The Pioneer
NEW DELHI | MONDAY | JULY 20, 2026

Indian States should ramp up fiscal discipline and investment priorities

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While averages are deceptive aggregate data blatantly lies. Disaggregated data can throw up surprises in all domains — be it in healthcare or financial robustness of a country.

For instance, India being a federal structure the country's overall risk profile does not reflect individual contributions of the States. At the combined, all-State level, the picture may look reassuring. But the disaggregated numbers tell a different story.

Eighteen of India's 28 States breached the constitutionally mandated ceiling of 3 per cent of gross State domestic product (GSDP) on fiscal deficit in FY25. The CAG (Comptroller and Auditor General) called it the sharpest downfall since the pandemic year of FY21.

While some States lag behind, others compensate making the national average look good. But it's time to take a close look at the States and their investment priorities.

State-level fiscal stress isn't a self-contained problem. It intersects with a national growth trajectory that is already under pressure due to the West Asia crisis. The IMF's projection for India crossing the $5 trillion economy mark has slipped four years, to 2028-29.

Three different scenarios with a common baseline

Let me take Punjab, Himachal Pradesh, West Bengal, Rajasthan and Kerala. They are at the persistent core of India's most indebted states. Punjab's debt has not dipped below 40 per cent of GSDP since 2017.

Punjab has run a revenue deficit of at least 3 per cent of GSDP for six consecutive years, meaning its day-to-day spending routinely exceeds its day-to-day revenue. Interest payments alone consumed close to a fifth of its revenue expenditure in FY25. Add salaries and pensions, and committed, non-discretionary spending swallowed well over half of everything the state spent on its revenue account. That leaves barely more than 1 per cent of GSDP for capital expenditure — the kind of spending that actually builds roads, power infrastructure or irrigation capacity rather than just servicing yesterday's obligations.

Take Odisha for example , it's a state that has posted a revenue surplus every year since 2016 regardless of which party governs it, funds its transfer scheme without any additional borrowing — the money comes out of revenue it already has left over. Maharashtra, by contrast, funds its Ladli Behna Yojana against a revenue account that is already in deficit, which means the scheme is effectively financed through borrowing, even though the state's overall debt load, at roughly a fifth of GSDP, remains comfortable by national standards. This is the crux of why a fiscal deficit ceiling alone will not tell the whole story — a State that borrows to build assets is in a fundamentally different position from one borrowing to pay salaries and interest, even if both show up identically against the 3 per cent limit.

Why this matters for India's growth story right now

Fiscally stretched states are the least equipped to close that gap through their own effort, because they have the least capital-expenditure headroom to invest in the infrastructure — power, roads, irrigation — that underscores real growth rather than budget-assumption growth. The Centre's 50-year interest-free capital expenditure loans to states, now sized at ₹2 trillion for FY27, have been a genuine cushion here. But they function as a subsidy States lean on rather than a substitute for building their own fiscal space, and they don't resolve the underlying revenue-deficit problem in states like Punjab or West Bengal.

This all lands at a moment when the Centre itself has less room to absorb shocks on States' behalf. The Government of India's own liabilities, net of on-lending to states, run above 55 per cent of GDP — nearly double the states' combined liability ratio. In a period of global market volatility and heightened sensitivity to sovereign and sub-sovereign credit signals, a handful of visibly over-leveraged States raises the cost of capital not just for themselves but, at the margin, for how international investors price India risk more broadly.

The compliance gap: Why CAG findings need muscle

States are required to table CAG reports in their legislatures, and in principle a Public Accounts Committee is meant to scrutinise them and produce an Action Taken Report. In practice, the rigour of that follow-through varies enormously by State, and there is no binding mechanism that converts a CAG finding into a fiscal correction. A State can breach the ceiling for successive years, appear in the CAG's tables each time, and face no change in its market borrowing terms or central assistance as a direct result.

The 16th Finance Commission's displeasure with this gap is visible in its recommendations. It explicitly pushed states to end off-budget borrowing — the practice of routing debt through State-owned entities or special purpose vehicles so it doesn't show up in headline fiscal-deficit numbers — and asked that the definition of deficit and debt be widened to capture it uniformly. That recommendation exists precisely because States have used such vehicles to stay technically compliant while structurally over-leveraged.

Now somehow the states have to be inspired to comply. Another tricky observation that perhaps needs a deeper study is the social sector spend.

Social-sector spending — education, health, water and sanitation, housing, and welfare of scheduled castes and tribes — makes up a little over 40 per cent of the average budget in some states. But the states that spend the most on it are not the states with the best outcomes.

The uncomfortable fiscal fact is that the states with the most catching up to do are also the ones with the weakest revenue bases to sustain that spending without deeper borrowing.

This vicious cycle needs to be understood and addressed. This is where state leadership plays an important role. Freebies are counterproductive beyond a point. Make people work. Building infrastructure both physical and social will ensure citizens earn livelihood and states contribute meaningfully during economic headwinds.

As PM Modi says in a federal structure, the states have to be both competitive and cooperative for taking the country forward. Let's hope the state leaders are listening.

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