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PATHWAYS FOR RESOLVING KERALA'S PUBLIC FINANCE CRISIS: CRITICAL EVALUATION OF GOVERNMENT RESPONSES AND POLICY SOLUTIONS

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ABSTRACT
Kerala's public finance system is currently experiencing one of the most serious fiscal crises in its post-reform history. The state, long recognised for its high human development indicators and welfare-oriented governance model, now faces persistent revenue deficits, rising debt burdens, increasing committed expenditure, and growing constraints on fiscal flexibility. This paper critically evaluates the structural causes of Kerala's fiscal stress, with particular focus on the effectiveness and limitations of current government responses. While the state government has attempted to address fiscal pressures through borrowing-led adjustment, off-budget financing mechanisms, tax mobilisation measures, expenditure controls, and infrastructure-led investment through the Kerala Infrastructure Investment Fund Board (KIIFB), these measures have largely provided temporary relief rather than long-term structural correction.

The paper argues that Kerala's fiscal crisis is not merely cyclical but deeply structural, rooted in demographic transition, weak industrialisation, dependence on consumption-driven taxation, rising pension liabilities, and constraints within India's federal fiscal architecture. The study critically examines ongoing reforms and proposes a broader framework for fiscal sustainability centred on productive economic expansion, pension reform, public enterprise restructuring, improved fiscal transparency, targeted welfare delivery, and cooperative federalism. The paper concludes that Kerala's long-term challenge is not whether it should continue as a welfare state, but whether it can transform itself into a fiscally sustainable productive welfare state.

KEYWORDS: *Kerala, fiscal crisis, welfare state, fiscal sustainability, public debt, KIIFB, public finance, federalism, pension reform.*

1. INTRODUCTION
Kerala occupies a distinctive position within India's political economy. Despite historically modest levels of industrialisation and relatively low per capita income during the early decades after independence, the state achieved remarkable progress in literacy, healthcare, life expectancy, gender development, and social welfare. This developmental trajectory, widely described as the "Kerala Model," depended heavily on redistributive public expenditure, social mobilisation, decentralised governance, and welfare-oriented state intervention (Drèze & Sen, 2013). However, the sustainability of this model has increasingly come under question. Since the late 2010s, Kerala has experienced severe fiscal stress arising from a combination of structural weaknesses and external shocks. Consecutive floods in 2018 and 2019, the COVID-19 pandemic, the end of GST compensation, rising debt obligations, slowing remittance growth, and tightening Union government borrowing restrictions have intensified pressure on the state's finances. Kerala's fiscal challenge is particularly significant because the state simultaneously faces rising welfare obligations, demographic ageing, increasing pension liabilities, high committed expenditure, limited industrial expansion, and dependence on consumption-led taxation.

2.OBJECTIVES
The fiscal crisis therefore reflects a deeper structural contradiction within Kerala's development model. The state must preserve historically important welfare achievements while operating within increasingly constrained fiscal conditions. This paper focuses primarily on the critical evaluation of current government responses and policy solutions for fiscal sustainability. Other sections are kept relatively brief in order to provide greater analytical focus on reform pathways and long-term policy implications.

3. RESULTS AND DISCUSSION
3.1 Kerala's Fiscal Crisis: A Brief Overview
Kerala's fiscal stress has evolved gradually over several decades but became particularly acute after 2018. Although the state maintained relatively high social sector expenditure, revenue mobilisation failed to expand at a comparable pace. According to Kerala budget

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documents, RBI State Finances reports, and PRS Legislative Research analyses, Kerala's fiscal deficit has remained persistently high, while revenue deficits continue to indicate that borrowing is increasingly being used to finance routine expenditure rather than productive asset creation. The structure of expenditure reveals severe rigidity. Salaries, pensions, and interest payments absorb nearly 70–73 per cent of revenue receipts. This leaves limited discretionary fiscal space for developmental expenditure.

Table 1: Indicators of Fiscal Stress in Kerala

Indicator	Approximate Position (2024–25 / 2025–26)
Fiscal Deficit	Around 3.5–3.9% of GSDP
Revenue Deficit	Around 2–2.5% of GSDP
Outstanding Liabilities	Around 35% of GSDP
Interest Payments	Around 21% of Revenue Receipts
Committed Expenditure	Around 70% of Revenue Receipts
Capital Outlay	Relatively low compared to revenue expenditure

Source: RBI, PRS Legislative Research, Kerala Budget Documents.

The crisis is not merely a temporary liquidity problem. It reflects long-term structural weaknesses within the state economy and public finance system.

3.2. Structural Nature of Kerala's Fiscal Stress

Kerala's fiscal problems arise from multiple interconnected structural factors.

- Demographic Transition and Pension Burden

Kerala's ageing population has increased pension obligations, healthcare expenditure, and welfare commitments. Rising dependency ratios reduce the long-term growth of the tax-paying workforce while simultaneously increasing social expenditure.

- Weak Productive Base

Despite strong human development indicators, Kerala's industrial base remains limited. The economy depends heavily on services, remittances, tourism, trade, and construction. Manufacturing contributes only a modest share to Gross State Domestic Product (GSDP).This creates vulnerability because consumption-driven taxation depends heavily on remittance flows and external economic conditions.

- Dependence on Consumption Taxation

Kerala's own-tax revenue depends substantially on GST collections, fuel taxes, and liquor revenue. Such taxes fluctuate with economic activity and consumption patterns. The implementation of GST also reduced the state's independent taxation flexibility.

- High Committed Expenditure

The most serious structural problem is the rigidity of expenditure. Salaries, pensions, and interest payments absorb a dominant share of revenue receipts, reducing fiscal flexibility.

- Federal Fiscal Constraints

Kerala's fiscal stress has intensified due to stricter borrowing ceilings imposed by the Union government and the end of GST compensation. The state has increasingly argued that existing fiscal federal arrangements restrict its developmental and welfare commitments.

3.3. Critical Evaluation of Current Government Responses

The Government of Kerala has adopted multiple policy responses to address the fiscal crisis. These include borrowing-led adjustment, off-budget financing through KIIFB, revenue mobilisation measures, treasury controls, expenditure compression, infrastructure-led growth strategies, and demands for greater fiscal space from the Union government. While these responses have prevented immediate fiscal collapse, their effectiveness in resolving the deeper structural causes of the crisis remains limited.

- **Borrowing-led Fiscal Management**

One of the central features of Kerala's fiscal strategy has been extensive dependence on borrowing. Borrowing enabled the state to continue welfare payments, salaries, pensions, infrastructure projects, and social protection schemes during periods of severe stress such as the floods and the pandemic. In the short term, this approach provided liquidity support and helped avoid abrupt expenditure cuts. Welfare continuity during the pandemic, in particular, prevented large-scale social distress. However, the long-term consequences of borrowing-led adjustment are increasingly problematic.

- **Persistent Revenue Deficits**

A major concern is that Kerala continues to run large revenue deficits. In public finance theory, borrowing is generally considered sustainable when used for productive capital formation capable of generating future economic returns. In Kerala's case, however, a substantial share of borrowing is used to finance current expenditure. This creates several risks: debt accumulates without corresponding productive asset creation; interest payments increase over time; fiscal flexibility declines; future developmental expenditure becomes constrained. The state therefore risks entering a debt-dependence cycle where new borrowing increasingly finances past obligations.

- **Rising Interest Burden**

Interest payments now consume roughly one-fifth of revenue receipts. This is significant because interest expenditure does not directly create developmental outcomes. Instead, it represents the cost of past borrowing. As debt expands, future governments inherit reduced fiscal flexibility.

- **Limited Structural Correction**

Borrowing temporarily postpones fiscal adjustment but does not address the underlying structural causes of the crisis. Without expansion of the productive economy and reform of committed expenditure, borrowing merely delays fiscal stress. Thus, while borrowing may be necessary during extraordinary crises, continued dependence on borrowing for routine expenditure is fiscally unsustainable.

3.4 KIIFB and Off-budget Borrowing: Innovation or Hidden Fiscal Risk?

The Kerala Infrastructure Investment Fund Board (KIIFB) became one of the most important instruments of Kerala's fiscal strategy. Positively, KIIFB enabled the state to continue infrastructure investment despite borrowing restrictions. Projects supported through KIIFB include roads and highways, hospitals, school infrastructure, urban development, and public facilities. During periods of economic slowdown, infrastructure investment also played a counter-cyclical role by sustaining employment and aggregate demand. From a developmental perspective, KIIFB represented an attempt to overcome rigid fiscal constraints and maintain capital expenditure. Despite these advantages, KIIFB also generated major concerns. The RBI, CAG, and Union government repeatedly raised questions regarding contingent liabilities, state guarantees, off-budget borrowing, and fiscal transparency. Although KIIFB borrowing initially remained outside conventional budgetary accounting, repayment obligations ultimately depend on government revenues and guarantees. This means that liabilities classified as "off-budget" may eventually become direct public liabilities.

A major weakness in the KIIFB model is that repayment sustainability depends on the economic returns generated by infrastructure projects. If projects fail to generate sufficient growth, revenue, or user charges, the repayment burden shifts back to the state budget. Several analysts have therefore argued that KIIFB expanded Kerala's effective debt burden while delaying transparent recognition of liabilities.

KIIFB should not be viewed entirely negatively. Infrastructure investment remains essential for long-term growth. However, the model requires greater transparency, stronger project evaluation, better revenue planning, and clearer integration with overall debt management. Without these safeguards, off-budget financing may weaken rather than strengthen fiscal sustainability.

3.5 Revenue Mobilisation Measures

The state government introduced several measures to increase revenue. These include, fuel cess increases, property tax revisions, increased user charges, higher reliance on liquor revenue, land monetisation, and revisions in road taxes. These measures helped generate short-term fiscal resources at a time of severe liquidity stress. Improved digital tax administration and better compliance systems also contributed to higher revenue collection efficiency. The state's efforts to modernise tax administration reflect recognition that Kerala cannot depend entirely on central transfers.

However, the effectiveness of these measures remains limited. First, many revenue sources are politically sensitive. Fuel cess increases and property tax revisions often face strong public resistance. Second, heavy dependence on liquor and petroleum taxation raises ethical and social concerns. Third, such measures do not fundamentally alter Kerala's narrow productive tax base. Revenue mobilisation without productive economic expansion can provide only temporary relief.

Kerala may also be approaching a point of tax fatigue which can be also known as Tax Saturation Risk. Repeated tax increases in a slow-growth environment can weaken consumption and create political dissatisfaction. Therefore, sustainable revenue growth requires broader economic transformation rather than repeated incremental taxation.

3.6 Administrative Expenditure Controls

The government also adopted treasury controls, expenditure compression, cash management restrictions, delayed payments, and tighter bill processing systems. These measures temporarily reduced liquidity pressure. Cash management strategies helped the government maintain essential expenditure during fiscal stress.

However, administrative compression often merely postpones liabilities. Delayed payments affect contractors, welfare beneficiaries, local governments, public sector enterprises, and infrastructure projects. This can weaken economic activity and reduce trust in public financial management. Moreover, expenditure compression does not resolve structural expenditure rigidity. Instead, it shifts fiscal stress into future financial years.

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Administrative controls are useful as emergency mechanisms but cannot substitute for structural fiscal reform. Long-term sustainability requires durable correction rather than temporary cash-flow management.

3.7 Demand for Greater Fiscal Space from the Union Government

Kerala has consistently argued that Union government borrowing restrictions are excessively restrictive. The state contends that GST reduced fiscal autonomy, borrowing ceilings limit developmental expenditure, and Finance Commission criteria disadvantage demographically advanced states.

Some of these concerns are legitimate. Kerala lost significant revenue after the end of GST compensation. Demographic criteria used in tax devolution also reduced the relative advantage of states that successfully controlled population growth. Furthermore, excessive fiscal centralisation can weaken cooperative federalism.

However, federal constraints alone do not fully explain Kerala’s crisis. Even with greater borrowing flexibility, structural problems would remain high committed expenditure, pension burdens, weak industrialisation, and limited productive revenue growth. Therefore, federal reform is necessary but insufficient. The state must simultaneously undertake internal structural correction.

3.8 Evaluation of Overall Government Strategy

The current government response reflects a combination of borrowing-led adjustment, infrastructure-driven growth strategies, revenue mobilisation, administrative controls, and political negotiation with the Union government. These strategies succeeded in preventing immediate fiscal collapse and preserving welfare continuity.

However, they have not adequately addressed the deeper structural drivers of fiscal stress. The current approach remains heavily focused on liquidity management rather than long-term fiscal restructuring. The core weaknesses remain unresolved rising pension liabilities, expenditure rigidity, weak productive sector growth, off-budget liabilities, and dependence on debt-financed welfare expenditure. Consequently, Kerala’s fiscal system remains vulnerable to future shocks.

4. POLICY SOLUTIONS: TOWARDS FISCAL SUSTAINABILITY

Kerala’s fiscal crisis requires a long-term structural reform strategy rather than short-term adjustment measures. Fiscal sustainability cannot be achieved through austerity alone. Excessive expenditure cuts could weaken Kerala’s important achievements in healthcare, education, and social welfare. The challenge therefore lies in combining fiscal discipline, productive economic expansion, institutional reform, and welfare sustainability.

4.1 Reorienting from a Consumption Economy to a Productive Economy

The most important long-term solution is expansion of Kerala’s productive base. Kerala’s current economy depends heavily on remittances, services, tourism, trade, and consumption. This structure generates revenue vulnerability.

4.2 Industrial Diversification

Kerala requires a modern industrial strategy focused on knowledge industries, biotechnology, electronics, renewable energy, logistics, food processing, and digital services. Unlike traditional heavy industrialisation models, Kerala can build on its educated workforce and human capital advantages.

4.3 Technology and Innovation

The Karnataka experience demonstrates how technology-driven growth can expand state revenues. Kerala should strengthen start up ecosystems, university-industry collaboration, innovation financing, digital infrastructure, and research institutions.

4.4 Port-led Development

Kerala’s geographical location offers opportunities in logistics, warehousing, transhipment, and export-oriented industries. Integrated infrastructure development around ports could stimulate productive investment.

4.5 Tourism Reform

Tourism policy should move beyond low-value mass tourism toward: health tourism, eco-tourism, cultural tourism, and wellness sectors. Higher-value tourism creates better fiscal returns and employment opportunities. The question now arises is why productive expansion matters? Ultimately, welfare sustainability depends on productive economic growth. Without expansion of income-generating sectors, revenue growth will remain insufficient to support welfare commitments.

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4.6 Pension Reform and Committed Expenditure Management

Kerala's pension burden represents one of the most serious long-term fiscal risks. The current pension system is increasingly difficult to sustain under conditions of demographic ageing. Pension expenditure crowds out developmental expenditure and contributes significantly to structural deficits. Kerala has gradually expanded contributory pension systems in which benefits are linked to accumulated contributions. This reduces long-term unfunded liabilities. Potential reforms include gradual increases in retirement age, revised pension indexation, tighter eligibility norms, and actuarial planning. These reforms must be implemented gradually and carefully to avoid social disruption.Pension reform is politically difficult because organised employee groups are influential in Kerala. Therefore, successful reform requires political consensus, phased implementation, and transparent communication.

4.7 Reforming Public Sector Enterprises

Public sector enterprises generate substantial quasi-fiscal deficits. Entities such as Kerala State Electricity Board, Kerala State Road Transport Corporation, and Kerala Water Authority frequently require budgetary support. These enterprises suffer from operational inefficiency, politically constrained pricing, wage burdens, and delayed tariff revisions.

Reforms should include professional management, stronger corporate governance, transparent accounting, periodic performance audits, and operational restructuring. Tariff reforms are politically sensitive but economically necessary. Subsidies should increasingly become targeted rather than universal. In selected sectors, carefully designed public-private partnerships may reduce fiscal pressure while improving service quality. However, essential public services must remain socially accessible.

4.8 Improving Fiscal Transparency and Debt Management

Fiscal transparency is essential for long-term credibility. Kerala should incorporate contingent liabilities, guarantees, and off-budget debt within a comprehensive public debt framework. The state requires a credible medium-term fiscal roadmap with clear targets relating to debt reduction, capital expenditure, revenue deficits, and pension liabilities.

Institutional mechanisms such as fiscal councils or periodic fiscal review bodies could improve transparency and public accountability. Transparent accounting improves investor confidence, borrowing credibility, fiscal planning, and democratic accountability.

4.9 Strengthening Local Governments

Kerala's decentralised governance system remains a major institutional strength. Urban local bodies require stronger revenue autonomy, digital accounting systems, property tax administration, and infrastructure financing capacity. GIS-based property mapping and periodic valuation updates can significantly improve municipal revenue. Stronger local governments can improve expenditure efficiency because local institutions often better understand developmental priorities.

4.10 Tax and Revenue Reform

Revenue mobilisation remains necessary but should focus on efficiency rather than excessive taxation. Digital analytics, e-invoicing, and integrated databases can improve tax compliance. Kerala should improve non-tax revenue through asset monetisation, better public enterprise performance, and rational user charges. Overdependence on petroleum and liquor taxation is fiscally risky and socially problematic. The long-term solution lies in expanding the productive tax base.

4.11 Cooperative Federalism and Fiscal Flexibility

Kerala's fiscal future is also linked to India's federal fiscal structure. States with strong human development outcomes and transparent fiscal systems could be provided greater flexibility for productive capital expenditure. The design of GST compensation and devolution formulas requires reconsideration. A more balanced fiscal relationship between Union and State governments is necessary for long-term stability. However, federal flexibility must be accompanied by internal fiscal discipline.

5. POLITICAL ECONOMY OF REFORM

Fiscal reform in Kerala cannot be understood purely as a technical issue. It is deeply shaped by political economy. Trade unions, employee associations, pensioners' groups, and political coalitions often resist expenditure rationalisation and institutional restructuring. This creates strong pressure for continuity in welfare commitments. Competitive politics encourages short-term welfare expansion because visible transfers generate immediate electoral returns. As a result, governments often postpone difficult reforms. Long-term reform requires broad political agreement extending beyond electoral cycles. Successful fiscal correction requires bipartisan cooperation, institutional continuity, and public trust. The debate should not be framed as a choice between welfare and growth. Kerala requires a productive welfare model in which welfare protections continue, but productive economic growth expands the fiscal base.

6. COMPARATIVE LESSONS

Comparative experience offers useful lessons for Kerala. Tamil Nadu combined welfare expansion with industrial diversification. Its manufacturing base strengthened fiscal capacity. The key lesson is that welfare systems require productive economic support. Karnataka expanded revenues through technology-driven growth. Kerala can similarly build on its human capital strengths. Nordic welfare states demonstrate that extensive welfare systems are sustainable when supported by high productivity, strong taxation systems, institutional transparency, and productive economies.

7. CONCLUSION

Kerala's fiscal crisis is structural rather than temporary. The state's welfare-oriented development model achieved major social successes, but its fiscal foundations have weakened due to demographic transition, high committed expenditure, weak industrialisation, dependence on consumption-led taxation, and increasing debt burdens. The Government of Kerala responded through borrowing-led adjustment, KIIFB-based infrastructure financing, revenue mobilisation measures, treasury controls, and demands for greater federal fiscal space. These measures prevented immediate fiscal collapse and maintained welfare continuity during periods of severe stress. However, the current response remains insufficient because it addresses liquidity pressures more effectively than structural weaknesses. Long-term fiscal sustainability requires deeper transformation. The evidence suggests that Kerala's future depends on its ability to expand productive sectors, improve fiscal transparency, reform pensions, rationalise expenditure, strengthen public enterprises, modernise revenue systems, and build political consensus around long-term fiscal reform. Kerala's challenge is therefore not whether it should remain a welfare state, but whether it can evolve into a productive welfare state capable of sustaining social development within fiscally sustainable limits.

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