



Fiscal situation of Indian States: Patterns and causes since Economic Liberalisation

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Abstract

This study analyses the fiscal performance of Indian states from 1980 to 2022, examining patterns and underlying causes within the context of India's federal structure. Using comprehensive state-level data, the research explores the emergence of fiscal imbalances, the evolution of central resource devolution, rising debt burdens, and key legislative and policy responses. The findings indicate that while economic liberalization initially constrained fiscal space through reduced central support, a severe fiscal crisis emerged in the late 1990s. Subsequent reforms, including Fiscal Responsibility Legislation, temporarily contained the crisis. However, renewed fiscal pressures from stimulus spending during the global financial crisis, ongoing power sector reforms, and the COVID-19 pandemic have exacerbated these challenges, underscoring the persistent vulnerability of state finances.

Keywords: Fiscal imbalances, economic liberalisation, central resource devolution, fiscal responsibility legislation, state finances

Introduction

The process of economic liberalisation in India, which gained significant momentum after the 1991 balance of payments crisis, was preceded by mounting fiscal pressures on the central government from the 1980s onward. The transition from a centrally planned to a market-oriented economy fundamentally altered revenue generation, expenditure priorities, and fiscal responsibilities across all levels of government. Within India's federal structure, states play a crucial role in delivering essential services such as education, healthcare, agriculture, and rural development. Consequently, their fiscal health is a critical determinant of economic development outcomes.

This study examines the fiscal situation of Indian states from 1980 to 2022, analysing the composition of expenditures, revenue mobilization patterns, debt dynamics, and the architecture of intergovernmental fiscal transfers. By systematically examining these variables, this research aims to identify key trends, understand underlying structural and policy causes, and provide insights for sustainable fiscal management at the sub-national level.

The study has four primary objectives. First, it seeks to analyse the evolution of key fiscal indicators for Indian states since economic liberalization, identifying distinct phases and turning points from 1980 to 2024. Second, it examines patterns of expenditure allocation and revenue mobilization across different states. Third, the study explores the changing central-state fiscal arrangements, including tax devolution, grants, and the implementation of the Goods and Services Tax (GST). Finally, the research suggests evidence-based policy recommendations for enhancing fiscal sustainability, improving inter-governmental coordination, and promoting equitable development across Indian states. This research contributes to the literature on Indian fiscal federalism by providing a comprehensive empirical analysis of state fiscal performance over an extended period (1980-2024), thereby addressing a gap in studies that often focus on shorter timeframes or specific aspects.

Literature Review

The Indian states fiscal crisis from the mid-1980s to the early 2000s represents a significant episode of fiscal deterioration in India's post-independence history. Scholarly consensus identifies the mid-1980s as the critical juncture when Indian states began experiencing severe financial distress, which intensified throughout the 1990s (Rao, 2002^[1]; Joseph, 2004^[3]; Kurian, 1999)^[4]. The crisis reached unsustainable levels in the decade following the 1991 liberalisation, ultimately prompting institutional reforms such as Fiscal Responsibility Legislations (FRLs) (Sawhney, 2018)^[5].

Research highlights three key dimensions of this deterioration. The first dimension involves deteriorating deficits, where states collectively shifted from marginal revenue surpluses in the early 1980s to persistent revenue deficits by 1987-88. Following pay commission awards, revenue deficits peaked at 2.5 percent of GDP by 1998-99. Concurrently, fiscal deficits escalated from approximately 3 percent of GDP in 1997-98 to 4.6 percent by 1999-2000. A concerning trend was the growing share of revenue deficits within the total fiscal deficit, rising from 38 percent to 60 percent in the same period (Rao, 2002^[1]; Anand *et al.*, 2001). The second dimension encompasses rising debt levels, as persistent deficits led to steady debt accumulation. After a brief decline in the mid-1990s, the debt-to-GDP ratio reached 23.1 percent by 2000-01, with outstanding liabilities for non-special category states averaging around 37 percent of their Gross State Domestic Product in the early 2000s (Dholakia, 2005^[7]; Pradhan & Prashad, 2018)^[8]. The third dimension involves declining expenditure quality, where fiscal consolidation was often achieved by compressing capital expenditure, which fell dramatically from 3.6 percent of GDP in the early 1980s to 1.8 percent by 2000-01. This decline severely constrained states' capacity to invest in social and physical infrastructure (Anand *et al.*, 2001)^[6].

Federal-level factors played a significant role in creating fiscal stress at the state level. A major shock was the

spillover effect of central pay commission recommendations, particularly the Fifth Pay Commission (1997-98), which mandated substantial increases in state salary bills (Lahiri, 2000 [9]; Bajaj, 1999) [2]. Concurrently, the central government's own fiscal constraints led to reduced transfers to states, exacerbating sub-national fiscal stress (Rao, 2002) [1]. Financial sector liberalization also increased borrowing costs, as states shifted from low-cost administered loans to market-based borrowing and expensive "small savings" loans (Sawhney, 2018 [5]; Lahiri, 2000) [9].

State-level policy failures constituted another critical dimension of fiscal deterioration. These included rapid growth in revenue expenditure outpacing revenue generation, exacerbated by inadequate cost recovery and extensive subsidies. Populist policies, such as free electricity for agriculture and the abolition of local taxes including octroi and land revenue, led to significant revenue losses (Joseph, 2004) [3]. State Electricity Boards (SEBs) became a major source of implicit liability, with losses exceeding ₹26,000 crore (1.2% of GDP) in 2000-01. Furthermore, states engaged in "tax wars," offering competitive concessions that eroded their own tax bases (Das, 2013) [10].

The crisis manifested differently across states, revealing varying patterns of fiscal vulnerability and resilience. Punjab entered a revenue deficit as early as 1984-85, with its situation worsened by civil strife and populist policies that created unsustainable fiscal commitments. Kerala's imbalances, emerging in the late 1980s, were driven by expenditure growth outstripping revenue growth, reflecting the state's expansion of social services without corresponding revenue enhancement. Even fiscally stronger states like Gujarat and Maharashtra experienced significant deterioration post-1997-98, demonstrating that high economic development did not guarantee immunity from fiscal pressures when faced with common structural challenges.

The severity of the crisis triggered central intervention aimed at restoring fiscal discipline across states. The Eleventh Finance Commission introduced the State Fiscal Reform Facility (SFRF), which linked grants to fiscal reforms, creating incentives for states to undertake necessary adjustments. This mechanism incentivized states to enact their own Fiscal Responsibility Legislations, a process that began with Karnataka and Punjab in 2002-03,

following the central Fiscal Responsibility and Budget Management Act (2003). By 2010, all states had enacted FRLs, establishing a comprehensive framework for fiscal discipline at the sub-national level.

Methodology

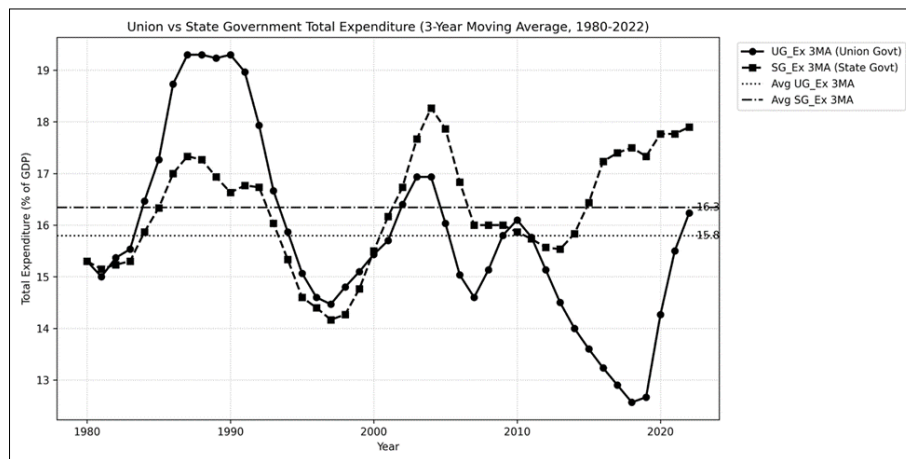
This study employs data from official sources, including the Reserve Bank of India's State Finances database, Finance Commission reports, and the Central Statistical Office (CSO) national accounts. The analysis covers all major Indian states from 1980 to 2022 to capture the effects of economic liberalization on state fiscal performance. Union Territories are excluded from the analysis due to their distinct fiscal arrangements, which differ significantly from state-level fiscal structures. All fiscal data are normalized using GDP with base year 2012 to ensure comparability across different time periods and states. Nominal values are deflated using the GDP deflator to present the analysis in real terms, eliminating the effects of inflation. The primary analytical approach involves comprehensive trend analysis through data visualization to identify patterns, turning points, and relationships across time and states. This methodology enables the identification of distinct phases in state fiscal performance and facilitates examination of how different states have responded to common fiscal challenges over the study period.

Analysis and Results

The analysis begins by examining the evolving roles of different government levels through expenditure patterns, followed by an assessment of state-level expenditure composition to evaluate spending quality. It then studies the dynamics of central devolutions, fiscal pressures, and resulting liability build-up.

1. Centre-State Expenditures

The analysis reveals a fundamental shift in India's fiscal architecture over 1980-2022, moving from union dominance to state-led public spending. As shown in Figure 1, state governments collectively account for a larger share of public expenditure than the union government, with averages of 16.3 percent and 15.8 percent of GDP, respectively. This pattern underscores the critical role of states in India's fiscal federalism and highlights the decentralized nature of public service delivery.



Source: Authors own calculation from Centre and State Finances data

Fig 1: Union and State Government Expenditure as a Percentage of GDP (1980-2022, 3-year moving average)

The trajectory of union government expenditure demonstrates distinct phases of volatility reflecting broader economic and policy shifts. The 1980s witnessed a peak exceeding 19 percent of GDP around 1987-88, reflecting the state-led development model that characterized India's pre-liberalization approach. Post-1991 liberalization triggered sharp fiscal consolidation as the central government sought to reduce its fiscal burden, leading to reduced central spending to approximately 14.2 percent of GDP by the late 1990s. The Fiscal Responsibility and Budget Management (FRBM) Act in 2003 institutionalized this fiscal discipline, pushing expenditure below 13 percent of GDP in the late 2010s. However, this consolidation trend reversed dramatically post-2019 due to extensive fiscal stimulus measures necessitated by the COVID-19 pandemic.

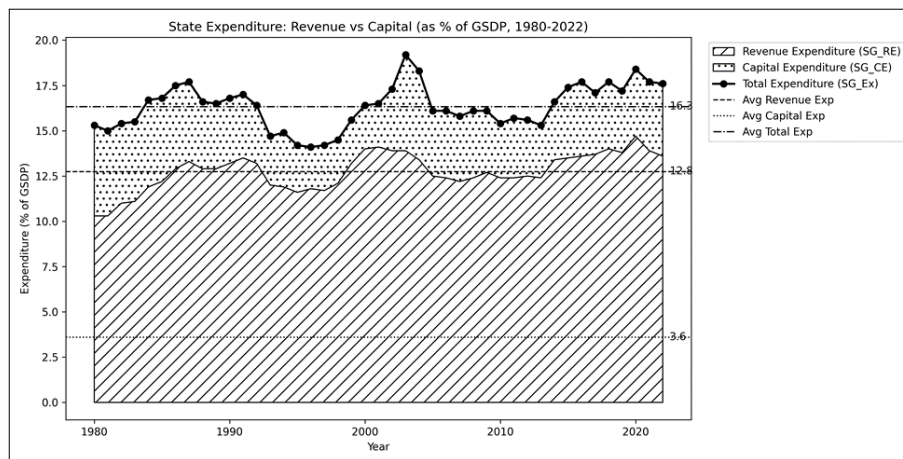
In contrast, state government expenditure demonstrates a more stable, upward long-term trend reflecting their expanding role in public service delivery. After remaining relatively constant between 15-17 percent of GDP during the 1980s and 1990s, state spending experienced notable increase in the early 2000s, exceeding 18 percent of GDP around 2003-04. This surge was driven by implementation of Fifth Pay Commission awards, which mandated substantial salary increases across state governments, and increased interest burdens. Following mid-2000s consolidation aided by state-level Fiscal Responsibility Legislations (FRLs), expenditure has been on a consistent upward trajectory from 2014 onwards. This recent increase has been influenced by the 14th Finance Commission's landmark recommendation to increase states' share of central taxes from 32 percent to 42 percent, providing states with enhanced fiscal resources. This evolutionary pattern marks a clear transition in India's federal fiscal structure, where state governments have emerged as the predominant

public spenders, reflecting their constitutional responsibility for delivering key services such as education, healthcare, and rural development.

2. State-Level Expenditure Composition

The composition of state expenditures reveals a critical structural challenge that has persisted throughout the study period: the overwhelming dominance of revenue expenditure over capital investment. As depicted in Figure 2, of the average 16.3 percent of Gross State Domestic Product (GSDP) spent by states, 12.8 percent is allocated to revenue accounts, while only 3.6 percent is dedicated to capital formation. This pronounced imbalance underscores a fundamental constraint on long-term growth potential and reflects the chronic challenge of balancing current commitments with future-oriented investments.

Revenue expenditure, encompassing salaries, pensions, interest payments, and subsidies, has remained consistently high throughout the study period, reflecting the sticky nature of these committed expenditures. A particularly dramatic surge is evident in the late 1990s and early 2000s, with revenue spending peaking at nearly 14 percent of GSDP around 2002. This spike is directly attributable to implementation of Fifth Pay Commission recommendations, which created substantial committed liabilities for states. Although state-level FRLs provided some moderation to this growth trajectory in the mid-2000s by imposing fiscal discipline, revenue spending has resumed a pronounced upward trajectory since 2015. This recent increase has been driven by multiple factors including extensive farm loan waivers announced by various state governments, implementation of the UDAY scheme for financially distressed power distribution companies, and the impact of Seventh Pay Commission recommendations.



Source: Authors own calculation from State Finances data

Fig 2: Composition of State Government Expenditure (1980-2022)

Conversely, capital expenditure, which funds creation of physical assets such as infrastructure, transportation networks, and productive facilities, represents both a smaller share of total spending and exhibits greater volatility over time. Capital spending experienced significant decline as a proportion of GSDP during the 1990s, demonstrating fiscal compression when states faced revenue constraints. The analysis clearly illustrates a crowding-out effect whereby sharp increases in revenue expenditure, such as those observed during the early 2000s, correspond directly with contractions in capital investment, creating a procyclical

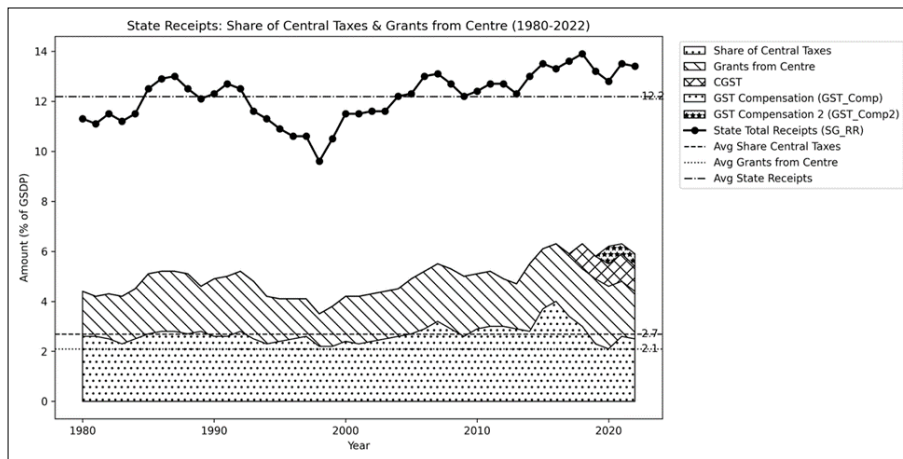
pattern that undermines long-term development objectives. This expenditure composition poses a central challenge to sustainable fiscal management, as it limits states' capacity to create productive assets, thereby constraining long-term economic growth potential and compromising the quality of public service infrastructure.

3. Devolution from the Central Pool

The analysis of central transfers to states reveals the complex architecture of India's fiscal federalism and its evolution over four decades. These transfers serve as a

critical determinant of state fiscal capacity, representing a fundamental mechanism through which resources are allocated within India's federal structure. As shown in Figure 3, the examination encompasses the complete

transfer mechanism, including the share of central taxes, grants from the centre, and the post-2017 GST compensation mechanisms that have emerged as instruments of intergovernmental fiscal coordination.



Source: Authors own calculation from Centre and State Finances data

Fig 3: Composition of Central Transfers to States (1980-2022)

Aggregate Trends in State Receipts

State total receipts, which aggregate own revenues and all central transfers, provide a crucial measure of overall fiscal capacity and reveal changing dynamics of resource availability at the sub-national level. Averaging 12.2 percent of GSDP from 1980-2022, the trajectory reveals four distinct phases that mirror India's macroeconomic transformations and policy shifts.

The first phase, spanning 1980-1991, represents steady growth in state fiscal capacity. The 1980s witnessed consistent growth in receipts, rising from 11 percent to 13 percent of GSDP, reflecting the expanding role of government. The second phase, covering 1991-2002, marked the post-liberalization decline that created significant fiscal stress for states. The post-1991 reform period triggered severe contraction in state receipts as the central government pursued aggressive fiscal consolidation to address its balance of payments crisis. During this period, transfers declined substantially, and states struggled to adapt their revenue systems to the new economic environment. Receipts fell to a historic low of approximately 9.5 percent of GSDP by the late 1990s, creating a fiscal crisis that threatened the viability of essential public services. The third phase, spanning 2002-2011, represents sustained expansion that restored state fiscal capacity to healthier levels. Strong recovery followed the earlier decline, with receipts peaking at nearly 14 percent of GSDP around 2010. This recovery was driven by robust economic growth that expanded the tax base, successful implementation of state-level Value Added Tax (VAT) that improved revenue mobilization efficiency and increased central transfers as the union government's fiscal position improved. The fourth phase, covering 2012-2022, has been characterized by elevated volatility despite maintaining receipts above the long-term average. This volatility reflects structural changes including initial disruption caused by GST implementation in 2017, which temporarily affected revenue flows, and the sharp COVID-19-induced dip in 2020, followed by swift recovery demonstrating the resilience of India's fiscal system.

The Share of Central Taxes

The share of central taxes, averaging 2.7 percent of GSDP over the study period, represents the most stable and untied source of state revenue within the federal transfer system. Its evolution demonstrates the profound impact of both economic performance and deliberate policy reforms on fiscal federalism in India.

The period from 1980-2002 was characterized by stability and fiscal pressure, during which tax devolution operated under predictable parameters governed by the Finance Commission system. However, notable decline occurred in the late 1990s, directly linked to the central government's post-1991 fiscal consolidation efforts, which constrained growth of the central tax pool from which states received their allocated shares. The phase spanning 2002-2014 witnessed significant buoyancy-driven growth in tax devolution, supported by India's strong economic performance. As the central tax pool grew rapidly due to high tax buoyancy, states automatically received larger transfers as beneficiaries of their fixed percentage share. The most recent phase, from 2015 to present, has been defined by structural shift following the landmark recommendation of the 14th Finance Commission in 2015 to increase states' share of central taxes from 32 percent to 42 percent. This recommendation led to immediate and substantial jump in tax devolution to states, representing significant decentralization of fiscal resources. However, a paradox emerged where states received a larger share of a relatively shrinking tax pool due to reduced overall tax buoyancy and the central government's decision to reduce corporate tax rates in 2019 as part of economic stimulus measures. The COVID-19 pandemic caused a sharp temporary drop in tax devolution, but recent data reveals a V-shaped recovery.

Central Grants

Central grants, averaging 2.1 percent of GSDP throughout the study period, represent the most discretionary and policy-sensitive component of intergovernmental transfers. Their inherent volatility reflects both the fiscal health of the

central government and the evolution of national policy priorities across different political administrations. The early period from 1980-2002 was marked by considerable volatility in grant transfers, with particularly sharp and sustained decline in the latter half of the 1990s, reaching a low point around 1998-99. This dramatic reduction was a direct consequence of severe fiscal pressure on the central government following implementation of Fifth Pay Commission recommendations in 1997, which forced reduction in discretionary transfers to states. The period from 2002-2014 witnessed dramatic expansion in grant transfers. This expansion was driven by the launch of major Centrally Sponsored Schemes (CSS) including National Rural Employment Guarantee Act (NREGA), National Rural Health Mission (NRHM), and Sarva Shiksha Abhiyan (SSA), aimed at social development outcomes. In the most recent phase after 2015, the 14th Finance Commission recommended substantially increased untied share of central taxes coupled with rationalization of discretionary grants, reflecting a move towards greater state autonomy in expenditure decisions. However, the long-run impact of this shift has been limited as grants still maintain significant proportion of overall transfers to states.

GST Compensation

The introduction of the Goods and Services Tax (GST) in 2017 added a new fiscal mechanism to secure state cooperation for indirect tax reform. The GST compensation mechanism was designed to address state concerns about potential revenue losses during the transition to GST. States were guaranteed a 14 percent annual growth rate in their tax revenues for a five-year period from 2017-2022, with any shortfalls to be covered by the central government using revenues collected from a GST Compensation Cess levied on luxury and sin goods.

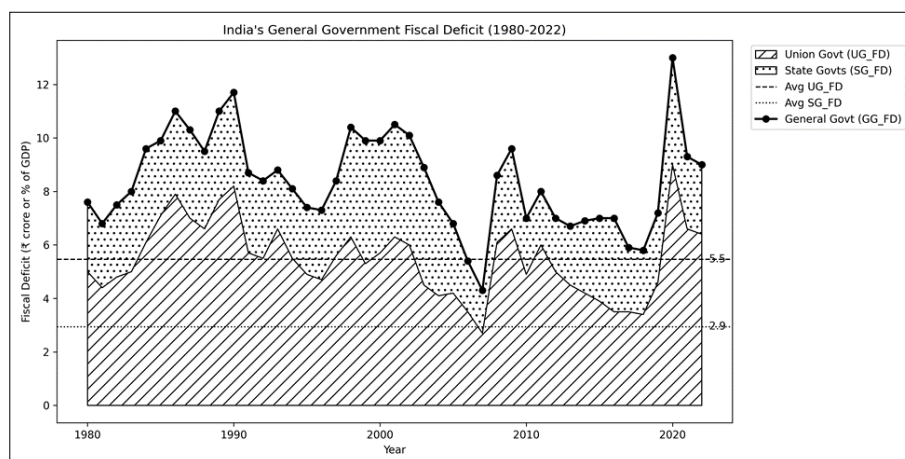
The initial implementation functioned largely as intended, providing promised stability during the early transition period and helping states adapt to the new tax regime. However, the COVID-19 pandemic created unprecedented disruption that tested the mechanism's resilience. The

pandemic caused both sharp decline in state tax revenues and dramatic reduction in compensation cess collections, creating substantial fiscal crisis that the original mechanism was not designed to handle. This situation led to an innovative solution where the central government facilitated "back-to-back loans" to states, essentially allowing states to borrow against future cess collections to bridge the immediate funding gap. We find small indication of GST compensation cess in the recent years.

General Government Fiscal Deficit: The Trajectory of Borrowing Requirements

The analysis of India's General Government Fiscal Deficit from 1980 to 2022 reveals the dynamics of fiscal management across different levels of government. The deficit, representing the combined borrowing needs of the union and state governments, provides critical insights into the sustainability of public finances and the evolving burden-sharing within India's federal structure. As Figure 4 shows, the union government's deficit has consistently been the larger component, with the general government deficit averaging 8.4% of GDP over the period.

The trajectory can be divided into distinct phases, each marked by specific economic events and policy shifts. The 1980s were characterized by a persistent upward trend in the general government deficit, which rose from approximately 7% of GDP in the early 1980s to nearly 10-12% by the decade's end. This expansion was driven by the union government's ambitious development agenda, significant public sector investment, and expansive social welfare programs. A key structural issue during this phase was the inability of the tax system to generate revenues commensurate with growing expenditure commitments. The tax framework, characterized by high rates and complex exemptions, created a persistent revenue-expenditure gap that became increasingly difficult to bridge. This structural imbalance had significant macroeconomic consequences, as high deficits contributed to accelerating inflation, a growing current account deficit, and mounting external debt.



Source: Authors own calculation from Centre and State Finances data

Fig 4: General Government Fiscal Deficit: Union and State Components (1980-2022)

The balance of payments crisis of 1991 forced a sharp reversal in fiscal policy, initiating necessary consolidation as the government prioritized restoring macroeconomic stability. The general government deficit declined significantly during this phase, with the union government

leading consolidation efforts through expenditure compression, particularly in capital expenditure, and enhanced revenue generation through improved tax administration and modest disinvestment programs. State governments participated in this adjustment process, though

more gradually than the union government. They faced additional pressure from reduced central transfers as the union government pursued its own consolidation objectives. The fiscal gains achieved during the mid-1990s were quickly reversed in the subsequent period, with the general government deficit surging to exceed even the elevated levels of the late 1980s. The distinctive feature of this phase was the severe deterioration of state government finances, which became the primary driver of the overall fiscal deficit. Implementation of Fifth Pay Commission recommendations mandated substantial increases in salaries and pensions for government employees, creating massive unfunded liability that dramatically increased committed expenditures across state governments. Many states, already carrying significant debt burdens from previous decades, were pushed toward severe financial distress. The spike in salary bills, combined with existing interest payment obligations and stagnant revenue growth, created a situation where committed expenditures crowded out almost all productive spending on infrastructure development and social services.

The FRBM-Led Consolidation period (2003-2008) represents the most successful fiscal consolidation in recent history. The enactment of the Fiscal Responsibility and Budget Management (FRBM) Act in 2003 institutionalized fiscal discipline by establishing clear deficit and debt targets, creating a rule-based framework that emphasized transparency and long-term sustainability. The results were remarkable, as the general government deficit fell dramatically from over 10% of GDP to around 4% through coordinated efforts by both union and state governments. State governments enacted their own FRBM laws, creating a comprehensive framework for fiscal discipline across all levels of government. This consolidation was facilitated by favourable macroeconomic conditions, particularly robust economic growth averaging over 8% per annum, which generated high tax buoyancy and enabled deficit reduction without severe expenditure compression.

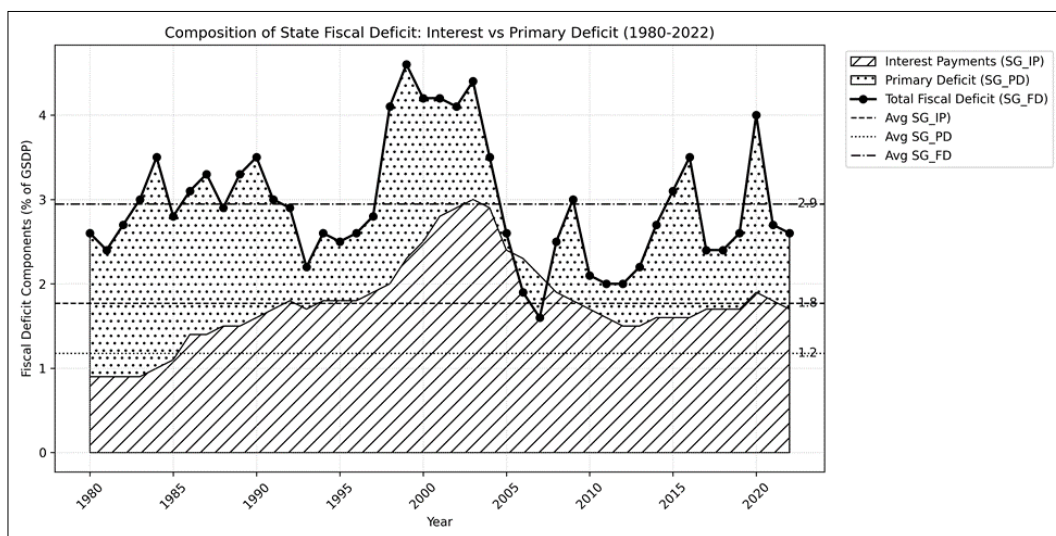
The 2008 global financial crisis interrupted the successful consolidation trend as the government implemented substantial fiscal stimulus to shield the domestic economy from global recession. The general government deficit

nearly doubled during this period, exceeding 9% of GDP by 2009, as the union government led the response with significant tax cuts and increased spending. Subsequently, the government embarked on gradual consolidation while avoiding sharp adjustments. The deficit declined, though it remained above pre-2008 crisis levels. A landmark change was the introduction of the Goods and Services Tax (GST) in 2017. Despite progress in structural reforms, persistent challenges including substantial subsidy burdens and narrow revenue bases prevented a complete return to the low deficit levels achieved during the mid-2000s.

The COVID-19 pandemic caused the most severe fiscal shock. The general government deficit surged to a multi-decade high of over 13% of GDP in 2020-21, resulting from both collapse in tax revenues due to economic disruption and surge in expenditure on relief measures including cash transfers, free food grain distribution, and health infrastructure development. State governments faced particularly severe stress during this period, grappling simultaneously with increased healthcare costs and plummeting own revenues, necessitating additional borrowing to maintain basic services. The subsequent sharp improvement in deficit indicators as the economy recovered demonstrates the largely temporary nature of the pandemic-induced fiscal deterioration.

State Fiscal Deficit Patterns

The analysis of state fiscal deficits from 1980 to 2022 reveals a cyclical pattern of fiscal stress and consolidation in Indian states, characterized by distinct phases of crisis, reform, and external shocks. The fiscal deficit, representing the total borrowing requirement of state governments, provides crucial insights into both the immediate fiscal stance and the accumulated burden of past borrowing decisions. The total fiscal deficit can be decomposed into two analytically distinct components: the primary deficit, which represents the gap between non-interest expenditure and total revenue, and interest payments on accumulated debt. A sustainable fiscal position requires that primary deficits remain manageable relative to economic growth rates and the government's debt-servicing capacity over time.



Source: Authors own calculation from State Finances data

Fig 5: State Fiscal Deficit Patterns

The initial phase 1980-1990 demonstrated steady but manageable deterioration in state fiscal positions. State fiscal deficits exhibited gradual upward trends in both the primary deficit and interest payment components. The controlled nature of this fiscal expansion suggests that while government finances were deteriorating, the pace and magnitude had not yet reached levels that would raise immediate concerns about fiscal sustainability. Interest payments grew steadily as states accumulated debt to finance their development expenditures and bridge recurring fiscal gaps. The relative stability of this growth reflected broader macroeconomic stability during the pre-liberalization period, when interest rate volatility was limited and external shocks were largely buffered by the closed nature of the economy.

In the late 1990s, total fiscal deficit surged dramatically, exceeding 4.5 percent of Gross State Domestic Product (GSDP), marking the most serious fiscal challenge faced by Indian states in the post-independence period. This crisis did not emerge from a single cause but rather resulted from a confluence of adverse factors. The immediate trigger was implementation of Fifth Pay Commission recommendations, which mandated massive and sudden increases in salary and pension expenditures. The expenditure shock was further compounded by broader economic slowdown that affected the Indian economy during this period, partly due to spillover effects from the 1997 Asian Financial Crisis. This economic deceleration reduced revenue buoyancy significantly and simultaneously increased deficit-to-GSDP ratios through a denominator effect, as economic growth slowed while fiscal imbalances persisted. The crisis manifested through explosive growth in both components of the fiscal deficit. Primary deficits increased dramatically, indicating a fundamental shift in government borrowing from productive capital investment toward financing current expenditure commitments and day-to-day operations. Simultaneously, the burden of interest payments sharpened considerably, establishing a vicious cycle where states required additional borrowing simply to service existing debt obligations, further constraining their ability to fund essential services and development programs.

Following the severe fiscal crisis of the late 1990s, Indian states underwent remarkable fiscal consolidation. This consolidation was enabled by enactment of Fiscal Responsibility and Budget Management (FRBM) Acts by state governments. These legislative frameworks introduced legally binding fiscal targets, such as the complete elimination of revenue deficits and the establishment of caps on fiscal deficits at 3 percent of GSDP. The FRBM Acts represented a fundamental shift from discretionary fiscal policy toward a rule-based system that created both legal obligations and political incentives for maintaining fiscal discipline over the medium term. The reform period fortuitously coincided with exceptional economic growth across Indian states, which significantly aided the consolidation effort through multiple channels. The high growth rates created favourable denominator effects that

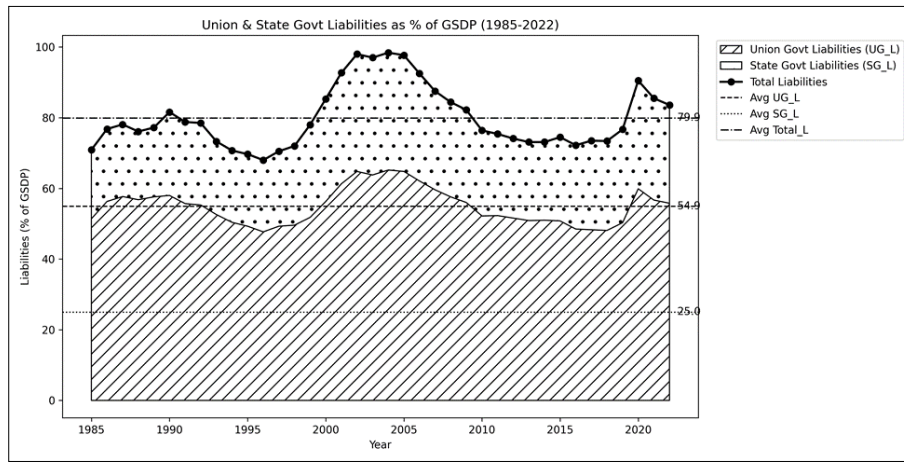
automatically reduced deficit ratios even without absolute improvements in fiscal balances.

The 2008 global financial crisis marked the end of the successful consolidation period and introduced new challenges that tested the resilience of the fiscal reforms implemented in the previous phase. The crisis necessitated active fiscal stimulus measures to maintain economic growth and employment, leading to deliberate relaxation of FRBM targets and renewed fiscal expansion. The initial stimulus response was subsequently compounded by several additional fiscal pressures that emerged during the post-crisis period. Implementation of Sixth Pay Commission recommendations renewed salary and pension pressures, though the improved institutional framework helped manage these pressures better. Additionally, widespread farm loan waiver programs implemented by various state governments created significant fiscal obligations. A particularly significant development was implementation of the Ujwal DISCOM Assurance Yojana (UDAY) scheme, designed to address the financial distress of state electricity distribution companies.

The COVID-19 pandemic delivered the most severe single-year fiscal shock to Indian state finances since the crisis of the late 1990s, with aggregate state fiscal deficits reaching approximately 4 percent of GSDP in 2020-21. Unlike previous fiscal deteriorations that developed gradually or resulted primarily from policy decisions, the pandemic created unprecedented dual shock that simultaneously devastated state revenues and dramatically increased expenditure requirements. The recovery phase that followed demonstrated the underlying resilience of state finances and the effectiveness of institutional frameworks developed over previous decades. Fiscal deficits began contracting relatively quickly as economic activity resumed and revenue collections recovered, indicating that the fiscal deterioration was indeed largely cyclical rather than structural.

Accumulation of debt stocks

This section examines how annual fiscal deficits accumulated into government borrowing and their impact on public debt stocks. The General Government Fiscal Deficit remained consistently high throughout the Initial period, averaging around 80% of GDP during the late 1980s, driven by substantial Union Government expenditure commitments across subsidies, public sector investments, and defense spending. This sustained fiscal profligacy contributed to the severe Balance of Payments crisis that compelled economic reforms in 1991. At the subnational level, states maintained low but consistently positive and growing Primary Deficits. The direct consequence was systematic accumulation of substantial debt stock. Total government liabilities remained elevated, reaching approximately 75% of GDP by the mid-1980s and creating significant future interest payment burdens. Although post-1991 economic reforms led to brief fiscal consolidation with modest debt-to-GDP ratio reduction, the underlying structural issues driving fiscal expansion remained unresolved.



Source: Authors own calculation from Centre and State Finances data

Fig 6: Accumulation of Liabilities for Union and State governments

The next period (1997–2004) represents severe deterioration of public finances. Implementation of the Fifth Pay Commission's recommendations led to massive structural increases in salary and pension expenditures across central and state levels. State governments were the epicentre of this fiscal crisis, experiencing Primary Deficits that nearly tripled. This dramatic deterioration fuelled sharp, unsustainable rises in interest payment obligations, creating a vicious cycle. Total government liabilities skyrocketed from less than 70% of GDP in 1996 to a dangerous peak above 90% of GDP by 2004.

The policy response to this fiscal crisis, coupled with an exceptionally favourable macroeconomic environment, ushered in a golden age of fiscal consolidation. The institutional foundation was provided by the Fiscal Responsibility and Budget Management (FRBM) Act of 2003, which established a credible, legally binding framework for fiscal discipline. The high-growth environment provided crucial dual benefits: first, a powerful "denominator effect" that automatically reduced deficit and debt ratios as the economy expanded faster than fiscal imbalances grew; second, exceptional tax buoyancy that enhanced government revenues without requiring tax rate increases or new levies. This combination enabled fiscal consolidation without severe austerity measures that might have undermined growth or social welfare. Sharp reductions in annual borrowing requirements, combined with sustained high GDP growth, produced the steepest decline in public debt ratio, with Total Liabilities falling by over 25 percentage points to approximately 72% of GDP.

The Global Financial Crisis of 2008 abruptly ended successful consolidation and established a "new normal" of elevated deficits and debt levels. The immediate policy response required substantial fiscal stimulus measures, suspending FRBM targets and causing the General Government Deficit to nearly double within a year. For over a decade following the crisis, the Total Liabilities ratio remained essentially unchanged, fluctuating within 72-75% of GDP.

The COVID-19 pandemic delivered the largest macroeconomic shock, causing severe rupture in public finances through a "scissors effect"—simultaneously collapsing revenues due to lockdowns while forcing massive increases in healthcare and social safety net spending. This produced a dramatic surge in debt-to-GDP ratio, with Total Liabilities leaping by over 15 percentage points to reach

90% of GDP. The legacy extends beyond the immediate crisis: significantly larger debt stock from emergency borrowing will constrain fiscal space and substantially increase interest payment burdens, permanently reducing government capacity to fund development programs and respond to future emergencies.

Discussion

The analysis of India's public finances from 1980 to 2022 presents a narrative of a fiscal system in constant evolution, shaped by structural reforms, macroeconomic shocks, and complex federal dynamics. The findings reveal critical interconnected themes that define opportunities and constraints facing contemporary Indian fiscal management.

The Structural Rebalancing of Fiscal Federalism

A significant finding is the profound transformation in India's intergovernmental fiscal relations over four decades. Empirical evidence demonstrates that state governments have emerged as primary engines of public expenditure, systematically eclipsing the Union government in their GDP share devoted to public spending. This shift reflects fundamental transformation in India's governance model and fiscal federalism implementation.

This transformation has been accelerated through deliberate policy changes, particularly the 14th Finance Commission's recommendations, which significantly increased untied tax devolution to states while rationalizing tied grants and centrally sponsored schemes. Greater autonomy places immense burden on subnational institutional capacity for financial planning, program execution, and fiscal management. The analysis reveals concerning volatility in state government receipts, particularly following GST implementation and during COVID-19, underscoring the fragility of this fiscal equilibrium. While states now possess greater fiscal decision-making freedom, they have become more exposed to macroeconomic volatility and increasingly dependent on national tax system performance over which they exercise limited control.

The Persistent Challenge of Expenditure Quality and Fiscal Rigidity

Perhaps the most structurally significant challenge is persistently poor expenditure composition quality, particularly at state level. Data clearly demonstrates continued dominance of revenue expenditure over capital

investment spending, representing a critical constraint on India's long-term growth potential. This pattern reflects fundamental misallocation of scarce public resources away from productivity-enhancing investments toward current consumption and administrative costs.

The analysis provides evidence that a substantial and growing proportion of public spending is absorbed by committed liabilities, including salaries, pensions, and interest payments. This creates profound fiscal rigidity that severely constrains policy flexibility. Periodic sharp increases in revenue expenditure, driven by events such as Fifth and Seventh Pay Commission recommendations, function as external shocks that permanently elevate state governments' fixed cost structure.

The Cyclicity of Crises and Public Debt

The four-decade fiscal trajectory reveals a distinct cyclical pattern in Indian public finance management, characterized by extended periods of fiscal expansion and deteriorating discipline, followed by severe crises that expose vulnerabilities and compel sharp consolidation periods. The major crises of 1991, late 1990s, and 2020 each served as critical junctures forcing fundamental policy corrections and institutional reforms.

While institutional frameworks like the FRBM Act have demonstrated effectiveness in guiding fiscal consolidation during macroeconomic stability, they are consistently suspended when confronted with major external shocks. This suggests India's fiscal institutions, while valuable during normal periods, lack flexibility and resilience needed to maintain discipline while providing adequate counter-cyclical support during crises.

Each major fiscal crisis has systematically pushed general government debt-to-GDP ratio to new, higher plateaus. Critically, subsequent consolidation phases, while often successful in reducing annual deficits, have proven insufficient to restore debt ratios to pre-crisis levels. This incremental but persistent upward movement in structural public debt levels systematically erodes fiscal space over time, as growing proportions of government revenue must service interest payments rather than fund productive expenditures, creating a self-reinforcing cycle that further constrains productive spending capacity and reduces fiscal flexibility for future shock responses.

The Relationship Between Growth and Fiscal Sustainability

This analysis underscores a fundamental insight: fiscal health and sustainability in India cannot be separated from broader macroeconomic performance and growth dynamics. The most successful fiscal consolidation period (2004-2008) provides evidence of powerful synergy between credible rule-based fiscal frameworks (exemplified by the FRBM Act) and high-growth economic environments that generate conditions for sustainable deficit reduction.

Robust GDP growth provides crucial support for fiscal consolidation through multiple channels. High growth rates generate a "tailwind" effect for deficit reduction by substantially boosting tax revenues through improved buoyancy, while simultaneously reducing debt-to-GDP ratios through favourable denominator effects as the economy expands faster than debt accumulates. This dual mechanism allows governments to achieve significant improvements in fiscal indicators without implementing

severe austerity measures that might undermine growth or social welfare. Conversely, periods of slow or stagnant growth invariably exacerbate fiscal stress and make consolidation efforts more difficult and costly, as evidenced during the late 1990s crisis and pre-pandemic economic slowdown.

Conclusion and Policy Implications

The analysis of India's public finances from 1980 to 2022 reveals complex dynamics. The core tension emerges between growing developmental expenditure needs of a large, diverse economy and constraints imposed by a rigid fiscal structure vulnerable to shocks.

Prioritizing Expenditure Quality over Simple Deficit Targets

A major inference is that headline fiscal deficit numbers, while important, are insufficient metrics for judging public finance quality and sustainability. The analysis shows fiscal consolidation is often achieved by compressing productive capital expenditure while leaving structural revenue expenditure drivers—salaries, pensions, and subsidies—untouched. This creates low-quality fiscal equilibrium where budgets are balanced at long-term growth's expense.

The fiscal framework needs to evolve beyond simple deficit targets like 3% of GDP to incorporate golden rules that explicitly protect or prioritize capital expenditure. This requires reforming State-Level Fiscal Responsibility Legislations (FRLs) to include indicative targets for capital expenditure share in total spending or maintaining capex above certain GSDP thresholds. The Union government, through Finance Commissions, could earmark grants specifically for states meeting or exceeding capital expenditure targets. The recent scheme providing 50-year interest-free loans to states for capex could be institutionalized to create permanent incentive structures for capital spending.

Fiscal Federalism for Enhanced Resilience

While the shift toward greater state autonomy through higher tax devolution is structurally sound, it has increased states' exposure to macroeconomic volatility. The GST transition and COVID-19 pandemic revealed that current intergovernmental fiscal architecture lacks robust, predictable mechanisms to help states manage severe economic shocks. The ad-hoc nature of crisis responses, exemplified by GST compensation "back-to-back loans," demonstrates urgent need for systematic approaches.

India needs to develop a permanent, rule-based Fiscal Shock Absorption Mechanism activated during national or state-specific economic crises. This would replace ad-hoc arrangements with predictable systems designed as dedicated funds, capitalized during high revenue growth years, from which states could draw during certified economic downturns. Such mechanisms would make central transfers explicitly counter-cyclical, addressing critical flaws where central tax collections fall during slowdowns, automatically reducing devolution to states and forcing spending cuts that deepen recessions.

Need for Counter-Cyclical Fiscal Stance

The FRBM Act should be amended to adopt cyclically-adjusted fiscal frameworks targeting structural deficits rather than fixed deficit targets for all years. Under this

approach, governments would target deficits adjusted for business cycle effects, requiring headline deficits below target during high-growth years to generate structural surpluses that pay down debt, while allowing headline deficits above target during downturns without violating fiscal rules. This provides flexibility needed for effective counter-cyclical policy.

Implementing such frameworks requires credible, independent estimates of output gaps and potential GDP, strengthening the case for establishing independent Fiscal Councils.

India's fiscal journey is at a critical juncture. Transition to a larger, more complex economy requires fiscal architecture that is disciplined, flexible, resilient, and supportive of high-quality public investment. Lessons from the past four decades are clear: sustainable public finances rest on a tripod of expenditure quality, federal resilience, and counter-cyclical prudence. Implementation of these second-generation reforms represents the central fiscal policy challenge for the coming decade, requiring technical expertise and political commitment to move beyond current approaches toward more sophisticated and effective fiscal frameworks.

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