State Finances: Capex Growth moderates to ~8-10% in FY27 Amid Geopolitical Headwinds

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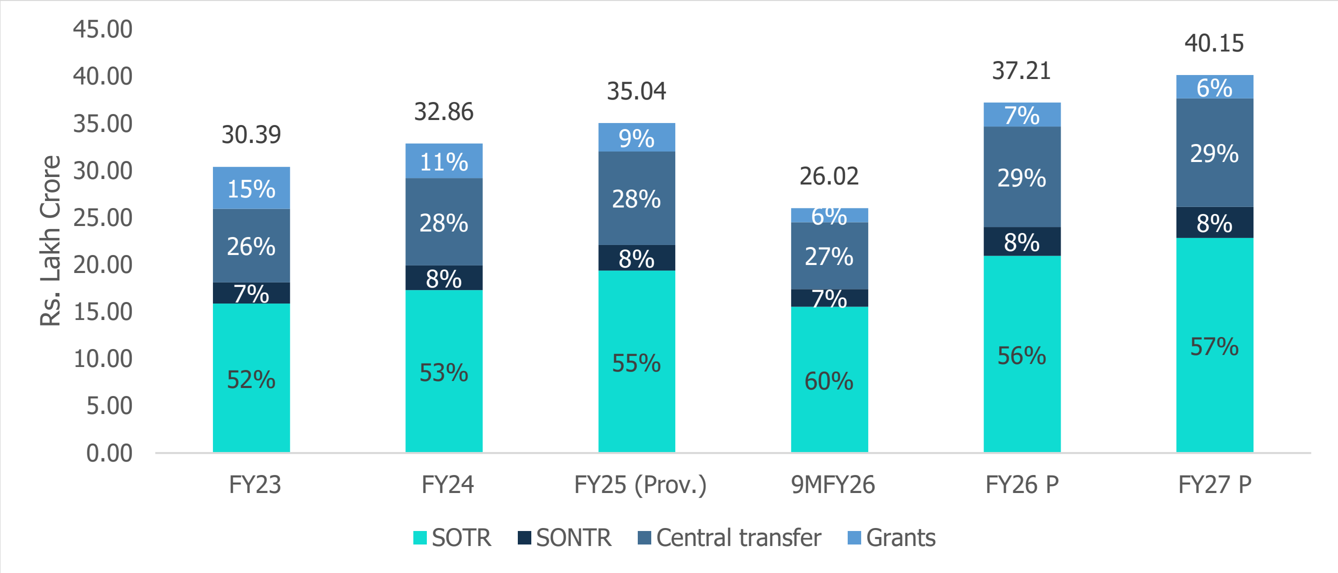
Synopsis

CareEdge Ratings has analysed the finances of the top 15 states, which account for 89% of India's Gross State Domestic Product (GSDP) for the financial year ending 31 March 2025 (FY25), to provide insights on aggregate state finances. These states are Andhra Pradesh, Bihar, Gujarat, Haryana, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Odisha, Punjab, Rajasthan, Tamil Nadu, Telangana, Uttar Pradesh, and West Bengal.

- Over FY26-FY27, state finances are expected to experience moderate revenue growth, with increasing revenue expenditure pressures. Revenue receipts are projected to grow by 6.2% in FY26 and 7.9% in FY27, due to moderation in grants and some sensitivity to external factors that may weigh on overall revenue realisations.
- Revenue expenditure is anticipated to remain high, driven by sustained growth in social sector spending and welfare-oriented measures alongside potential pressures from higher energy and commodity costs, leading to a gradual widening of revenue deficits and limiting fiscal flexibility.
- States are likely to focus on public investment; however, capital expenditure growth is expected to moderate to ~8-10% in FY27 (reaching about 2.3%-2.4% of GSDP at Rs 8.32 - 8.46 lakh crore) as compared to estimated 17% in FY26, reflecting tighter fiscal headroom. This moderation may be accentuated by geopolitical crisis in West Asia, which could exert pressure on both revenues and expenditure through their impact on energy prices, thereby constraining the pace of capital outlay. While large states such as Uttar Pradesh, Madhya Pradesh, Gujarat, Maharashtra, and Telangana continue to lead overall capex in FY25, states like Andhra Pradesh, Haryana, and Bihar are experiencing relatively faster growth from a lower base.
- Therefore, fiscal indicators are expected to remain under pressure, with the fiscal deficit projected to be around 3.3% of GSDP in FY26 and moderately higher at 3.5% in FY27, primarily due to the widening revenue deficit.
- These projections are based on nominal GSDP growth assumptions which can vary to an extent depending upon external uncertainties, including the evolving geopolitical situation in West Asia.

Moderate Revenue Growth with Pressure on Central Transfers
Exhibit 1: Growth and Composition of Revenue Receipts



Source: State budgets documents, CAG provisional financials, CareEdge Ratings

As shown in **Exhibit 1**, revenue receipts grew by 7% year-on-year in 9MFY26, mainly supported by higher states' own tax revenue and increased transfers from the Centre. For FY26 (P), revenue receipts are projected to grow by 6.2% to Rs 37.2 lakh crore basis past trends and estimates.

Going forward, CareEdge Ratings expects revenue receipts to increase by approximately 7.9% in FY27 (P) to ₹40.1 lakh crore. This growth is lower than the pace of nominal economic expansion and reflects moderation in states' own tax revenue buoyancy due to softer consumption trends and volatility in fuel-linked taxes. In addition, the pace of growth in central transfers is expected to slow, constrained by fiscal pressures at the Centre arising from elevated subsidy requirements amid geopolitical developments in West Asia.

SOTR is estimated to grow by 8.2% in FY26 (P) and improve further to 9% in FY27 (P). The trajectory of SOTR remains closely linked to GST collections, which constitute a significant share of states' own tax revenue. The GST rate rationalisation from September 2025, which simplified the tax structure and reduced rates on several consumption items, is expected to support demand in the economy and improve compliance over time. While nominal GSDP growth remains supportive, SOTR growth is expected to underperform headline GSDP, reflecting moderation in SGST buoyancy as higher fuel and logistics costs dampen discretionary consumption and corporate profitability.

Central transfers support has remained steady, with growth of around 15% during 9MFY26, reflecting higher tax devolution to states. The Sixteenth Finance Commission has kept the states' share in the divisible pool of central taxes at 41%, ensuring continuity in the devolution framework. Growth in central transfers is therefore expected to be supported by the Union government's expanding tax base. Accordingly, central transfers are projected to increase by 7.5% in FY26 (P). Central transfers are expected to grow by around 8% in FY27 (P), lagging nominal GSDP growth and emerging as a key drag on overall revenue receipts. While transfers remain formula-protected, growth is likely to moderate as geopolitical developments in West Asia raise global oil prices, increasing the Centre's subsidy burden, softening gross tax buoyancy, and constraining fiscal space.

Grant receipts from the Centre have moderated in recent periods, declining by 17% in FY25 and by 17.3% year-on-year during 9MFY26. This decline largely reflects the tapering of Revenue Deficit Grants (RDGs) recommended by the Finance Commission over its award period.

For FY26 (P), grants are expected to decline by 16%, as RDGs reach the final year of their phased reduction. Going forward, the discontinuation of RDGs after FY26, as recommended by the 16th Finance Commission, is expected to further moderate grant flows from the Centre. The withdrawal of these grants is intended to encourage states to strengthen fiscal discipline and improve their own revenue mobilisation. Consequently, states are expected to increasingly rely on their own revenue sources and tax devolution to fund their expenditure commitments, particularly Andhra Pradesh, Kerala, Punjab and West Bengal, which have historically been significant recipients of these grants and extent of revenue deficit of these states is key monitorable.

Social Spending pushes Revenue Expenditure Growth

Mirroring the 9MFY26 trend, revenue expenditure is estimated to increase by 8% in FY26 (P) and 11% in FY27 (P). A significant portion of this growth is attributable to social sector expenditure, which is projected to grow at around 11% annually.

The rise in social spending is mainly driven by welfare programmes and policy-driven initiatives across states. Over the past three years, several states have expanded social protection programmes—including cash transfers, subsidies, and other welfare efforts—leading to nearly a doubling of social security and welfare expenditure from FY22 to FY25. This has resulted in a consistent increase in revenue expenditure. Additionally, upcoming elections in some states may result in higher allocations to social welfare measures, further increasing revenue expenditure. Moreover, policy changes, such as the restructuring of rural employment programmes under the Viksit Bharat Guarantee for Rozgar and the Ajeevika Mission (Gramin), which modify the cost-sharing framework between the Centre and the states, could also raise states' expenditure commitments. Notwithstanding the above, external factors such as elevated energy prices linked to West Asia developments may increase subsidy-related expenditure at the state level, further limiting expenditure flexibility.

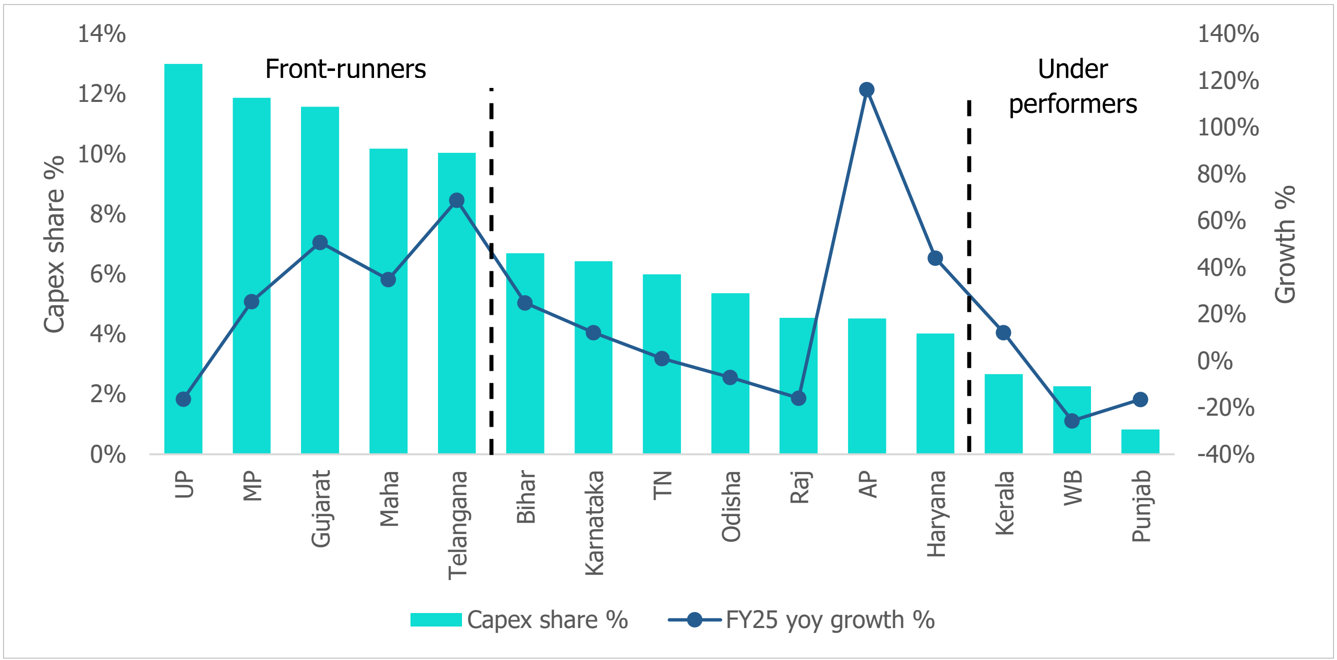
While such spending supports social development goals, it also puts pressure on revenue balances, especially amid moderate revenue growth. Consequently, CareEdge Ratings forecasts the revenue deficit to widen to 0.9% of GSDP in FY26 (P), up from 0.8% in FY25 (Prov) and further to 1.2% of GSDP in FY27 (P), reflecting persistent rise in social expenditure alongside moderate revenue growth.

Capex Growth Moderates Sharply Amid Tighter Fiscal Headroom

Capital expenditure by states recorded 17% year-on-year growth during 9MFY26, indicating continued momentum in public investment and supporting expectations of healthy capex growth in FY26.

Capital outlay is estimated to grow by 16.7% to reach around 2.4% of GSDP in FY26 (P) at Rs 7.7 lakh crore, reflecting sustained public investment by states. However, the capex is expected to fall short of the FY26 (BE) of Rs 8.7 lakh crore by around 12%, reflecting typical execution challenges such as delays in project approvals, land acquisition, and tendering processes.

Exhibit 2: State-wise share and growth in Capital Outlay



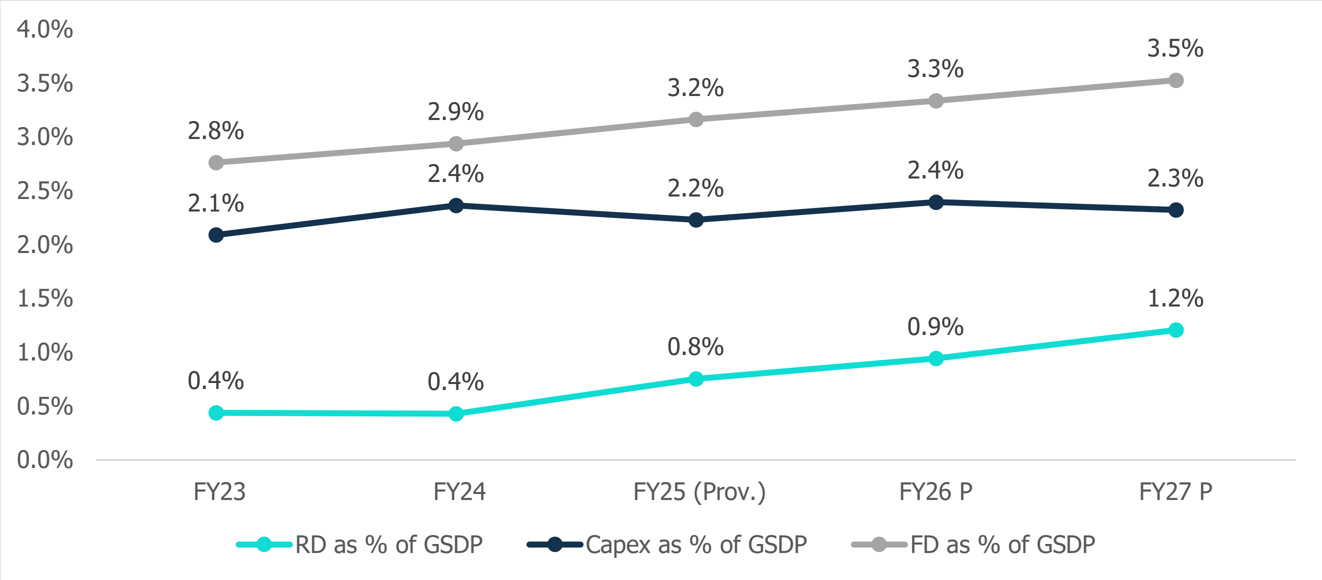
Source: State budgets documents, CAG provisional financials, CareEdge Ratings

As seen in the Exhibit 2, capital expenditure remains concentrated among a few large states, with Uttar Pradesh, Madhya Pradesh, Gujarat, Maharashtra and Telangana emerging as the front-runners in terms of overall capex share. Meanwhile, states such as Andhra Pradesh, Haryana and Bihar are witnessing stronger growth in capital outlay, reflecting a catch-up in investment from a relatively lower base.

States' capex outlay continues to be directed towards transport connectivity, urban infrastructure, irrigation, and water supply.

Going forward, CareEdge Ratings expects state capex growth to moderate to around 8%-10% in FY27 (P), reaching about 2.3%-2.4% of GSDP at Rs 8.32 – 8.46 lakh crore. Capital expenditure is expected to be supported by continued policy emphasis on infrastructure creation and incentives such as the Special Assistance to States for Capital Investment (SASCI) scheme, which provides long-term, interest-free loans to states for capital projects. The higher allocation under the scheme of Rs 2 lakh crore in FY27 and the healthy utilisation by states in recent years are expected to continue to incentivise infrastructure spending. Nevertheless, the moderation reflects tighter fiscal headroom due to lower growth in revenue receipts, particularly from central transfers, and higher revenue expenditure commitments, especially towards welfare and energy-related support, which, in turn, constrain the pace of capital outlay. This is expected to crowd out capital spending as states prioritise essential and committed expenditures amid a more uncertain macroeconomic environment.

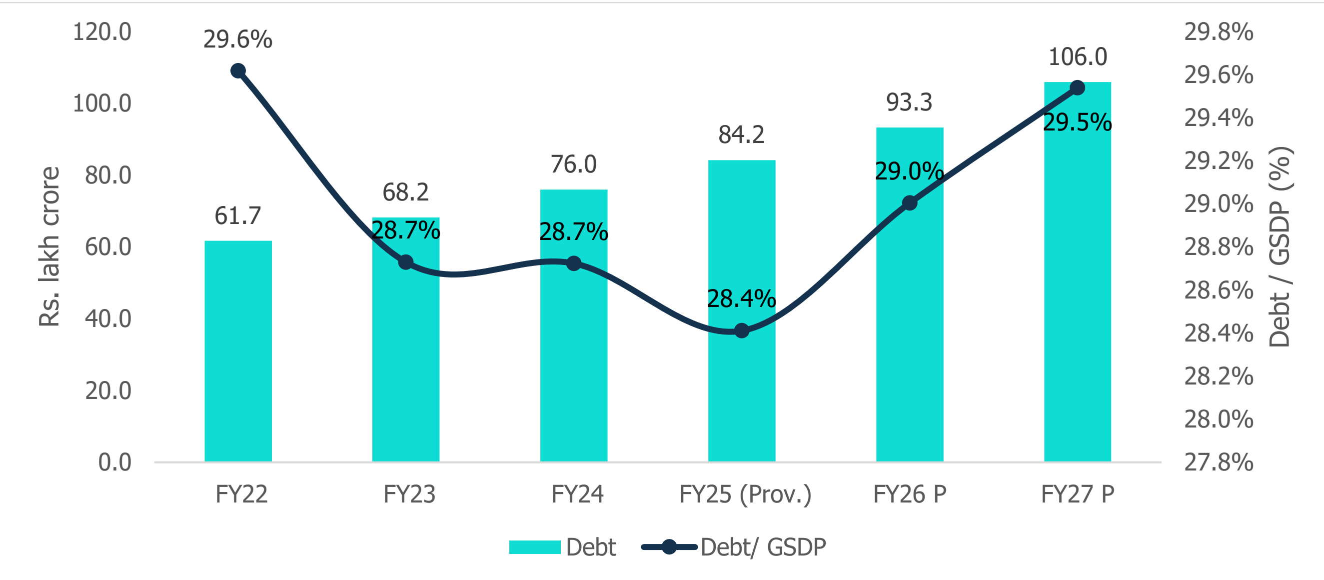
Exhibit 3: Trend in Capital Outlay and deficits as a percentage of GSDP



Source: State budgets, CAG provisional financials, MoSPI, CareEdge Ratings

The fiscal deficit is projected to remain at around 3.3% of GSDP in FY26 (P) and moderately increase to 3.5% in FY27 (P). The increase is primarily driven by the widening revenue deficit, reflecting moderation in revenue growth. States may also be encouraged to maximise the utilisation of SASCI funds, as the 16th Finance Commission has recommended a 3% fiscal deficit ceiling, excluding SASCI borrowings, during FY27–FY31.

Debt Levels to Edge Up Amid Fiscal Pressures
Exhibit 4: Indebtedness trend



Source: State budgets, RBI, MoSPI and CareEdge Ratings

Outstanding debt is estimated to increase from 28.4% of GSDP in FY25 (Prov.) to 29% in FY26 (P) and further to 29.5% in FY27 (P) to Rs 105.9 lakh crore.

The increase in debt levels is driven by a combination of widening revenue deficits and continued capital investment. However, the growing share of revenue expenditure in borrowing requirements indicates a gradual shift in the composition of debt, with a relatively lower share directed towards asset creation. Debt levels also vary significantly across states, reflecting differences in fiscal capacity, revenue mobilisation, and expenditure priorities.

Going forward, sustained economic growth and stable revenue performance will remain important for maintaining debt sustainability, particularly as states continue to balance rising revenue expenditure against the need to drive capital investment. Moreover, meaningful traction in monetization of state infra projects and bolstering of investor confidence for Public Private Partnership (PPP) in states are critical for funding higher capital outlay.

Conclusion

State finances are expected to remain under pressure over FY26–FY27, with revenue growth trailing nominal GSDP and expenditure commitments elevated, impacted by geopolitical developments in West Asia. While capex will remain a priority, its growth may moderate amid tightening fiscal headroom, leading to a modest uptick in fiscal deficits and debt.

Commenting on the outlook for state finances, Prasanna Krishnan, Associate Director, CareEdge Ratings said, "State revenue growth is expected to remain moderate through FY26 and FY27, primarily due to a tapering of grants from th Centre, with external headwinds further weighing on overall receipts in FY27. Meanwhile, revenue expenditure is likely to stay elevated, driven by (i) continued social sector spending, (ii) a higher state share under select schemes, and (iii) additional inflationary pressures from elevated commodity and fuel prices amid geopolitical developments in West Asia which may also push subsidy outgo at the state level. As a result, the revenue deficit is projected to widen from 0.8% of GSDP in FY25 to around 1.2% by FY27. Maintaining fiscal discipline will therefore remain critical as states balance welfare commitments with the need to sustain capital investment".

"Prominent states such as Uttar Pradesh, Madhya Pradesh, Gujarat, Maharashtra and Telangana have continued to prioritise capital expenditure despite moderate revenue growth, reflecting a sustained focus on infrastructure creation. States like Andhra Pradesh, Bihar and Haryana reported higher capex growth in FY25. However, with fiscal space becoming tighter due to rising revenue expenditure commitments and moderation in revenue growth, state capex growth is expected to moderate to around 8%-10% in FY27. This would translate into capex of about 2.3%–2.4% of Gross State Domestic Product (GSDP), supported by interest-free loans from the Centre. The fiscal deficit is expected to rise gradually from 3.2% of GSDP in FY25 to around 3.5% of GSDP in FY27, driven by widening revenue deficits. These deficits are also expected to exert upward pressure on debt levels, with additional downside risks stemming from evolving geopolitical developments. While capital expenditure remains a key growth lever, fiscal pressures may constrain flexibility. Therefore, meaningful traction in monetization of state infra projects and bolstering of investor confidence for Public Private Partnership (PPP) projects in states are critical for funding higher capital outlay," added Maulesh Desai, Director, CareEdge Ratings.

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