

Policy Note: 5

Revenue Potential of Panchayats in Kerala

Some indications from a study of a few selected Panchayats

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How much more taxes would it be possible for Panchayats in Kerala to collect? This question is important in deciding the financial allocations to such local governments. Information regarding this may enable to frame resource allocation rules that provide incentives to local governments to enhance their own resources. This is especially so, if the allocation of `more' resources from the state government serves indirectly as a disincentive for the LSG to mobilise the available tax resources from the locality. This study carried out in six panchayats of different districts of Kerala provides some indicative insights.

1. Sources of revenue loss for the local governments

There are at least four major proximate reasons behind a particular local government's failure to collect tax resources from its territory at a level that matches its potential. These are the following.

- a. ***Under-collection*** When a particular tax unit (say a building) is invoiced or billed (or its owner knows the amount of tax to be paid) but the amount is not collected by the panchayat under-collection occurs. This may be due to the negligence of the staff of the panchayat in collecting the amount due, or because the panchayat fails to take prompt and appropriate action against an individual/unit failing to pay the tax on time. This is the difference between the `demand' and the `collection' of the tax as per the records of the panchayat. (There is a perception that many panchayats record actual collection as the demand). ***However this information is available among the records of all local governments and this may be available in a compiled form at the state level. Hence we, as an academic institution, cannot provide any additional insights on this issue.*** However we have noted a certain extent of under collection in the selected panchayats.
- b. ***Under-invoicing***: This happens when the invoiced amount of tax paid on a unit falls short of the tax amount that it is supposed to pay (based on the mandate/rules/guidelines). Such under invoicing could be intentional or unintentional. This may also be due to political reasons – stemming from an unwillingness to antagonize the voter by charging him/her the due tax. **This study gives some indication on the extent of such under-invoicing in the selected panchayats. This is based on a systematic random verification of the units taxed, the assessment of their tax potential, and the difference of this potential tax against the actual tax collected.**
- c. ***Non-invoicing***: This occurs when some units, though they are liable to be taxed are not billed or invoiced or considered within the tax domain. In one sense, this

can also be taken as part of under-invoicing, if zero taxation is also taken as part of such under-invoicing. This study provides some indications of this source of tax loss in the selected panchayats.

- d. *Non-use of tax sources:* Certain activities, which can be potentially taxed by the local governments, may not be actually taxed by them. Though we have made some attempt in this direction, the information collected is incomplete. Thus more effort is needed in this direction.

2. Selection of sample panchayats

Given the limited time frame and the intensive field work required, we were not in a position to conduct the study over a large sample of local governments. Moreover, it is not easy to verify the potential tax on a building or a commercial unit in panchayat as the owner has no incentive to provide the correct information whenever there is under- or non-invoicing. Further, they may have a very negative (if not violent) attitude towards an outside investigator.

Thus we have attempted to use some former presidents or secretaries of the same panchayat or knowledgeable persons in the locality, as the main investigator. However, we have cross-checked this information through a peer review (using the investigator in one panchayat to do a random check in another). Thus the investigators visited the tax unit (without revealing the purpose) and did an **approximate** assessment of the potential tax of that unit. Systematic efforts have been made to avoid overestimation of the potential tax, but the figures may be underestimates by up to around 25 percentage points.

The size of the sample is limited because the study required specific types of persons as investigators, who had to be willing to devote quality time for the purpose, and hence the sample selection is somewhat purposive. However we have made an effort to have a reasonable distribution of panchayats in terms of their actual tax collection and region. This is attempted in the following manner: We have identified one such investigator from six districts of Kerala namely Kannur, Kozhikode, Palakkad, Trissur, Ernakulam, and Kottayam (though we have enlisted one person from Trivandrum, the data collection did not take off). Each of them were asked to gather tax collection details of two panchayats one with above-average and another with less than average of tax incomes from the district - for the most recent two consecutive years. The tax collection information from all these twelve panchayats were listed, and six were selected for the study to represent panchayats with varying range of tax incomes. Thus the selected panchayats, as evident from Table 1, comprise high, medium and low tax-income generating panchayats. (The names of the panchayat are not given due to the confidential nature of information revealed here). **We do not claim that these six panchayats constitute a representative sample of panchayats in Kerala, and hence the results of this study can be taken as only indicative.**

Table 1: Tax collection in (Rs) details of some the panchayats considered for selecting a sample for a detailed analysis

Panchayats	Years	
	2007-08	2008-09
Ke	3229405	3520514
Po	923775	807218
K	2282859	8534124
V	2255508	1243370
C	13701151	11475104
KM	722035	542218
E	4980426	4582998
KA	981439	1039335
A	3060746	3320705

3. Method of assessment and verification

Based on the different sources of taxes for the selected panchayats, we decided to focus on two items namely **building tax** and **professional tax**. As evident from Table 2, these two items constitute nearly 90 percent of the tax income of most of the selected local governments. Regarding under-collection, we have depended on records kept at the Panchayats. As indicated before, this study does not provide any additional insight on this issue.

Table 2: Composition of Building and Professional Tax (in percentage) within the Tax domain among the Selected Panchayats during 2006-09

Panchayats		Years	
		2007-08	2008-09
V	P	29.9	61.3
	B	59.4	23.3
C	P	31.2	28.5
	B	6.9	9.4
KM	P	43.1	54.4
	B	57.0	45.6
E	P	38.5	45.1
	B	56.4	52.7
KA	P	46.1	52.3
	B	52.9	47.7
A	P	49.5	51.7
	B	35.5	34.8
P	P	33.0	24.6
	B	17.8	55.9

K	P	7.8	26.9
	B	13.7	72.2
Total	P	24.6	24.6
	B	38.2	29.1

Note: P and B stand for professional and building tax.

Regarding the under-invoicing of building tax, the following method was used. A stratified random sampling was used to identify the sample of tax units to be verified. A single ward was selected at random, from which a sample of 50 buildings were selected through systematic random sampling based on a list of buildings available for the ward. This sample of 50 buildings were visited for obtaining information regarding the taxation details like whether invoiced or not, if invoiced then the amount of tax paid as well as the potential amount of tax to be collected based on the norms of valuation. The investigator, who is familiar with the rules of assessing taxes, made an assessment of the tax potential of that building. In order to avoid over estimation, we encouraged underestimation to the tune of 20 percent. The amounts so assessed by this investigator were randomly cross-checked by one or two investigators from other districts. This was to serve two purposes: (a) all the investigators use similar methods of estimating potential tax; (b) no one person deviates from a given norm due to biases or differential interpretation of the rules/procedures. Such cross-checking led to similar estimates for similar tax units under similar conditions in all the districts. Since the list used here is one of buildings (and not one of the tax paying buildings), the same process provides information on non-invoicing – the sample showed some building which are not taxed currently, but should be paying tax based on the prevailing rules.

Regarding the under invoicing in professional tax, different methods had to be adopted. In one panchayat, we could do a census where by all these tax payers and the amount of tax that they should (and actually) pay could be assessed. In certain other cases, we used the list of licensed units kept in Panchayats, and verified a random sample of them in one ward or commercial centre. The government offices and establishments like aided schools are exempted from verification for this purpose, since it is known that there is unlikely to be any under invoicing in these cases. In certain other cases, we noted all such units which had the potential to pay professional tax in the main town/commercial centre of the panchayat, and examined whether these have been actually paying the due tax. Whatever be the method, the sample selected gives a reasonable picture of the payment of professional taxes by establishments other than governmental offices and similar organisations.

4. Results of the Assessment

The results are described below for under collection, under invoicing, and non-invoicing with building and professional taxes separately.

Regarding the extent of under collection, some information is presented in Table 3. Three out six panchayats do not seem to have any under collection as per their records. (There is a perception that the actual collection is recorded as demand too, and hence there is no

gap between them). In other panchayats, 10 to 20 percent under collection is the most frequent figure. Under-collection seems to be much lower or insignificant in the domain of Professional Tax. On the contrary, there is substantial under-collection in the building tax domain although it varies across Panchayats as well as over years. Undoubtedly, the building tax component can very well be increased by about twenty percent from the current collection by addressing the issue of under-collection.

Table 3: Extent of Under- Collection (%) in Building and Professional Tax component across Selected Panchayats

Panchayats	Extent of Under collection								
	Building Tax			Professional tax			Total		
	2006-07	2007-08	2008-09	2006-07	2007-08	2008-09	2006-07	2007-08	2008-09
C	16.6	12.5	18.8	12.0	0.7	1.6		8.8	13.9
A	0.0	3.1	27.3	0	0	0.7			
K	0	67.4	14.4	0	0.2	0			

Table 4 provide information on under invoicing in building tax. Nearly 70 to 80 percent of the buildings are under invoiced. The average underestimation in each panchayat varies from 44 to 90 percent, with the sample average of 71 per cent . It may be safe to assume that the building tax in Kerala can be increased by around 70 per cent if this under invoicing is corrected. It may also be noted that around 5 to 10 percent of the buildings are not taxed at all.

Table 4: Characteristics of Building Tax across Selected Panchayats based on sample verification

Panchayats	% of units non-invoiced	% of units under-invoiced	% of units Over invoiced	Percentage under-invoiced		
				Average	Maximum	Minimum
A	12	84	Nil	78.4	100.0	12.0
K	6	66	8	76.3	97.5	16.5
KC	Nil	70	2	44.1	91.6	6.2
KM	Nil	50	8	90.4	99.8	62.5
V	14	86		69.2	97.1	42.4
C	18	38	NIL	81.1	95.7	57.7
Total	6.8	70.8	3.6	71.7	97.0	29.2

The under and non-invoicing in professional tax are reported in Tables 5, 6 and 7. The figures of the percentage of commercial or private units range from 13 to 68 percent. The extent of under invoicing in terms of the amount of tax can be to the tune of Rs. 100-400

per unit. Based on this sample data, there is under-invoicing in 32 per cent of units and the average extent of such under-invoicing is to the tune of fifty per cent on the whole. The extent of non-invoicing is much higher. In a majority of panchayats, nearly fifty percent of such units are not invoiced at all. The average amount, of non-invoicing per unit, ranges between rupees 400 and 2000. **It may be noted that this under and non-invoicing are with respect to professional tax to be collected from establishments other than governmental or government-funded (and cooperative) organisations.**

Table 5: Characteristics of Professional Tax across Selected Panchayats based on a sample verification

Panchayats	% non-invoiced	% under-invoiced	%Over invoiced	Statistics of the amount under-invoiced		
				Average	Maximum	Minimum
A	50	50	Nil	376.8	1960.0	60.0
K	50	Nil	Nil			
KC	Nil	68	2	401.43	2390.0	60
KM	36.8	13.2	10.5	312	480	120
V	Nil	64.0	Nil	109.68	270	60
C	30	14	NIL	192.9	850	20
Total	14.6	48.9	2.1			

Table 6: Extent of Under-invoicing in professional tax across selected Panchayats

Panchayats	% under-invoiced	Extent of under-invoicing in percentages		
		Average	Maximum	Minimum
A	50	60.7	94.2	33.3
K	NIL			
KC	68	44.1	91.6	6.2
KM	13.2	48.2	60.0	33.3
V	64	41.5	60	33.3
C	14	33.2	50	16.7
Total	48.9	46.8	77.8	23.4

Table 7: Extent of non-invoicing of professional tax across selected sample Panchayats

Panchayats	% non-invoiced	Average	Max	Min
A	50	396.4	2150	120
K	50	1934.3	6810	480
KC	Nil			
KM	36.8	557.1	240	840
V	Nil			
C	30	188	300	120
Total	40.7	1055.9	3716.8	397.2

Conclusion

An assessment of tax potential of the rural local governments based on this preliminary investigation provides some indications regarding the extent and composition of tax loss that need attention. As building and professional taxes comprise nearly 90 per cent of total tax collection, this study provides indications of losses in these tax domains. While under-collection, non-invoicing and under invoicing contribute differently to this loss, under-invoicing is more commonly observed in case of the building tax and under-invoicing as well as non-invoicing are important in the case of professional tax. The extent of loss can be to the tune of two thirds of the potential tax revenue under both heads. The magnitude of under invoicing is positively linked with the level of taxation in both the domains of taxation. Non-invoicing is less prevalent in case of buildings but is quite prevalent in the case of professional tax. These observations could provide a guide towards a policy initiative on correcting under invoicing in the building tax component and a greater coverage of the professional tax domain. It may **be noted that the loss in revenue estimated here is not due to lack of implementation of revised tax rules but to factors that discourage local governments from charging the due tax from its citizens.** Hence this cannot be addressed by a change of tax rules, but only by changing the incentives (disincentives) associated with own resource mobilisation.