GENERAL STUDIES III

State Finances in India 2026: RBI Report & UPSC Notes

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India's state finances face growing pressure from public debt, salaries, pensions, subsidies, and infrastructure requirements. Explore RBI's State Finances: A Study of Budgets of 2025–26, the Sixteenth Finance Commission, GST revenue, fiscal deficit, capital expenditure, and key reforms for UPSC Prelims and Mains

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State Finances in India 2026: Fiscal Deficit, Rising Debt, RBI Report and Challenges to Fiscal Federalism

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State finances are fundamental to India's economic development and cooperative federalism. State governments play a central role in providing healthcare, education, agricultural support, infrastructure and social welfare services.

The Reserve Bank of India's January 2026 report, State Finances: A Study of Budgets of 2025-26, highlighted challenges relating to fiscal deficits, public debt, expenditure commitments and demographic changes.

According to the report, states budgeted a consolidated gross fiscal deficit of 3.3% of GDP in 2025-26. Their outstanding liabilities were budgeted at approximately 29.2% of GDP by end-March 2026.

The Sixteenth Finance Commission's recommendations for 2026-31 further highlight the importance of a sustainable balance between fiscal discipline, development expenditure and autonomy for state governments.

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State Finances: Quick Facts for UPSC

- **Report:** RBI State Finances: A Study of Budgets of 2025-26.
- **Publication:** January 2026.
- **Special theme:** Demographic Transition in India: Implications for State Finances.
- **2025-26 budgeted fiscal deficit:** 3.3% of GDP, consolidated states.
- **2024-25 provisional fiscal deficit:** 3.3% of GDP.
- **Budgeted outstanding liabilities:** 29.2% of GDP at end-March 2026.
- **16th Finance Commission period:** 2026-31.
- **Recommended tax devolution:** 41% of divisible central taxes.
- **Constitutional Article:** Article 280 establishes the Finance Commission.
- **UPSC relevance:** Fiscal federalism, public debt, FRBM, GST and welfare expenditure.

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1. Why in the News?

State finances have gained renewed importance following the RBI's January 2026 report and the recommendations of the Sixteenth Finance Commission.

The RBI report examined state budgets for 2025-26 and assessed the implications of changing demographic patterns for fiscal policy.

It highlighted the need to maintain fiscal prudence while protecting growth-enhancing capital expenditure.

Other important issues include high debt burdens, committed expenditure, contingent liabilities and differences in fiscal capacity among states.

Important Current Affairs Developments

- States budgeted a consolidated fiscal deficit of 3.3% of GDP in 2025-26.
- Outstanding liabilities remained elevated in the post-pandemic period.
- Capital expenditure continued to receive policy attention.
- Demographic differences created new fiscal opportunities and obligations.
- The Sixteenth Finance Commission recommended retaining 41% vertical tax devolution.

> **UPSC Current Affairs Note:** Some fiscal indicators reported as budget estimates should not be confused with final audited actuals.

2. What Are State Finances?

State finances refer to the management of revenue, expenditure, public borrowing, debt and financial obligations of state governments.

A state budget reflects the government's priorities for taxation, welfare, infrastructure development and public services.

2.1 Main Components

- Revenue receipts.
- Capital receipts.
- Revenue expenditure.
- Capital expenditure.
- Fiscal deficit and borrowing.
- Outstanding debt and guarantees.

2.2 Why Are State Finances Important?

State governments implement many public programmes directly affecting the daily lives of citizens.

Sound state finances support sustained investments in roads, schools, public health, irrigation and local infrastructure.

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3. Constitutional Framework of State Finances

3.1 Article 246

Article 246 governs the distribution of legislative powers between the Union and states through the Seventh Schedule.

3.2 Article 266

Article 266 provides for the Consolidated Funds and Public Accounts of the Union and the states.

3.3 Article 267

Article 267 provides for Contingency Funds.

3.4 Article 275

Article 275 provides for certain grants-in-aid from the Union to the states.

3.5 Article 280

Article 280 provides for the constitution of the Finance Commission.

The Commission recommends principles governing the distribution of specified financial resources between the Union and states.

3.6 Article 293

Article 293 concerns borrowing by state governments.

Under specified circumstances, states require the Union government's consent for further borrowing when outstanding central loans or guarantees exist.

3.7 Article 279A

Article 279A provides for the GST Council.

> **Constitutional Quick Revision:** Article 280: Finance Commission. Article 293: State borrowing. Article 279A: GST Council.

4. RBI State Finances Report: 2025-26

The RBI's annual publication, State Finances: A Study of Budgets, examines state budget trends and fiscal risks.

The January 2026 edition focused on demographic transition and its implications for state finances.

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4.1 Major Fiscal Findings

Indicator	Reported Position
2024-25 consolidated gross fiscal deficit	3.3% of GDP, provisional accounts.
2025-26 consolidated gross fiscal deficit	3.3% of GDP, budget estimates.
2025-26 revenue deficit	0.2% of GDP, budget estimates.
2025-26 primary deficit	1.5% of GDP, budget estimate
2025-26 capital expenditure	Budgeted at approxi ely 3.2% of GDP.
End-March 2026 outstanding liabilities	Estimated at 29.2 % o GDP.

4.2 Fiscal Deficit

State fiscal deficits widened in 2024-25 amid expenditure dem nds an comparatively slower revenue growth.

For 2025-26, states budgeted the consolidated deficit a 3.3% o GDP.

4.3 Capital Expenditure

Investment in infrastructure helps cr ate lo -term productive assets.

The RBI highlighted the import nce of maintaining expenditure quality despite fiscal constraints.

4.4 Debt Sustainability

Elevated ou standi g liabilities remain an important fiscal risk.

The sus ainability of debt depends on economic growth, interest costs, primary fiscal balances and the structure of liabilities.

5. Important Fiscal Indicators and Formulas

5.1 Revenue Deficit

Revenue deficit arises when revenue expenditure exceeds revenue receipts.

Revenue Deficit = Revenue Expenditure - Revenue Receipts

5.2 Fiscal Deficit

Fiscal deficit measures the gap between total government expenditure and non-debt receipts.

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

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5.3 Primary Deficit

Primary deficit excludes interest payments from the fiscal deficit.

Primary Deficit = Fiscal Deficit - Interest Payments

5.4 Gross State Domestic Product

GSDP measures the value of goods and services produced within a state during a period.

5.5 Debt-to-GSDP Ratio

Debt-to-GSDP Ratio = Outstanding Debt / GSDP x 100

5.6 Revenue Surplus

A revenue surplus occurs when revenue receipts exceed revenue expenditure.

> **Prelims Concept:** Fiscal deficit reflects the government's net borrowing requirement under the standard budget definition. Revenue deficit measures imbalance in the revenue account.

6. Major Sources of State Government Revenue

6.1 State GST

State Goods and Services Tax is an important source of own-tax revenue for state governments.

6.2 State Excise Duty

States collect excise duty on alcoholic liquor for human consumption, subject to applicable law.

6.3 Stamp Duty and Registration Fees

Property transactions generate revenue through stamp duty and registration charges.

6.4 Value Added Tax

States continue to levy VAT or sales tax on specified goods outside GST, including certain petroleum products.

6.5 Motor Vehicle Taxes

Taxes on motor vehicles contribute to state own-tax revenue.

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6.6 Share in Central Taxes

States receive a share of the divisible pool of central taxes in accordance with the applicable fiscal framework.

6.7 Grants from the Union

Grants support specified expenditure requirements and development programmes.

6.8 Non-Tax Revenue

Non-tax revenue includes various fees, user charges, royalties, dividends and other receipts.

> **UPSC Important:** States receive both their own revenue and transfers from the Union. Dependence on central transfers varies significantly among states.

7. Composition of State Expenditure

7.1 Revenue Expenditure

Revenue expenditure includes recurring operational spending, salaries, pensions, interest payments and many subsidies.

7.2 Capital Expenditure

Capital expenditure includes spending that creates assets or reduces liabilities, subject to budget classification.

7.3 Committed Expenditure

Salaries, pensions and interest payments form major committed expenditure obligations.

PRS analysis reported that these items consumed 53% of states' revenue receipts in 2023-24.

7.4 Subsidies and Welfare Programmes

States provide subsidies and transfers to support various social and economic objectives.

The fiscal implications depend on the design, targeting, financing and long-term effectiveness of each programme.

7.5 Public Infrastructure

Spending on roads, irrigation, schools and hospitals can create development benefits, particularly when projects are well designed and implemented.

8. Rising State Debt and Fiscal Sustainability

State debt represents outstanding financial obligations from past borrowing.

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8.1 Why Do States Borrow?

- To finance fiscal deficits.
- To undertake infrastructure investment.
- To manage temporary cash-flow mismatches.
- To meet certain development requirements.

8.2 State Development Loans

State Development Loans, or SDLs, are market borrowing instruments issued by state governments.

8.3 Interest Burden

Higher debt can increase future interest costs and limit resources available for development.

8.4 Contingent Liabilities

Government guarantees may create liabilities if borrowers fail to meet obligations.

8.5 Off-Budget Borrowing

Borrowing through public entities or special arrangements can reduce transparency if liabilities are not fully disclosed.

8.6 Debt Sustainability

Debt is not automatically unsustainable merely because its amount is high.

Debt sustainability requires evaluation of growth, interest rates, fiscal balances, repayment obligations and contingent risks.

9. Sixteenth Finance Commission and State Finances

The Sixteenth Finance Commission provides recommendations for the period 2026-31.

9.1 Vertical Tax Devolution

The Commission recommended retaining the states' share of the divisible pool of central taxes at 41%.

9.2 Horizontal Devolution

Horizontal devolution concerns the distribution of states' tax share among individual states.

9.3 Distribution Criteria

The Sixteenth Finance Commission used criteria including:

- Population.
- Demographic performance.
- Area.

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- Forest-related considerations.
- Per-capita income distance.
- Contribution to national GDP.

9.4 Fiscal Deficit Recommendations

The Commission recommended a fiscal deficit limit of 3% of GSDP for states during the 2026-31 period, with specified treatment of eligible special assistance loans.

9.5 Importance for Fiscal Federalism

The recommendations seek to balance the financial capacity of the Union and states with [illegible]lopment needs, efficiency and fiscal sustainability.

> **UPSC Key Fact:** The Sixteenth Finance Commission recommended retaining 41% of the divisible tax pool for states. This is different from saying that states receive 41% of all central government revenue.

10. GST and Fiscal Federalism

10.1 GST Reform

The Goods and Services Tax was introduced in July 2017, transforming the indirect tax system.

10.2 GST Council

The GST Council is a constitutional body under Article 279A.

10.3 Revenue Autonomy

States participate in GST decisions, but their ability to independently vary taxes on GST-covered supplies is constrained by the shared framework.

10.4 GST Compensation

The original compensation framework protected states against specified revenue shortfalls during the initial five-year transition period.

10.5 Fiscal Implications

Differences in economic structure, consumption and tax administration influence GST collections among states.

Maintaining sustainable own-source revenue is essential for state fiscal autonomy.

11. Demographic Transition and State Finances

The RBI's 2026 report focuses on demographic transition and its fiscal consequences.

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11.1 Demographic Dividend

States with expanding working-age populations may benefit from higher labour supply, productivity and revenue potential.

11.2 Ageing Populations

States with ageing populations may face rising demand for healthcare, pensions and social support.

11.3 Human Capital Investment

States with younger populations need adequate investment in education, skills and employment.

11.4 Regional Differences

Indian states are at different stages of demographic transition.

Uniform fiscal and expenditure approaches may therefore fail to reflect differences in development requirements.

> **UPSC Analytical Insight:** Demographic transition influences both sides of a state budget: revenue potential and expenditure needs.

12. Major Challenges Facing State Finances

12.1 High Committed Expenditure

Salaries, pensions and interest payments consume significant portions of state revenue.

12.2 Rising Debt Obligations

High liabilities may restrict future spending flexibility.

12.3 Revenue Mobilisation

States face challenges in improving tax compliance, property-related receipts and non-tax revenue.

12.4 Power Sector Liabilities

Financial weaknesses of electricity distribution companies can create fiscal risks for state governments.

12.5 Subsidy Commitments

Poorly targeted or inadequately funded subsidies can crowd out other expenditure priorities.

12.6 Regional Fiscal Inequality

States differ widely in economic capacity, per-capita income and revenue generation.

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12.7 Off-Budget Liabilities

Incomplete reporting of guarantees and public-sector liabilities can weaken fiscal transparency.

12.8 Climate-Related Spending

Floods, droughts, extreme weather and climate adaptation create additional budget pressures.

12.9 Local Government Financing

Municipalities and Panchayati Raj institutions often require greater financial resources and administrative capacity.

13. Reforms and Way Forward

1. **Strengthen FRBM Compliance:** Adopt credible medium-term fiscal consolidation strategies.
2. **Improve Own-Tax Revenue:** Strengthen tax administration, compliance and revenue forecasting.
3. **Protect Capital Expenditure:** Prioritise productive infrastructure investment.
4. **Rationalise Subsidies:** Evaluate targeting, outcomes and long-term affordability.
5. **Improve Debt Transparency:** Disclose outstanding liabilities, guarantees and off-budget borrowing.
6. **Power Sector Reform:** Reduce distribution losses and improve utility financial performance.
7. **Performance-Based Budgeting:** Link expenditure with measurable development outcomes.
8. **Strengthen Local Bodies:** Improve predictable transfers and local revenue capacity.
9. **Plan for Demographic Change:** Adapt education, employment, healthcare and pension policy to regional needs.
10. **Promote Cooperative Federalism:** Improve policy coordination between the Union and state governments.

14. UPSC Examination Relevance

UPSC Paper	Relevant Topics
GS Paper II	Federalism, constitutional finance, Finance Commission, Centre-State relations and governance.
GS Paper III	Government budgeting, fiscal policy, debt, infrastructure, economic growth and resource mobilisation.
UPSC Prelims	Fiscal deficit, revenue deficit, primary deficit, Finance Commission, GST Council and Articles 280 and 293.
Essay	Cooperative federalism, welfare economics, fiscal sustainability and inclusive development.
Economics Optional	Fiscal policy, public debt, intergovernmental transfers and public expenditure.

Ten Important Facts for Quick Revision

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1. RBI publishes State Finances: A Study of Budgets.
2. The January 2026 edition examines 2025-26 state budgets.
3. The theme is demographic transition and state finances.
4. States budgeted a 3.3% consolidated fiscal deficit for 2025-26.
5. Outstanding liabilities were budgeted at 29.2% of GDP by March 2026.
6. Article 280 deals with the Finance Commission.
7. Article 293 concerns state borrowing.
8. Article 279A establishes the GST Council.
9. The 16th Finance Commission recommended 41% vertical tax devolution.
10. Fiscal deficit equals total expenditure minus non-debt receipts.

15. UPSC Prelims Practice MCQs

Question 1

Which institution publishes the report State Finances: A Study of Budgets?

(a) NITI Aayog
(b) Reserve Bank of India
(c) Election Commission of India
(d) Securities and Exchange Board of India

Answer: (b) Reserve Bank of India

RBI publishes the annual study of state budgets and fiscal trends.

Question 2

Article 280 of the Indian Constitution deals with:

(a) GST Council
(b) Finance Commission
(c) Election Commission
(d) State emergency

Answer: (b) Finance Commission

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Article 280 provides for the constitution of the Finance Commission.

Question 3

Fiscal deficit is:

(a) Revenue receipts minus revenue expenditure
(b) Total expenditure minus non-debt receipts
(c) Fiscal deficit minus interest payments
(d) Total debt minus government assets

Answer: (b)

Fiscal deficit is the excess of total expenditure over non-debt receipts.

Question 4

The Sixteenth Finance Commission recommended what share of the divisible pool of central taxes for states?

(a) 32%
(b) 35%
(c) 41%
(d) 50%

Answer: (c) 41%

The Commission recommended retaining the states' share at 41%.

Question 5

Which of the following forms part of committed expenditure?

1. Salaries
2. Pensions
3. Interest payments

Select the correct answer:

(a) 1 only
(b) 1 and 2 only

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(c) 2 and 3 only
(d) 1, 2 and 3

Answer: (d)

Salaries, pensions and interest payments are major committed expenditure items.

Question 6

Primary deficit is calculated as:

(a) Revenue deficit plus capital receipts
(b) Fiscal deficit minus interest payments
(c) Outstanding debt minus GSDP
(d) Capital expenditure minus taxes

Answer: (b)

Primary deficit excludes interest payments from the fiscal deficit.

Question 7

Consider the following statements:

1. Article 293 deals with state borrowing.
2. Article 279A provides for the GST Council.
3. State Development Loans are issued by the World Bank.

Which statements are correct?

(a) 1 only
(b) 1 and 2 only
(c) 2 and 3 only
(d) 1, 2 and 3

Answer: (b) 1 and 2 only

State Development Loans are borrowing instruments issued by Indian state governments, not by the World Bank.

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16. UPSC Mains Practice Questions

Question 1 — GS Paper III

"The sustainability of state finances is essential for long-term economic growth and effective cooperative federalism in India."

Discuss the major challenges facing Indian state finances in light of the RBI's State Finances report. Suggest reforms to improve fiscal discipline without compromising developmental expenditure.

15 Marks | 250 Words

Suggested Answer Framework

Introduction:

Explain the role of states in India's public finance system and mention the RBI's 2025-26 fiscal estimates.

Body — Challenges:

- Fiscal deficits and high debt.
- Committed expenditure.
- Subsidy and welfare obligations.
- Power-sector liabilities.
- Own-revenue mobilisation.
- Off-budget borrowing.
- Demographic and regional differences.

Body — Reforms:

- Credible FRBM frameworks.
- Improved revenue administration.
- Expenditure rationalisation.
- Debt transparency.
- Capital investment.
- Cooperative fiscal federalism.

Conclusion:

States require financially sustainable budgets that protect investment in human capital and infrastructure while managing debt-related risks.

Question 2 — GS Paper II

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Examine the role of the Finance Commission in strengthening fiscal federalism. Discuss the significance of the Sixteenth Finance Commission's recommendations for Centre-State financial relations.

10 Marks | 150 Words

Question 3 — GS Paper III

How does demographic transition affect state government revenues and expenditure requirements? Explain with reference to the differing demographic structures of Indian states.

10 Marks | 150 Words

17. Conclusion

State finances are critical to India's long-term economic and social development.

The RBI's 2026 report highlights that states must manage fiscal deficits, debt and committed expenditure while continuing to invest in essential public services and productive infrastructure.

The Sixteenth Finance Commission's recommendations reinforce the importance of predictable resource sharing and fiscal responsibility.

Demographic changes, climate risk and unequal revenue capacities will increasingly influence the financial requirements of different states.

Sustainable reform therefore requires better revenue mobilisation, responsible borrowing, transparent reporting, efficient welfare expenditure and greater investment in human capital.

Final UPSC Takeaway: Strong state finances are essential for effective federalism. The objective is not merely reducing deficits, but ensuring that public resources support sustainable growth, social welfare and long-term fiscal stability.

Official References and Further Reading

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2. **Sixteenth Finance Commission:** Report for 2026-31. Read Finance Commission Report
3. **PRS Legislative Research:** State of State Finances 2025-26. Read State Finances Analysis
4. **Ministry of Finance:** Union Budget 2026-27 and fiscal transfers to states. India Budget Website
5. **Comptroller and Auditor General:** State Finance Accounts and audit reports. CAG Official Website

State Finances India | RBI State Finances 2026 | Fiscal Deficit | State Government Debt | Fiscal Federalism | Sixteenth Finance Commission | GST Revenue | Tax Devolution | Revenue Deficit | Capital Expenditure | FRBM | Indian Economy | UPSC Current Affairs 2026 | UPSC Prelims | GS Paper II | GS Paper III

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