CHAPTER -III

EVOLUTION OF LOCAL TAXATION IN INDIA

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This chapter focuses on the evolution of local taxation in India. The tracing of its origin is useful in understanding the status and situation and growth of local taxation in the past, the changes that have taken place over the years and the comparative advantage of 73rd and 74th Amendment Act, etc. Keeping these imperatives in the background, this chapter makes an attempt to study the development of local taxation. In the growth of property taxation the analysis may be split into four parts: pre-1842 period, period between 1842-1882, period between 1882-1935, and the post-1935 period. Further an attempt is made to study the growth of octroi and growth of the rural sector: land revenue.

3.1 Introduction

In adopting a purely British model of local taxation the states in the eastern parts of India have a striking resemblance. Bengal including Bihar and Orissa which were later on separated and Assam belong to this group where introduction of property tax met with little resistance and was finally accepted. In the western regions and south property tax was supplemented on a moderate scale by personal taxes and indirect taxes; the latter were more important in the western parts. Octroi, the indigenous variety, was widely adopted in Sind, Punjab, North West Frontier Province, U.P., C.P. and Bombay continuously after 1850. This fiscal division exists even today thus differentiating the problems of local taxation of each region from the other.

It is in the eastern regions, typically in Bihar, where the British pattern has been in vogue for the longest period and behaviour of this tax is, therefore, of special interest in judging the suitability of such a tax in an under developed economy. It is difficult to assign clearly any specific reasons why these parts of India abandoned octrois and accepted the direct tax on properties, nor can it be said that the relatively slower and chequered growth of local institutions in this part was primarily due to adoption of an unpopular tax. But it is true that these were the localities economically more backward, more agricultural and with a denser population and consequently under greater control of the higher layer governments for their finances. With weaker usage
of local government, these parts lacked local initiative. All these factors account for slower growth of local government and poor performance of the units, and also for the indifference shown towards the new form of taxation imposed during the British rule.

The resistance to property taxation elsewhere was generally made by the middle class which did not like to be assessed directly, and by traders who found it difficult to shift. But in the eastern parts there was a relative paucity of traders due to the agricultural character of the area and its subsistence economy with little inter local trade.

It may also be argued that these areas had a weaker usage of octrois than many other states. U.P. was the nucleus of the chungi of the Mughal kings; western regions had also small princely states and Bombay under the Marathas had established traditions of Muhtarfa while Punjab under the Sikhs had Dharat. Further, the octroi regions were generally those which seem to have numerous geographical barriers of mountains and rivers separating localities from each other. This made octrois convenient, while the existence of a trading class and trading centers in sparse areas like the Deccan or Rajasthan would make octrois productive and property taxes uneconomical.

It is also suggested that the adoption of the British model in Bengal might be due to the fact that the head quarter of the Government of India was located in Bengal which made a direct impact on the policy and practice of local taxation in the areas proximate to it.

All these forces have made an impact on the growth of different patterns of local taxation in various regions and these taxes have in their own way affected the growth of local institutions in the areas. An analysis of the process of development of the various patterns is given below.

3.2 Growth of Property Taxation: Bihar

Bihar, typically representing the eastern part where property tax has had a long period of trail, has witnessed a slower growth of municipal administration. Though not quite dissimilar to the trends in other regions, the developments in this state were more
handicapped. Accidentally, in Madras the local government was initiated much ahead in 1687. This created a big time lag between such developments in the presidencies. The extension of municipal government to mofussils is marked after 1850, mainly under the impact of the 1850 Act which provided for indirect taxation, but in Bihar real progress could be made only after the report of the Royal Army Sanitary Commission of 1863 which drew attention of the government to the filthy conditions of towns. The slower growth in Bihar was partly due to largeness of Bengal itself (Bihar and Orissa were separated only after 1912) but partly also to economic backwardness, slower rate of urbanization and poorer local response. These led to greater pressure of the state on local finance and almost sudden replacement of octrois by property taxes for which a scientific basis of valuation was yet to be evolved.

From the point of view of development of local taxation in Bihar, the analysis may be split into four parts: Pre-1842 period, which was characterized by experiments in direct and indigenous forms of local taxation—all levied by the central government; Period between 1842-1882 in which a beginning of creation of municipal units was made; Period between 1882-1935 during which some perfection could be achieved in matters of local taxation and finance, and the Post-1935 period during which little progress could be effected and actually a reversion of the trend of decentralization, especially in matters of taxation and administration, was witnessed with growing control of state over the urban administration.

3.2.1 The Pre-1842 Period

In the mofussil areas, octrois, being old taxes, were levied by Regulations and they continued to be collected in the early period of East India Company’s rule. They were abolished in 1795 and a police tax was imposed by Regulation XXXIII of 1793 on “merchants, traders, resident or having establishments in several cities, towns, bazaar or elsewhere on the principle that they carried on the whole internal trade free from duty in consequence of the late abolition of the inland customs and, although one of the most opulent classes of people, they paid no immediate tax to the state.” This was the
earlier substitute to octrois with some local character. Abuse in the collection of the tax was, however, so pronounced that it was abolished in 1797 and was replaced by the levy of a new stamp duty. The earliest attempt to introduce a house tax on all houses in cities and towns in which collectors of land revenue were stationed was made in 1810 at the rate of 5% of house rent and 10% of rents of shops. But it was abolished only after two years due to popular opposition. By Regulation X of 1810 of octroi was revived in Patna, Purnia, Bhagalpur, Muzaffarpur, Chapra and Arrah- some of the major towns of the period, while it was already revived in Dacca and Murshidabad in 1801. Local tax for the provisions of the town chowkidar was imposed on the inhabitants of Patna (also Dacca and Murshidabad) in 1813. This was the first municipal law enacted in Bengal. The tax was assessed by five substantial holders subject to the magistrate’s control. The rates were not to exceed two annas per mensem per head. A rate on each shopkeeper or householder was levied in 1837 expressly for the purpose of cleaning and repairing towns in which the tax was levied. This was the first tax appropriated for local improvement.

Local taxes of the above type, without local institutions, were meant only to raise local contributions to the higher government and were motivated mainly to meet the cost of police and were little used for local improvements.

3.2.2 Period between 1842-1882

The Bengal Act of 1842 was the first to attempt at extension of municipal government to mofussil towns of Bengal but it remained a dead letter because the initiative to form such committee was left on two-thirds of householders of any town. It was also unpopular due to its provisions for property taxation. The Act of 1850 was an improvement over the earlier Act as it reserved the right of initiation with the government and provided for indirect taxation. But in Bengal little use could be made of this Act too and it was used mainly in Bombay. It could only create a few small units in Bengal which were hardly urban. The Town Police Act of 1856, with a provision for house tax (assessed on the basis of value, importance and size of the
property) could also create a few semi-rural units where an officer of police or a Jamadar was stationed. It created a few urban units which later on became second class municipalities and were brought under the purview of Act 1868 of a similar nature. The extension of municipal government to larger towns which later on became first class units could be possible only after the report of the Royal Army Sanitary Commission, 1963 which drew the attention of the government towards the filthy condition of towns. By this time the resistance to property tax had grown weaker and the Act of 1864, to which most of the bigger municipalities today owe their existence, provided for a tax on the annual value of holdings.

Under the impact of Lord Mayo’s financial reform in 1870, the various units, which were created so far, were recognized and grouped on the basis of certain population, area, profession and density but the committees were largely official and nominated. Under the Act IV of 1876 the whole body of commissioners was to be appointed by government unless at least one-third of the ratepayers prayed for an elective system. The major weakness which persisted in spite of reorganization of the new urban units was a confusion of principles leading to the existence of charges for things not sufficiently local in character and though finances were fairly decentralized as between central and provincial governments, local finance remained in a state of flux. The reasons can be assigned partly to the process of devolution of responsibilities from the higher tiers of government to the lower one’s and partly to local indifference.

3.2.3 Period between 1882-1935

A few very significant developments could be made in the Bengal Municipal Act of 1884 under the impact of the policies of the government during the period of Lord Ripon. The Act provided for an elective system for two-thirds of the commissioners, and municipalities were no longer subject to police duties.

A better division of functions and resources could be brought about only in the period which follows the review of municipal policy by the Decentralisation Commission in 1907-08 and the reforms of 1919. The Mont-Ford report accepted the
recommendations of the Commission that municipalities should have full liberty to impose and alter taxation within the limits laid down by law. The Boards were to control all such services which they paid for and all such services under government control were to be provincialised. The accepted policy was to allow the Boards to profit by their own mistakes and to interfere only in case of gross mismanagement. Since January 1921 the local self-government was a transferred subject. An increase in the resources of the municipalities became urgently necessary and Municipal Bill which was laid before the Council was expected to make this step easier.

The tax pattern provided in the Act of 1922 continues more or less in the same order till today. It is, however, to be noted that the 1919 reforms gave a long schedule of taxes which was demarcated and reserved for the local bodies but this Act availed only a few of them and placed the reliance firmly on the property taxes. Provisions were made only to simplify and facilitate assessments and collections. In the U.P. attempts to replace octrois were relaxed by 1920 and this source was fully utilized but in Bihar no such attempt could be made due to a long break in octrois. Thus the foundation of an annual value tax on properties was finally established.

This has in it the seeds of growing financial crisis as the property tax was based on rental which was generally depressed due to poor machinery, while “the illusion of the inexhaustible purse of government still persisted” The urban bodies supported in theory costly schemes but their suggestions for financing them often did not go beyond a declaration of poverty and an appeal for government grant. The grants themselves fluctuated widely according to good or bad harvest and thus to the paying capacity of the government.” On the inadequacy of property taxes the government attitude, on the lines of the English municipal law, was to remove the statutory limit on rates which would have been more objectionable than productive. Politically, however, ‘the politics of the municipalities proved to be of such absorbing interest and so much more productive of immediate and tangible result that little energy or inclination was left for wider aspects of Indian affairs.” The result was a progressive relaxation of official control and the growth of autonomy in local affairs.”
3.2.4 Post-1935 Period  The inauguration of provincial autonomy in 1937 gave impetus to the development of municipalities but financially they were more handicapped due to removal of the demarcation between provincial and local tax, deprivation of the profession tax and the reversion of the local tax provisions towards the pre-1919 pattern. The unfavorable economic and political events during the 1930’s had many disturbing effects while the new Act restricted the scope of extension of local spheres of taxation. The municipal administration continued to be indifferent towards raising the receipts from the property tax while grants were being recklessly used. Revision of assessment was “elaborate pretence bearing no proportion to the increased prosperity of the places concerned.” Municipalities were asked to increase receipts through service taxes which were only property taxes in disguise. No real improvement could be made and most of the municipalities had huge indebtedness.”

Almost all the municipalities began to feel the pinch of the abnormal time particularly after 1943. The Government proposed to give assistance for six months in the first instance within which period the municipalities were asked to take definite steps to raise their rates of taxation. This was another step taken to inflate the receipts through manipulation. No real progress could be made even after Independence. Dependence on grants increased from 13.7 in 1938-39 to 35.7% in 1952-53. Tax receipts fell from 63.8% to 43.5% during the same period. Further, per capita tax increased by 14% while per capita expenditure increased by 100%. Municipal population during the period increased by 35% but the number of ratepayers went down from 16.8% of population to 12.6. The weakness of the local tax system was thus exposed and the municipalities were asked to introduce professions tax in 1953. The tax appeared to be too new to be accepted and the response was very poor.

The two reports, one by the Local Finance Enquiry Committee, 1951 and the other by the Taxation Enquiry Commission, 1953-54 threw light on the weak finances of the local institutions and commonly suggested (1) broadening of the tax base and (2) increasing efficiency in tax administration and making a qualified and especially selected person responsible for administrative and executive functions. But little has
been achieved in practice, while new problems have emerged due to increase in number of towns to which municipal administration has to be extended and the chaotic growth of uneconomic units. The system of grants has also a demoralizing effect on development of autonomous sources while the state seems to have a wider zone of taxation with many such taxes which could have been better utilised at the local layer.

It is not however correct to conclude that replacement of the indigenous variety of taxes by a property tax in this state has weakened the financial potentiality of local units more than others. In fact the tax has been good in many ways; it was least dislocated during the Depression, but the real weakness of the tax was that it remained crude and was badly administered while there was a complete absence of a few other taxes to supplement it. It may also be noted that unlike the property rate in England, which developed to meet the cost of poor relief (and was hence onerous), property tax in this state was initially levied to meet the police charges. With different purposes in view the English rate was based on ability to contribute while it was a benefit tax in India as police services were essentially to protect the properties of the residents. In strict adherence to the British model, however, the basis of levy was chosen to be rental value when capital value could have been more appropriate, and benefit-oriented.

3.3 Growth of Octroi

The western, central and north-western parts belong to the octroi group of states and local bodies in these areas show slightly better development than those in other parts. They however share many points in common. Too much emphasis on octrois (as on property tax in eastern parts) has led to retention of some local taxes by states. Further, there has been absence of a proper system of grants in these regions also and grants have tended to increase though less than in other parts. As regards administration of the taxes, octroi was also facing a crisis, in some sense more severe than that in the property tax areas. The elasticity of octrois has, however, arrested the forces of financial centralization and local units have enjoyed more autonomy in matters of finance than any other part. The tax component and tax incidence of these areas have
been highest which clearly reveal that local indirect taxes played a useful part in the development of the urban units of various states.

It may here be noted that the attempts to reform octrois had always been vigorously made and the tax was judged by the local governments in terms of actual performance. Such attempts of reforms of the property tax in the property tax regions have been conspicuously absent and in fact its merit was never questioned. This accounts for the failure of a good local tax to deliver the goods which a primitive tax could do. It must not be forgotten that whereas the former was an imposition on the localities, the latter had grown within.

In theory octroi was always condemned; the opposition was greater in the pre-1850 period which in fact led to finally dropping it in Bengal and Madras and to its temporary discontinuance in other states. During early British period when the transit of goods was carried by roads and rivers this tax was widely used as it was easy to check it at local boundaries. This was pointed out in 1825 by Holt Mackenzie as to how most of the consumption goods were subject to repeated detentions and tax created inequality of prices of such goods between neighbouring localities placing greater burden on petty traders. It was abolished in Bombay, Bengal and Madras after Trevelyan’s report in 1828. The evils in its administration marked in other parts were again brought to light by Lord Ellen borough in 1835 who reported that “the effects upon the national morals is yet more serious than the effect on national wealth.” The duty was therefore abolished in many states between 1835-42.

With the initiation of a municipal government in various states under the Act of 1850 octroi was again introduced at many places as the Government found it more popular than direct taxes, but all the same it attempted to reform the tax in the light of earlier experiences. Trevelyan in 1864 pointed out that this tax ought to be confined to a few article of local consumption. This led to wide exemptions and special emphasis was placed on refunds and establishment of warehouses for goods in transit. Further, rates were so fixed as to keep price differential between two areas low. But these provisions
proven uneconomical. An attempt was made to fix the standard of average consumption for each town in order to test whether the quantity of articles taxed without seeking refund was just equal to that average. But this average being a highly variable factor was difficult to be worked out. Even if the system of refunds was thorough, the flow of trade was bound to be disturbed due to various formalities to be done before the release of goods for movement to final destination.

The popularity of the tax in various states, however, allowed it a smooth sailing even with little of reform which was introduced. Some efforts were made to classify goods and to increase the incidence on luxuries in order to make the tax less regressive. Question of reorganizing the financial system of the local bodies was, by this time, becoming important in response to the changes in policy during the period of Lord Ripon. With the advent of railways and its growing popularity, there was a shift of emphasis from octrois to terminal taxes which seemed to be a good substitute. This tax was only an octroi on railway-borne goods levied at exporting or importing stations. It thus excluded the complicated mechanism of refunds in between the route. This did not disturb the flow of trade but the burden on trade was great due to absence of refunds, taxes at both the export and import points and tax on excisable articles including materials used for manufacture. In 1917 it was made a duty only at the importing locality except in big exporting centres, while differential duties were introduced for salt, mineral oil and materials used in the process of manufactures.

After the 1919 reforms, with local government as a transferred subject and in the wake of greater financial autonomy to the localities, the tendency was again to revert to octrois. Terminal tax, by its very nature, was under the grip of the Central Government and was less local in character. Further, in the case of terminal tax the localities had still to maintain the octroi machinery for collecting tolls on goods carried by road. This prompted them to go for a more independent tax which could be very smoothly undertaken.
It may here be noted that in the Resolution of 1905 it was implicit that terminal taxes were to be regarded as "facilitating the transition to a system in which direct taxation would form an increasingly important factor, not as an elastic means of progressively increasing the sources of municipalities apart from normal developments due to increase in traffic. Gradually, the Government of India had given up such measures of control as they once exercised. This led to grave abuses in the working of terminal taxes. The result was increased faith in octrois as the municipalities found it extremely difficult to set up a new machinery for valuation of properties in order to establish the alternative suggested by the Government. The tax-payers also went against it as a house tax involved direct assessment.

A sales tax as an alternative to octrois was first suggested by the Taxation Enquiry Committee in 1924-25. This tax at the state level was getting popular after the First World War in many of the European countries and in America but was not favoured in England. The Government of India was naturally against it especially as a local tax, though after provincial autonomy it became a provincial tax in late thirties and thus a still remote possibility for the localities. Further, even the terminal taxes became a federal subject except for a few states. Naturally these states fell back on octrois with no alternative choice. This tendency is visible even today and needs a solution in the absence of which octrois will continue to be important. A draft Bill in 1957 proposes the levy of a terminal tax and the proceeds are to be assigned to states to be attributed to localities. Such receipts from a centrally controlled tax would hardly be a substitute for octrois though it may add some money to the revenues of the localities.

3.3.1 Growth of the Rural Sector; Land revenue

There is a wide discrepancy of growth of local taxation in India as between the rural and urban sectors during the British period. This was due to the gradual growth of East India Company’s rule over larger areas and the natural desire of the administration to extend first to the wealthier and more organized sectors, but largely due to the complete disintegration of rural bodies during 1750-1850 as a result of the collapse of the
Mughals and the period of anarchy that followed. Rural government stemmed again from the ideas of Ripon after 1882 and provinces were allowed to set up rural boards at district levels. It might be noted that by this time the urban bodies had been set up and were being organized on more scientific lines. The establishment of a very large size of rural government was bound to come under the control of the district officers and the venture did not pan out very well. Any attempt to revive local bodies at the village level seemed difficult during the 1880's because the traditional panchayats had decayed quite early and the villages, having been separated from government for a long period, had lost all interest in it and had developed complete indifference.

It was again after 1920 under the impact of the Reforms that serious steps were taken to establish rural government, this time at village levels, but various factors worked against the proper functioning of these bodies. Apart from factionalism in the villages, the local interest was shifting towards towns which were more organised by the time and offered a better living. Thus the faster growth of the urban bodies was retarding the growth in the rural sector and there was a flow of population from villages to towns. Strangely enough, whereas the politics of the municipalities was very much concentrated in the towns, the political interest in the villages had shifted from locality to state.

At the same time, the financial arrangement of the local bodies did not work well, firstly because of a very large unit at the district level and small uneconomic units at the village level, secondly because of the system of small shares from land revenue available to the local bodies. Not only that the share was small, its influence on rural finance has been similar to that of grants on the finances of the urban bodies. It thwarted the efforts of rural units to raise their own resources and was just a claim without responsibility. Land revenue was treated as a rent to the state for the tenancy of the state land and continued to be the mainstay of state finance for a long time. Naturally, only a little could be spared while this source itself was inelastic and could not be worked out well due to difficulties of calculations.
Initially, before the more scientific basis of assessment was evolved, the basis of gross produce was adopted in almost all states. In the Zamindari areas of Bengal land revenue was fixed on this basis and the amount so determined in 1793 was permanently settled with the Zamindars, while in some other states (Punjab after 1850) it was fixed for a long term varying between 20 to 30 years. The gross produce basis does not take into account the fertility of each land nor the change in prices, while the government share of it has been invariably low (except in the ryotwari areas of Madras where it was one-third) in order to reduce the rigour of such assessment on the less fertile lands. Assessments on the basis of the Ricardian principle could be most successfully made in the Bombay region in the 1830’s. The basis was net produce, which was calculated on the bases like fertility of land, the money value of the produce minus the cost of production. The tax, however, did not exceed 55% of the net produce. In other parts more considerations were taken into account so as to make the tax less extortionate. The introduction of empirical basis, however, led to an increasing role of the judgment of the settlement officers. Thus, though the land revenue in India was based on the utilitarian principle, the calculation of the tax came down much below the level of ‘surplus over cost’. Due to increasing gap between current values and assessed value of land in later years, a large surplus in the rural sector remained untapped; it could be tapped in the Zamindari areas only after the provincial autonomy in 1937 through the introduction of agricultural income tax and through surcharges elsewhere at a quite later period. But the local share remained low.

For the above reasons the growth of the rural bodies remained slow. Difference in growth (generally quantitative) of some states like U.P. and M.P. was, however, due to better panchayat traditions in these areas. After Independence the rural sector has engaged the main attention of the Government. It orders to increase the local share in land revenue the Taxation Enquiry Commission made the following suggestions:

1. In view of other sources of revenue to states, the state’s share of the land revenue should be frozen at a ‘standardized assessment’ (which should vary within narrow
limits) and all surcharges on such assessment should be left to the exclusive use
of local bodies.

2. A further allocation of 15% of land revenue should be made to panchayats on
derivation principle.

3. In case of any increase in the standarised assessment the share to local bodies
should also be increased.

4. The disequalising effects of the local surcharge in the less developed agricultural
areas should be removed by grants.

It appears that the local surcharge could be developed in a full-fledged tax if it was
more fully worked out at local levels. It might be based on local prices, market ability
of different crops, fertility of plots etc. as the assessment at the state level would ignore
details. But a system of surcharges would tap farming incomes only. Further, the
difficulties of such calculation would be great for the localities. If the surcharge is flat,
it would be discriminatory between bad and good land and between earning and non-
earning crops. It may be as rigid as its base, i.e. the standarized assessed value. Even
at the state level the assessment was not to be an easy task. The Taxation Enquiry
Commission, however, approved the retention of the land revenue with certain
modifications and this would hardly introduce any change in the pattern of rural
finances.

The recent emphasis on improving the state of affairs in the rural sector is not so much
towards bringing about any change in the tax pattern as promoting suitable machinery
at the village level for implementing more effectively the development programmes. It
implies a break of the old distinction between local and non-local services and the rural
bodies may extend the sphere of activities from health, education and roads to
agriculture, cottage industries and welfare. From the organizational point of view, the
democratic decentralization initiated in 1957 has created a three-tier organization at the
village, block and district levels thus removing the void created by the absence of an
optimum-sized middle layer. By 1962, 94% of the villages had been covered by
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panchayats and the rest were to be covered in the next few years. When geared to the community development programmes these units will have new problems of finance but the financial structure is yet to take a shape. Its success would naturally depend on how satisfactorily is the division of functions and finances made between the various tiers of rural government.

Local government is thus slightly less than three centuries old in India. Its history since 1687 is rather chequered and even exotic. Broadly, it may be divided into the following five periods, each period characterized by a certain aim and purpose.

<table>
<thead>
<tr>
<th>Period</th>
<th>Description</th>
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<tbody>
<tr>
<td>1. 1687-1881</td>
<td>Local government was viewed and utilized to ease central and provincial finances, and thus, to subserve imperial needs.</td>
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<tr>
<td>2. 1882-1919</td>
<td>Local government began to be viewed as self-government.</td>
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<tr>
<td>3. 1920-1937</td>
<td>Local government came within the jurisdiction of provinces and, further, was transferred to popular control.</td>
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<tr>
<td>4. 1938-1949</td>
<td>Local government was in a state of repair and reconstruction.</td>
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<td>5. 1950-1992</td>
<td>Local government as the creation of the state government subjected to its supervision and control has been keyed to the requirements of the Constitution.</td>
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</table>
Conclusion

As apparent from the preceding discussions, the rural and urban tax structure in India is widely different while they differ greatly from state to state. This makes any generalization for all the local bodies difficult. The broad trends in rural and urban areas, however, are towards more and more centralization, especially in the matters of finance. This has weakened the local character of various units in different degrees. During the British rule, it appears that the financial structure has been inherently defective and this may serve as a lesson for the new one which are slowly developing with almost a similar tax pattern.
Reference

