

Why the Debt of India's States Is Rising

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Until India's federal fiscal architecture addresses these inherited structural constraints, states will remain stuck in an unfair cycle.



GIF: The Wire, with Canva.

In what seems to be a growing friction between fragmented fiscal realities within Indian states, distinct financial realities are playing out under a single national fiscal umbrella.

National debates over what really constitutes a legitimate social safety net versus an irresponsible electoral “freebie” have shaped policy and welfare discourse in recent years and assembly polls. The debates signalled a loud, deeply polarising argument involving clashes over the fiscal health of the public exchequer i.e. for the states polling and also for the Union government supporting those where its own party is in power for a ‘double-engine’ fiscal governance push.

To see past the noise and uncover the underlying structure of sub-national public finance, it is impertinent to analyse state budgets by applying advanced tools of assessment. One also needs to understand the growing concerns emerging from the rise in hidden debt or off-budget borrowings plaguing the macro-fiscal landscape.

For analysing the former, we use cluster modelling based upon three core variables to analysing India’s state budgets: fiscal stress, welfare intensity, and capital investment ratios. The result of this analysis helps in going past political rhetoric, signalling the emergence of a hidden taxonomy shaped by four unique financial regimes where we see states operating in two different economies.

debts eat up about 50% of revenue receipts, entirely freezing the state's capacity for new capital formation.

The demographic giants in northern India find themselves in a different kind of fiscal stranglehold. Uttar Pradesh has been able to formalise its economy by deriving over 41% of its own tax revenues from the State Goods and Services Tax (SGST), but its low per capita income prevents it from having a sufficient revenue base.

This fiscal strain is compounded by the millions of dollars of debt owed by the power distribution corporations in Madhya Pradesh and Rajasthan, creating enormous contingent liabilities that are steadily eroding the states' credit ratings.

The *second* regime presents a paradox with respect to high levels of capital expenditure and low headline amounts of fiscal stress. However, this is only an illusion driven by two diametrically opposed realities. On one hand, special-category border states like Arunachal Pradesh, Nagaland, Manipur, Sikkim, and Jammu and Kashmir possess virtually no local tax base.

They survive because the Union government entirely underwrites their existence, covering up to 90% of the costs for flagship national programmes. Conversely, legacy states such as Punjab and Himachal Pradesh remain restrained.

Punjab's budget continues to be adversely affected by agricultural power subsidies for which there are no clear criteria for access. These subsidies were originally intended to encourage agriculture in order to ensure food security for the nation.

Compounding this is the political temptation to revert to the unfunded Old Pension Fund (OPF) which will result in immediate cash flow benefits by ceasing to contribute to pension funds, but will also create a wall of unbacked future pension obligations for the subsequent generation. Across these trapped economies, committed costs consume over 60 percent of all revenues, completely crowding out real long-term investment.

The *third* regime has a capital deficient trajectory and exhibits a structural tendency towards immediate consumption rather than asset creation. Assam, Meghalaya and Mizoram are examples of such states. They receive a significant portion of their budget from transfers from the central government.

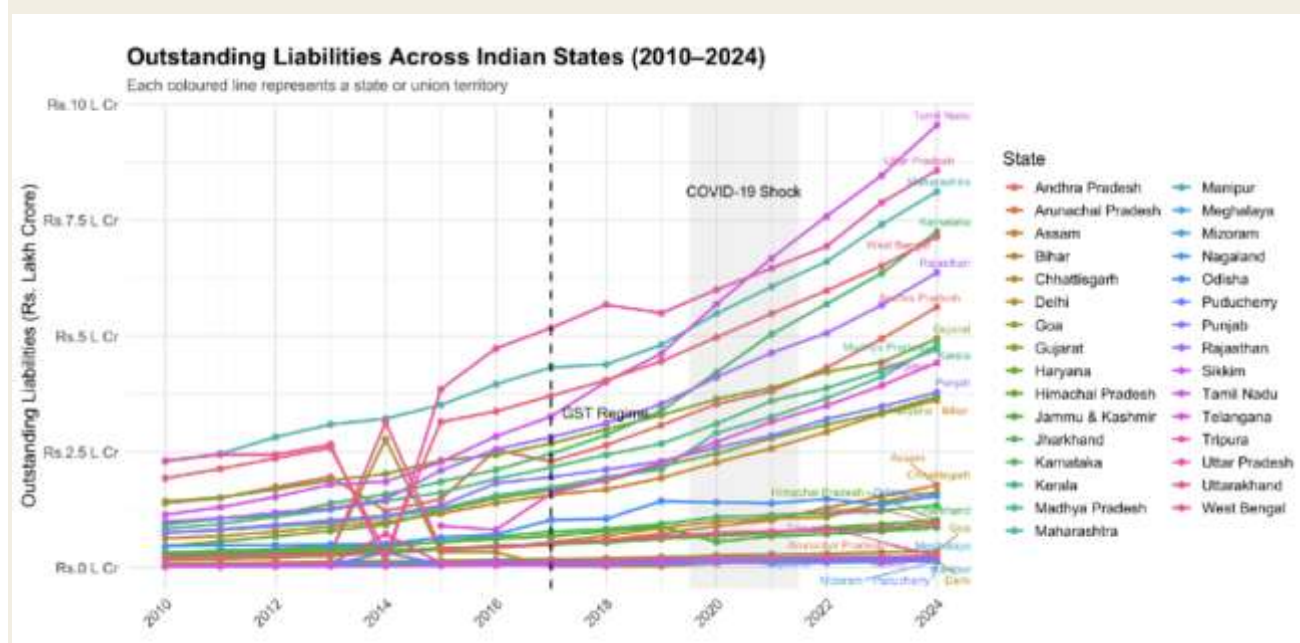
In the event of a declining share of tax revenues, local infrastructure budgets will typically be the first to be altered in order to maintain cash income assistance programs (by dropping projects from future funding consideration or delaying funding requests for projects).

Kerala represents a very different demographic variant of such a situation. With the most advanced longevity and lowest birth rates in the country, Kerala has become very similar to the aging European welfare states. The demand for increased public health care expenditures and social security pensions is generated by the demographic shift toward an older population and will compress the proportion of infrastructure investment in the overall budget, down to only 17% of total budget expenditures. Consequently, the treasury will need to continue issuing market debt to fund day-to-day operating expenses for the government.

The *final* quadrant regime includes states like Odisha, Chhattisgarh, Jharkhand that achieve high levels of spending on social programs and investment in physical assets with low levels of fiscal stress. As a result of their recent mining revenues, Odisha has been providing adequate nutritional support to rural families, while simultaneously providing funding for regional infrastructure capable of withstanding disasters, with virtually no market debt being issued.

Rising hidden debt and off-budget borrowings

The last 10 years offer a clearer picture of how state liabilities have changed during this time. The evolution of outstanding liabilities for Indian states (FY 2010-11 to FY 2023-24) shows that accruing debt is now almost universal to India's federal financial system. While each Indian State has accrued liabilities over this period, the rate at which states have accumulated these liabilities is markedly asymmetrical across the country. By the end of FY 23-24, Tamil Nadu's outstanding liability will be approximately Rs 10 lakh crore, followed closely by Uttar Pradesh. Also tied for third place are the states of Maharashtra, Karnataka, Telangana, Andhra Pradesh, Rajasthan, and West Bengal) each will have accrued more than Rs 5 lakh crore in liabilities.



As observed in the figure, there are two key structural events that caused states to take on more liabilities. The introduction of the GST and the COVID-19 crisis have had the most significant impact on the fiscal situations of Indian states in the last decade. The former permanently changed the indirect tax regime in India, while the latter caused a slew of states to increase borrowing in response to a fall in revenues and a rise in expenditures in response to the health and economic crises. Even though the economic damage caused by COVID has been mitigated, the borrowing by the states continues to have long-term implications for their fiscal space. Debt outlived the crisis that created it. The total impact of taking on this debt is enormous. By March 31, 2025, the total combined debt of all the states of India was Rs 75.52 trillion (or Rs 75.52 lakh crore), while the total value of the liabilities owed by all the states was Rs 90.51 trillion (or Rs 90.51 lakh crore), which represents 27.89% of the total Gross State Domestic Product (GSDP) for the 28 states taken together. Fiscal stress is also not confined to only a few states that are in a weak financial condition. Each and every one of the twenty-eight states reported a fiscal deficit in fiscal year 2024-25, and fifteen states exceeded the 3% fiscal deficit limit set by the Fifteenth Finance Commission, suggesting a systemic problem rather than sporadic instances of state financial mismanagement.

India's real fiscal divide

This indicates that the categorisation of India's states based on their fiscal position is not essentially one between the welfare states (fiscally liberal) and the fiscally conservative states (fiscally prudent). It is rather a divide across states with better revenue-generating capacity and those states that have structurally weak tax bases.

For FY 2024-25, State Own Tax Revenue (SOTR) is projected to account for just under 50% of total revenue receipts, while State GST will account for approximately 43% of this internal revenue pool. The states that have a greater diversity of manufacturing and service industries (for example, Punjab, Gujarat, Haryana, and Karnataka) are generally experiencing stronger tax mobilisation as a result of GST and are thus able to withstand the pressures of increasing liabilities to a much greater extent than those with a narrower economic base. The disparity in actual fiscal returns relative to fiscal budget projections further illustrates the impact of these structural limitations. For example, 18 states projected they would have a revenue surplus for FY 2024-25, indicating their anticipation of having improved fiscal conditions. Of these, however, only 9 states achieved a revenue surplus, while some of the most economically significant states (Karnataka, Maharashtra, Telangana, Assam, Bihar, and Himachal Pradesh) had revenue deficits instead.

Rethinking India's fiscal debate

Simply reducing welfare expenditure is unlikely to resolve this dilemma. A lot of this spending is aimed at human capital development, which has long-term implications for not just economic growth but also fiscal health. With a smaller workforce, tax revenues will fall, as will consumption and, by extension, indirect tax revenues. Thus, even if states manage to reduce their fiscal deficits in the short term, they may find the long-term implications of their actions to be even more devastating.

A better alternative would be to undertake structural reforms, such as improving State Own Tax Revenue (SOTR), tax collection, and local economic growth for the long-term growth and betterment of the states' fiscal health.

Additionally, states must adhere to credible fiscal consolidation, as well as fiscal rules that encourage reductions in existing debts. It will also be vital to remember that, when it comes to fiscal policy, states rarely start on equal footing.

One-size-fits-all solutions will be ineffective in addressing why, when, and how states struggle the most with fiscal management. Until India's federal fiscal architecture addresses these inherited structural constraints, states will remain caught in the defined debt-ridden, path-dependent equilibrium from which they cannot simply spend or cut their way out of.

In order to maintain the macroeconomic stability of the nation, federal fiscal policies also need to radically shift from a static uniform system of prohibiting deficits to a dynamic reward structure while building upon revenue capacity-both, with assistance from the Union government and through their own efforts. This must also allow for greater limits on state borrowing for higher productivity-the growth of true productive assets to ensure that states' expenditures become a sustainable engine of creating distributive growth as national wealth rather than being a continuing source of fiscal anxiety and stress.

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