Kerala's Persistent Fiscal Stress

A Failure in Public Resource Mobilisation?

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Since the mid-1980s, Kerala has been battling fiscal stress, despite the state's economy growing faster than the national economy. Moreover, this stress is only getting aggravated, even though Kerala's tax effort has been recognised as above average. Studying available data with an alternative approach points to the failure of public resource mobilisation as the primary cause of this fiscal stress. The inability to harness the state's fiscal potential, an incorrect perception about the state's fiscal situation, and a lack of political will to address the situation have exacerbated the crisis.

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Kerala has been facing fiscal stress with varying intensity since the mid-1980s. Though the state has been coping with it in various ways, it is only getting aggravated as the years pass by. Kerala's fiscal crisis is baffling, considering the fact that the state's economy has been growing faster than the national economy in recent years. Also, studies on relative tax efforts of states have consistently found Kerala as one putting in above average effort. Attempts have been made in the past to explain the fiscal problem in terms of the structure of the state's public expenditure (George 1990) and the limitations imposed by the federal Constitution in mobilising its own resources (Mohan and Shyjan 2005).

This article argues that the methodology suggested in the literature to assess the relative tax performance of states suffers from limitations in the context of Kerala. Adopting an alternative approach and using revenue data for the last six decades, the article attempts to show that Kerala's persistent fiscal stress is the fallout of the failure of public resource mobilisation. It is argued that the political institutions that evolved over the years made public resource mobilisation increasingly difficult, and in the process, helped the evolution of an own revenue structure, that places a disproportionately high burden on the poor and marginalised sections of society.

Fiscal Stress Then and Now

Kerala began experiencing fiscal stress earlier than most Indian states. The state has been consistently incurring revenue deficits since 1983–84, and its size has expanded exponentially over the years. The fiscal crisis and its impact on the size of the state's plan gave rise to debates in the political and policy circles in the mid-1980s, which led to the appointment of a study team (Bagchi and Rao 1987). The problem aggravated in the early 1990s, leading to the appointment of the Resources Commission in 1993. From early 2000, Kerala has been striving for fiscal sustainability and passed the Fiscal Responsibility and Budget Management Act in 2003.

But Kerala, along with West Bengal and Punjab, could not achieve the Twelfth Finance Commission's target of eliminating revenue deficit by 2007–08. For these states, the Thirteenth Finance Commission proposed an adjustment path, which required them to eliminate revenue deficit by 2014–15. Again, Kerala could not achieve this target. The Fourteenth Finance Commission awarded a revenue deficit grant to Kerala, along with 10 other states. Though the commission projected zero revenue deficit for Kerala for 2018–19, the state budget for

2018–19 has posted a deficit of ₹12,859.81 crore (Government of Kerala 2018: 102). In 2016–17, among 14 major states, Kerala stood second in revenue deficit, third in gross fiscal deficit and second in outstanding liabilities (Table 1).

Table 1: Per Capita Revenue Deficit/Surplus, Gross Fiscal Deficit and Outstanding Liabilities of 14 Major States, 2016–17 (₹)

States	Revenue Deficit(+) Surplus(-)	Gross Fiscal Deficit	Outstanding Liabilities*
Andhra Pradesh	3,333.98	5,994.96	49,317.30
Bihar	-956.42	1,456.73	12,292.94
Gujarat	-855.10	2,552.90	37,698.67
Haryana	5,746.79	9,496.12	53,967.85
Karnataka	-199.68	4,436.26	32,686.83
Kerala	4,508.26	7,703.06	55,805.69
Madhya Pradesh	-480.02	3,521.86	19,871.91
Maharashtra	706.38	3,194.43	32,754.88
Odisha	- 2,065.54	2,092.30	16,055.85
Punjab	2,304.32	16,656.68	57,554.46
Rajasthan	2,458.63	6,288.44	34,682.80
Tamil Nadu	1,692.64	7,336.06	37,042.07
Uttar Pradesh	-922.43	2,546.69	13,340.67
West Bengal	1,680.51	2,651.84	35,261.37

* Denotes as at end-March.
Source: Computation using data obtained from RBI (2018).

Economic growth is generally accompanied by improved fiscal health. After a long spell of stagnation, the economy of Kerala exhibited a remarkable turnaround in economic growth from 1987–88 (Ahluwalia 2000; Kannan 2005), but this had little impact on the finances of the state. Kerala presents the paradox of a fast-growing economy confronting a severe financial crisis. It is against this backdrop that this article examines in what manner the performance of the state in public resource mobilisation has contributed to the current crisis.

Imperative of Public Resource Mobilisation

The importance of public resources in economic development, especially in developing economies, is well-recognised in public finance literature. The process of public resource mobilisation in countries following the federal structure differs from that of unitary countries. Compared to a unitary state, a federal structure offers the federating unit the autonomy, albeit limited, to pursue a development path of its choice, as in India. The needed fiscal resources come from central transfers and own revenue sources, as provided by the constitutional division of taxing powers between the centre and the states. Generally, central transfers are formula-based, though there do exist "implicit and invisible ways" by which powerful states can effect resource transfers in their favour (Rao and Singh 2005: 214). Assuming that this is unlikely to have any systematic impact on the finances of an individual state, the reasons for Kerala's persistent fiscal stress have to be sought in its fiscal management. In prudent fiscal management, the mobilisation of public resources from own tax and non-tax sources, goes hand in hand with expenditure management.

Among Indian states, Kerala has pursued a development path markedly different from others, by investing heavily in social sectors, as against physical infrastructure. It is universally acknowledged that it is this social sector expenditure that largely shaped the "Kerala model of development." Though this did not result in significant growth of the domestic economy, at least till the late 1980s, it raised the capability of the people, leading them to migrate to other parts of India and abroad, and bring income and wealth to the state. However, from the point of view of the finances of the state, this development path had serious adverse implications.

The high expenditure on social and community services in successive five year plans resulted in high salary and pension commitments, as remuneration for services of teachers and health professionals had to be continued in the non-plan account at the expiry of each plan period (George 1993: 74–78). With productive sectors remaining almost stagnant and the number of educated unemployed swelling, successive governments have been under pressure to accommodate as many unemployed as possible in the government sector. Under these circumstances, reining in public expenditure, let alone reducing it, has been a politically impossible proposition. As a consequence, Kerala's per capita expenditure on wages, salary and pension is the highest among major states (Table 2).

Table 2: Per Capita Wages and Salary and Pension of Major States, 2016–17 (₹)

States	Wages and Salary	Pension
Andhra Pradesh	6,309.15	2,496.58
Bihar	1,454.08	1,105.63
Gujarat	3,645.01	1,750.94
Haryana	5,699.84	2,044.19
Karnataka	3,327.97	1,748.37
Kerala	8,291.35	4,449.15
Madhya Pradesh	2,919.61	1,119.61
Maharashtra	5,962.05	1,394.39
Odisha	4,282.75	1,526.30
Punjab	6,849.92	2,765.64
Rajasthan	4,093.19	1,669.27
Tamil Nadu	5,239.86	2,608.54
Uttar Pradesh	1,745.25	1,283.89
West Bengal	Not available	1,456.45

Source: Same as Table 1.

Assessing Kerala's Tax Performance

Given that the possibility of reining in public expenditure is difficult, the only option left before the state to reduce dependence on borrowed funds, was to mobilise more own resources, commensurate with its expenditure requirements. Studies on own resource mobilisation performance of states have generally focused on tax efforts, as the revenue contribution of non-tax sources is negligible (Garg et al 2014; Karnik and Raju 2015). All studies on tax efforts of states till date have found Kerala as putting in above average tax effort.[1] The Eighth and Ninth Finance Commissions which studied the tax efforts of states also found Kerala as making above average effort (George 1990: 2098).

However, from the point of view of understanding Kerala's fiscal stress, these studies are of little assistance for the following reasons. First, the concept of tax effort that they have used does not address the question of whether a particular state is putting in effort commensurate with its expenditure requirements. Here, tax effort is a relative concept. Studies based on the Representative Tax System Approach or Regression Approach essentially try to measure whether an individual state is putting in tax effort above or below the average of states under study. Despite being ranked high in tax effort from the early 1980s, Kerala's fiscal situation has only deteriorated over the years.

Second, in arriving at the finding that Kerala is putting in effort above the average of states, these studies have not taken into account the factors immediately relevant for the actual fiscal potential of the state. The proxy base/bases adopted by most of these studies are either gross state domestic product (GSDP) or its various components. Commodity tax is the single most important source of revenue of Indian states. The potential for commodity tax is primarily dependent on the level and composition of consumer expenditure of a state. The income originating within the state and accruing to the state together determine the level of consumer expenditure. It has been argued that in the context of Kerala, estimates of tax effort using GSDP would underestimate the fiscal potential, as the level of consumption is heavily dependent on external remittances, and therefore, the actual tax effort would be overestimated.[2]

Consumer expenditure has been presented as a better indicator of the fiscal potential of Kerala, as it captures the effect of income originating as well as accruing to the state (Sebastian 1989). While admitting the obvious limitations of consumer expenditure as a proxy base of commodity taxes for states in general, its level, composition and change over the years can be taken as reasonable indicators of commodity tax potential, and its change over the years for individual states. From the point of view of tax potential, the composition of consumer expenditure is equally important, as its level as non-food items in general and durable consumer goods in particular, are levied higher rates than necessities and comforts in a differentiated rate structure. The thick sample surveys of the National Sample Survey Office (NSSO) on consumer expenditure are considered more reliable and comparable across years. Table 3 presents the per capita consumer expenditure and the expenditure on durable consumer goods of major states for four points in time.

Table 3 shows that among major states, Kerala is the state which registered the highest increase in the potential for commodity taxation during 1972–2012. In per capita consumer expenditure (PCE), Kerala climbed up from eighth rank in 1972–73 to third rank in 1983. From 1999–2000, Kerala has been occupying the first rank. Since 1983, Kerala has persistently enjoyed the largest share in the consumption of consumer durables, as well as in per capita consumption. There is a marked difference between Kerala and other major states in the level of consumption of durable goods. While it ranges between 3.30% and 6.09% in the case of other states, it is as high as 15.61% for Kerala in 2011–12. It could be argued that consumer expenditure per se cannot be taken as an indicator of commodity tax potential, so long as the expenditure on services is not taken into account. This line of argument is quite plausible, considering the fact that states did not have powers to tax services till recently. Table 4 presents the per capita expenditure on services in the case of major states for 2011–12, the latest year for which data is available.

Table 4 shows that though per capita expenditure on services is highest in Kerala, as a percentage of per capita consumer expenditure, four states are above Kerala. In fact, in most of the states with metropolitan cities or large cities, per capita expenditure on services is higher than less urbanised states.[3] It may be noted that the increase in the fiscal capacity of Kerala is not limited to commodity taxes alone. External remittances, the main driver of economic activity since the late 1970s, have raised the potential of other tax handles, like stamps and registration fee and motor vehicle tax. This has also raised the

Table 4: Per Capita Consumer Expenditure on Services of Major States 2011–12 (₹)

State	Per Capita Consumer Expenditure (PCE) on Services	Total PCE	PCE on Services as a % of Total PCE
Andhra Pradesh	6,086.56	25,119.19	24.23
Bihar	1,645.32	14,230.57	11.56
Gujarat	5,638.29	24,103.38	23.39
Haryana	9,231.06	33,440.44	27.60
Karnataka	7,405.03	25,884.67	28.61
Kerala	9,990.04	36,762.61	27.17
Madhya Pradesh	3,293.82	17,065.20	19.30
Maharashtra	9,436.19	28,337.92	33.30
Odisha	2,072.74	14,103.18	14.70
Punjab	6,739.51	30,575.89	22.04
Rajasthan	4,593.97	21,992.85	20.89
Tamil Nadu	7,723.33	26,069.43	29.63
Uttar Pradesh	2,953.51	16,490.61	17.91
West Bengal	4,977.31	20,745.50	23.99

Source: Computation using NSSO (2014).

Table 3: Per Capita Consumer Expenditure and Expenditure on Durable Goods of Major States (₹)

State	1972–73		1983		1999–2000		2011–12	
	PCE	PCED	PCE	PCED	PCE	PCED	PCE	PCED
Andhra Pradesh	522.95 (12)	4.33 (0.83)	1,512.08 (9)	38.83 (2.57)	6,572.96 (10)	131.26 (2.00)	25,119.19 (7)	1,004.71 (4.00)
Bihar	524.03 (11)	3.33 (0.64)	1,208.57 (14)	13.13 (1.09)	4,961.57 (14)	95.57 (1.93)	14,230.57 (13)	500.88 (3.52)
Gujarat	649.11 (4)	13.82 (2.13)	1,647.32 (5)	31.36 (1.90)	8,254.51 (6)	294.56 (3.57)	24,103.38 (8)	1,447.10 (6.00)
Haryana	852.11 (2)	25.86 (3.03)	1,940.05 (2)	30.90 (1.59)	9,389.20 (3)	200.35 (2.13)	33,440.44 (2)	1,651.48 (4.94)
Karnataka	581.30 (6)	6.73 (1.16)	1,595.48 (7)	29.20 (1.83)	7,780.72 (7)	249.34 (3.20)	25,884.67 (6)	1,575.70 (6.09)
Kerala	545.09 (8)	12.78 (2.34)	1,837.65 (3)	100.13 (5.45)	9,843.55 (1)	672.21(6.83)	36,762.61 (1)	5,737.75 (15.61)
Madhya Pradesh	537.37 (9)	17.56 (3.27)	1,332.48 (12)	26.84 (2.15)	5,832.62 (12)	223.60 (3.83)	17,065.20 (11)	869.11 (5.09)
Maharashtra	631.77 (5)	22.75 (3.60)	1,658.69 (4)	31.58 (1.90)	8,502.47 (5)	340.85 (4.01)	28,337.92 (4)	1,213.55 (4.28)
Odisha	453.37 (14)	11.24 (2.48)	1,277.01 (13)	21.35 (1.67)	4,987.06 (13)	155.47 (3.12)	14,103.18 (14)	506.70 (3.59)
Punjab	917.29 (1)	38.44 (4.19)	2,121.10 (1)	61.05 (2.88)	9,682.04 (2)	274.13 (2.83)	30,575.89 (3)	1,769.10(5.79)
Rajasthan	657.93 (3)	16.80 (2.55)	1,629.44 (6)	64.03 (3.93)	7,380.47 (8)	196.77 (2.67)	21,992.85 (9)	838.77 (3.81)
Tamil Nadu	518.77 (13)	7.66 (1.48)	1,571.97 (8)	51.55 (3.27)	8,696.22 (4)	214.91 (2.47)	26,069.43 (5)	1,266.85 (4.86)
Uttar Pradesh	531.96 (10)	13.55 (2.55)	1,338.98 (11)	26.19 (1.96)	6,242.91 (11)	192.29 (3.08)	16,490.61 (12)	656.96 (3.98)
West Bengal	557.48 (7)	6.16 (1.10)	1,482.93 (10)	19.16 (1.29)	6,937.75 (9)	99.02 (1.43)	20,745.50 (10)	685.31(3.30)

PCE—Per capita consumer expenditure; PCED—Per capita consumer expenditure on durable goods. Figures in the parenthesis relating to PCE and PCED are ranks and PCED as a percentage of PCE respectively.
Source: Computation using NSSO (1978, 1986, 2001 and 2014).

capacity of a significant section of Keralites to bear the cost of public services, especially in health and education, on which the state has been spending the lion's share of its public resources. By enhancing user charges on these services, the state could mobilise more non-tax revenue.

Relative Share as an Alternative Indicator

We have seen that among major states in India, Kerala is the state which registered highest increase in the potential for public resource mobilisation during the last 60 years. The pertinent question here is whether the state has exploited this potential. As we have seen, this question cannot be answered by comparing Kerala's performance with other states adopting conventional measures of tax effort. Comparing Kerala's own performance across years is also rendered difficult because of the problems discussed above. Besides, the potential and performance of Kerala in non-tax sources will also have to be factored in.

Therefore, an alternative approach is to see whether Kerala's effort at public resource mobilisation has kept pace with the capacity. For this, the relative share of Kerala in total public resources mobilised by all states is taken. The rationale of the approach is simple. It is well-recognised that the relative fiscal performance of a state is a function of its relative fiscal capacity and effort. If the relative fiscal capacity of a state has increased over the years, the fall in its relative share has to be explained in terms of the slackening of fiscal effort. Table 5 presents the relative share of Kerala in own tax revenue, own non-tax revenue and own revenue, during the last 60 years. The 60-year period has been divided into six sub-periods, so as to facilitate comparison across sub-periods.

Table 5 shows that Kerala's relative share in state's own tax revenue consistently increased from 4.54% in the first sub-period to reach 5.09% in the fourth sub-period, and thereafter started falling to reach 4.64% in the last sub-period. In the case of the state's own non-tax revenue, the fall has been consistent till the last sub-period. The marginal increase in the state's own revenue (SOR) from 4.45% in the first sub-period to 4.50% in the last sub-period, is due to the sharp increase in revenue from lottery as we shall see shortly. I will now undertake a disaggregated analysis to identify the tax and non-tax sources which are responsible for this.

Table 5: Relative Share of Kerala in SOTR, SONTR and SOR of All States (%)

Period	Share in SOTR	Share in SONTR	Share in SOR
1957–58 to 1966–67	4. 54	4.26	4.45
1967–68 to 1976–77	4.48	4.12	4.37
1977–78 to 1986–87	4.87	3.52	4.49
1987–88 to 1996–97	5.09	2.14	4.33
1997–98 to 2006–07	5.02	1.90	4.38
2007–08 to 2016–17	4.64	3. 82	4.50

SOTR refers to states' own tax revenue, SONTR stands for states' own non-tax revenue and SOR stands for states' own revenue. All states do not include the National Capital Territory and Pondicherry.

Source: Computation using 60 years of data obtained from the relevant issues of *Reserve Bank of India Bulletin* and Reserve Bank of India annual publication *State Finances: A Study of Budgets*.

Performance in Various Revenue Sources

In this section, an attempt is made to compare the relative shares of individual taxes and duties of Kerala in all states.

Tax revenue: Table 6 shows that in all sources of taxes and duties, except "sales tax/sales tax and value added tax (VAT)" and "other taxes and duties," the relative share exhibits a falling trend. As explained below, in the case of the former, a comparatively better performance is obviously because of a few items that are less prone to evasion and/or avoidance.

Table 6: Relative Share of Individual Taxes and Duties of Kerala in All States (%)

Period	AIT	LR	PR	S&R	UIPT	MVT	ST/ST & VAT*	SE	TP & G	ET	ED	OT & D
1957–58 to 1966–67	23.54	1.53	1.92	5.12	0.00	6.73	5. 53	5.25	–	0.83	1.31	1.55
1967–68 to 1976–77	26.25	1.81	0.39	5.85	1.34	5.64	4.87	4.82	1.68	0.64	2.98	0.03
1977–78 to 1986–87	19.54	1.86	0.09	5.80	9.24	5.46	5.20	5.67	0.01	0.06	5.50	0.14
1987–88 to 1996–97	15.74	1.94	0.00	6.04	16.69	5.60	5.85	4.62	0.00	0.01	2.26	0.52
1997–98 to 2006–07	11.88	2.02	0.00	4.11	35.81	5.85	6.06	3.70	0.00	0.08	1.28	1.98
2007–08 to 2016–17	20.71	1.23	0.00	3.91	8.72	5.89	5.65	2. 50	0.00	0.03	0. 25	4.16

AIT—agricultural income tax; LR—land revenue; PR—profession tax; S&R—stamps and registration; UIPT—urban immovable property tax; MVT—motor vehicle tax; ST/ ST & VAT—sales tax/sales tax and value added tax; SE—state excise; TP & G—tax on passengers and goods; ET—entertainment tax; ED—electricity duty and OT & D—other taxes and duties.

*VAT was introduced with effect from 1 April 2005, but sales tax continued being levied on petroleum products and liquor.

Source: Same as Table 5.

Non-tax revenue: In the case of non-tax revenue, a disaggregated analysis is possible only for the period 1972–73 to 2016–17, as the data for the period 1957–58 to 1971–72 are not strictly comparable with those relating to subsequent years (Table 7).

Table 7: Relative Share of Kerala in Non-tax Revenue (%)

Period	IR	Ds & Ps	GS		SS	ES
			GS	Of which L		
1972–73 to 1976–77	2.39	4.81	7.47	11.58	9.07	5.36
1977–78 to 1986–87	1.93	3.66	6.27	5.80	6.18	3.02
1987–88 to 1996–97	0.86	4.68	2.92	3.76	4.68	2.28
1997–98 to 2006–07	0.48	5.01	3.00	3.25	3.10	1.76
2007–08 to 2016–17	0.65	5.22	14. 20	54.19	1.70	1.15

Abbreviations used are as follows: IR—Interest Receipts; Ds &Ps—Dividends and Profits; GS—General Services; L—Lotteries; SS—Social Services and ES—Economic Services.

Source: Same as Table 5.

Table 7 shows that the relative shares of all, except "dividends and profits" and "general services," registered a steep fall across the years. In the case of "dividends and profits," the increase is mainly attributable to the very high dividends paid by the Kerala State Beverages Corporation (KSBC), a public sector marketing company dealing in the wholesale and retail marketing of Indian made foreign liquor (IMFL).[4] Whatever increase is observed in "general services," is due to revenue from lotteries, as we shall see shortly. Among the various sources of non-tax revenue, one potential source is the fee levied on the services provided by state governments, especially in health and education. Revenue receipts from

Table 8: Trends in Resource Mobilisation from Social Services

Period	Revenue Receipts as a % of Revenue Expenditure
1972–73 to 1981–82	5.60
1982–83 to 1991–92	3.24
1992–93 to 2001–02	2.00
2002–03 to 2011–12	1.96
2012–13 to 2016–17	1.69

Source: Same as Table 5.

Table 9: Transformation in Kerala's Own Revenue Structure

Period	Tax Revenue#			Non-tax
	Tax Revenue as a % of SOR	Direct Taxes as % to SOTR	Indirect Taxes as % to SOTR	Rrevenue as % of SOR
1957–58 to 1966–67	67.92	38.62	61.38	32.08
1967–68 to 1976–77	71.54	25.00	75.00	28.46
1977–78 to 1986–87	77.81	17.86	82.14	22.19
1987–88 to 1996–97	87.13	17.86	82.14	12.87
1997–98 to 2006–07	91.14	16.51	83.49	8.86
2007–08 to 2016–17	86.04	17.03	82.97	13.96

#Agricultural income tax, land revenue, profession tax, stamps and registration, urban immovable property tax, motor vehicle tax and entertainment tax are classified under direct taxes and sales tax and value added tax, tax on passengers and goods, state excise and electricity duty are classified under indirect taxes. Other taxes and duties are apportioned equally between direct and indirect taxes.
Source: Same as Table 5.

Table 10: Change in the Commodity Composition of Sales Tax/Commercial Tax Revenue (₹ crore)

Commodity	1960–61	1970–71	1980–81	1991–92^	2000–01	2010–11	2016–17
1 Petrol and petroleum products	1.28*	4.25	12.73	303.02	1,427.21	3,550.52	6,875.00
2 Liquor of all kinds, including beer, wine and arrack@	0.07*	0.94	6.95	55.157	764.27	3,775.04	8,571.49
3 Motor vehicles and parts, including tyres and tubes	0.27*	1.76	13.28	34.81	237.42	1,664.36	2,638.33
Total of 1 to 3	1.62	6.95	32.96	392.98	2,428.90	8,989.92	18,084.82
% to total sales tax/sales tax and VAT	19.76	18.57	16.16	35.02	55.91	56.78	54.06
Other commodities	6.58	30.47	170.98	729.12	1,915.43	6,843.19	15,368.67
% to total sales tax/sales tax and VAT	80.24	81.43	83.84	64.98	44.09	43.22	45.94

*Tax levied; @ arrack was banned in 1996. ^Figures for 1990–91 are not available.
Sources: Administration reports of Agricultural Income Tax and Sales Tax Department, Government of Kerala for the years 1960–61, 1970–71 and 1980–81. Unpublished data obtained from Agricultural Income Tax and Sales Tax Department, Government of Kerala for the years 1991–92 and 2000–01. Unpublished data obtained from Commercial Taxes Department, Government of Kerala for the years 2010–11 and 2016–17.

Table 11: Main Pillars of Kerala's Revenue Structure (₹ crore)

Year	Petrol and Petroleum Products	Liquor of All Kinds		Motor Vehicles		Lottery#	Total of col 2 to 7	Col 8 as % of SOR
		State Excise@	Sales Tax	Motor Vehicle Tax	Sales Tax/VAT			
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
1960–61	1.28	2.62	0.07	2.39	0.27	–	6.63	23.13
1970–71	4.25	10.01	0.94	6.82	1.76	2.54	26.32	28.82
1980–81	12.73	65.23	6.95	20.01	13.28	3.74	121.94	27.93
1991–92	303.02	210.30	55.15	94.75	34.81	53.87	751.91	39.39
2000–01	1,427.21	688.94	764.27	394.85	237.42	134.17	3,646.86	55.85
2005–06	2,028.88	841.00	1,427.59	628.51	585.20	229.57	5,740.75	53.57
2010–11	3,550.52	1,699.54	3,775.04	1,331.37	1,664.36	571.46	12,592.29	53.24
2016–17	6,875.00	2,019.30	8,571.49	3,107.23	2,638.33	7,283.29	30,494.64	58.78

@ Excise revenue includes a small portion of revenue from other excisable products like narcotics. # Lottery was introduced in 1967.
Sources: Administration reports of Agricultural Income Tax and Sales Tax Department, Government of Kerala for the years 1960–61, 1970–71 and 1980–81. Unpublished data obtained from Agricultural Income Tax and Sales Tax Department, Government of Kerala for the years 1991–92 and 2000–01. Unpublished data obtained from and Commercial Taxes Department, Government of Kerala for the years 2010–11 and 2016–17. Figures on excise and lottery are obtained from the relevant issues of *Reserve Bank of India Bulletin* and Reserve Bank of India annual publication *State Finances: A Study of Budgets*.

social services as a percentage of revenue expenditure can be taken as a reasonable indicator of this. Comparable data on both these are available from 1972–73 onwards only. Table 8 (p 35) shows that Kerala's performance has been consistently coming down over the years, from 1972 through 2017.

Kerala's own revenue structure underwent a remarkable transformation during the last 60 years (Table 9). The steep fall in the share of direct taxes and non-tax revenue sources over the years, as we shall see shortly, deepened the fiscal illusion phenomenon associated with indirect taxes in Kerala society, and helped the growth of competitive populism of coalition politics.

Sales tax/sales tax and VAT: As we have seen, sales tax/sales tax and VAT are the only tax items where the state has put in some effort. However, a close look at the commodity composition of sales tax would show that over the years, the state has been becoming increasingly dependent on a few items which could not be easily avoided or evaded.[5] Since independence, petrol and petroleum products are dealt with by public sector oil companies, which have no reason to evade and/or avoid tax. The same is true of IMFL, which is marketed by KSBC, a public sector company formed in 1986. The need to get motor vehicles registered as per the Motor Vehicles Act ensures that sales tax/VAT is not evaded and/or avoided.

A perusal of the annual finance bills presented in the state legislature every year reveals that the rate of tax on petrol and petroleum products has gone up from 20% in 1960–61 to an average 25%–30% over the years. On liquor, the state has been levying prohibitive rates to discourage consumption. The rate of tax which was 25% in 1960–61, has been raised in stages to reach the present level of 210%, over and above state excise duty. The relative share of these three commodities registered a sharp increase from 19.76% in 1960–61 to 54.06% in 2016–17 (Table 10). Following the Gulf boom, the period since 1980 has been marked by a sharp increase in the level of household consumption in general, and durable goods in particular. There is no reason why the relative share of "other commodities" should register such a steep fall during this period. In other words, if the state had put in effort to raise revenue from "other commodities," perhaps the relative share of these three commodities would not have risen to the present level.

Equity Implications

The equity implications of poor fiscal performance can be further examined. Kerala admittedly has a wide tax base covering various sections of people and different kinds of economic activities. This is not reflected in the revenue performance, as exemplified in Table 11. Virtually, the effective revenue base has been getting narrowed down to four items. An unintended consequence of the evolution of Kerala's revenue structure is that it places a disproportionately high burden on the poor and marginalised sections of society. They are the major consumers of liquor and lottery. The share of these two in SOR increased from 14.77% in 1970–71 to 34.46% in 2016–17. Motor vehicles run on petroleum products like three-wheelers, pickup vans and taxis, which are the source of livelihood for many of this class.

The high reliance on liquor and lottery for public resource mobilisation is perhaps a unique feature of Kerala. From the point of view of the state, it is to protect the poor and marginalised from the harmful effects of liquor that such a high rate of tax is levied. But there is no evidence that this has reduced liquor consumption. According to the 68th round of the NSSO survey on household consumer expenditure for 2011–12, Kerala stands second among 14 major states in per capita liquor consumption (NSSO 2014). It is "predominantly a problem of men, poorer socio-economic groups and among particular groups like the tribal, slum and coastal populations" (Kerala Alcohol Study Team 2015: 17). Kerala banned arrack in 1996, forcing these groups to go in for high-cost IMFL.

On lottery, the specious justification is that nobody is forced to buy lottery tickets.[6] However, even in developed countries, lower income individuals spend a larger share of their income on lottery tickets, compared to those with higher incomes (Beckert and Lutter 2013). Considering the harmful effects of lottery on the poor, most Indian states have banned lottery. Of the 10 states that ran lottery in 2016–17, Kerala accounted for 92.73% of lottery revenue (RBI 2018). Recent evidences indicate that Kerala is the state where inequality is increasing at an alarming rate (Oommen 2014; Sreeraj and Vakulabharanam 2016). To what extent the extraction of public resources from the poor and marginalised contributes towards this has not been subjected to any serious study.

Slackening of Fiscal Effort

We have seen that contrary to conventional wisdom, Kerala's fiscal effort has actually slackened during the last 60 years.[7] Two factors seem to have contributed to this: incorrect perception about Kerala's fiscal performance and competitive populism of coalition politics. One factor that perhaps stymied the increased fiscal effort in Kerala is the popular perception that tax burden in the state is unduly high. The fact that Kerala is top in per capita tax burden is often highlighted in the media and on the floor of the legislature. But the need for more public resources as evidenced by the ever-growing revenue and fiscal deficits and debt burden, in relation to the increase in the ability of the people to contribute towards public purposes, is often ignored in public discourses.

Scholarly studies on tax effort, which invariably found Kerala as putting in "above average effort," buttressed this perception (Garg et al 2014; Karnik and Raju 2015). The hype of Kerala "performing well" at the tax effort front seems to have generated a sense of complacency at the political and administrative levels, and lent justification for dependence on borrowed funds to meet the growing expenditure needs. Successive Finance Commissions and the Planning Commission also seem to have been influenced by these studies. Though the state has been undergoing fiscal stress for well over three decades, there has been no serious questioning of its fiscal performance by these agencies. Presumably, the overwhelming appeal of the "Kerala model" might have induced many to bypass this vital shortcoming.

The incorrect perception about Kerala's tax performance has misled even serious scholars to arrive at a wrong "diagnosis" of Kerala's fiscal crisis. Since the state is perceived to be performing well at the tax effort front, the reasons for the fiscal stress had to be sought elsewhere. Two explanations have been advanced. One from the expenditure side held that the root cause of Kerala's fiscal crisis was the high non-plan revenue expenditure in the field of social and community services. Teachers and health professionals appointed during the successive five year plans had to be paid salary and pensions in the non-plan account at the expiry of the plan period. Central agencies, such as the Planning Commission and successive Finance Commissions, instead of recognising and rewarding the contribution of this in the creation of the "Kerala model of development," took note of this, only to deny central funds (George 1990).

Another explanation was the constraint imposed by the Constitution in tapping the potential of the service sector of the state. Kerala is a service sector-oriented state and the service sector is the fastest-growing sector of the economy. Since states were not constitutionally empowered to tax services in general (except certain specific services such as entertainment and supply of electricity), Kerala was unable to mobilise the required public resources to meet its growing expenditures (Mohan and Shyjan 2005). The solution therefore was to empower the states to tax services. As we shall see shortly, the introduction of the goods and services tax (GST), which enabled the state to bring services under the tax net, has not led to higher tax revenue. Evidently, the studies mentioned above do not provide much insight into Kerala's persistent fiscal stress. However, they lent considerable legitimacy to the bogey of the "Centre's neglect," raised by coalition governments opposed to the centre.

Turning to the second issue, in a democratic polity, fiscal management is essentially a political process. The time horizon before an elected government is short. This makes governments in power to resort to competitive populism quite often, characterised by a reluctance to mobilise public resources from taxes and user charges and incurring expenditures for short-term political gains. Under such circumstances, public debt becomes a residual source of finance for governments (Grilli et al 1991: 355). The problem gets exacerbated with coalition governments supported by political parties of different ideological persuasions and constituencies. A coalition government has to negotiate with the populist tendencies of each of its constituents and this renders coalition governments inherently weak.[8]

Right from its formation in 1956, Kerala has been having coalition governments. Till 1980, the coalitions did not have any distinct ideological orientations. This changed with the realignment of political forces in 1980, under two competing fronts: the Left Democratic Front (LDF) and the United Democratic Front (UDF). Since 1982, the LDF and UDF governments have been taking turns consistently. A perusal of the budget speeches of the finance ministers of alternating front governments reveals some interesting patterns. Proposals for additional resource mobilisation put forward by a ruling front are often opposed by the opposition front on the floor of the legislature, press and public forums. To a large extent, this is a tit for tat for opposing their proposals when they were in power. Instead of boldly going ahead with the proposals, the ruling front withdraws the proposals.

They seek to cover the revenue deficits by borrowing, or raising the rate of tax on liquor or starting new lotteries.[9] The opposition front does not oppose these proposals, as they stand to lose popularity by doing so. Another reason could be that the same opportunities are available to them when they come to power in the next election. From the point of view of popularity, this has been a win-win situation for both fronts. The fiscal illusion which the whole of Kerala society faced, together with the popular perception that Kerala is a highly taxed state, and the findings of scholarly studies on Kerala's tax performance, provided a perfect setting for the political class to engage in competitive populism.

Goods and Services Tax

At the political and policy level, there have been high expectations about the prospect of the GST bailing out Kerala. This seems to have misfired. To quote from the budget speech of the finance minister:

> It is true that, I have argued, even in the Legislative Assembly that the tax revenue of the state will increase to 20–25% on introduction of GST. But, our tax revenue increases only below 10% as in the time of VAT. (Government of Kerala 2018: 7)

Part of the reason for the low rate of growth could be the teething problems of the GST. The rate of growth is likely to pick up once the GST gets stabilised. Even if an allowance is provided for this factor, the chances of revenue growth rate hitting 20%–25% is very remote. Kerala's expectations about GST, based on the size of its service sector, is unrealistic. It is true that in the case of states, the power to tax services is the main driver of revenue growth in the GST scenario. However, from the revenue point of view, what matters is not the absolute size of the service sector, but the presence of taxable services and size of the service providers.

One major source of service tax revenue is services associated with manufacturing activity, such as patents and trademarks, freight and forwarding, insurance, advertising, legal and technical consultancy, etc. Kerala is industrially backward and a vast majority of service providers are small businessmen. The statewise service tax collection figures for 2012–13 brought out by the central excise and service tax department showed that six manufacturing-oriented states—Andhra Pradesh, Gujarat, Karnataka, Maharashtra, Tamil Nadu and West Bengal—accounted for 62.85% of the total service tax revenue (excluding those relating to Large Tax Payer Units and Delhi). Kerala's share was only 1.30%. The fastest-growing segments of Kerala's service sector, such as education and health, are exempted under GST. Based on these evidences, it has been argued that Kerala would not benefit much in the GST scenario (Sebastian and Anithakumary 2015).

Conclusions

The devastating floods of August 2018 have virtually landed Kerala finances in deep waters. Post-disaster need assessments on Kerala floods by various United Nations' agencies have estimated that the state may need ₹27,000 crore for reconstruction (*Hindu* 2018a). Going by the media reports, the main source of finance is borrowings from various sources and "crowd funding." The state has requested the centre to extend the limits for borrowing from 3% of GSDP to 4.5%, and a 10% cess on GST. The state has also launched a "global salary challenge," wherein working Keralites all over the world are exhorted to contribute one month's salary to the Chief Minister's Distress Relief Fund. Two measures of additional resource mobilisation from the own sources of revenue have been proposed. One is raising the excise duty on liquor for 100 days and the revenue estimated from this is ₹230 crore (*Hindu* 2018b). The other is a new lottery known as the Nava Kerala lottery, and the estimated revenue from this is ₹90 crore (*Hindu* 2018c). In this scenario, it is pertinent to urgently address the fiscal stress facing the state.

This article enquired into the causes of Kerala's persistent fiscal stress since the mid-1980s. The findings question the widely held view that Kerala has been performing well in public resource mobilisation. The fiscal potential of the state registered tremendous increase during the last 60 years, but the state failed to exploit it. Two factors that seem to have contributed to it are an incorrect perception about the state's fiscal performance, emanating from methodological inadequacies of scholarly studies, and the alternating coalition governments which engaged in competitive populism since 1982. Over the years, the own resource base of the state has narrowed down to a few items.

The present revenue structure of the state places a disproportionately high burden on the poor and the marginalised. Perhaps a more serious consequence of Kerala's fiscal stress is that the political class now finds it increasingly difficult to engage with the people on public resource mobilisation. It is as if they cannot communicate this imperative to a society long accustomed to a light fiscal burden. Instead of presenting the state as an empowered and legitimate entity to seek resources from the people, they seem to be tempted to go in for softer options. All these make the future fiscal scenario of the state extremely unpredictable, if not dim.

NOTES

1 Some of the recent examples are Garg et al (2014), Panagariya et al (2014) and Karnik and Raju (2015).

2 According to Gulati and Mody (1983:70), remittances as a percentage of GSDP was 6%–8% in 1976–77, which increased to 22%–28% by 1980–81. Recent estimates for 2014 put it as 36.3% of NSDP (Zachariah and Rajan 2015: 21).

3 It may be noted that some of the major services consumed by households like health and education (except private coaching/tuition centres) are exempted from the then central service tax and the present goods and services tax.

4 In 2010–11, the KSBC paid 800% dividend to government (see Kerala State Beverages Corporation Ltd nd).

5 Till 1980–81, the erstwhile agricultural income tax and sales tax department (a single department) used to bring out detailed commodity-wise revenue data, though it suffered from serious limitations. This practice was subsequently discontinued. Since 1981–82, the department has been bringing out the revenue data of only 25–30 major commodities. Though not entirely free from limitations, these data appear to be comparable across years.

6 The state seeks some legitimacy and respectability in the extraction of public resources through lottery, by launching special lotteries wherein the revenues are earmarked for specific purposes. Accordingly, revenue from "Karunya" and "Karunya Plus" is earmarked for the treatment of chronic diseases like cancer, heart and kidney diseases, whereas revenue from "Nirmal" and "Sthreesakthi" is utilised for waste disposal and women-centric projects.

7 Laxity in public resource mobilisation is prevalent in the local governments in Kerala. A case in point is the property tax, the single most important source of revenue of local governments. The Kerala Panchayati Raj Act, 1994 and Kerala Municipality Act, 1994 envisage quinquennial revision of property tax. The latest revision took place in 2013, after a gap of 17 years in the case of gram panchayats, and 20 years in the case of urban local bodies. However, the Government of Kerala put on hold the revision through an executive order on 27 May 2015. Till date, the revision has not been implemented, though the Fifth State Finance Commission recommended to revoke the above government order (Government of Kerala 2015: 153–56).

8 Since 1976–77, a regional party with strong peasant interests began holding the finance portfolio in different coalition ministries. In 1986, a controversy erupted in Kerala, centred on the nexus between political interference by the finance minister of this party and the steep fall in the revenue contribution of agricultural income tax and sales tax. The Kerala State Planning Board and well-known economist K N Raj aired their views broadly, hinting that Kerala's sales tax collection potential remained vastly untapped (*Indian Express* 1986a; 1986b). This led to his resignation and the taking over of the finance portfolio by the national party, which was leading the ministry.

9 A recent example is the phenomenal growth of revenue from lottery since 2010–11. The UDF government that came to power in 2011 revived the system of daily lotteries. New lotteries like "Karunya" and "Mangalya" were also launched. The LDF government that came to power in 2016 started four more lotteries. Revenue from lottery increased from ₹571.46 crore in 2010–11 (RBI 2013: 196) to ₹7,283.29 crore in 2016–17 (RBI 2018: 362), that is, an increase of 1,174.51%.

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