IV The Way Forward

State finances are exhibiting early signs of vulnerability. Elevated debt levels, growing number of cash-transfer schemes, impending pay-commission awards, and heightened climate-related risks are expected to intensify the medium-term fiscal pressures. Strengthening fiscal disclosures, adopting a glide path for debt consolidation, and mainstreaming climate budgeting can together enhance States' long-term fiscal resilience.

4.1 State government finances have somewhat deteriorated compared to last year. Geopolitical uncertainty, persistently high debt levels, growing contingent liabilities from guarantees and cash transfer schemes pose risks to State finances at the current juncture. The State government finances beyond 2025-26 will be shaped by multiple factors like recommendations of the FC-XVI, 8th Central Pay Commission awards, rationalisation of GST rates, and changes related to GST compensation cess, among others. Going forward, several challenges that the States need to address to attain a durable fiscal recovery are highlighted below.

4.2 To start with, general government debt across the world is likely to touch 100 per cent of global gross domestic product (GDP) by 2029, the highest level since the aftermath of the second world war (IMF, 2025). The general government debt to GDP ratio which surged during the pandemic, remains elevated across major economies driven by escalation of tariff barriers, slowing growth, likely higher defence spending, and the fiscal impact of geopolitical conflicts. As per IMF projections, India's gross general government debt to GDP ratio may hold steady in the range of 76 - 80 per cent over the next five years. Following the global trend, the consolidated debt-GDP ratio of Indian States remains high in the post pandemic period with a budget estimate of 29.2 per cent at end-March 2026. Several States have a debt level above 35 per cent of GSDP, which is much higher than the 2018 FRBM Review Committee's recommendation of 20 per cent. The Centre has laid a roadmap for bringing down its debt-GDP ratio to 50 per cent by 2031. The highly leveraged States may also frame a clear glide path for debt consolidation as high level of debt comes in the way of investment and growth.

4.3 Second, the mounting debt levels of States put pressure on State budgets through rising interest expenses. To meet higher interest payments, governments often cut down other productive expenditures, affecting medium term growth prospects. It is observed that the States with a debt-service ratio (interest payments to revenue receipts) higher than 15 per cent, have capital expenditure of less than 2 per cent of GSDP as against the all-India average of 2.7 per cent. This calls for fiscal reforms in the concerned States with emphasis on improvement in expenditure quality.

4.4 Third, market borrowings of State governments have witnessed a significant expansion over the last two decades. Most major States have budgeted a higher borrowing in 2025-26. During H1: 2025-26, States' market borrowing has risen by 21.0 per cent year-on year. Increased market borrowings by the State governments including elongated maturity profile of borrowings have impacted the yield structure in the government securities market and the borrowing space available for the central government and the private corporate sector. In addition, the demand for long-term sovereign debt among the largest investors *viz.*, scheduled commercial banks, insurance companies and pension funds has declined (RBI, 2025). Thus, fiscally profligate States may review their market borrowings through fiscal consolidation, exploring alternative financing options and better cash management practices.

4.5 Fourth, States' social sector expenditure increased sharply in the post-Covid period, partially led by higher cash transfers. Several States have introduced measures in their 2025-26 budgets, leading to farm loan waivers, free electricity for agriculture and households, subsidised transport, allowances for unemployed youth, and direct cash transfers to women. While social welfare programmes are essential in a country where economic disparities remain stark, these welfare expenditures run the risk of crowding out critical investments in physical and social infrastructure. Thus, it is important to carry out impact assessment to evaluate the effectiveness of welfare schemes in achieving the intended outcomes. Cross-State studies on diverse models of delivery can provide valuable insights for policy design. Evidence-based evaluation of such models can help identify best practices and guide the evolution of more efficient and equitable welfare systems across States.

4.6 Fifth, Central Pay Commissions are set up every decade to evaluate and suggest modifications to pay scales, allowances, and benefits for central government employees considering inflation and other economic factors. The Union Cabinet on October 28, 2025, approved the terms of reference for the 8th Pay Commission, which will review salaries, allowances and pension benefits for central government employees and pensioners. The Commission has 18 months (typical term) to submit its recommendations. Generally, State governments also revise pay structure of employees in line with the Central Pay Commission though with some modifications and delay. The implementation of the 8th Pay Commission is likely to exert pressure on India's public finances, from the financial year 2027-28 onwards.

4.7 Sixth, climate change presents a growing threat to India's macro-financial outlook, with significant implications at the subnational level. India with its diverse geographic profile is highly susceptible to natural disasters. As per the 2025 Climate Risk Index, India ranks sixth among the countries most affected by extreme weather events between 1993 and 2022[1]. Nine Indian States - Bihar, Assam, Uttar Pradesh, Rajasthan, Maharashtra, Tamil Nadu, Punjab, Gujarat, and Kerala - rank among the top 50 regions that are globally most vulnerable to climate change-related damages[2]. States like Assam, Bihar and Kerala are projected to experience the greatest escalation in damage from 1990 to 2050. In view of this, the States should prioritise adoption of climate budgeting to align fiscal planning with climate action. With coherent policies and strategic investments, Indian States can significantly advance their climate resilience goals, contributing

[1] Published annually by Germanwatch, an independent environmental think tank.
[2] Gross Domestic Climate Risk Report, 2024 released by Cross Dependency Initiative (XDI).

positively toward achieving national and global climate commitments.

4.8 Seventh, there is a scope for improvement in data transparency and disclosure practices of States. The Comptroller and Auditor General of India's (CAG) mandate for States to adopt a uniform accounting framework by 2027-28 is a timely and much-needed reform that will enhance the consistency, comparability, and transparency of State accounts. Building on this initiative, further improvements in the reporting of subsidies, grants-in-aid, and off-budget borrowings, along with guidelines on classification across heads of accounts, will strengthen the credibility of fiscal data and enable a more accurate assessment of the underlying fiscal risks. Additionally, the growing number of cash transfer schemes necessitates the creation of a comprehensive database of Direct Benefit Transfers (DBT) at the State level. Introducing separate budget codes or a standardised reporting format for DBT-related expenditure would enable systematic tracking of fiscal outlays and facilitate inter-State comparison of welfare initiatives.