

# Budget 2026-27 and Coping with the Emerging Economic Challenge

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Stable fiscal ratios, high growth and low inflation portray India as a haven of stability and calm in a very turbulent world. However, this may well be a calm before the storm. The stable fiscal ratios notwithstanding, fiscal space is shrinking, which handicaps the country in coping with the economic shock, which is expected in the wake of the Iran war and Iran's chokehold on supplies through the Strait of Hormuz. An expansionary fiscal policy, combined with a tight monetary policy stance, can moderate the impact of the shock, but a period of slower growth and elevated inflation seems unavoidable.

The war unleashed on Iran by the United States (us)–Israel alliance is still raging at the time of writing this article, while the Ukraine war continues unabated and wars are also being fought in Africa and elsewhere. The geopolitical order established by the us and its allies is being torn down, ironically by the us itself, while the contours of any emerging new order remain unclear. The uncertainty of this geopolitical transformation has been added to the rapid technological transformation of the way the world lives and works, led by artificial intelligence, the biochemical revolution and climate change. We have not seen such an extreme level of uncertainty since World War II. Does the 2026-27 budget allow fiscal space to cope with the economic consequences of such uncertainties as they unfold? Before addressing this grand question, it is necessary to first address two specific domestic developments which have significant fiscal implications.

First, the much-improved new GDP series (2022-23 base) was released after the 2026-27 budget was presented to Parliament. Accordingly, all the aggregate fiscal ratios have had to be recalibrated based on the new GDP series for the FY 2026-27 budget and those preceding it, which have been presented here for the purposes of comparison. The second development is Parliament's acceptance of the main recommendations of the Sixteenth Finance Commission, which will impact the outlook for state finances and, hence, combined government finances.

We begin by analysing the budget assumptions for revenue receipts, especially tax receipts, to assess whether these assumptions are realistic, keeping in view the performance of union government

revenue receipts in recent years. Further, we discuss some important changes in the pattern of union government expenditure to assess whether these changes will entail an improvement in the quality of expenditure. Subsequently, we review the aggregate levels of revenue, expenditure, deficits and debt in the FY 2026-27 budget in comparison with the earlier budgets to analyse the direction of change and assess how well the budget is addressing the goal of fiscal consolidation. This part also discusses the impact of the Sixteenth Finance Commission on the macroeconomic fiscal outlook. The key takeaway here is that the debt path may be unsustainable and that the fiscal space is likely to shrink going forward, even without taking into account the implications of the uncertainties mentioned earlier. Starting from this baseline, we ask what fiscal measures may be necessary to cope with the emerging economic challenge, in particular the economic consequences of the uncertainties confronting the Indian economy.

## BUDGET 2026

### Receipts: Stable Tax Ratios Projected for FY 2026-27 Despite Declining Direct Tax Growth

Direct taxes have been assumed to grow at 11.4% in the budget, implying a buoyancy of well over 1 (Table 1, p 17). Considering that the growth of direct tax receipts has declined quite drastically in recent years, from 17.9% in FY 2023-24 to 13.6% in FY 2024-25 and further to only 9% in FY 2025-26, the high buoyancy assumed for FY 2026-27 seems unwarranted. Indirect taxes, on the other hand, have been assumed to grow by only 3% in FY 2026-27, implying a very low buoyancy, with the GST component assumed to grow at a modest 6.3%. This implies a gradual recovery from the sharp reduction in growth of GST collections last year, 5.4% compared to 10.8% in FY 2024-25, because of the massive reduction in GST rates. The combined impact on the union government's tax receipts, net of devolution, is a modest growth of 7.2%. This is very much in line with the growth of the union government's net tax receipts during the last two years, FY 2024-25 and FY 2025-26. On these

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assumptions, the union government's tax-to-GDP ratio will continue to decline gradually from 8% in FY 2023-24 to 7.5% in FY 2026-27 (Table 1).

Non-tax revenue receipts are expected to decline marginally in 2026-27, mainly due to much slower growth of dividends and profits, the largest component of the latter being transfer of surpluses of the Reserve Bank of India (RBI). Non-debt capital receipts, on the other hand, are expected to increase by nearly 85%, mainly on account of the disinvestment of government equity. Disinvestment increased by 97% in FY 2025-26 and is

now projected to increase by a massive 136%, mainly due to the sale of central public sector undertakings' assets.

### Mixed Picture on Changes in Quality of Expenditure

Turning to the expenditure side of the budget, one of the signature features of all budgets of the present government is the high share of capital expenditure. It has been maintained at between 22% and 23% of total spending in all years, except in the aftermath of the COVID-19 shock (Table 2). What is interesting and unusual about the FY 2026-27 budget is that high capital

expenditure has been combined with high social expenditure. After cutting down social spending by over 23% in FY 2024-25 and again by over 6% in FY 2025-26, social spending has now been raised by as much as 23% in the FY 2026-27 budget. In contrast, the budget provision for economic services has actually been reduced. While the re-prioritising of social spending is to be welcomed, it is important to look at the fine print of where exactly social spending will be increased or economic spending reduced. Expenditure on general services, which is projected to grow at a moderate 7%,

**Table 1: Receipts**

1		₹ Trillion					% Change				% of GDP at 2022-23 Series				
		2022-23	2023-24	2024-25	2025-26	2026-27	2023-24	2024-25	2025-26	2026-27	2022-23	2023-24	2024-25	2025-26	2026-27
		(Act)	(Act)	(Act)	(RE)	(BE)	(Act)/ 2022-23 (Act)	(Act)/ 2023-24 (Act)	(RE)/ 2024-25 (Act)	(BE)/ 2025-26 (RE)	(Act)	(Act)	(Act)	(RE)	(BE)
1	Gross tax revenue (centre+ states) (1.1+1.2)	30.54	34.66	37.96	40.78	44.04	13.5	9.5	7.4	8	11.7	12	11.9	11.8	11.6
1.1	Direct tax	16.59	19.56	22.22	24.21	26.97	17.9	13.6	9	11.4	6.4	6.7	7	7	7.1
1.2	Indirect tax, of which	13.95	15.09	15.74	16.57	17.07	8.2	4.3	5.2	3	5.3	5.2	4.9	4.8	4.5
	1.2.1 Central GST	7.19	8.21	9.09	9.58	10.19	14.2	10.8	5.4	6.3	2.8	2.8	2.9	2.8	2.7
	1.2.2 Integrated GST	0.05	-0.05	-0.32	0		-202.1	569.8			0	0	-0.1	0	0
	1.2.3 GST compensation cess	1.26	1.41	1.51	0.88		12.4	6.5	-41.6		0.5	0.5	0.5	0.3	0
2	Revenue receipts (2.1+2.2)	23.83	27.29	30.37	33.42	35.33	14.5	11.3	10.1	5.7	9.1	9.4	9.5	9.7	9.3
2.1	Tax revenue (net to centre)	20.98	23.27	25	26.75	28.67	10.9	7.4	7	7.2	8	8	7.9	7.7	7.5
2.2	Non-tax revenue, of which	2.85	4.02	5.37	6.68	6.66	40.8	33.5	24.4	-0.2	1.1	1.4	1.7	1.9	1.8
	2.2.1 Interest receipts	0.28	0.38	0.4	0.4	0.42	37.4	5.7	-0.7	4	0.1	0.1	0.1	0.1	0.1
	2.2.2 Dividends and profits	1	1.71	3.08	3.76	3.91	71	80.5	21.8	4.1	0.4	0.6	1	1.1	1
3	Non-debt capital receipts, of which	0.72	0.6	0.42	0.64	1.18	-17.2	-30	53.1	84.9	0.3	0.2	0.1	0.2	0.3
3.1	Disinvestment of government equity	0.46	0.33	0.17	0.34	0.8	-28.1	-48.1	96.7	136.4	0.2	0.1	0.1	0.1	0.2
4	Total non-debt receipts (2+3)	24.55	27.89	30.78	34.06	36.52	13.6	10.4	10.7	7.2	9.4	9.6	9.7	9.9	9.6

RE—revised estimates; BE—budget estimates; Act—actuals.

Source: Receipt budget, budget documents, various years.

**Table 2: Expenditure and Allocations (Broad Heads)**

1		Total Expenditure (₹ trillion)					Share in Total Expenditure (%)					% Change				
		2022-23	2023-24	2024-25	2025-26	2026-27	2022-23	2023-24	2024-25	2025-26	2026-27	2023-24 (Act)/ 2022-23 (Act)	2024-25 (Act)/ 2023-24 (Act)	2025-26 (RE)/ 2024-25 (Act)	2026-27 (BE)/ 2025-26 (RE)	
		(Act)	(Act)	(Act)	(RE)	(BE)	(Act)	(Act)	(Act)	(RE)	(BE)	(Act)	(Act)	(Act)	(RE)	
1	Total expenditure	41.93	44.43	46.53	49.65	53.47	100	100	100	100	100	6	13	14	15	
		(17.6)	(21.4)	(22.6)	(22.1)	(22.8)						4.7	6.7	7.7		
2	General services, of which	17.77	19.79	21.16	24.01	25.68	42.4	44.5	45.5	48.4	48	11.4	6.9	13.5	7	
		(9.1)	(9.0)	(9.0)	(10.3)	(10.3)										
2.1	Interest payment and servicing of debt	9.29	10.64	11.16	12.74	14.04	22.1	23.9	24	25.7	26.3	14.6	4.9	14.2	10.2	
		(0.0)	(0.0)	(0.0)	(0.0)	(0.0)										
2.2	Defence services	3.99	4.45	4.51	5.68	5.95	9.5	10	9.7	11.4	11.1	11.4	1.4	26	4.7	
		(35.8)	(34.7)	(35.4)	(38.4)	(38.5)										
3	Social services	2.12	2.47	1.89	1.78	2.18	5.1	5.6	4.1	3.6	4.1	16.3	-23.2	-6.2	23	
		(5.7)	(3.5)	(5.9)	(6.2)	(5.3)										
4	Economic services	14.17	14.23	15.37	16.52	16.16	33.8	32	33	33.3	30.2	0.4	8	7.4	-2.2	
		(31.8)	(42.3)	(42.5)	(38.1)	(41.3)										
5	Grants-in-aid and contributions	7.87	7.94	8.11	7.34	9.44	18.8	17.9	17.4	14.8	17.7	1	2.1	-9.4	28.6	
		(14.7)	(20.3)	(24.3)	(28.4)	(29.5)										

BE—budget estimates, RE—revised estimates, Act—actuals.

Figures in parenthesis denote share of capital expenditure in total expenditure under each head.

Source: Expenditure budget, budget documents, various years.

now accounts for nearly half of total union government spending (48%). What is concerning, however, is that, of this, the share of interest cost and debt servicing has now crept up to over 26% of the total union government expenditure.

A more granular view of social expenditure indicates that spending on both education and health services is budgeted to increase by 10%–11% each, a modest step-up from increases of 4%–5% last year (Table 2.1). The really big increase in

social spending is under the head “labour, employment and skill development,” where spending has been budgeted to increase by a massive 160% from ₹13,000 crore in FY 2025–26 to ₹33,000 crore in FY 2026–27. Most of this is for the Pradhan Mantri Viksit Bharat Rozgar Yojana. From an expenditure of only ₹848 crore for its predecessor programme (New Employment Generation Scheme) in FY 2025–26 (RE), the allocation has been raised to ₹20,083 crore in FY 2026–27 (BE).

However, it is important to note that the original allocation for the predecessor scheme in FY 2025–26 (BE) was also nearly as large at ₹20,000 crore, but only ₹848 crore was actually spent. It remains to be seen how much of the current allocation is spent. More importantly, it is crucial to see how much additional employment actually gets created because of this scheme since skilling programmes in India have not translated into much extra employment in the past.

**Table 2.1: Allocation of Social Services Expenditure**

		Total Expenditure (₹ trillion)					Share in Total Expenditure (%)					% Change			
		2022-23 (Act)	2023-24 (Act)	2024-25 (Act)	2025-26 (RE)	2026-27 (BE)	2022-23 (Act)	2023-24 (Act)	2024-25 (Act)	2025-26 (RE)	2026-27 (BE)	2023-24 (Act)/2022-23 (Act)	2024-25 (Act)/2023-24 (Act)	2025-26 (RE)/2024-25 (Act)	2026-27 (BE)/2025-26 (RE)
1		2	3	4	5	6	7	8	9	10	11	12	13	14	15
1	Social services, of which	2.12 (5.7)	2.47 (3.5)	1.89 (5.9)	1.78 (6.2)	2.18 (5.3)	5.1	5.6	4.1	3.6	4.1	16.3	-23.2	-6.2	23.0
1.1	Education, sports, art and culture, of which	0.57 (0.1)	0.88 (0.1)	0.68 (0.3)	0.71 (0.3)	0.79 (0.3)	1.4	2.0	1.5	1.4	1.5	52.3	-22.8	4.4	11.3
1.1.1	Education	0.52	0.81	0.62	0.64	0.71	1.2	1.8	1.3	1.3	1.3	57.1	-24.1	4.0	10.9
1.2	Medical and public health	0.39 (7.8)	0.39 (5.0)	0.46 (5.0)	0.49 (4.8)	0.54 (5.2)	0.9	0.9	1.0	1.0	1.0	1.3	17.3	5.8	10.4
1.3	Housing	0.20 (9.0)	0.08 (17.9)	0.09 (22.9)	0.09 (20.9)	0.15 (25.5)	0.5	0.2	0.2	0.2	0.3	-58.2	8.7	1.3	60.2
1.4	Labour, employment and skill development	0.15 (0.0)	0.13 (0.0)	0.13 (0.0)	0.13 (0.0)	0.33 (0.0)	0.4	0.3	0.3	0.3	0.6	-14.5	0.2	-3.4	160.3
1.5	Social security and welfare	0.06 (0.0)	0.04 (0.0)	0.04 (0.0)	0.05 (0.0)	0.06 (0.0)	0.1	0.1	0.1	0.1	0.1	-25.3	4.3	9.2	17.7

BE—budget estimates, RE—revised estimates, Act—actuals. Figures in parenthesis denote share of capital expenditure in total expenditure under each head. Source: Expenditure budget, budget documents, various years.

**Table 2.2: Allocation of Economic Services Expenditure**

		Total Expenditure (₹ trillion)					Share in Total Expenditure (%)					% Change			
		2022-23 (Act)	2023-24 (Act)	2024-25 (Act)	2025-26 (RE)	2026-27 (BE)	2022-23 (Act)	2023-24 (Act)	2024-25 (Act)	2025-26 (RE)	2026-27 (BE)	2023-24 (Act)/2022-23 (Act)	2024-25 (Act)/2023-24 (Act)	2025-26 (RE)/2024-25 (Act)	2026-27 (BE)/2025-26 (RE)
1		2	3	4	5	6	7	8	9	10	11	12	13	14	15
1	Economic services, of which	14.17 (31.8)	14.23 (42.3)	15.37 (42.5)	16.52 (38.1)	16.16 (41.3)	33.8	32.0	33.0	33.3	30.2	0.4	8.0	7.4	-2.2
1.1	Agriculture and allied activities, of which	4.71 (0.7)	3.93 (0.1)	3.90 (0.1)	4.07 (0.1)	4.05 (0.1)	11.2	8.9	8.4	8.2	7.6	-16.6	-0.9	4.3	-0.3
1.1.1	Crop husbandry	1.60 (0.0)	1.47 (0.0)	1.46 (0.0)	1.35 (0.0)	1.30 (0.1)	3.8	3.3	3.1	2.7	2.4	-8.1	-1.2	-7.0	-3.7
1.1.2	Food storage and warehousing	2.76 (0.7)	2.14 (0.1)	2.02 (0.1)	2.31 (0.0)	2.31 (0.0)	6.6	4.8	4.3	4.6	4.3	-22.6	-5.6	14.3	-0.1
1.2	Rural development, of which	0.94 (0.0)	0.93 (0.0)	0.90 (0.0)	1.21 (0.0)	1.30 (0.0)	2.3	2.1	1.9	2.4	2.4	-1.0	-3.6	34.9	6.9
1.2.1	Rural employment	0.91 (0.0)	0.89 (0.0)	0.86 (0.0)	1.18 (0.0)	1.26 (0.0)	2.2	2.0	1.8	2.4	2.4	-1.8	-3.7	37.1	6.8
1.3	Energy	0.50 (4.2)	0.42 (5.3)	0.59 (6.2)	0.75 (6.7)	0.92 (0.8)	1.2	0.9	1.3	1.5	1.7	-16.1	39.6	28.2	22.1
1.4	Transport	3.88 (95.5)	5.37 (95.8)	5.75 (94.8)	5.26 (97.4)	5.77 (97.4)	9.3	12.1	12.4	10.6	10.8	38.4	7.1	-8.6	9.7
1.5	Communications	1.24 (44.8)	0.93 (65.2)	1.28 (58.2)	0.58 (41.8)	0.77 (59.7)	3.0	2.1	2.8	1.2	1.4	-25.2	38.2	-54.9	34.1
1.6	Industry and minerals	2.17 (3.0)	1.81 (3.5)	1.80 (7.1)	1.86 (6.0)	1.97 (5.2)	5.2	4.1	3.9	3.8	3.7	-16.9	-0.5	3.7	5.6
1.7	Special areas programmes for North East areas	0.01 (29.7)	0.02 (55.7)	0.03 (68.6)	0.89 (28.3)	1.08 (24.9)	0.0	0.0	0.1	1.8	2.0	84.8	85.8	2,604	22.1

BE—budget estimates, RE—revised estimates, Act—actuals. (1) Figures in parenthesis denote share of capital expenditure in total expenditure under each head. (2) Expenditure allocation to rural employment includes both MGNREGA and Viksit Bharat Guarantee for Rozgar and Ajeevika Mission (Gramin) (VBGRAM G) for 2026–27. Source: Expenditure budget, budget documents, various years.

Housing is the other major social sector head under which expenditure is projected to go up significantly, by over 60% to around ₹15,000 crore. This is mainly for the Pradhan Mantri Awas Yojana–Urban scheme. Again, it should be noted that the original allocation for this scheme in FY 2025–26 (BE) was even more than the current allocation at ₹19,794 crore. Of this, only ₹7,500 was actually spent.

Regarding the slightly restricted allocation for economic services, the reduction is mainly on account of the fertiliser subsidy, under the head “crop husbandry,” and the food subsidy under the head “food storage and warehousing.” In contrast, the allocation for “rural employment” has been raised significantly from ₹86,000 crore two years ago (FY 2024–25) to ₹1.18 trillion in FY 2025–26 and further to ₹1.26 trillion in FY 2026–27.

However, the allocation under employment in FY 2024–25 was entirely for MGNREGA, which was a demand-driven central scheme of employment guarantee. The present allocation is for MGNREGA, which is being wound up, plus the new VB G RAM G programme which will replace MGNREGA. The two schemes are quite different. VB G RAM G is no longer a demand-driven employment guarantee scheme but a supply-driven scheme, where the employment offered will depend on the availability of funds. Also, it is a centrally sponsored scheme, not a central scheme. So, fund availability will now depend on how much the states can put up as their share.

The other “economic services” head for which allocation has been significantly raised is energy. The increase is mainly for reforms to improve the performance of the “DISCOMS” and for battery storage projects to step up the generation of renewable energy.

In summary, the increased allocation for social spending is welcome, but it remains to be seen how much of the increased allocation is actually used, how much additional employment is actually created by the new urban and rural employment creation schemes, how far DISCOMS are actually reformed and how much additional housing or renewable energy capacity is actually created.

### Deficit, Debt Dynamics and Fiscal Space

The receipt and expenditure components of the budget discussed so far can now be combined for a consolidated picture of the FY 2026–27 budget. The union government’s total receipts are projected to grow at 7.2% in FY 2026–27 and revenue receipts by 5.7%. These are both modest assumptions compared to their observed double-digit growth in recent years (Table 3). The union government’s share of tax revenue is projected to grow 7.2%, which is similar to its observed growth rates during the last couple of years. As a proportion of nominal GDP, union government’s total receipts, revenue receipts and tax receipt projection work out to 9.6%, 9.3% and 7.5%, respectively, which are all quite realistic

and marginally lower than the corresponding proportions observed during the last couple of years.

On the expenditure side, revenue expenditure, which was severely compressed during the adjustment period after the COVID-19 shock (FY 2022–23 to FY 2024–25), grew by 7.4% during FY 2025–26 and is again projected to grow significantly at 6.6% during the current year. Capital expenditure, on the other hand, grew very significantly in the post-COVID-19 adjustment period but was cut down to only 4.2% in FY 2025–26. It has now been projected to grow by as much as 11.5% during the current year (Table 3). Budget projections of total expenditure, revenue expenditure and capital expenditure work out to 14.1%, 10.9% and 3.2% of nominal GDP respectively, which are all about the same level as in recent years.

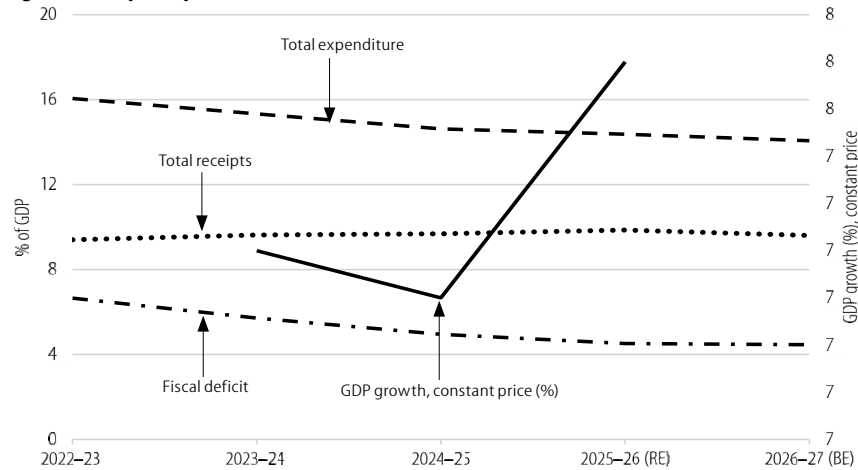
Thus, total receipts and their main components are stable as proportions of nominal GDP. Aggregate expenditure and its main components are also stable relative to nominal GDP (Table 3, Figure 1, p 20). This stability of fiscal projections, combined with continuing robust growth of over 7% during the last few years and very mild inflation, points to a very benign economic outlook. However, the uncertainties cited at the outset raise a question as to whether the present tranquillity is a lull before the storm. That in turn raises the question whether the FY 2026–27 budget is on a path that provides enough fiscal space to cope with any major economic shock.

**Table 3: Receipts, Expenditure and Deficits**

	₹ Trillion					% Change			% of GDP at 2022–23 Series						
	2022–23	2023–24	2024–25	2025–26	2026–27	2023–24	2024–25	2025–26	2026–27 (BE)/	2022–23	2023–24	2024–25	2025–26	2026–27	
	(Act)	(Act)	(Act)	(RE)	(BE)	(Act)/	(Act)/	(RE)/	2025–26 (RE)	(Act)	(Act)	(Act)	(RE)	(BE)	
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
1 Revenue receipts	23.83	27.29	30.37	33.42	35.33	14.5	11.3	10.1	5.7	9.1	9.4	9.5	9.7	9.3	
1.1 Tax revenue (net to centre)	20.98	23.27	25	26.75	28.67	10.9	7.4	7	7.2	8	8	7.9	7.7	7.5	
1.2 Non-tax revenue	2.85	4.02	5.37	6.68	6.66	40.8	33.5	24.4	-0.2	1.1	1.4	1.7	1.9	1.8	
2 Non-debt capital receipts	0.72	0.6	0.42	0.64	1.18	-17.2	-30	53.1	84.9	0.3	0.2	0.1	0.2	0.3	
3 Total receipts (1 + 2)	24.55	27.89	30.78	34.06	36.52	13.6	10.4	10.7	7.2	9.4	9.6	9.7	9.9	9.6	
4 Total expenditure (4.1 + 4.2)	41.93	44.43	46.53	49.65	53.47	6	4.7	6.7	7.7	16.1	15.3	14.6	14.4	14.1	
4.1 Revenue expenditure	34.53	34.94	36.01	38.69	41.25	1.2	3.1	7.4	6.6	13.2	12.1	11.3	11.2	10.9	
4.2 Capital expenditure	7.4	9.49	10.52	10.96	12.22	28.3	10.8	4.2	11.5	2.8	3.3	3.3	3.2	3.2	
5 Revenue deficit (4.1-1)	10.7	7.65	5.64	5.27	5.92	-28.5	-26.3	-6.7	12.4	4.1	2.6	1.8	1.5	1.6	
6 Fiscal deficit (4–3)	17.38	16.55	15.74	15.58	16.96	-4.8	-4.8	-1	8.8	6.7	5.7	4.9	4.5	4.5	
7 Primary deficits	8.09	5.91	4.59	2.84	2.92	-27	-22.3	-38.1	2.7	3.1	2	1.4	0.8	0.8	
8 Total debt (outstanding)	152.23	168.65	182.15	200.4	218.5	10.8	8	10	9.1	58.3	58.2	57.3	58	57.5	
9 GDP at current price (2022–23 series)	261.2	289.8	318.1	345.5	380.2	11.0	9.7	8.6	10.0	100	100	100	100	100	

RE—revised estimates; BE—budget estimates; Act—actuals.

Source: Receipt and expenditure budget, budget documents for various years.

**Figure 1: Receipts, Expenditure, Deficits, GDP Growth**

That the fiscal deficit at 4.5% will remain the same in FY 2026-27 as in FY 2025-26, with no further reduction, does not imply that the government has abandoned fiscal consolidation. Instead, it reflects the fact that the government has switched from the earlier annual fiscal deficit target to the debt-to-GDP ratio as the key monitoring indicator for fiscal consolidation, with the target ratio being set over a period of time. This allows the government some elbow room for year-to-year countercyclical adjustments while maintaining a downward trajectory of the debt-to-GDP ratio over the reference period, a reasonable switch if the ultimate aim of fiscal consolidation is debt sustainability.

However, is fiscal consolidation on track in terms of this new monitoring indicator? Union government debt at the end of FY 2025-26 was 58% of nominal GDP. The new fiscal consolidation target is to bring this down to 50% by FY 2030-31. Even though the debt stock typically grows at a slower pace than nominal GDP, a reduction of 8% in five years or 1.6% reduction per year is a tough call. Moreover, from a debt sustainability perspective, what matters is not just union government debt but the combined debt of the union and the states, which amounts to over 85% of nominal GDP. Sajid Chinoy and Toshi Jain (2026) have pointed out in a recent article that the debt dynamics of the state governments are in a more precarious position than that of the union government for a number of reasons. One of us has also argued in another recent article that some features of the award of the Sixteenth

Finance Commission may make the fiscal position of the states even more fragile (Mundle 2026). All of this taken together leads to the conclusion that the fiscal space of the government (union plus states combined) going forward is likely to shrink rather than expand.

### Coping with Emerging Fiscal Challenge

A baseline of shrinking fiscal space does not position India well to cope with any major economic crisis that the country may have to face in the near future. What is the likelihood of such an eventuality? Of all the uncertainties listed at the outset of this article, the one dominating at present is the war in Iran and Iran's chokehold over the Strait of Hormuz. As a consequence, the price of oil (Brent crude), which was under \$70 on average in February, has already gone up 50% to over \$100 per barrel and is still rising.<sup>1</sup> Stock markets around the world have become extremely volatile and supply chains have been disrupted because of the virtual closure of Hormuz for the passage of oil, gas and other products. The net economic impact of such disruption on the global economy, and hence India, will be to drive up inflation and choke growth. How will India cope with this emerging challenge?

The impact on India will be mediated via the external account: oil price inflation, collapse of export demand, supply chain disruption on the import side and capital flight. In an old paper published way back in 1987, Jha and Mundle had estimated that the direct and indirect impact of a 10% increase in oil prices

would ultimately add 1.4% to wholesale price inflation. More recent calculations suggest that the impact today would be in the same ballpark, that is, a 50% increase in oil prices would lead to about 7% extra inflation. Given the very benign inflation as present, this shock would lead us close to double-digit inflation if normal oil flows are not restored any time soon. The RBI should address this challenge, inflation control being its main mandate. A tight monetary policy and higher interest rates would not only reduce excess liquidity and help contain inflation but also help contain the outflow of portfolio foreign capital.

That would leave fiscal policy to deal with the adverse impact of the external shock on growth. Despite the shrinking fiscal space discussed earlier and problems of debt sustainability, the fiscal deficit should be allowed to expand through a supplementary demand for grants. Extraordinary challenges require extraordinary responses. However, while fiscal interventions may ease the demand constraint, they cannot solve supply chain constraints. For this, the government will have to resort to more direct quantitative measures.

### Concluding Remarks

At the time of this writing, the Iran war is still raging and the Hormuz chokehold is continuing to disrupt the global economy. Even if hostilities end, normal economic activities will not be restored any time soon. Rising inflation and declining growth are unavoidable. The fiscal and monetary policies outlined above will moderate the impact of these shocks, but slower growth and higher inflation seem inevitable despite such measures.

#### NOTE

- 1 The average price of oil for the Indian basket is actually around \$150 at present.

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