INTRODUCTION

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CHAPTER I
INTRODUCTION

1.1 Introduction

The 'ever increasing activity' of the 'welfare state' compels every government to make all-out efforts for resource mobilization. The two important sources of revenue are taxes and non-taxes. Share of taxes in total revenue of the governments far exceed non-taxes.

Tax is important not only as an instrument of resource mobilization but also as a strong weapon in attaining other objectives like equity in the society, correcting inflationary and deflationary tendencies in the economy, promoting and steadying employment\(^1\), etc. Thus, taxation has manifold roles to play and a good tax system is essential for every economy. A good tax system must have some basic qualities\(^2\).

Developing countries, in the initial stages of their development, have the scarcity of sufficient resources and generally their tax systems are beset with many infirmities. India is facing this problem and despite the best efforts, the central government is finding it difficult to keep the fiscal deficit below 5 per cent of the Gross Domestic Product.

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\(^2\) Musgrave summarises the requirements for a good tax structure as: (i) Revenue yield should be adequate, (ii) The distribution of the tax burden should be equitable, i.e., everyone should be made to pay his or her fair share, (iii) Taxes should minimise interference with economic decisions in otherwise efficient markets, (iv) The tax structure should facilitate the use of fiscal policy for stabilisation and growth objectives, (vi) The tax system should permit fair and non-arbitrary administration and it should be understandable to the tax payer, vii) Administration and compliance cost should be as low as is compatible with other objectives, etc. (Richard A. Musgrave and Peggy B. Musgrave, *Principles of Public Finance*, (New Delhi: Allied Publishers Pvt. Ltd., 1978), p.118.
Kerala is going through a critical stage of its development. The doubt about the economic sustainability of its world acclaimed development pattern (the so-called Kerala Model) is gaining ground. Resource crunch is a major problem the state economy is facing. Paucity of fund is a major hazard in the quality of education, including medical education.

Resource crunch has compelled this ideologically committed state to think differently on many social issues such as self financing educational institutions, public sector restructuring, salary and pension benefits of the state government employees, private initiative in public utilities such as roads, bridges etc. The present government had to bring out a “White Paper on State finance” to highlight the major areas of financial concerns of the state. The paper identifies 12 dimensions of the crisis involving about Rs. 4616.78/- crores.

Fiscal deficits and revenue deficits are alarmingly high and are on the increase. Fiscal deficit is a measure of the amount that a state government has to borrow to meet its total expenditure. The fiscal deficit is as high as 5.49 per cent of the Gross State Domestic Product (GSDP). The present Government has identified sustainable fiscal deficit to be around 3.5 per cent to 4 per cent of the

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4 Most important feature of Kerala model of development is the high social development with low economic development.


GSDP and the actual amount should be between Rs.3200/- crores and Rs.3500/- crores. But the government failed to bring down it to the desired level.

Increase in revenue deficit is a more worrisome aspect of the budget. This means that government has to borrow to finance even the day today expenses of administration; there by ruling out the possibility of any surplus for reinvestment or taking up any new projects in this high literate state where educated unemployment is a serious problem.

Similar is the case with the indebtedness of the state. Total debt of Kerala state shows a continuous increase from Rs.217.34/- crores in 1970-71 to a total of Rs.31060/- crores in 2002-03. The increase is alarming and is about 37.5 per cent of the Net Domestic Product in 2000-01. The behaviour of per capita debt outstanding also is similar. It was Rs.102/- in 1970-71 and skyrocketed to Rs.9425/- in 2002-03. This is in contrast to the all states average of Rs.6652/- in 2002-03. The state is moving fast to a debt trap.

All these point to one important fact that there should be an all out effort for additional resource mobilization. Agriculture is a dominant sector of the economy and taxation of this sector should attract our special attention to see whether there is scope for increased mobilization of resources from the sector.

Agriculture, all over the world, used to contribute considerably to the government resources. For example in Argentina agricultural sector contributed about 15 per cent of Gross Domestic Product to the total revenue of the Government and this came about 40 per cent of the total tax revenue in 1977.

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10 Various issues of Budget in Brief, Government of Kerala.
Uruguay in 1973-74 about 43 per cent of gross agricultural income was taken away in direct taxes on agriculture.\textsuperscript{12} Indian land tax had brought in more than two-third of all government revenue in the eighteenth century and one-third in the first part of the 20th century.\textsuperscript{13}

Agricultural sector in Kerala is undergoing tremendous changes, which have their impact on the taxable capacity of the sector.

Government expenditure for the agricultural sector through five year plans have increased considerably. There is an increase from Rs.249/- lakhs in the first plan to Rs.187872/- lakhs during the 9\textsuperscript{th} plan (1997-2002).\textsuperscript{14} The increase in absolute amount is manifold. The share was 9.6 per cent of the total plan expenditure in the first plan and it increased to 19.46 during the 6\textsuperscript{th} plan and to 11.41 per cent during the 9\textsuperscript{th} plan. This shows that Five-year plans have spent a large amount on agricultural sector. This must have increased the taxable capacity of the sector and it is argued that agriculture should contribute in accordance with what it receives from the government.

Primary sector had an average growth rate of 2.3 per annum from 1980-81 onwards, till 2000-01.\textsuperscript{15} Average growth rate of secondary sector was 5.1 per cent and that of tertiary sector was 5.9 per cent. Primary sector and agriculture contributed about 17.5 and 17.2 per cent of the Net Domestic Product in 2002-03. Their respective shares were 39.23 and 39 in 1980-81.\textsuperscript{16}

Similarly, agriculture is still a main source of living of a major section of the population in Kerala. Agricultural sector employed about 23.27 per cent (7.2 per \textsuperscript{12} Ibid.,p.149 
\textsuperscript{15} Various issues of Economic Review. 
cent cultivators and 16.07 per cent Agricultural labours) of the total workers in 2001. In 1961 agriculture employed about 54.6 per cent of the work force (cultivators-29.84 per cent and Agricultural labours-24.8 per cent). In addition to this, there are the people employed in fishing, forestry, mining and quarrying, etc.

As per the Agricultural Census conducted by Directorate of Economics and Statistics17, number of holdings increased. The average size of holding decreased to 0.27 hectares in 1995-96 from 0.36 hectares in 1985-86. Number of small and marginal farmers (below 2 hectares) increased. The number of medium and large farmers (4 hectares and above) fell. The area held by them decreased. Therefore the average size of holding of the medium and large framers came down from 10.56 hectares to 9.41 hectares.

Fall in the average size of holdings, increase in the number and area held by the marginal and small holders, fall in the number and area held by the medium and large holders are indications of a decreasing taxable capacity in the agricultural sector.

Another aspect of agricultural scenario of Kerala is the changing cropping pattern. Cropping pattern has undergone a tremendous change. In 1960-61, 45.4 per cent of the gross cropped area was used for food crops; it decreased to 15.52 per cent in 2000-01. The share of cash crops including plantation was 44.5 per cent in 1960-61 and it increased to 68.6 per cent in 2000-01. There is commercialisation of the agricultural sector and production has become increasingly market oriented, which is an indication of the increased capacity of the sector to pay more tax.

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1.2 **Statement of the Problem**

Resource mobilization is essential for economic and social development. Taxation is the most important tool of resource mobilization. Every sector should be taxed fairly, in accordance with the ability to pay. A sound tax system has certain basic qualities and is necessary, as it would generate revenue and a host of other positive effects in the society and economy. Kerala economy is passing through a critical stage of its development. The state has a very difficult financial position now. Therefore, it should search for fresh sources of revenue and better utilise the existing ones.

In this context, an analysis of the agricultural taxation in Kerala becomes relevant. There are many questions like, whether the sector is taxed properly, whether there exists excess taxable capacity, whether the agricultural tax system is efficient or not, whether there is inter-sectoral and intra-sectoral equity in taxation and so on, which need concrete answers. Present study is an attempt to find out answers to some of these questions pertaining to the agricultural tax system of the state. This calls for a systematic and detailed investigation.

1.3 **Objectives**

We propose to make a detailed study of the agricultural taxation in Kerala with the following objectives:

(i) To analyse the revenue structure of the State Government of Kerala,

(ii) To examine the performance of the agricultural taxation in Kerala and to compare it with other states,

(iii) To assess the existing tax burden of the agricultural sector and to measure the taxable capacity of the sector,

(iv) To examine the cost of collection of agricultural taxes and efficiency in tax collection, and
(v) To analyse the impact of the introduction of compounding on agricultural income tax.

1.4 Data Source and Methodology

Here, we give only a brief account of the methodology used in the study. A detailed account of the methodology will be given in each chapter together with the analysis.

Data are collected from both primary and secondary sources. Secondary data are collected from various issues of R.B.I. bulletin, Economic Review, Statistics for Planning, Economic and Political Weekly (Research Foundation), Hand book of Statistics on Indian Economy (RBI), various Census Reports, Indian Rubber Statistics 2003, Rubber and cultivation 2004, NABARD etc.

Data on Net Domestic Product and Agricultural income at Current and Constant prices (1993-94 series) are used wherever needed.

The structure of the revenue of the state was examined using secondary data from 1957-58 to 2000-01. It gives the composition of total revenue, total tax revenue, own revenue, state’s own tax revenue and non-tax revenue. The importance of the direct taxes of the agricultural sector in Kerala in each of the above is brought out. Conventional methods like tax-income ratio, elasticity of the tax system in relation to Net State Domestic Product (NSDP) and elasticity of the direct taxes of the agricultural sector in relation to Net State Domestic Product and Adjusted Agricultural Income are made. The relative importance of each taxes such as sales tax in the state’s own tax revenue was analysed. The interstate comparison of the structure of revenue was also done for the above period on the basis of per capita tax, tax-income ratio, share of state’s own tax in total revenue, Adjusted Agricultural Income refers to income from agriculture alone that is it excludes income from fisheries, fishing and animal husbandry etc
share of state’s own tax in total taxes, share of central taxes in tax revenue of the states, elasticity of the tax system etc.

Performance of the agricultural tax system of the state was examined with secondary data for the period from 1957-58 to 2000-01. Conventional methods were used to assess the performance of the taxes. Simple and multiple regressions were also done to interpret the data.

Performance of the direct taxes of the agricultural sector of the state was compared with other states like Assam, Haryana, Punjab and all major south Indian states. Comparison with Assam is done because it has many features similar to that of the agricultural sector of Kerala. In both states, there is the predominance of plantation crops and in both states agricultural income tax existed right from the constitution of the state. Comparison with Punjab and Haryana is made because these are the two Indian states where agriculture is said to have made great leap forward.

Tax burden of agriculturists is computed by estimating the tax net income ratio. Net income of the cultivator was estimated by using the data on cost, prices and productivity collected from secondary sources mentioned above. Taxes paid by the agriculturists were computed by estimating the taxes paid by the agriculturists with different size of holdings as per the existing tax laws. Tax burden of the cultivators of different crops was estimated and compared for 2003 to know the intra sectoral equity in taxation.

Taxable capacity was measured by estimating the net income of different cultivators of different crops. Taxable capacity was assessed also by conducting a family survey and constructing a Composite Capacity Index on the basis of the primary data collected through this household survey. The survey was conducted between June 15 and August 31 of 2003 in Meenachil taluk of Kottayam district and Kozhikode taluk of Kozhikode district. 1700 questionnaires were distributed,
900 in Meenachil taluk and 800 in Kozhikode taluk. These areas were selected because of the presence of large number of financially well-to-do agriculturists, cultivating different crops such as rubber, coconut and areca nut. 1308 filled in questionnaires were returned, 776 from Meenachil and 532 from Kozhikode of these 642 belonged to the agricultural families\(^\text{19}\) and 666 to non-agricultural families\(^\text{20}\).

Among the non-agricultural families, there were 122 households where at least two members of the family (most often both the spouses) are employed, whom here in after referred to as 'both employed families' and 156 families where at least one of the members (most often either of the spouses) of the family is employed. Only those employed in organised sector, government, semi-government, banks, co-operative societies, and private firms, where salary is paid either through bills or cheques, are considered as employed. This is to make sure that they have accounted income and pay proper taxes. Others were classified as unorganised sector and had business, trade, driving, rubber tapping, daily labour, etc. as their main source of income.

Capacity index reflecting the standard of living, asset position, bimonthly expenditure on telephone and electricity, type of education provided to the children and amount and purpose of loan availed was constructed for 122 both employed families, 156 single employed families and 195 agriculturists families.

Of the 642 agricultural families, 195 possess a land size of 3 or more than 3 acres. Families with less than 3 acres of land fall in the category of marginal and

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\(^{19}\) Agricultural families are those whose only source of income is farming. They do not have any supplementary source of income such as small trade, rubber tapping, taxi driving, etc.

\(^{20}\) Non agricultural families include all the families, who have any source of income other than agriculture such as business, employment in organised sector, in government, cooperative sector, shops, driving, rubber tapping, taxi cars, auto rickshaw, petty shops, slaughter shop etc. Any one who was not willing to reveal all sources of income also was grouped as non-agricultural families. This is why the numbers of non-agricultural families are so large.
small farmers and we presume that they do not have much taxable capacity. Thus capacity indices of 473 (122+156+195) families were constructed\textsuperscript{21}.

Capacity indices of agricultural and non-agricultural families are compared to know the income levels of families having similar capacity indices. Then by comparing the amount of taxes paid by them we can conclude who is paying less tax. Thus, it helps us to assess the intersectoral inequality in taxation. Intersectoral inequality/equity was examined also by comparing tax income ratios of cultivators of various crops with that of salaried people of various income groups.

There is an attempt to estimate the taxable capacity of a few of the top 19 agricultural families by estimating their income on the basis of their size of holding, type of crop cultivated etc.

Cost of collection of tax is a wide concept comprising various aspects of cost such as administrative cost, compliance cost, efficiency cost, social cost etc. Cost of collection of Direct taxes of agricultural sector is composed of cost of collection of Land revenue and Agricultural Income Tax. Land revenue is collected through the village offices and agricultural income tax through three types of offices such as

(i) Assistant Commissioner (AC special) offices in Ernakulam and Kozhikodu. AC offices deal only with the tax returns of a few major companies and firms in the plantation sector.

(ii) Agricultural Income Tax and Commercial taxes offices which deal only with agricultural income tax returns, and

(iii) Agricultural Income Tax and Commercial taxes offices, which handles agricultural income tax returns together with sales tax returns. Their main

\textsuperscript{21} Details of the procedure followed for constructing the capacity index are given in Chapter V.
business is to collect sales tax but they also handle some agricultural income tax files.

The expenditure incurred on Agricultural Income Tax is not available from the third type of offices as their main duty is to deal with Sales tax and they do not keep separate account for the expenditure for the collection of Agricultural Income Tax. Other two offices have their accounts and data are collected from the files of these offices to estimate the cost incurred on the collection of Agricultural Income Tax. Efficiency in tax collection was assessed by evaluating the performance of the offices, returns per rupee spent on tax collection and so on.

In order to analyse the impact of recent changes especially the impact of the introduction of compounding on tax collection we analysed the secondary data on various variables before and after the introduction of compounding of agricultural income for tax purpose in 1991. The impact was also studied through collecting data from Agricultural Income Tax offices. Change in the cost, change in the pattern and growth of tax collection immediately before and after the introduction of compounding could be ascertained from the office files. Conventional methods like per capita tax, tax income ratio, growth rate of various taxes, share of tax in total revenue, share of tax in Net Domestic Product, share of tax in Adjusted Agricultural Income (AAI) etc. were used to analyse the data. Simple and multiple regressions were also done to interpret the data.

1.5 Limitations of the study

This study has the following limitations:

(i) A defect of the study on cost effectiveness is that, data for 1990-91, the year immediately preceding the introduction of compounding is the only year for which data are available and that too only of four offices. It means

22 Details are given in Chapter VII
that pre compounding cost situation was derived from the data of one year of only four offices that collected Agricultural Income Tax. This is because the offices either do not have the data or are not ready to disclose.

(ii) The net income of a cultivator is calculated on the basis of the cost and productivity data provided by agencies like NABARD, Spices Board, Rubber Board and Kerala State Planning Board. There is yearly variation in the productivity, as the plants grow older; but this could not be accounted for due to lack of credible data. Average of prices and productivity for the last three years (2000-01, 2001-02 and 2002-03) is taken to calculate net income. The average price thus derived is different from the existing market price.

(iii) Income alone is not the only factor that determines the number and size of consumer goods possessed, assets like gold, house, vehicles owned, expenditure on electricity and telephone, type of education to the children etc. Therefore the inference that people having similar capacity index, which is constructed on the basis of these variables, have similar income is questionable. But whether the incomes are similar or not they have similar capacity to own and use them. So we are not wrong in assuming that they have similar income, because without income or accessibility to income, such assets and services of such assets cannot be enjoyed.

1.6 Plan of the Study

First chapter is the introductory chapter, which states the research problem and spells out the objectives of the study. This is followed by a brief discussion on the source of data and methodology. Some of the limitations of the study are also given.

In the second chapter, a survey of the existing studies is made. This chapter deals with the important arguments for and against the taxation of agricultural
sector. This is followed by the review of the major studies at the national and states level. The studies are arranged in the order of national studies first followed by studies at the states' level and finally the studies in Kerala. Attempt is made to arrange the studies chronologically.

The third chapter deals with revenue structure of the state government. It gives the composition of total revenue, total tax revenue, own revenue, state’s own tax revenue and non- tax revenue. The importance of the direct taxes of the agricultural sector in Kerala in each of the above is brought out. The relative importance of each taxes such as, sales tax in the state’s own tax revenue was analysed. Third chapter also contains an inter- state comparison of the tax performance. The comparison is made with all the major south Indian states.

Fourth chapter examines the performance of the direct taxes of the agricultural sector in Kerala. Land revenue and Agricultural Income tax are taken separately to analyse the behaviour of each tax. Then all direct taxes of the agricultural sector (AGT) together were considered to analyse the total burden of the direct taxes on the agricultural sector. Here, a comparison of the direct taxes on the agricultural sector of the important South Indian states and states like Assam, Haryana and Punjab are made.

An attempt to measure the actual tax burden of a cultivator is made in the fifth chapter by estimating the net income of the cultivator from land and the direct taxes he has to pay, as per the existing tax laws. Tax income ratio was worked out to know what percentage of his income is paid as direct taxes to the exchequer and this was compared with the tax income ratio of the so-called ‘properly taxed’ employees of the state government. An attempt is also made to measure the taxable capacity of a few families on the basis of a family survey and a capacity index constructed on the basis of the information gathered through the survey.
Chapter six gives the estimation of the cost of collection of the taxes. Cost of collection of a tax includes administrative cost (collection cost proper), compliance cost, efficiency cost, social cost etc. The cost effectiveness was assessed by collecting data from the Agricultural Income Tax offices all over the state. Cost-revenue ratio of each office is estimated.

A comparison of cost of collection of the Agricultural Income tax in Kerala is made with cost of collection of certain taxes in some other countries to see whether cost of collection of Agricultural Income Tax is on similar levels. A comparison is also made with the cost of collection of sales tax in Kerala.

In the next chapter an analysis of the behaviour of agricultural income tax after the introduction of compounding in 1991 and in 1980s, the decade immediately preceding the introduction of compounding is made.

In the last chapter, summary of the major findings of the study, policy implications and suggestions are given.