there would be large differences in fiscal capacity across sub-national governments. This is called vertical and horizontal inequality respectively. Existence of such inequalities creates a potential problem of equalisation. One cannot design an appropriate system of taxation without designing an appropriate system of inter-governmental transfers. Practically, local governments in developing countries have very limited financial autonomy and in most of the countries they are dependent on higher levels of government for funds. One does not find many examples of tax base sharing, and even limited existing bases available to local governments are typically under-exploited. Fiscal transfers typically account for 60% of revenues in developing countries as opposed to only 34% in OECD countries (Broadway and Shah 2009).

The issue of equalisation is an important problem before governments. As there could be different types of functions, devolution based on one criterion for all functions may not be appropriate. For example, devolution formula for specific services like maintenance of roads, buildings etc. might not be good for the devolution of development grants. Therefore, the design of intergovernmental transfer system should ensure appropriate funds to poorer regions and localities.

1.3 Decentralisation in India

With the 73rd and 74th constitutional amendments, recognition was given to the local governments at village, block, and district levels. They become self-governing institutions when powers, functions and funds are devolved on them. This constitutional amendment focus on socio economic developments and Article 243 G specifically mentions the devolution of powers for the preparation of plans and implementation of schemes for economic development with social justice. The constitution allows the state governments to devolve functions other than development to Panchayathi Raj Institutions and lists 29 functions that state government may devolve to local governments. These include, subjects pertaining to rural development such as agriculture, minor irrigation, animal husbandry, small-scale industries etc; social infrastructure, poverty alleviation programmes, welfare of worker sections, the public distribution system and civic functions. To carry out the functions assigned to the Panchayats, they must have authority to impose adequate and noticeable taxes. Power of taxation are important as own source revenue is a key part of the independence and autonomy of Panchayats.

Despite constitutional recognition to rural local governments, in actual practice the degree of decentralisation has been limited and the actual empowerment varies widely across states. This is true of fiscal decentralisation also. There is considerable difference between what is intended in law and how it is implemented. By all accounts, the states have been reluctant to devolve powers to local governments. Most state governments have devolved only a few of the 29 functions listed in the schedules and powers transferred in respect of the devolved functions are not too many. Rao (2007) is more categorical that none of the state governments has devolved functions after a proper examination of activities the local governments can effectively implement.

Significant changes have taken place in the structure of intergovernmental relations after the constitutional amendments (Rani 1999). The amendments mandated the creation of State Finance Commissions (SFCs) to rationalise fiscal relations at the sub-state level and make periodic fiscal corrections. Decentralization (thus) involved the

transfer of functions, functionaries and finances to local bodies with the objective of strengthening them by giving some fiscal autonomy and to make the provision of public goods more effective. The empowerment of local governments has helped in eliciting the preferences of people for public services at local levels more effectively than before (Rao 2007). The most determined effort at decentralization has been carried out in the state of Kerala.

Except for a brief period of district councils in the early 1990s, Kerala had a Gram Panchayat system with a fairly good revenue base. Their receipts consisted of revenue from taxes assigned by state government but collected and appropriated by Panchayats; taxes assigned to Panchayats but collected by the state government and passed to them; shared taxes; non-tax revenue; grants in aid from the state government; and loans from the state government or financial institutions. Expenditures were confined to traditional civic functions.

Decentralisation led to transfer of political, administrative and fiscal responsibilities to local level governments in Kerala. Kerala Gram Panchayats (GPs) are almost self-governing institutions. A number of sectors have been devolved like agriculture, primary education etc. Administrative responsibilities have been passed on to them and assets have come under their administrative control. The decentralisation process has led to major changes in the fiscal domain of local bodies in Kerala. District and blocks have no taxing powers and little expenditure autonomy. Gram Panchayats are closest to the people, have some independent taxing powers, some discretion in expenditure decisions, and are most powerful among the three tier system ensuring people's participation in governance.

In the context of larger devolution of state resources or plan funds, maintenance grants, the issue of own source revenue mobilisation at local level assumes importance. As taxation of local economic agents is not so popular action and funds are available through devolution from state government "you pay I spend" tendency is expected to prevail in the local governments. Researchers and administrators have drawn attention to the following issues: own source revenue of Gram Panchayats,

the relation between own source revenue and devolution and the tax effort of Gram Panchayats. Generally, the conclusion drawn from the existing studies is that tax effort is poor (Oommen 2004); and that larger devolution has not led to a fall in tax effort (World Bank 2004). The entire variation of own source revenue per-capita across Gram Panchayats is attributed to variation in tax effort without taking due care of variation on account of tax base, tax system design, variation of the occupation of the population, or asset composition. They have adopted aggregate regression method to measure tax effort. The general criticism against aggregate regression method as spelt out by Bahl (1978) and a galaxy of tax researchers is that it does not allow a desirable examination of the kinds of explicit relationships between particular taxes and particular economic structure variables. Researchers have moved over to Representative Tax System approach to address these general criticisms.

Representative Tax System is a disaggregated method taking separate tax items and applying regression method choosing the relevant tax bases for each. Own source revenues of Gram Panchayats in Kerala consist of property, profession and 'other' heads of revenue. Although 'others' is the major source of revenue in almost all Gram Panchayats it cannot be subjected to Representative Tax System method as it is a composite basket consisting of many items with the weights varying across the Gram Panchayats. A further disaggregation of constituents of 'other' to subject them to Representative Tax System analysis is not expected to yield desired results as for many Gram Panchayats some of the items are not relevant and wherever relevant would be too specific to the Gram Panchayat concerned.

The general analysis thus gets confined to property tax and profession tax. The application of the representative tax system approach to these two categories of taxes will have to be modified in two important ways: firstly, to incorporate the tax system element and secondly, to apply robust regression method to overcome problems associated with the influence of outliers. That is the point of departure of this study. In other words, it is an exploration of the variations in own source revenue mobilisation in terms of tax base and tax effort by incorporating some elements of system of taxation and by applying robust regression.

1.4 Objectives

The issue of equity and efficiency across Gram Panchayats of Kerala are discussed in the literature. Studies have found large variation in own revenue mobilisation across the Gram Panchayats. While there have been many explanations, the methods have been too limiting largely because of the failure to incorporate the system of taxation in the analysis. In this study, we seek to provide an explanation of the variation in own revenue of Gram Panchayats in terms of tax base and tax effort.

The specific objectives are

- to explain the variations in the own source revenue in terms of tax base
- to explore methodological issues in the estimation of tax effort by incorporating some elements of the system of taxation and by applying robust regression.

1.5 Data and Methodology

An empirical analysis of the inter-relationship between resource capacity and resource mobilisation of local self government institutions requires disaggregated data especially on the following aspects. (a) Indicators of taxable capacity, such as income, wealth and other proxies of tax bases, (b) data regarding the revenues of Gram Panchayats and c) information on other characteristics of Gram Panchayats like asset position, and about trade and other economic activities. The relevant data are not available in published form. In fact, a major weakness of the Kerala Panchayat level database has been its lack of sensitivity. This insensitivity becomes a major handicap for decentralised administration and planning as well as the analysis of such process. In particular, one has to look for various sources to collect and collate the required data for research purposes. The present study of Gram Panchayat level finances is based on the secondary data collected from various public departments as well as 2001 population census. The task has been made rather difficult as comparative data have not been available and the available data often suffers from severe limitations.

The data on population, area, number of residential buildings and number of households are collected from the 2001 Population Census for characterising the Gram Panchayats. Data regarding the Gram Panchayat wise distribution of formal institutions such as number of industrial units, number of banks are collected from the Panchayat Level Statistics published by the Department of Economics and Statistics in 2006.

For analysing revenue mobilisation of Gram Panchayats, state level and district level consolidated data of revenue of Gram Panchayats are collected from the Panchayat Directorate of Kerala. The district level disaggregated data for 2008-09 of various kinds of tax revenue and non tax revenue such as property tax, profession tax; entertainment tax, service tax, licence fee, market fee, library fee etc. are collected from the State Resource Group working under the Local Self Government Department, Government of Kerala.

Turning to the methodology, to analyse the variations in tax base of the Gram Panchayats, summary statistics like mean and coefficient of variation are used. The substantive issue of tax effort of Gram Panchayats is approached through the Representative Tax System Method. The objective of this method is to explain regional variations in tax performance by relating collections of each type of tax to the best available measure of the true tax base. Taxable capacity is defined in this approach as the total tax amount that would be collected if each country applied an identical set of effective rates to the selected tax bases, that is, as the yield of a representative tax system. The ratio of actual level to the predicted level of tax is taken as the index of tax effort. Robust Regression method is used to eliminate the influence of outlier observations.

1.6 Chapter Scheme

The study is organised in six chapters. Following the statement of the problem and discussion of the data and methods used in the study in the Introduction, the second chapter reviews the relevant literature. A critical review of the studies on Kerala's fiscal decentralisation takes us to the problem of the thesis. The third chapter deals

with the analysis of tax base of Gram Panchayats and discusses the structure of their funds, functions and functionaries. The fourth chapter deals with the composition and pattern of own source revenue of Gram Panchayats making an attempt to find out the outlier Gram Panchayats. In order to compare the taxable capacity of Gram Panchayats with the own revenue mobilisation a disaggregated analysis is carried out. The main focus of the fifth chapter is the estimation of tax effort of Gram Panchayats using regression method. The sixth chapter concludes.