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EDITORIAL ANALYSIS

Expensive State Borrowing and Fiscal Federalism

THE HINDU

1 July 2026 · **ECONOMY** · **GS2** · **GS3**

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Expensive State Borrowing and Fiscal Federalism

 **The Hindu**

1 July 2026

GS2
GS3

 Source: ujjyari.com — researched, fact-checked & UPSC-mapped

INTERVIEW ANGLE

"If States do most of the spending that citizens actually feel, schools, hospitals, roads, why should they pay a premium to borrow, and what would a fairer system of access to savings look like?"

 Source: [Original editorial](#)
[The Hindu](#)
 **Every fact web-verified against primary sources** (<https://ujjyari.com/how-we-verify/>)

WHY THIS MATTERS NOW

With Indian States borrowing record amounts, and **State Development Loans** pricing well above central government bonds, the cost of State debt has become a live issue. For an aspirant, this is a GS2 and GS3 case on **fiscal federalism** (<https://ujjyari.com/terms/fiscal-federalism/>), **the vertical fiscal imbalance, and public capital investment**.

THE CRUX IN 60 WORDS

The **Centre** raises most taxes; **States** do most of the spending citizens feel. Yet States borrow through **SDLs** at a spread over central bonds, paying more for every rupee. Costly debt **crowds out capital investment**. India needs to channel its large pool of **domestic savings** to States more cheaply, paired with credible fiscal rules that reward prudence.

THE ISSUE, DECODED

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CONCEPT	WHAT IT MEANS	WHY IT MATTERS
Vertical fiscal imbalance	Centre collects, States spend	The structural mismatch
State Development Loans (SDLs)	The main way States borrow	They price above central bonds
SDL spread	Extra yield over G-Secs of same tenor	Raises the cost of State debt
Crowding out	Interest costs squeezing capital spending	The long-run growth cost

THE ANALYSIS

- ❶ **The spending falls to the States.** Health, education, policing, agriculture and much capital creation are State subjects; States therefore carry expenditure far larger than their own revenue.
- ❷ **Devolution** (<https://ujijari.com/terms/devolution/>) **does not close the gap.** Tax devolution and grants help, but a sizeable financing gap remains, which States meet by borrowing.
- ❸ **State borrowing is dearer.** SDLs trade at a spread over central securities; with record issuance meeting weak demand, that spread and the absolute cost stay elevated.
- ❹ **Capital investment is the casualty.** When debt is expensive, committed revenue spending and interest crowd out the long-horizon capital outlays that build future growth.
- ❺ **The savings are there.** India has a deep pool of long-term domestic savings; the failure is in channelling it to State capital needs affordably and transparently.

DATA AND INSTITUTIONS VAULT

State Development Loans (SDLs), dated securities issued by States and auctioned by the **RBI**, priced at a spread over **Government Securities (G-Secs)** of similar tenor. **Scale:** States have been raising record quarterly amounts (in the trillions of rupees) as borrowing needs rise. **Framework:** the **Finance Commission** (<https://ujijari.com/terms/finance-commission/>) (tax devolution and grants), the **FRBM** and State fiscal-responsibility laws, and Article 293 (State borrowing). **Concept:** vertical and horizontal fiscal imbalance; fiscal federalism (<https://ujijari.com/terms/federalism/>); capital versus revenue expenditure; crowding out.

THE DEBATE

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Argument that high State yields are justified: Spreads reflect genuine differences in fiscal discipline and creditworthiness; uniform cheap access would blunt (<https://ujjiyari.com/vocab/blunt/>) incentives for prudent State finances.

Argument for cheaper State access: The premium is disproportionate (<https://ujjiyari.com/vocab/disproportionate/>) for issuers backed by the federal structure, and it starves capital investment; deeper markets and better instruments would lower costs without sacrificing discipline.

Balanced verdict: Give States cheaper, more reliable access to domestic savings through deeper markets, transparency and benchmark issuance, but pair it with credible fiscal-responsibility frameworks so prudence is rewarded and moral hazard (<https://ujjiyari.com/terms/moral-hazard/>) is contained.

HOW TO THINK ABOUT THIS (TRANSFERABLE SKILL)

In any federal or delegated system, ask who holds the revenue and who holds the responsibility, and whether the two match. A mismatch between spending duty and financing power is the root of most fiscal-federalism disputes; naming it lets you diagnose water, health or education debates the same way.

DIAGRAM-IN-WORDS

Centre raises buoyant taxes -> States carry the larger spending -> financing gap -> States borrow via SDLs at a spread -> dearer debt crowds out capital investment -> cheaper access to domestic savings + fiscal rules

THE WAY FORWARD

- ① **Deepen the market for State paper.** Improve liquidity, transparency and benchmark issuance so SDL spreads narrow.
- ② **Channel patient savings.** Design instruments that match long-term domestic savings with State capital investment needs.
- ③ **Protect capital spending.** Ring-fence and incentivise capital outlays so interest costs do not crowd them out.
- ④ **Pair access with discipline.** Tie cheaper access to credible fiscal-responsibility frameworks that reward prudent (<https://ujjiyari.com/vocab/prudent/>) States.

THE TAKEAWAY BOX

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Frame expensive State borrowing as a symptom of the vertical fiscal imbalance, with capital investment as the casualty and cheaper savings access as the remedy.

“In India’s federal accounts, the Centre collects and the States spend, so those who spend most on citizens borrow most dearly to do it.”

State Development Loans; SDL spread; G-Secs; RBI auctions; Finance Commission; FRBM; Article 293; vertical fiscal imbalance.

Is it fair that the tier of government closest to citizens’ daily needs pays the highest price to fund them.

UPSC has asked about fiscal federalism, the Finance Commission and Centre-State financial relations; this connects those to the cost of State debt.

the Finance Commission; capital expenditure and growth; Centre-State relations; the bond market.

Sources: *The Hindu* (<https://www.thehindu.com/opinion>), *Reserve Bank of India* (<https://www.rbi.org.in/>)

Source: Expensive State Borrowing and Fiscal Federalism — Ujyari.com | Free UPSC & State PCS Editorial Analysis

KEY ARGUMENTS AT A GLANCE

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The Union raises most taxes while States bear the larger burden of social and economic spending, yet States borrow expensively through State Development Loans at rates well above comparators, so India needs a system that gives States cheaper access to domestic savings to fund capital investment.

 **SUPPORTING**

- The vertical fiscal imbalance means States shoulder spending responsibilities far larger than their own revenue base.
- State Development Loans carry a spread over central government securities that raises the cost of every rupee States borrow.
- Costlier debt crowds out capital investment, the very spending that builds long-run growth and public assets.

 **COUNTER**

Higher State yields partly reflect real differences in fiscal discipline and creditworthiness across States, and cheap uniform access could dull incentives for prudence.

 **WAY FORWARD**

Deepen the market for State paper, improve transparency and benchmark issuance, channel long-term domestic savings toward State capital spending, and pair cheaper access with credible fiscal-responsibility frameworks.


MAINS ANSWER FRAMEWORK

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QUESTION

"India's fiscal federalism concentrates revenue at the Centre but pushes expensive borrowing onto the States." Examine the mismatch and its consequences for capital investment, and suggest reforms for cheaper State access to domestic savings. (250 words)

INTRODUCTION

In India's federal accounts, the Centre collects and the States spend. The awkward result is that those who spend most on citizens borrow most dearly to do it.

BODY

The architecture of Indian fiscal federalism concentrates the elastic, buoyant taxes at the Union while assigning to the States the expenditure that citizens experience directly: health, education, police, agriculture, local roads and much of capital creation. This vertical fiscal imbalance is partly corrected by tax devolution and grants, but a large financing gap remains, and States fill it by borrowing.

Here the problem sharpens. States borrow chiefly through State Development Loans (SDLs), and these trade at a spread over central government securities of comparable tenor.

With benchmark yields elevated and record State borrowing pressing on subdued demand, ten-year SDLs from major States have been pricing around the higher end of the range, well above what a sovereign issuer of India's standing pays. Every basis point of that spread is money diverted from schools and hospitals to interest payments.

The deeper cost is on capital investment. When debt is dear, States trim exactly the long-horizon spending, infrastructure, assets, capacity, that builds future growth, because interest and committed revenue expenditure crowd it out.

A fairer system would give States cheaper, more reliable access to India's own large pool of long-term savings, through deeper and more liquid markets for State paper, greater transparency and benchmark issuance, and instruments that match patient savers with State capital needs. This is not a plea to abandon fiscal discipline; cheaper access should be paired with credible responsibility frameworks so that prudence is rewarded, not penalised.

CONCLUSION

Fiscal federalism works only if the level of government doing the spending can finance it affordably. Giving States cheaper access to domestic savings, alongside credible fiscal rules, is central to India's investment future.


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