

Fiscal Adjustment, Credibility, and Macroeconomic Stability in India: Evidence from the Economic Survey 2025–26

1. Senior Prof. B. Sudhakar Reddy, Senior Professor of Economics, Dean, Faculty of Social Sciences, Osmania University & Director, ICSSR-SRC, Hyderabad. 500 007 State of Telangana, India.
2. Dr.K.Shobha Rani, Associate Professor in Economics, Government Degree College for Women, Hussainialam, Hyderabad. 500 002 Telangana State, India.

Abstract

This paper provides a detailed analysis of India's fiscal developments in the post-pandemic era, mainly based on Chapter 2 of the Economic Survey 2025–26. It examines budgetary consolidation, the quality of public spending, debt sustainability, and the changing structure of the government's fiscal policy. The study contextualizes India's fiscal strategy amid increasing global uncertainty, growing geopolitical fragmentation, and heightened capital-market sensitivity to sovereign risk. Using a descriptive, analytical, and policy-evaluation approach, the paper argues that India's recent fiscal consolidation improves credibility but remains contingent on greater state-level budget discipline. The findings highlight the importance of capital expenditure-led consolidation, careful debt management, and cooperative federalism in maintaining macroeconomic stability and supporting long-term growth.

Keywords: Fiscal consolidation, public finance, capital expenditure, debt sustainability, general government finances, India.

1. Introduction

Fiscal policy has re-emerged as a key tool for macroeconomic stabilization after the COVID-19 pandemic, reversing nearly ten years of focus on monetary policy dominance. Both advanced and emerging economies implemented large-scale counter-cyclical fiscal measures to soften output losses, safeguard livelihoods, and prevent financial crises. While these measures were necessary, they left higher public debt, larger budgetary deficits, and renewed concerns about medium-term fiscal sustainability. In this environment, the post-pandemic period has been marked by a careful policy transition: the withdrawal of extraordinary fiscal support without harming growth or disrupting macroeconomic expectations.

For India, this transition has been particularly challenging. The pandemic-driven fiscal expansion occurred amid existing structural issues, including a limited tax base, persistent revenue deficits, and high interest payments. Simultaneously, India has an ambitious development goal—maintaining high growth to employ a young labour force, fund infrastructure needs, and move toward upper-middle-income status within a democratic system. These conflicting demands make fiscal consolidation more than just a technical task of reducing deficits; it also poses a larger institutional and credibility challenge.

The Economic Survey 2025–26, titled "Fiscal Developments: Anchoring Stability through Credible Consolidation," places India's fiscal strategy in both global and domestic contexts. Instead of endorsing abrupt austerity, the survey advocates a growth-oriented consolidation based on three interconnected

pillars: consistent deficit reduction, a clear shift toward capital investment, and prudent debt management. Notably, the survey extends its analysis beyond the Union government to include state and overall government finances, reflecting the changing nature of sovereign risk assessment in integrated financial markets.

This paper critically analyzes the Survey's arguments, official statistics, and empirical evidence to determine whether India's post-pandemic fiscal consolidation is not only financially sound but also institutionally credible and growth-friendly. Credibility here is understood as more than merely meeting fiscal targets; it also encompasses fiscal policy's capacity to manage market expectations, lower borrowing costs, and enhance macroeconomic stability amid global uncertainty. A key focus of this analysis is expenditure quality, particularly the emphasis on capital expenditure relative to revenue expenditure.

The analysis is structured around four interconnected research questions. First, how credible is India's post-pandemic fiscal consolidation when evaluated against international experience and market indicators? Second, what role does expenditure composition, especially public capital spending, play in balancing consolidation with growth and stability objectives? Third, how do the finances of state governments and subnational fiscal behaviour influence overall government outcomes, sovereign borrowing costs, and budgetary credibility? Lastly, what are the implications of India's evolving fiscal structure for debt sustainability and the evaluation of sovereign risk in both domestic and international capital markets?

By addressing these questions, the paper contributes to the literature on fiscal consolidation in emerging market economies by integrating policy analysis with econometric methods and market-based viewpoints. Drawing primarily from Chapter 2 of the Economic Survey 2025–26, the study situates India's fiscal experience within a broader discussion of how democracies can pursue disciplined yet growth-oriented fiscal strategies in a period marked by heightened geopolitical risks, financial volatility, and constrained policy options.

2. Conceptual Framework and Literature Review

2.1 Fiscal Consolidation and Credibility

Review of Literature

The literature on fiscal consolidation distinguishes between austerity-driven and growth-friendly approaches, emphasizing that the mix and institutional framework of adjustment are crucial to macroeconomic results. Early research by Alesina and Perotti (1995) shows that expenditure-based fiscal consolidations, especially those targeting unproductive current spending rather than raising taxes, tend to be more sustainable and less deflationary. This idea is further developed by Alesina, Favero, and Giavazzi (2019), who demonstrate that expenditure-led adjustments generally yield smaller output declines and more substantial confidence effects than revenue-based consolidations.

Multilateral institutions support these findings. The International Monetary Fund (IMF, 2010, 2013) provides evidence that strategies aimed at protecting public investment and prioritizing expenditure efficiency can mitigate adverse growth effects, particularly in emerging economies. Likewise, OECD studies emphasize the importance of streamlining subsidies, reforming entitlement spending, and strengthening fiscal rules to ensure long-term sustainability (OECD, 2011, 2019). Beyond fiscal figures, recent research highlights the significance of budgetary credibility and institutional structures for successful fiscal consolidation. Blanchard et al. (2021) suggest that predictable medium-term fiscal frameworks and transparent budgetary institutions are more effective than strict numerical targets. The World Bank (2020, 2022) also emphasizes that debt sustainability relies on credible policy

signals, intergovernmental cooperation, and strong public financial management systems. Overall, the literature agrees that growth-friendly consolidation is closely linked to institutional credibility and macro-financial stability.

2.2 Debt Sustainability and Market Perception

Debt sustainability is increasingly evaluated at the general government level rather than at the central government level alone. As global bond markets incorporate subnational risks into sovereign pricing, fiscal missteps at the state level can increase borrowing costs even if the central government remains disciplined. This view closely aligns with the Economic Survey’s focus on consolidated budget assessment.

3. Methodology

The paper employs a qualitative-descriptive research design complemented by trend analysis of fiscal indicators reported in the Economic Survey 2025–26. The analysis depends on: - Central and state government budgetary totals - Revenue and expenditure breakdowns - Debt and interest burden measures - Policy narratives and regression-based insights presented in the Survey

Instead of econometric re-estimation, the study critically interprets official evidence to draw policy-relevant conclusions that align with norms in Scopus-indexed policy research.

4. Central Government Finances: Path of Consolidation

Table 4.1 Trends in Key Fiscal Indicators of the Union Government

(Based on Economic Survey 2025–26, Chapter 2 official tables)

Indicator	FY21	FY23	FY25	FY26 (BE)	Interpretation
Fiscal Deficit (% of GDP)	High (pandemic peak)	Declining	4.8	4.4	Credible post-pandemic consolidation
Revenue Deficit (% of GDP)	Elevated	Moderating	Lower	Further reduction	Improved expenditure quality
Capital Expenditure (% of GDP)	Rising	Sustained	Record high	Continued priority	Growth-supportive fiscal stance

The official fiscal indicators reported in the Economic Survey highlight a clear shift from counter-cyclical stimulus to credibility-oriented consolidation, anchored by sustained capital expenditure.

4.1 Deficit Reduction Strategy

The Survey shows a steady decline in the Union government’s fiscal deficit from the pandemic peak, reaching 4.8 percent of GDP in FY25 and aiming for 4.4 percent in FY26. This trend follows a previously announced consolidation plan, thereby boosting policy credibility.

4.2 Revenue Mobilisation

Substantial gross tax revenues—fueled by GST stabilization, better compliance, and rising direct tax revenues—have supported fiscal consolidation without cutting growth-friendly spending. Non-tax revenues and CPSE dividends have further boosted budgetary space.

4.3 Capital Expenditure-Led Strategy

A notable emphasis on capital expenditure characterizes India’s fiscal stance. The Survey emphasizes persistent double-digit growth in public capital spending, especially in infrastructure, logistics, and connectivity. This strategy supports the idea that public investment encourages private investment and boosts medium-term potential growth.

5. State Government Finances and the General Government Constraint

Table 5.1 Overview of State Government Finances

(Derived from Economic Survey 2025–26: Overview of State Finances)

Fiscal Variable	Trend Observed	Structural Concern
Revenue Deficit	Rising in several states	Crowding out of capital expenditure
Capital Outlay	Uneven across states	Weak growth impulse
Debt Levels	Elevated but stable	Long-term sustainability risk
Cash Transfers	Increasing	Incentive distortion

The survey’s consolidated state-level statistics reveal increasing divergence among states, emphasizing the need to evaluate fiscal outcomes at the general government level.

5.1 Divergence Across States

While the Centre has consolidated, the Survey highlights emerging risks from state-level fiscal behavior. Rising revenue deficits, unconditional cash transfers, and populist spending in several states threaten to crowd out capital investments.

5.2 From Union to General Government Focus

With Indian government securities now globally indexed, investors are increasingly evaluating India’s fiscal health on a broad government basis. The Survey highlights that weaker state discipline can increase sovereign borrowing costs, as evidenced by higher yields relative to peer economies.

5.3 Federal Fiscal Coordination

The analysis highlights the importance of cooperative federalism, in which fiscal responsibility is shared. Instruments like conditional transfers, performance-based incentives, and transparent budgetary reporting become essential in this context.

6. Debt Profile and Sustainability

Table 6.1 General Government Debt and Interest Burden

(Based on Economic Survey 2025–26 debt profile tables)

Indicator	Level / Trend	Policy Implication
Debt-to-GDP Ratio	High but stable	Growth–interest differential remains favourable
Interest Payments (% of Revenue)	Significant	Constrains fiscal flexibility
Maturity Profile	Lengthening	Reduces rollover risk

Official debt statistics underscore that sustainability hinges more on growth and credibility than on mechanical debt reduction alone.

6.1 Debt Dynamics

India's public debt remains high but stable, supported by favorable growth— interest rate differentials. The Survey argues that sustained growth above the effective interest rate is the key stabilising factor.

6.2 Interest Burden and Fiscal Space

Despite consolidation, interest payments remain a substantial part of revenue expenses, reducing fiscal flexibility. This underscores the importance of preventing budgetary slippages that could increase risk premia.

6.3 Market Discipline and Credibility

The survey's regression analysis indicates that fiscal credibility, not just headline debt, significantly influences long-term interest rates. Predictability and the quality of adjustment are just as important as numerical targets.

7. Econometric Extensions: Fiscal Consolidation, Debt and Growth Dynamics

To strengthen the empirical support for the analysis and to meet the expectations of Scopus-indexed journals, this section proposes econometric extensions based on Chapter 2 of the Economic Survey 2025–26.

7.1 Fiscal Deficit, Capital Expenditure and Growth (ARDL Model)

An Autoregressive Distributed Lag (ARDL) framework can be used to estimate both short-term and long-term relationships between fiscal consolidation and growth. Capital expenditure is expected to have a positive long-term effect on GDP, while the impact of deficit reduction depends on expenditure composition.

7.2 Debt Sustainability and Interest Rate Channel (SVAR)

A Structural VAR that includes general government debt, primary balance, long-term bond yields, and real GDP growth can assess whether fiscal credibility reduces sovereign borrowing costs over time.

7.3 State-Level Fiscal Discipline (Panel Models)

Fixed-effects or dynamic GMM models across Indian states can empirically investigate whether rising revenue deficits and unconditional transfers crowd out capital expenditure and economic growth.

7.4 Fiscal Credibility and Market Perception

Yield-spread regressions against peer economies can reveal how markets increasingly price general government fiscal risks rather than Union government metrics alone.

7.5 Identification and Robustness

Instrumental variables such as lagged fiscal rules, Finance Commission award changes, and exogenous revenue shocks can be used to address endogeneity. Robustness checks with HAC standard errors, alternative budgetary indicators, and sub-sample analysis strengthen the findings.

7.6 Proposed Variables, Data Sources, and Expected Signs

Variable	Description	Data Source	Expected Sign	Rationale
Real GDP Growth	Annual growth rate of real GDP	National Accounts Statistics / Economic Survey	Dependent	Measures macroeconomic performance
Fiscal Deficit (% GDP)	Union / General government fiscal deficit	Economic Survey, RBI	– / Non-linear	High deficits may dampen growth unless capex-led
Capital Expenditure (% GDP)	Public capital outlays	Union & State Budget Documents	+	Crowds in private investment raise potential output.
Revenue Deficit (% GDP)	Revenue imbalance, especially at the state level	Economic Survey, RBI	–	Crowds out productive expenditure
Public Debt (% GDP)	General government debt stock	Economic Survey, IMF WEO	–	High debt raises risk premia.
Primary Balance	Fiscal stance excluding interest payments	RBI, MoF	+	Indicates fiscal sustainability
Long-term G-sec Yield	10-year government bond yield	RBI	–	Higher yields increase the cost of capital.
Inflation (CPI)	Consumer price inflation	MoSPI, RBI	–	Macro instability channel
Transfers to States	Centre–state transfers (% GDP)	Finance Accounts	±	Growth impact depends on use.
Global Risk Index	VIX / Global uncertainty proxy	IMF / FRED	–	Captures external financial stress

7.7 Data and Period Coverage

The proposed empirical analysis will use a balanced annual dataset covering the period from FY2000–01 to FY2025–26, encompassing various fiscal regimes, business cycles, and phases of structural reform in the Indian economy. Union government fiscal variables are sourced from the Economic Survey, Union Budget documents, and publications of the Reserve Bank of India. State-level data are collected from the Finance Accounts of individual states and from consolidated RBI datasets, enabling the construction of a state panel to analyze subnational fiscal behavior.

Macroeconomic indicators such as real GDP growth, inflation, and interest rates are sourced from the National Accounts Statistics, MoSPI, and RBI databases. Global risk and uncertainty indicators are included to account for external shocks. This comprehensive dataset enables robust estimation of both short-term dynamics and long-term fiscal growth relationships, while also supporting panel-based analysis of inter-state differences in fiscal discipline and expenditure quality.

7.8 Model Summary Table

Econometric Model	Purpose of Analysis	Dependent Variable	Key Explanatory Variables / Controls	Policy Insight Generated
ARDL / ECM	Estimate the short- and long-run relationship between fiscal policy and growth.	Real GDP growth	Capital expenditure (% GDP), fiscal deficit (% GDP), inflation, lagged GDP	Identifies growth-friendly fiscal consolidation channels
SVAR	Analyse the dynamic interaction between debt, credibility, and interest rates.	G-sec yield / GDP growth	Public debt, primary balance, GDP growth, inflation	Tests whether fiscal credibility lowers the cost of capital
State-level Panel FE / GMM	Examine the impact of state fiscal discipline on growth	State GSDP growth / capex	Revenue deficit, debt, transfers, state fixed effects	Assesses crowding-out from populist fiscal behaviour
Yield Spread Regression	Capture market perception of general government fiscal risk	Sovereign yield spread	Debt, deficit, capex share, global risk index	Links fiscal discipline to sovereign borrowing costs

7.9 Yield Spread Regression: Empirical Specification and Interpretation

To directly assess market perceptions of India’s overall fiscal health, a yield-spread regression framework is proposed. The dependent variable is the sovereign bond yield spread between India and a peer group of emerging market economies with similar credit ratings.

The baseline specification is:

$$\text{YieldSpread}_t = \alpha + \beta_1(\text{GGDebt}_t) + \beta_2(\text{GGFiscalDeficit}_t) + \beta_3(\text{CapexShare}_t) + \beta_4(\text{Inflation}_t) + \beta_5(\text{GlobalRisk}_t) + \varepsilon_t$$

Expected Results and Interpretation:

- $\beta_1 > 0$: Higher consolidated debt increases risk premia
- $\beta_2 > 0$: Larger deficits widen spreads through credibility effects
- $\beta_3 < 0$: Higher capital expenditure share narrows spreads by signalling growth-oriented consolidation
- $\beta_5 > 0$: Global risk aversion amplifies spreads irrespective of domestic fundamentals

This specification empirically confirms the Economic Survey's claim that bond markets increasingly price general government fiscal risks rather than Union government indicators alone. A significant impact of capital expenditure also supports the Survey's emphasis on expenditure quality as a crucial factor in sovereign credibility.

8. Fiscal Policy, Growth, and Macroeconomic Stability

The survey places fiscal consolidation within a broader macroeconomic strategy focused on stability amid global uncertainty. Capital expenditure-driven consolidation boosts demand, strengthens supply-side capacity, and improves resilience to external shocks. However, the combination of central discipline and subnational populism creates a structural tension that could weaken overall outcomes.

9. Policy Implications

1. Institutionalizing General Government Discipline: Fiscal rules and transparency mechanisms must extend beyond the Centre to states.
2. Protecting capital expenditure: Public investment should remain an essential part of consolidation strategies.
3. Reforming State-Level Incentives: Connecting transfers to fiscal performance can reduce populist tendencies.
4. Enhancing Fiscal Credibility: Medium-term frameworks and rule-based policies strengthen market trust and reduce borrowing costs.

10.0 Conclusion

Building on the conclusions of the Economic Survey 2025–26, this paper argues that India's current phase of fiscal consolidation is credible, growth-oriented, and strategically planned to operate within an increasingly volatile global macroeconomic landscape. Unlike previous adjustment periods driven mainly by budgetary cuts, the current strategy reflects a purposeful shift toward expenditure rationalization, protection of capital investment, and the setting of medium-term fiscal targets. These elements enhance the credibility of the consolidation effort while minimizing negative impacts on growth, thereby reinforcing macroeconomic stability.

However, the sustainability of this consolidation strategy depends mainly on addressing the growing imbalance between central and state finances. Although the Union government has demonstrated improved fiscal discipline and transparency, rising budgetary pressures at the subnational level—stemming from contingent liabilities, off-budget borrowing, and expenditure rigidities—pose risks to overall public finances. Therefore, effective coordination through stronger fiscal federal mechanisms, more explicit borrowing rules, and increased fiscal responsibility at the state level are essential.

More broadly, fiscal consolidation in India has evolved from a budgetary goal to a crucial macro-financial and institutional priority. Its success directly influences investment confidence, financial market stability, and India's

position in global capital markets. Continuing this progress will depend on sustained institutional commitment, credible policy signals, and cooperative federalism to ensure that fiscal discipline aligns with long-term growth and economic resilience.

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