**GENERAL STUDIES II**

# State Fiscal Space in India – UPSC Mains 2027

**Faculty/Author:** Faculty Editorial Board
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*Why are Indian States facing fiscal pressure despite rising economic activity. Explore the 16th Finance Commission, tax devolution, cesses and surcharges, State debt, revenue deficits, borrowing limits, fiscal federalism and reforms for restoring State fiscal space. Comprehensive UPSC Mains 2027 notes by Civil Service Gurukul.*

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# Restoring Fiscal Space for Indian States: Debt, Tax Devolution and the Future of Fiscal Federalism

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Understanding State fiscal autonomy, revenue mobilisation, the 16th Finance Commission, public debt, borrowing constraints and reforms for inclusive development.

UPSC Mains 2027 Indian Economy GS Paper II & III 16th Finance Commission Fiscal Federalism

### Executive Summary

Indian States occupy a central role in implementing public services, infrastructure and social development programmes.

However, increasing debt obligations, committed expenditure, uneven tax capacity, rising demands for social protection and dependence on intergovernmental transfers can constrain their fiscal flexibility.

The 16th Finance Commission recommended retaining the States' share in the divisible pool of Union taxes at 41% for FY 2026–27 to FY 2030–31. The Union Government accepted this recommendation.

Nevertheless, debates continue over the treatment of cesses and surcharges, the adequacy of transfers, borrowing conditions, fiscal risks and the distribution of revenue responsibilities.

Restoring fiscal space requires a combination of stronger State revenues, better expenditure quality, prudent debt management and effective cooperative federalism.

**41%** Vertical tax devolution, 2026–31

**3.3%** Aggregate State fiscal deficit, FY26 BE, as % of GDP

**₹1.4 L cr** Finance Commission grants in Union Budget FY27

**Data Accuracy Note:** The consolidated State fiscal-deficit figure of 3.3% of GDP is a budget estimate for FY 2025–26 reported by the RBI. It is not the statutory borrowing limit for every individual State. The 41% devolution applies to the divisible pool of Union taxes, not to total gross Union tax revenue.

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## 1. Introduction: Why State Fiscal Space Matters

India's federal development system depends heavily on State Governments. They are responsible for substantial public spending on education, healthcare, agriculture, local infrastructure and law and order.

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States must also respond to climate shocks, demographic changes, urbanisation and demands for public welfare.

These responsibilities require predictable revenue and the capacity to finance productive public investment.

Fiscal stress arises when existing spending commitments, debt servicing and weak revenues leave insufficient resources for emerging development priorities.

**Core UPSC Argument:** Strong State finances are essential not only for fiscal sustainability but also for delivering India's human-development and economic-growth objectives.

## 2. What Is Fiscal Space?

Fiscal space refers to the capacity of a government to undertake additional expenditure or reduce taxation without undermining medium-term debt sustainability or macroeconomic stability.

### Main Sources of Fiscal Space

### Revenue Capacity

Improving tax collections, administration and sustainable non-tax revenues.

### Expenditure Efficiency

Reducing avoidable expenditure while improving the quality of public services.

### Debt Management

Maintaining affordable borrowing and sustainable future repayments.

### Intergovernmental Transfers

Predictable tax devolution, grants and support from higher levels of government.

### Fiscal Space versus Fiscal Deficit

Fiscal deficit measures a government's borrowing requirement during a period. Fiscal space is broader: it reflects the capacity to finance policies while remaining fiscally sustainable.

A government with a low current deficit may still face limited fiscal space if future debt obligations or committed expenditure are high.

## 3. Constitutional Framework of Fiscal Federalism

| Constitutional Provision | Subject Significance |
|---|---|

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|---|---|---|
| Article 246 | Legislative powers | Distribution of legislative competence between Union and States. |
| Article 268 | Specified Union levies collected by States | Relevant to distribution of certain duties. |
| Article 269A | Inter-State GST | Framework for IGST levy, collection and apportionment. |
| Article 270 | Distribution of Union taxes | Constitutional basis of tax devolution, subject to exclusions. |
| Article 271 | Surcharges | Allows Parliament to impose surcharges for Union purposes. |
| Article 275 | Grants-in-aid | Provides a constitutional basis for grants to States. |
| Article 280 | Finance Commission | Provides for a constitutional commission on fiscal transfers. |
| Article 281 | Finance Commission report | Provides for laying the report and explanatory memorandum before Parliament. |
| Article 293 | State borrowing | Deals with State borrowing and specified conditions requiring Union consent. |

### Vertical Fiscal Imbalance

Vertical fiscal imbalance arises when the revenue-raising powers and expenditure responsibilities of different levels of government are not perfectly aligned.

In India, States undertake substantial expenditure, while the Union controls several major revenue sources.

### Horizontal Fiscal Imbalance

Horizontal imbalance refers to differences among States in taxable capacity, development needs, population, geographical conditions and service-delivery costs.

**UPSC Concept:** Vertical devolution distributes resources between the Union and States. Horizontal devolution determines how the States' share is distributed among individual States.

## 4. Current Position of Indian State Finances

The RBI's State Finances report released in January 2026 analyses budgetary trends, debt sustainability and the quality of State expenditure.

| Indicator | Reported Position | Reference Period |
|---|---|---|
| Consolidated gross fiscal deficit | 3.3% of GDP | FY 2024–25 provisional accounts |

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|---|---|---|
| Budgeted fiscal deficit | 3.3% of GDP | FY 2025–26 budget estimates |
| Budgeted revenue deficit | 0.2% of GDP | FY 2025–26 budget estimates |
| Capital expenditure | 3.2% of GDP | FY 2025–26 budget estimates |
| Outstanding liabilities | 29.2% of GDP | End-March 2026 budget estimate |

### Interpretation

The fiscal-deficit estimates suggest continuing demands on State borrowing.

At the same time, budgeted capital expenditure indicates efforts to preserve development-oriented investment.

Debt stocks and future repayment obligations remain important considerations for medium-term fiscal sustainability.

**Important Statistical Distinction:** The aggregate figures use GDP as the denominator. Individual State deficit and debt ratios are normally assessed against Gross State Domestic Product (GSDP).

## 5. Why Are Indian States Facing Fiscal Stress?

### 5.1 High Committed Expenditure

Salaries, pensions, interest payments and other contractual obligations can absorb a substantial portion of revenue receipts.

This limits the resources available for new programmes and capital expenditure.

### 5.2 Debt-Servicing Burden

Interest payments reduce funds available for current public services and productive investment.

### 5.3 Uneven Revenue Capacity

States differ significantly in economic development, formal sector activity, tax bases and administrative capacity.

### 5.4 Dependence on Transfers

Greater dependence on Union tax devolution and grants can expose State budgets to changes in transfer composition and timing.

### 5.5 Subsidy and Welfare Commitments

Subsidies can provide important social and economic benefits.

However, poorly targeted or fiscally unsustainable commitments may displace other essential expenditure.

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### 5.6 Climate and Disaster Risks

Floods, droughts, extreme weather and other disasters may create unplanned expenditure needs.

### 5.7 Public Sector and Power Sector Risks

Financial weakness in State public enterprises and electricity distribution companies may create additional fiscal obligations.

### 5.8 Off-Budget Liabilities

Borrowings or guarantees linked to public entities may generate risks that are not immediately visible in headline deficits.

## 6. Tax Devolution and State Fiscal Autonomy

Tax devolution refers to the distribution of a share of Union tax proceeds to State Governments under the constitutional fiscal-sharing framework.

### Vertical Devolution

The 16th Finance Commission recommended retaining the States' share at 41% of the divisible pool for FY 2026–27 to 2030–31.

The Union Government accepted this recommendation in the Union Budget 2026–27.

### Illustrative Calculation

Suppose the divisible pool of Union taxes amounts to ₹100 lakh crore.

**States' Aggregate Share = 41% × ₹100 lakh crore** Illustrative States' share: ₹41 lakh crore

This is an illustrative calculation and does not represent actual budgeted tax devolution.

### Why the Denominator Matters

The divisible pool differs from gross Union tax revenue. Specified cesses, surcharges and other constitutionally permitted exclusions affect the pool available for sharing.

**UPSC Value Addition:** A 41% share of the divisible pool is not equivalent to 41% of every rupee of total Union tax collections.

## 7. Cesses and Surcharges: The Divisible Pool Debate

### Understanding a Cess

A cess is a tax levied for a specified purpose, subject to the legal framework under which it is imposed.

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### Understanding a Surcharge

A surcharge is an additional charge on an existing tax.

Under Article 271, specified Union surcharges are not shared with States through the ordinary divisible-pool mechanism.

### Why States Raise Concerns

When a larger portion of Union taxation is collected through non-shareable instruments, the shareable tax base may be smaller than it would otherwise be.

This can reduce the revenue available through ordinary tax devolution.

### Union Government Perspective

Cesses and surcharges can provide revenue for specified national or fiscal purposes within constitutional limits.

### State Government Perspective

States seek predictable, untied resources because their development responsibilities require flexibility in expenditure decisions.

### Balanced Reform Approach

1. Improve transparency about non-shareable tax collections.
2. Publish clear divisible-pool calculations.
3. Review the continued need for individual cesses.
4. Strengthen predictability of State transfers.
5. Preserve constitutional and fiscal accountability.

**Balanced UPSC Argument:** The issue is not simply whether cesses are legitimate, but whether their structure supports transparent and balanced fiscal federalism.

## 8. The 16th Finance Commission: 2026–2031

The 16th Finance Commission, chaired by Dr. Arvind Panagariya, submitted its report on 17 November 2025.

The report covers the five-year award period from FY 2026–27 to FY 2030–31.

### Major Recommendations

### 41% Tax Devolution

Retain the States' aggregate share in the divisible pool of Union taxes.

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### Transparency

Improve disclosure of tax proceeds and devolution information.

### Horizontal Distribution

Allocate the States' share using criteria such as income distance, population, demographic performance and other factors.

### Public Expenditure Efficiency

Strengthen evaluation and rationalisation of inefficient spending programmes.

### Horizontal Devolution Criteria

The Commission used six parameters: population, demographic performance, area, forest, per-capita-income distance and contribution to GDP.

### Finance Commission Grants

The Union Budget 2026–27 provided ₹1.4 lakh crore for Finance Commission grants to States.

These include grants relating to local bodies and disaster management.

**Important UPSC Distinction:** The 41% tax devolution and Finance Commission grants are different transfer mechanisms. They should not be treated as the same budget component.

## 9. State Borrowing, FRBM and Debt Sustainability

### Article 293

Article 293 governs borrowing by States.

Under Article 293(3), a State requires Union consent to raise a loan where the specified constitutional conditions relating to outstanding Union loans or guarantees apply.

### FRBM Framework

Fiscal Responsibility and Budget Management arrangements seek to impose discipline on deficits and debt.

Individual State borrowing space depends on applicable fiscal rules, Union permissions and notified conditions.

### Key Fiscal Deficit Formula

**Fiscal Deficit = Total Expenditure − (Revenue Receipts + Non-Debt Capital Receipts)**

### Revenue Deficit

**Revenue Deficit = Revenue Expenditure − Revenue Receipts**

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### Primary Deficit

**Primary Deficit = Fiscal Deficit − Interest Payments**

### Debt Sustainability

Debt sustainability depends on economic growth, interest costs, primary balances and the level of outstanding debt.

States should preserve the capacity to finance productive investment while maintaining credible repayment obligations.

## 10. GST and State Fiscal Autonomy

The implementation of GST reorganised indirect taxation and introduced a common decision-making framework.

### Positive Outcomes

1. Greater integration of the domestic market.
2. Digitisation of tax administration.
3. Reduction of selected tax-cascading effects.
4. Institutional cooperation through the GST Council.

### Fiscal Concerns

1. Reduced unilateral flexibility over certain indirect tax rates.
2. Unequal State revenue capacities.
3. Administrative and compliance challenges.
4. Uncertainty arising from economic cycles and tax-policy changes.

### GST Council and Cooperative Federalism

The GST Council under Article 279A provides a platform for collective fiscal decision-making.

Effective cooperation requires consultation, transparency and recognition of States' differing economic circumstances.

## 11. Revenue Expenditure versus Capital Expenditure

Restoring fiscal space is not only about raising additional revenue. It is also about improving expenditure quality.

| Expenditure Type | Illustration | Fiscal Significance |
|---|---|---|

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|---|---|---|
| Revenue expenditure | Salaries, interest and recurring services | Supports ongoing operations but may constrain flexibility when commitments rise. |
| Capital expenditure | Roads, public assets and infrastructure | Can strengthen long-term productive capacity. |
| Developmental social expenditure | Education, healthcare and nutrition | Can improve human capital even when classified as revenue spending. |
| Debt servicing | Interest and principal repayments | Creates ongoing financing obligations. |

**Important Economic Qualification:** Revenue expenditure should not automatically be considered unproductive. Education, healthcare and maintenance can generate substantial long-term benefits.

### Quality of Expenditure

Expenditure quality should be evaluated through service delivery, social outcomes, asset maintenance, productivity and public welfare.

## 12. Consequences of Constrained State Fiscal Space

### Impact on Education

Limited fiscal flexibility can delay school infrastructure, teacher training and learning-improvement programmes.

### Impact on Healthcare

Financial stress may constrain investment in public hospitals, primary healthcare and disease prevention.

### Impact on Infrastructure

Reduced capacity for capital investment can slow connectivity, urban infrastructure and local development.

### Impact on Local Governments

Fiscal pressures at the State level can affect transfers to municipalities and Panchayats.

### Impact on Economic Growth

Lower public investment and service capacity may weaken productivity, private investment and employment opportunities.

**Development Insight:** State fiscal health has consequences far beyond government accounts. It influences the everyday quality of public services.

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## 13. Roadmap to Restore State Fiscal Space

### 1. Strengthen Own Tax Revenues

Improve GST administration, property-related taxes, excise collection and other constitutionally available State revenues.

### 2. Improve Non-Tax Revenue

Review user charges, royalties and returns from public assets, while protecting essential services.

### 3. Rationalise Poorly Targeted Subsidies

Evaluate subsidies through distributional benefits, efficiency and fiscal sustainability.

### 4. Protect Productive Expenditure

Prioritise high-quality infrastructure, education, healthcare and maintenance.

### 5. Strengthen Debt Transparency

Disclose guarantees, off-budget liabilities, repayment schedules and major fiscal risks.

### 6. Make Transfers Predictable

Improve transparency and timeliness in tax devolution and applicable grants.

### 7. Review Cesses and Surcharges

Enhance accountability and transparency concerning collections outside the divisible pool.

### 8. Empower Local Governments

Strengthen State Finance Commissions and predictable transfers to municipalities and Panchayats.

### 9. Improve Public Expenditure Management

Adopt outcome budgeting, expenditure reviews and better project evaluation.

### 10. Build Fiscal Resilience

Strengthen disaster preparedness, contingency planning and medium-term fiscal frameworks.

Stronger Own Revenues

Predictable Transfers

Better Spending Efficiency

Sustainable Debt

Greater Development Capacity

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**Reform Principle:** Fiscal space should be restored through better revenue capacity, efficient expenditure and credible fiscal federalism—not through unsustainable borrowing alone.

## 14. UPSC General Studies Syllabus Linkage

| Paper | Relevant Theme |
|---|---|
| GS II | Federalism and Union-State financial relations. |
| GS II | Constitutional bodies and the Finance Commission. |
| GS II | Governance, welfare and public service delivery. |
| GS III | Indian Economy and government budgeting. |
| GS III | Public debt and macroeconomic stability. |
| GS III | Infrastructure, inclusive growth and fiscal policy. |
| GS IV | Accountability and ethical use of public resources. |

## 15. UPSC Mains 2027 Practice Questions

**Question 1 | 150 Words | 10 Marks**Define fiscal space and explain its importance for State Governments in India.

**Question 2 | 250 Words | 15 Marks**"India's States face rising expenditure responsibilities without commensurate fiscal flexibility." Critically examine.

**Question 3 | 250 Words | 15 Marks**Discuss how the 16th Finance Commission addresses vertical and horizontal fiscal imbalances.

**Question 4 | 150 Words | 10 Marks**Explain the implications of cesses and surcharges for India's divisible tax pool and fiscal federalism.

**Question 5 | 250 Words | 15 Marks**How can Indian States restore fiscal space while safeguarding capital expenditure and debt sustainability?

**Question 6 | 250 Words | 15 Marks**Evaluate the role of cooperative federalism in strengthening State public finances and inclusive development.

## 16. UPSC Mains Model Answer

### Question

"Restoring fiscal space for States is essential to strengthen cooperative federalism and achieve inclusive development." Discuss. (250 Words)

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### Introduction

Fiscal space refers to the ability to finance additional public expenditure without compromising fiscal sustainability. Indian States undertake substantial responsibilities in healthcare, education, infrastructure and welfare.

### Major Challenges

1. High committed expenditure on salaries, pensions and interest payments.
2. Unequal revenue-raising capacity across States.
3. Debt-servicing obligations and contingent liabilities.
4. Dependence on Union transfers and grants.
5. Reduced divisible-pool resources due to constitutionally excluded cesses and surcharges.

### Importance of Fiscal Space

1. Supports productive public investment.
2. Improves delivery of essential services.
3. Allows States to respond to emergencies.
4. Strengthens economic competitiveness.
5. Supports decentralisation and cooperative federalism.

### Way Forward

States should improve own-source revenue collection, evaluate expenditure outcomes, manage debt prudently and strengthen fiscal transparency.

The Union should support predictable transfers, transparent divisible-pool accounting and effective Centre-State consultation.

### Conclusion

Sustainable fiscal federalism requires a balance between State financial autonomy, national macroeconomic stability and accountability in public expenditure.

## 17. Quick Revision Notes for UPSC

| Concept | Essential Point |
|---|---|
| Fiscal Space | Capacity for additional fiscal action without jeopardising sustainability. |
| Vertical Fiscal Imbalance | Mismatch between revenue powers and spending responsibilities across government tiers. |
| Horizontal Fiscal Imbalance | Differences in fiscal capacity and needs among States. |

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| | |
|---|---|
| Article 270 | Distribution of specified Union taxes. |
| Article 271 | Union surcharges. |
| Article 280 | Finance Commission. |
| Article 293 | State borrowing arrangements. |
| 16th Finance Commission | Chaired by Dr. Arvind Panagariya. |
| Finance Commission Award Period | FY 2026–27 to FY 2030–31. |
| Vertical Devolution | 41% of the divisible pool. |
| Fiscal Deficit | Borrowing requirement after accounting for receipts other than borrowings. |
| Revenue Deficit | Excess of revenue expenditure over revenue receipts. |
| Primary Deficit | Fiscal deficit less interest payments. |
| FRBM | Fiscal Responsibility and Budget Management. |
| GSDP | Gross State Domestic Product. |

**Final UPSC Takeaway.** State fiscal autonomy, revenue adequacy, debt sustainability and accountable public spending must work together to strengthen India's cooperative federal system.

## 18. Frequently Asked Questions

What is fiscal space for Indian States?It is the ability of State Governments to undertake fiscal measures without jeopardising debt sustainability or stability.

What is the States' tax devolution share under the 16th Finance Commission?41% of the divisible pool of Union taxes for FY 2026–27 to FY 2030–31.

Why are cesses and surcharges important?They affect the size of the ordinary divisible tax pool because specified Union cesses and surcharges are excluded.

What is vertical fiscal imbalance?It is a mismatch between revenue-raising powers and expenditure responsibilities at different government levels.

How can States strengthen fiscal health?Through improved own-source revenues, efficient spending, prudent borrowing, stronger accountability and predictable transfers.

Why is State fiscal space important for UPSC Mains 2027?It links fiscal federalism, constitutional provisions, public budgeting, State debt, governance and inclusive development.

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## 19. Conclusion: Empowering States for Viksit Bharat 2047

India's development trajectory depends substantially on the capacity of States to finance essential services and productive investments.

Restoring fiscal space requires more than increasing borrowing limits or adjusting transfer percentages.

It requires a comprehensive approach involving stronger revenue mobilisation, transparent intergovernmental finance, prudent debt management and better public expenditure outcomes.

The 16th Finance Commission offers an important framework for continued fiscal cooperation during 2026–31.

The larger objective should be a system in which States possess adequate resources, responsible borrowing capacity and meaningful development flexibility.

**Memorable UPSC Conclusion:** A fiscally strong Union and financially empowered States are complementary, not competing, pillars of a resilient and developed India.

## SEO Topic Tags

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Author: CA Dhananjay Ojha

Website: www.civilservicegurukul.com

Email: info@civilservicegurukul.com

Mobile: +91 9911020626

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