DOES DECENTRALISED LOCAL TAX ADMINISTRATION WARRANT RE-EXAMINATION?

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Abstract

The higher-level government's degree of control over the subnational government administration is frequently a topic for discussion among academics and policymakers. Generally, local taxes are designed poorly and in a presumptive way, and "administered with low coverage rates, arbitrary assessments, and large delinquent lists" (Bird, 2015, p. 18). Increases in incidences of tax evasion and compliance costs are important arguments against the local administration of taxes. Recent theoretical and empirical studies argue for the existence of self-governing local governments, which requires an efficient local tax system to be in place. Using panchayat-level and municipal-level data, this paper investigates the efficiency of the local tax administration in Kerala, a state in India, and tries to estimate the amount of revenue that would be generated if the system were to be rationalised. It also addresses the question of whether local tax administration needs to be re-examined.

Keywords: Local Taxes, Profession Tax, Decentralisation of Tax Administration
JEL Codes: H71, H24, H77

1. INTRODUCTION

As a policy approach and an academic subject, the concept of fiscal federalism has gained a new dimension, with the widespread practice of decentralisation by both developed and developing countries taking place towards the end of the twentieth century. Consequently, the degree of control that the higher-level government has over the administration at subnational or lower government levels became a topic for discussion in the field. In many countries, decentralisation has been practiced as assigning public expenditure activities and providing centrally collected tax revenue to lower levels of government. In developing countries, the main challenge is to ensure accountability. Empirical studies have confirmed that the expenditure funded by revenue, especially tax revenue, sourced at lower government levels is more effective than expenditure based on transfers from higher levels of government (Bird, 2001; Boex & Yilmaz, 2010; de Mello, 2000; Meloche et al., 2004; Rodden, 2003; Rodríguez-Pose & Krøijer, 2009), and have recommended using taxes and user charges in order to increase accountability (Rodden, 2003; Singh & Srinivasan, 2006; Weingast, 2009). This emphasises the need for lower levels of government to boost their own revenue (especially, in the case of local governments, tax revenue) so that they can function as self-governing institutions.

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In India, the 73rd and 74th Constitutional Amendment Acts[4] have increased local governments' expenditure responsibilities without assigning additional tax revenue to them. The power to assign revenue and expenditure responsibilities is vested with the state governments. No state has taken the initiative to transfer more power to levy and collect taxes to the local governments. Therefore, the discrepancy between revenue and expenditure—often referred to as vertical imbalance—increased after the amendments. The amount of revenue generated by ("own revenue") the grama panchayats (India's village councils) is less than ten percent of their total revenue receipts (Comptroller and Auditor General of India, 2024).

Property tax is the major source of revenue for the panchayats in all states. However, in some states, octroi (a tax imposed on goods that a person takes with them when crossing state borders, which is imposed by the states of Gujarat, Maharashtra, and Rajasthan), profession tax (imposed by the states of Assam, Gujarat, Kerala, Madhya Pradesh, and Punjab), and entertainment tax (imposed by the states of Assam, Gujarat, Kerala, Punjab, Uttar Pradesh, and Tamil Nadu) provide significant sources of revenue. It has been reported that the main issue with own revenue mobilisation is "not the lack of the tax bases" devolved, but "the lack of will or incentives" to collect taxes that correspond to already provided tax bases" (Jha et al., 2019, p. 74). The capacity of the local governments to administrate and enforce taxes is limited. In addition, as pointed out by Jena and Gupta (2008), the excess "state control" over the "tax rates, base, and exemptions" also limits states "revenue raising capacity" (p. 130). Country-level experiences also give the impression that local taxes are poorly designed and that administrative efficiency is insufficient to draw all potential taxpayers into the tax net, to assess all income, and to value all property. Therefore, the attention given to the decentralisation of tax administration needs further examination (Bird, 2015). The focus of the present paper is to identify the constraints faced by the local governments in Kerala when attempting to increase their revenue mobilisation capacity through profession tax.

The rest of this paper is organised as follows: the second section explains the theoretical arguments for local taxes and country-level practices. The extent of revenue decentralisation in India, particularly in Kerala, and the issues related to the mobilisation of profession tax in Kerala is also examined in this section. In section three, we present the research method used in this paper. The data analysis and results are presented in section four. Section five concludes the paper.

2. THE THEORETICAL ARGUMENTS FOR LOCAL TAXES AND COUNTRY-LEVEL PRACTICES

The spirit of fiscal federalism is decentralisation by giving the local governments the authority to frame policies, regulate local markets, design the provision of local public goods and services according to the local circumstances, and fix tax rates (ideally to reflect local demand for public services). Therefore, Pareto efficiency can be attained by equating the cost and benefit of providing collective goods. The spatial incidence of benefit and of tax burden are the two key factors determining the types of expenditure and taxation at various levels of government (Musgrave, 1971; Oates, 1972). In a decentralised government, economic efficiency can be attained through benefit taxation, where tax is equal to the marginal cost of providing public goods at the jurisdictional level and can also be applied at the individual level (Musgrave, 1971). The best system, as noted by Olson (1969), is one that can balance benefit

[4] 73rd Constitutional Amendment Act, 1992 (India); 74th Constitutional Amendment Act, 1992 (India).

and cost. However, this does not occur in the real world, as governments cannot provide public goods by equating benefit with the tax burden.

Oates (1996) and McLure (1999) remark that if the function of local government is limited to garbage collection and sweeping, user fees are optimal and sufficient. In contrast, more responsible social services should go hand in hand with taxation. According to Musgrave (1983, 1959, 1969), the taxes imposed by the local government should be in the form of benefit taxes with stable revenue and immobile tax bases, like property tax and user fees. Brennan and Buchanan (1980), however, argue that local taxes should be on mobile tax bases to facilitate competition, which would reduce the size of the public sector and thereby increase the efficiency of public service provision. In the Tiebout model (Tiebout, 1956), taxes are considered to be the price paid for the use of local public goods. Benefit taxation will induce firms and households to choose the jurisdiction that effectively and efficiently supplies public goods.

According to Weingast (2009), “an ideal type” of fiscal federalism or “market-preserving federalism” must satisfy “five conditions” (p. 281). There must be: (a) a “hierarchy of governments”, (b) institutionalised political authority, (c) autonomy for the subnational governments, (d) “a common market that allows factor and product mobility” across subnational governments, and (e) “hard budget constraints” for subnational governments (Weingast, 2009, p. 281). Weingast (2009) emphasises the need for fiscal and political incentives for subnational governments and the importance of relying on complementary institutions that support one another in order to provide efficient public services. Vo (2008), citing Garzarelli (2004), states that subnational and local governments need “incentives” in order “to do a better job to avoid outward migration of people and firms” and “knowledge of local preferences and tastes” if “economic efficiency” is to be achieved when providing “local public goods and services” (p. 49).

Tax is an important fiscal incentive when trying to achieve fiscal autonomy and accountability. According to Weingast (2006), “on the government accountability dimension, citizens have strong incentives to monitor their taxes, to demand responsiveness, and to ensure that they get their money’s worth” (p. 28; see also Bahl, 1999; McLure, 1999; Oates, 2005; Pöschl & Weingast, 2013; Weingast, 2009). Musgrave (1971) is of the view that tax assignment should be in such a manner that its burden falls on the local residents, so that a functional relationship between the community through contribution and the benefit received can be established (see also Musgrave & Musgrave, 1989). As Bahl and Bird (2008) have rightly pointed out:

> local residents are likely to hold officials more accountable if local public services are financed to a significant extent from locally imposed taxes and charges as opposed to central government transfers. Ideally, to have this beneficial effect, local taxes must be both visible to local voters and large enough to impose a noticeable burden. (pp. 4–5)

According to Watt (2006), an ideal local authority is one where “people pay for and vote” for what they need (p. 9). Such a system will ensure accountability. The “principle of benefit” is the philosophical support for local taxes, as it ensures the efficient utilisation of public expenditure and guarantees fiscal discipline among local governments. Empirical studies also substantiate this argument (Bird, 2001; Boex & Yilmaz, 2010; de Mello, 2000; Meloche et al., 2004; Rodden, 2003; Rodríguez-Pose & Krøijer, 2009).

Weingast (2009) cites McKinnon (1997), who states that there is a disincentive problem in relation to the transfer system. According to Weingast (2009), McKinnon (1997) points out that Canada and Italy, which have been subject to soft budget constraints, provide huge subsidies to their poorer regions, leading their public sector enterprises to make losses. The southern US states, meanwhile, face hard budget constraints and receive no subsidies (McKinnon, 1997, as cited in Weingast, 2009). According to Weingast (2009), these states were the poorest in the US "after the Civil War through mid-20th century" but "were able to grow rich by redesigning their economies with low regulatory burdens relative to the industrialized North and to take advantage of lower labor costs" (p. 284). The results of Dillinger and Webb's (1999) study, based on the experiences of Argentina and Brazil, and Kornai et al. (2003)'s findings with regard to the collapse of the banking sector in East Asian countries, also substantiate this argument. Expenditure based on intergovernmental transfers forces electorally motivated politicians to take advantage of fiscal illusion.[5] The implementation of the transfer system leads to inefficiency in the allocation of funds due to uncertainty about the amount that will be received and when it will be received if the design of the system is not transparent (Bird, 2001; Boex & Yilmaz, 2010). Oates (2005) suggests that "the solution to the problem" is "the reform of political and fiscal institutions to alter the whole structure of incentives for budgetary decision-making" (p. 361). Grants should be given to meet the allocative and distribution functions, and not to provide fiscal bailouts. The greater the proportion of revenue generated by local governments, the greater effort the local government will make to improve the efficiency of its operations and introduce innovative methods of delivering public goods. If there is no link between tax and expenditure activities, people think that taxes collected from them are used in other localities and this prevents public officials from being able to provide public goods efficiently.

When developing a revenue base, local governments are usually advised to implement local income tax and business tax. According to McLure (1999), residence-based income tax, which is collected through the filing of tax declarations, is "probably superior to employment-based payroll taxes" (p. 14). However, due to the challenges involved in implementing this in developing countries, Bahl (1999) suggests using separate tax systems for urban and rural sectors, if needed. Important arguments for introducing business taxes are revenue flexibility and the benefit principle. Since it is difficult to impose user charges on every business activity and input, it is better to levy a generalised tax on business. The optimal option for this is value added income tax (BVT) i.e. value added tax (VAT) which is levied on an income basis (Bahl & Bird, 2008). Bird (1999) opines that this "would minimize both" the "horizontal and vertical" spillover effects of taxation (p. 32). Business taxation is also advocated from the point of view of efficiency, equity, and political cost. Another argument favouring the implementation of business tax is that "a significant portion of the local government expenditure directly benefits businesses" (Bird, 2014, p. 2). Waste disposal, for example, is a major problem faced by most of the local bodies, especially in cities. Therefore, such a tax would be more suitable for large cities and metropolitan regions. McLure (1980) has opposed this tax on efficiency grounds, claiming that the distortion effect is greater. To limit the burden of taxes on non-residents, one suggestion is to introduce "a uniform set of tax bases for local governments…with a limited amount of rate flexibility being permitted" (Bird & Slack, 2014, p. 366). BVT requires a well-designed accounting system, political will, and a developed administrative set-up with a clear legal framework; therefore, it is important for developing and transitional countries to design

[5] If the citizens are subject to fiscal illusion, instead of actual benefits received from the government, they do not fully understand the true cost of fiscal deficits and future tax liability.

and implement BVT to suit their particular circumstances (Bird & Gendron, 2007; Bird & Vaillancourt, 1998).

Recently, little attention has been given to the decentralisation of tax administration. Even if tax decentralisation and the decentralisation of tax administration are related issues, separate decisions need to be made with regard to them. While decentralising the administration of local taxes is theoretically advisable, owing to the comparative advantage of identifying the tax base, country-level experiences show that these taxes are designed poorly and in a presumptive way, and are "administered with low coverage rates, arbitrary assessment, and large delinquent lists" (Bird, 2015, p. 18). A common and economically feasible approach is to allow the local governments to administer those taxes that are easy for them to assess and collect. The key arguments against the local administration of taxes are increased tax evasion and increased compliance costs. In practice, as Bird (2015) points out, property valuation, assessing income, and other tasks "can be complex and require coordinated action between a number of different local, state, and national agencies and departments" (Bird, p. 17).

Tax revenue is less than 50 per cent of the total revenue of the local governments in most countries (Steffensen, 2010). Financial autonomy is only given to local governments in some North American countries to some extent. In most developing countries, central government intervenes in fixing tax rates and tax bases, and the share of subnational tax revenue in total taxes accounts for 10 per cent on average (Bahl & Bird, 2008). According to Bahl and Bird (2008), "sub-national governments in countries like Cambodia, China, and Vietnam…raise less than 5 percent of their total revenue from own sources" (pp. 5–6). In Africa, local governments' own revenue is, on average, 30 per cent of their total budget, except in Zambia (77 per cent) and South Africa (90 per cent) (Letaief et al., 2009). Their main source of funding is shared taxes, with VAT being the most important of these (Letaief et al., 2009). Countries like South Africa, Tanzania, Zambia, and Zimbabwe enjoy some freedom in fixing service fees and tariffs (Letaief et al., 2009).

Surcharges on income tax and VAT are now widely accepted in the US and Canada. Surcharges are the easiest tool with which to achieve fiscal autonomy without "unacceptable inequities, economic distortions, or complexities of compliance and administration" (McLure, 1999), but this comes at the expense of the fiscal freedom of the local government and brings with it the problem of transferring revenue (Bird, 1999; Sjoquist, 2015). In Organisation for Economic Co-operation and Development (OECD) countries, local governments rely on direct taxes on businesses and surcharges on national income taxes. In Denmark, Norway, and Sweden, surtaxes on national income tax are the main source of revenue for local governments, and these are "levied at a flat, locally-established rate…and collected by the central government" (Bird, 2010, p. 35). The Canadian VAT experience[6] reveals that "a single administration and common base" would be an efficient system (Bahl & Bird, 2008, p. 22). It is argued that, in large countries with federal features, such as India and Brazil, surcharges can be used to expand the revenue bases of the subnational governments (Bird, 2000).

[6] Bahl and Bird (2008) explain that two forms of VAT system are in place in Canada. The first is a "'dual VAT system'" comprising "the Québec Sales Tax (QST) and the federal VAT (GST)" (p. 22). The second is a system of "VATs (the Harmonized Sales Tax [HST])", which are applied by "three small provinces…" on the same base as the federal GST" (Bahl and Bird, 2008). In the second system, revenue is collected by the federal government and "distributed to the provinces based on estimated taxable consumption in each province" (Bahl and Bird, 2008, p.22).

2.1. Revenue Decentralisation in India and Kerala

In India, decentralisation has only been introduced seriously in some states. The 73rd and 74th Constitutional Amendment Acts have the provision to transfer 29 functions and 24 taxes to the local governments. Some states have transferred all 29 functions, some states have transferred some of them, and others have not taken the initiative yet. The number of taxes assigned to panchayats ranges from 19 in Gujarat to one in Uttarakhand. Although taxes are assigned to the panchayats, half of the states do not collect all the taxes that have been assigned. Notably, the states of Bihar, Jharkhand, Odisha, Punjab, and Assam do not collect any of the assigned taxes (Alok, 2024).

Maharashtra collects the most tax per capita (₹209.36), with Kerala in second place (₹178.09) (Government of India [GoI], Ministry of Panchayati Raj, & Tata Institute of Social Sciences, Mumbai, 2016; Rao & Rao, 2008). Relatively inelastic taxes, like taxes on property, profession, entertainment, and advertising are assigned to the local governments. The discretion enjoyed by the central government in transferring funds led it to transfer more funds to some states (Gupta & Mukhopadhyay, 2014; Singh, 2015; Singh & Srinivasan, 2006). The states of Karnataka, Kerala, Tamil Nadu, and Maharashtra occupy the top positions in the devolution index (Alok, 2024). Although Kerala is in a better position than other states, the extent of fiscal decentralisation in India is meagre when compared to developed countries.

In Kerala, own revenue resources of the local governments constitute less than 10 per cent of the total revenue receipts during the eight years between 2014–15 and 2021–22 (Comptroller and Auditor General of India, 2018, 2024). The ratio of local government own revenue to the gross domestic product of the state, which stood at 0.34 in 2009–10, declined to 0.204 percent in 2019–20 (GoK, 2021). A similar trend of decline can be observed in the ratio of local government own revenue to states' own revenue (GoK, 2021). The GoK (2021) notes that "these declining ratios reflect the absence of buoyancy of Local Government revenues relative to the growth of the economy, indicating the urgent need for interventions to improve revenue mobilisation" (p. 12). Total tax revenue as a percentage of total receipts is less than seven percent between 2013–14 and 2021–2024 (Comptroller and Auditor General of India, 2018, 2024). Property tax and profession tax together contribute 95 per cent of the tax revenue of local governments in Kerala (GoK, 2021). When the Goods and Service Tax (GST) was introduced in 2017, entertainment tax was abolished in Kerala but additional tax revenue was not provided to the local governments (GoK, 2021).

2.2. Profession Tax in India and Kerala

Article 276 of the Constitution of India refers to taxes on "professions, trades, callings or employments" and provides that power is given to the state government to make laws on such taxes, subject to a maximum ceiling, which is fixed in the constitution. The maximum ceiling was fixed as ₹250 in 1949 and revised to ₹2500 in 1988. Among the 25 states, 16 have assigned the profession tax to panchayats and 12 of these are collecting it (Alok, 2024). In India, and particularly in Kerala, profession tax is a payroll tax imposed on earned income.

In Kerala, profession tax is the second largest source of tax revenue for the local governments, (with property tax being the largest) (GoK, 2021). Profession tax is levied based on half-yearly income. Kerala's profession tax slabs, showing the half-yearly income limits and tax rates, are detailed in Table 1. The author's calculate that the share of profession tax within the total tax revenue, on average, fell from 39.3 per cent during the period 2009–10 to 2013–14 to 29.9 per cent during the period 2014–15 to 2019–20. According to the authors' calculations, the ratio of profession tax to net state domestic product also shows a declining trend during the last decade. However, the annual growth rate of profession tax revenue was 5.96 per cent during 2014–15 to 2019–20, which was higher than the annual average growth rate of total tax revenue (4.04 per cent) during the same period (GoK, 2021).

Table 1: Profession Tax Rates in Kerala prior to and as of October 2024

Slab	Half-Yearly Income	Previous Rate	Current Rate (from 01-10-2024)
1	Up to ₹11999	Nil	Nil
2	₹12,000 – ₹17,999	₹ 120	₹ 320
3	₹18,000 – ₹29,999	₹ 180	₹ 450
4	₹30,000 – ₹44,999	₹ 300	₹ 600
5	₹45,000 – ₹99,999	₹450/₹600/₹750	₹ 750
6	₹100,000 – ₹124,999	₹ 1,000	₹ 1,000
7	₹125,000 and over	₹ 1,250	₹ 1,250

Source: Govt. Order LSGD-RC2/13/2024-LSGD Or.No.1149/2024/LSGD dated 27/06/2024; Mundra (2025).

The key constraints faced by the local government when trying to boost the collection of profession tax are the ceiling on the amount of tax that can be collected and the requirement for a constitutional amendment to be made in order to raise this ceiling. India's Finance Commissions have repeatedly recommended both an upward revision of the ceiling for profession tax and that this provision should be removed from the constitution so that Parliament can revise the ceiling when appropriate (GoK, 2021). Although these proposals have been accepted in principle (GOK, 2021), they have not yet been put into practice.

The state government has been lax in implementing and revising the tax rules of local government. The existing maximum ceiling of ₹2,500 per annum was set in 1988 but was only introduced in Kerala with effect from 1996 (GoK, 2021). As per the recommendation of the First State Finance Commission (GoK, State Finance Commission, 1996), the Government of Kerala introduced The Kerala Panchayat Raj (Profession Tax) Rules, 1996, and the income slabs and tax amounts were revised accordingly. However, when the authors were collecting the data for their research, local governments confirmed that the village panchayats had only started to levy the new rate in 2003 and the municipalities had only started to do so in 2005. The succeeding State Finance Commissions reported that not all potential taxpayers are being brought into the tax net.

The Kerala Panchayat Raj Act 1994 (Profession Tax Rules) stipulated that the secretary to the local governments should keep a register of all institutions and employees who are liable to pay profession tax. However, this is not practiced in most of the local governments. A wide gap has been observed between the actual and potential amount of key taxes levied and collected by local governments. Tax evasion is high among employees in private businesses and establishments, and among self-employed professionals (GoK, 2021). Thus, the mobilisation of profession tax revenue has been partially constrained by omissions and laxity on the part of the central, state, and local governments.

The base of profession tax is the income earned by employed persons and this also comes under the base of income tax, the key shared tax imposed by the central government. It has been empirically proven that expenditure activities that are financed by own revenue resources are more effective than transfers from higher levels of government (Bird, 2001; Boex & Yilmaz, 2010; de Mello, 2000; Meloche et al., 2004; Rodden, 2003; Rodríguez-Pose & Krøijer, 2009). Hence, a rigorous examination of the possibility of revising the profession tax system by giving local governments more power to levy tax on income can throw light on the space for local self-governance in relation to taxation.

Given this backdrop, this paper analyses two specific objectives. First, it analyses the space that would be open to the local governments in Kerala if the present system of profession tax were to be redefined. Secondly, it examines the prevalence and extent of underassessment of the income of traders/dealers and estimates the potential increase in profession tax revenue in different scenarios.

3. METHODOLOGY

Area of Study, Sampling Design, and Approach

Our paper estimates the gap between actual and potential profession tax revenue in Kerala for the financial year 2017–18 by expanding the existing tax base, and examines the possibility of introducing an alternative to the current profession tax system in the light of various forms of local income taxes that prevail in other countries. The estimation was conducted by selecting seven grama panchayats and two municipalities in the Kannur district of Kerala. Kannur ranks first among the districts of Kerala in per capita tax incidence (GoK, 2009), which indicates that it has better revenue mobilisation than other districts. This might mean that the overestimation of the results is avoided. The selection of the sample local governments was based on the share of profession tax revenue within total tax revenue, the number of people employed, the collection efficiency of the local government, and urban proximity. The numbers, categories, and incomes of all taxpayers, and the amounts of profession tax collected from them, were taken from the profession tax registers of the selected local governments. The potential tax revenue is estimated based on the taxpayers' reported income by raising and removing the constraints of the maximum ceiling and slab system.

A hypothetical schedule with progressive increases in the intervals of consecutive income slabs is used to estimate potential revenue at an enhanced maximum ceiling of ₹12000, as recommended by the Fourteenth Union Finance Commission (GoI, Finance Commission India, 2014). For this, the minimum amount of tax to be imposed is calculated based on the minimum wages announced by Government of Kerala.[7] We estimated the minimum wages of persons employed in different occupations in Kerala during the second half of the financial year 2017–18. Hence, as per the minimum wages declared by the Government of Kerala,[8] the minimum six-month salary of the persons employed in different sectors was greater than ₹50000 in the financial year 2017–18. To estimate this, this paper used the Consumer Price Index Numbers for agricultural labourers and industrial workers published by the Department of Economics and Statistics for the respective year (GoK, Department of Economics and Statistics, 2025). The average minimum wages of non-agricultural workers in rural Kerala ranged from ₹689 to ₹783 in June 2015 (GoK, State Planning Board, 2017). The profession tax rate at the time of

[7] Government Order (Ms.) No,100/2009/LBR, 23 July 2009, issued in Thiruvananthapuram.
[8] Government Order (Ms.) No,100/2009/LBR, 23 July 2009, issued in Thiruvananthapuram.

calculation constituted one per cent of the minimum income for each slab. At the time of conducting this research, therefore, the minimum and maximum amounts of profession tax were fixed at ₹500 and ₹6000, corresponding to the income levels of ₹50000 and ₹600000 respectively in a half-year period.

The underassessment of the income of traders/dealers by the local government was examined by comparing the income reported in profession tax registers and the income reported to the Commercial Tax Department in VAT returns. A sample of 128 dealers from Thalassery Municipality and 63 dealers from Kuthuparamba Municipality, both in the Kannur district of the state of Kerala, was used in order to estimate this. The underassessment was estimated for the year 2016–17 to avoid the initial issues of implementing GST in India in the year 2017. The dealers were selected from the list of institutions paying ₹450 and more as profession tax because these institutions are required to register under the GST scheme. The number of taxpayers in each higher slab could not be calculated due to problems faced when identifying taxpayers who appear in both registers.

4. RESULTS AND DISCUSSION

In Kerala, profession tax is collected under two accounts: institution tax and employee tax. Accordingly, there are four groups of profession taxpayers: public sector institutions, private institutions, public sector employees, and private employees. The data shows that public sector employees account for the largest portion of the revenue. It was found that there was no scope for further notable increases in profession tax receipts from them because the majority of the taxpayers already paid the maximum amount of ₹1250 and the growth rate for taxpayers in the public sector was also significantly less. This is the reason behind the fall in the growth rate of profession tax receipts during the period 2012–13 to 2017–18. This points to the significance of raising or removing the existing maximum ceiling of profession tax.

The comparison of the average tax amounts paid in both the private and public sectors shows that the average tax paid by public sector employees was more than double that of private sector employees. Most private institutions were still paying only ₹180 and ₹300 during a half-year period. This was unbelievable when the collected data stated that most institutions' income still lay within the ₹18000 to ₹30000 range in a half-year period. The performance of one panchayat with relatively low urban proximity was remarkable in terms of collecting institution tax during the years 2015–16 to 2017–18. This panchayat had the highest average tax collection from private institutions even without a significant industrial base or urban-related institutions. This indicates that other panchayats and municipalities could raise institution tax and mobilise more revenue. The GoK reported that the average minimum wage for non-agricultural workers in rural Kerala ranged from ₹689 to ₹783 in June 2015 (GoK, State Planning Board, 2017). This reveals that workers may be under-reporting their income. This supports the argument for the better assessment of income of private employees, institutions, and self-employed persons. Hence, priority should be given to introducing rational assessment of income rather than revising the maximum ceiling or this will further lead to the unequal distribution of tax burden. The questions here are whether there is underassessment or not and, if there is, to what extent and what policy changes should be made?

4.1. Potential tax revenue at a maximum ceiling of ₹12000

The revenue of the local governments from profession tax would increase, on average, by 55 per cent in panchayats and 70 per cent in municipalities if the maximum ceiling were to be enhanced to ₹12000—as recommended by the Fourteenth Union Finance Commission (GoI, Finance Commission of India, 2014)—and the minimum ceiling to ₹500. Therefore, an increase of around 25 per cent would result from increasing the minimum tax amount ceiling to ₹500 and bringing all existing taxpayers who would fall outside of the tax net as a result of the revision into this minimum slab. Otherwise, 50 per cent of the institutions and 25 per cent of employees would be within the tax net. The said ratio is 75 per cent for institution tax in municipalities since most of them belong to the ₹180 and ₹300 slabs. More than 95 per cent of them are from the private sector in all local governments. Implementing a revision without including all existing taxpayers would result in a revenue loss for the panchayats and municipalities. However, the fall in tax revenue from the private sector would be outweighed by the revenue collected from public sector. Therefore, the periodic revision of the schedule in tune with income growth and distribution is quintessential in order to maintain profession tax revenue generation by the local governments. The analysis also reveals that, in order to attain this potential tax increase, state governments should strictly adhere to the timely revision of the minimum amount of profession tax as corresponds to the existing minimum wages, which do not require any constitutional amendment.

The results reveal that the tax amounts of 75 per cent of the public sector employees would be above the existing maximum ceiling of ₹1250 in all local governments. In contrast, the proportion would only be five per cent in the case of private sector employees and institutions. Therefore, the potential increase in tax revenue would be higher in local governments where public sector employees account for a large proportion of tax revenue. The per capita tax incidence for public sector employees would increase from ₹1165 to ₹2156, while the per capita tax incidence for private sector employees would increase from ₹521 to ₹712. There would be a 95 per cent increase in per capita tax incidence for public sector employees compared to a 37 per cent increase in the private sector.

Moreover, the private sector share of potential tax revenue would decline from 51 per cent to 42 per cent in panchayats, and from 42 per cent to 36 per cent in municipalities. Within this, the share of private sector employees' tax would fall from 37 per cent to 28.5 per cent. The authors found that the increase in profession tax revenue from public sector employees would primarily be due to raising the upper ceiling. Conversely, the growth in tax revenue from private employees and private institutions would mainly be accounted for by the revision of the lower ceiling. Raising the ceiling to ₹12000 without introducing any measures for better assessing private individuals' income would lead to the unequal distribution of the tax burden, and profession tax may not satisfy the canon of equity. Therefore, as rightly stated by the Third State Finance Commission of Kerala (2005), priority should be given to improving tax collection through the rational assessment of private individuals' income instead of raising the maximum ceiling.

From discussions with the officials of panchayats and municipalities, it is noted that political intervention is one of the major constraints faced by the authorities when raising even a single slab rate for private taxpayers. In addition, political cost/benefit calculations usually result in leaders deciding against making the seemingly unpleasant decision to raise the maximum ceiling. Another constraint is a lack of professionalism among officials. If local or state governments were to be empowered to fix the tax rate at a flat rate with a maximum allowable rate, frequent revisions to income slabs and slab rates would not be made.

4.2. The Tax Space of Profession Tax

The potential of profession tax, which is estimated by removing the legal constraints—particularly the upper ceiling and the slab system—is called economic revenue potential. The difference between economic revenue potential and actual revenue collection is defined as the "tax space" of profession tax in this paper. When estimating economic revenue potential, the exemption is given only to low-income groups.

4.3. Revenue Potential at a Flat Rate of One Per Cent[9] of Income

The existing slab rate for profession tax is fixed as one per cent of the minimum income level of each slab. Although a tax on income with a flat rate is regressive, the main arguments for this are "to introduce simplicity, broaden the tax base, reduce administrative costs, and improve tax compliance" (Khwaja & Iyer, 2014, p. 4). Moreover, in the case of profession tax, central income tax is charged at a progressive rate on the same base.

The authors' estimation of the tax space of profession tax at a flat rate of one per cent by giving exemption to low-income groups reveals a possibility of an 80 per cent increase in tax revenue in municipalities and a 65 per cent increase in panchayats. The average potential increase in tax revenue at a flat rate over the slab system, on an average, is 10 per cent in both panchayats and municipalities. The local governments could mobilise this extra revenue without any additional cost, and have the potential to increase revenue mobilisation further by raising the flat rate or by fixing tax at a progressive rate. A one per cent increase in the tax rate would generate a 100 per cent increase in tax revenue.

One limitation of this flat rate is the tendency to under-report income in order to reduce the tax amount as much as possible. Local governments can overcome this problem by adopting mechanisms to minimise administrative loopholes. However, with this increase, the authors calculate that the ratio of profession tax to the total expenditure of local governments increases from 2.1 per cent to 8.7 per cent in panchayats, and from 4.5 per cent to 15.5 per cent in municipalities. The ratio of total tax revenue to total expenditure rises from 7.11 per cent to 11.2 per cent in panchayats, and from 14.9 per cent to 23.6 per cent in municipalities. These low ratios demand further increases in tax revenue mobilisation.

4.4. Forms of Local Income Taxes: A Comparison

Among the four types of local income taxes identified by Sjoquist (2015),[10] the tax base is broader when tax is imposed on gross income without exemptions, deductions, and credits.

[9] The most common tax rates are a flat rate of one per cent to be levied on gross income and gross earned income, and a rate of greater than one if the tax is levied on taxable income under the central or state income tax, or as surcharge on state tax liability.

[10] Local income taxes are mainly imposed on four bases: gross earned income, gross income, taxable income, and a surtax on state tax liability (Sjoquist, 2015). Tax on gross earnings without personal exemptions, deductions, or credits (known as payroll tax) is the most used tax. Gross earnings comprise wages, salaries, other allowances, and net profits from business (Sjoquist, 2015). In some places, gross income (which includes "all state taxable sources of income" without any deductions, exemptions, or credits) is taken as the base (Sjoquist, 2015, p. 37). Taxable income under the central or state income tax is another base used for local income tax (Sjoquist, 2015). This allows "all of the exemptions and deductions of the state income tax" scheme (Sjoquist, 2015, p. 37). Finally, local income tax is imposed as a surtax on state income tax, which "incorporates the progressivity of the state's income tax rate structure" (Sjoquist, 2015, p. 37). Sjoquist (2015) notes that such "alternative tax bases…differ in terms of the equity of the tax, i.e., the degree of regressivity or progressivity, as well as administrative and compliance costs" (p. 38). See also, Bird (1999).

Therefore, tax on gross income levied at a flat rate will generate more revenue than tax on earned income levied at a flat rate. The sector-wide analysis of the distribution of the burden of profession tax shows that the tax burden falls more upon public sector employees and the majority of the taxpayers employed in the private sector are still within the low income slabs. The estimated monthly income, based on the average minimum wage of non-agricultural workers according to the GoK State Planning Board (2017), was greater than the reported income of the taxpayers. It needs to be stressed that the existing administrative system of the local government is not efficient when assessing the income of persons employed in the private sector. Therefore, tax on gross income may not mobilise more tax revenue than the existing tax on earned income (profession tax) that is collected by the local governments in Kerala.

The under-reporting of income by traders, professionals (such as lawyers and chartered accountants), and other self-employed persons is an important constraint faced by authorities when attempting to mobilise profession tax revenue. It is beyond the administrative domain of the local government to assess the actual gross income earned by these persons. The GOI's successes in bringing private individuals into the income tax net during the period 2001–08 are a tribute to the Income Tax Department's effective tax efforts. There was a 40 per cent increase in the number of people paying tax between 2015 and 2018 (GoI, Central Board of Direct Taxes, 2018). Therefore, tax on gross income as reported in income tax returns can be used as the basis for local income tax and this could lead to increased tax collection by local governments. In 2018, the state of Punjab introduced this type of tax for all persons[11] whose income exceeded the minimum exception limit chargeable under the Income Tax Act of 1961 (India), i.e. everyone with an income above ₹250,000 (2.5 lakhs) in the 2018–19 financial year was liable to pay ₹200 per month (see the Punjab State Development Tax Act, 2018).

The statistics of income tax payers during the 2017–18 financial year reveal that persons with an annual gross income above ₹500,000 rupees (five lakhs) were liable to pay income tax (GoI, Central Board of Direct Taxes, 2018). As per the profession tax register, only 17 per cent of the total number of taxpayers in the panchayats earned under this income level. In the municipalities, this increased to 25 per cent. 95 per cent of these taxpayers were public sector employees. Suppose that local income tax is only levied on gross income as per the income tax of the central government. In that case, the majority of the existing profession taxpayers would escape the tax net. Moreover, the entire tax burden would fall upon public sector employees. The same problem would arise if local governments were to impose tax on taxable income and surcharges on personal income tax liability. Such a surcharge would have the following advantages: it would incur relatively low administrative costs, taxation would be according to the ability to pay, and the distribution of tax burden would be more equitable. However, this could only be implemented at the expense of the fiscal freedom of the local government. Hence, local income tax on gross income, taxable income, or tax liability cannot be advocated, at present, from the point of view of revenue and accountability. Therefore, priority should be given to improving the existing tax system rather than revising the existing tax base and rate.

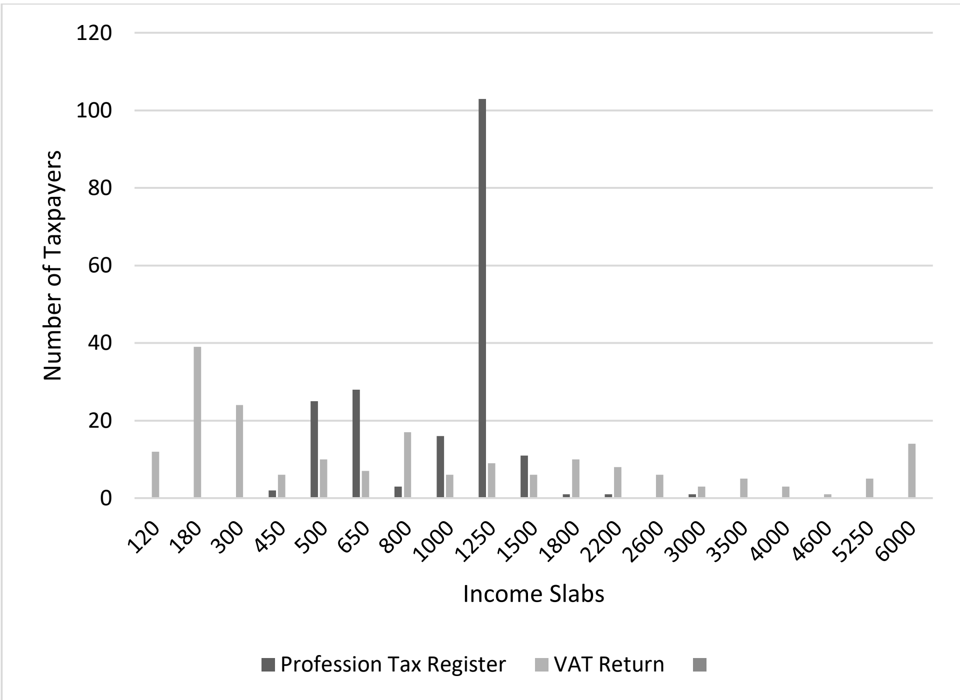
4.5. Potential Tax Revenue Through the Rational Assessment of Income

A dealer's income is based on their turnover as reported in their VAT return and is assessed as per the schedule prescribed by the state government. 45 per cent of dealers fall within the lower tax slabs according to the profession tax register 2017–18, and the authors' tax revenue

[11] Exceptions are made for senior citizens, those who earn wages on a casual basis, and workers who are exclusively engaged in agriculture.

estimations, based on VAT turnover, are 33 per cent lower than the actual revenue collected. This highlights the inefficiency of the Commercial Tax Department in respect of assessing the turnover of the dealers. However, when tax revenue is estimated at a maximum ceiling of ₹12,000, the potential revenue would be 26 per cent higher than the estimated revenue as per income reported in the profession tax register. This increase is attained when 45 per cent of taxpayers are removed from the tax net due to an increase in the minimum ceiling to ₹500. By bringing all of these dealers into the tax net by imposing a minimum tax rate, potential revenue would increase to 46 per cent. The potential increase is 74 per cent if the estimation is made using both records. Therefore, revenue mobilisation through profession tax can be enhanced by assessing the income of private institutions based on information obtained from the Commercial Tax Department when the tax base is expanded. There is a possibility that profession tax revenue can be increased further if the advantages of GST are realised. The theoretical arguments for decentralising the administration of local taxes due to the comparative advantage of identifying the tax base is visible at low income levels (Figure 1). At the same time, the analysis supports the coordination of different departments functioning at various levels of government in order to achieve a better result.

Figure 1: Distribution of Taxpayers By Income Slab



Source: Author's Compilation

A similar trend of increases is also observed in potential profession tax revenue when an estimation is carried out at a flat rate of one per cent, without any maximum ceiling or slab system (Table 2).

Table 2. Actual and Potential Yields of Institution Tax at 1% (in ₹)

Actual Tax Revenue	Potential Tax Revenue*		
	1	2	3
199700	209710.00	393993.00	489664.00
Actual as % of Potential	95.2	50.7	40.8
Potential Increase (%)	5.0	97.3	145.2

Source: Authors' Calculations
Note: * 1. Estimation as per profession tax register, 2. Estimation as per VAT register, 3. Estimation based on both registers.

The potential increase is only six per cent when the estimation is based on the income reported in the profession tax register. Although 45 per cent of taxpayers are removed from the tax net when tax is assessed as per VAT returns, the tax revenue would increase by 97 per cent. This is because 14 dealers earned income of more than ₹600,000 (6 lakhs). The highest income assessed was ₹3,600,000 (36 lakhs). Therefore, when profession tax is assessed at a flat rate, it will generate more revenue than other taxes and ensure a more equitable distribution of the tax burden. Suppose provision is included in the income tax rule to deduct profession tax from the amount of tax payable rather than at source: there would be no need to fix a maximum ceiling for profession tax. The possible yield in profession tax revenue would increase to 145 per cent if the potential revenue is estimated at a flat rate of one per cent based on the records of both registers.

The under-reporting of income by traders is visible in both the profession tax register and VAT returns. There is no significant correlation between the income reported in both registers. The correlation coefficient for one municipality is 0.078 and the value is close to zero i.e. -0.00047 in another. Therefore, it would be better to impose profession tax by collecting information about turnover from a state's GST department in order to augment own revenue mobilisation. The impact of adopting a new method of assessment on tax revenue can be analysed by estimating the elasticity of profession tax with respect to taxpayers' income.

The use of a new method of income assessment in order to respond to changes in profession tax revenue due to changes in dealers' income shows how the tax system keeps up with such developments. The elasticity of profession tax is estimated by regressing tax amounts on taxpayers' income using the ordinary least squares (OLS) method. The estimation is made in three different scenarios, i.e. tax revenue at the existing maximum ceiling of ₹1250 (scenario A), at an enhanced rate of ₹12,000 (scenario B), and at a flat rate of one per cent (scenario C), using the following econometric specification:

$$logTR_i = \propto \ + \beta_1 \log Y_i + \ u_i \qquad (1)$$

where TR represents the profession tax amount and Y_i represents the taxpayers' income. The coefficient value of β_1 gives the elasticity of profession tax with respect to changes in income.

Table 3: Regression Results Showing the Elasticity of Profession Tax in the Proposed Tax Regime

	Scenario A			Scenario B		
	coefficient	*p*-value	R^2	coefficient	*p*-value	R^2
constant	4.867	4.15e-052 ***	0.31	−2.417	4.77e-024 ***	0.92
β	0.177	3.74e-017 ***		0.808	5.39e-106 ***	

Source: Authors' estimations.

* Significant at 10% level ** significant at 5% level *** significant at 1% level

The elasticity coefficient in scenario A is very low (0.176) with a highly significant *p*-value. A coefficient lower than one and close to zero implies poor tax performance on behalf of local governments at the existing maximum ceiling of ₹1250. Although the elasticity coefficient at the enhanced ceiling of ₹12000 is less than one (0.808), it is higher than in scenario A. Therefore, profession tax collection in scenario B would improve the tax revenue mobilisation capacity of municipalities. Since the elasticity coefficient at a flat rate of one per cent is one, the estimation has not been made for scenario C and is not presented in Table 3.

The comparison of the elasticity coefficients in the three scenarios also supports the need for revenue mobilisation from private individuals to be improved through better income assessment. The largest portion of the tax burden will, otherwise, fall upon public sector employees.

5. Conclusion and Policy Recommendations

The theoretical and empirical components of the literature suggest that local governments could function efficiently if their expenditure activities were funded by own revenue rather than by transfers from higher level governments. In India, the 73rd and 74th Constitutional Amendment Acts have the provision to transfer 29 functions and 24 taxes to the local governments. Some states have transferred all 29 functions, some states have transferred some of them, and others have not taken the initiative yet. However, no states have taken the initiative to transfer more power to levy and collect taxes to the local governments. Therefore, the discrepancy between revenue and expenditure, often referred to as the vertical imbalance, has increased after the amendment. The literature also recommends that local income tax and business tax should be used when developing a revenue base for local government (Bird, 2010).

Country-level experiences show that local taxes are designed poorly and in a presumptive way, and "administered with low coverage rates, arbitrary assessments, and large delinquent lists" (Bird, 2015, p. 18). In India, profession tax, which is imposed on earned income, is levied and collected by the local governments. The authors' analysis reveals the inefficiency of the local governments in respect of assessing the incomes of private employees and institutions, and of the self-employed. The authors found that six out of the nine selected local governments have kept separate registers of default taxpayers. The number of default taxpayers is relatively high in the municipalities. Therefore, this paper supports the above argument. Raising the maximum profession tax ceiling, as recommended by the Fourteenth Union Finance Commission (GoI, Finance Commission India (2014), without the rational assessment of private individuals' income would increase the unequal distribution of the tax burden, and the lion's share of the tax burden would fall upon public sector employees. The authors' findings show that tax mobilisation capacity can be increased by improving coordination between departments that function at higher levels of government. Therefore, attention should first be given to increasing own tax revenue mobilisation through the coordination of departments functioning at various levels of government, rather than to decentralising the tax administration.

The following practices could be used to improve tax collection. First, to overcome the inefficiency of local governments when assessing the income of the self-employed and private institutions, a list of those paying income tax and their gross earned income should be provided by the income tax department, and turnover details should be provided by the relevant state's GST department, so that profession tax can be levied accordingly. Secondly, a dual system, comprising of tax collection by the local governments from those who do fall within the income tax net, together with the introduction of a flat rate tax on the gross earned income of individuals who are paying income tax, with that amount being transferred to the local governments after collection. State governments should be given the freedom to fix the rate of tax within the maximum rate allowed. Provision could also be included in the Income Tax Act for profession tax to be deducted from the tax liability rather than, as happens now, from gross income. This would also mean that there would be no need to fix the maximum ceiling. Thirdly, local governments could be given the power to demand annual GST returns at the time of renewal of the traders' licenses or issue of their ownership certificates etc. Finally, local governments could reduce their reliance on grants from the higher levels of government by imposing tax at a progressive rate within the maximum allowable rate fixed by the central government. Such a tax would be convenient for taxpayers and have the dynamism to raise civic consciousness and accountability. Therefore, it would also be essential to have political will at various levels of government.

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