Intergovernmental Fiscal Outlook for 2024 to 2026

This document is prepared semi-annually to set the stage for discussions at the OECD Network on Fiscal Relations across Levels of Government annual and interim meetings. It presents an overview of the economic outlook and how it translates into the prospective fiscal scenario across levels of government. It also includes a discussion on relevant themes that impact subnational governments' (SNGs) fiscal sustainability and their impacts on central and general government.

Key Messages

1. GDP growth estimates have been revised slightly upwards since the last outlook and projected inflation declined further towards targets, yet interest rates are likely to remain elevated.[1]
2. In 2023, subnational government (SNG) fiscal balances in the OECD have moved into negative territory not seen for a decade.
3. More than two-thirds of OECD countries saw their SNGs' fiscal balances worsen in 2023.
4. SNG revenues are projected to grow by around 1% in 2024 and 2% in 2025, still below the pre-pandemic growth of 2% to 4% from 2015 and 2019, but they may pick up to 2.5% in 2026 (in real terms).
5. US SNG bond issuance volume is set to reach a record year in 2024, even with higher interest rates.
6. In the European Union, a new Stability and Growth Pact, with stricter fiscal oversight, amid spending pressures, poses challenges to SNGs.
7. China is seeking to address off-balance subnational debt, balancing between managing fiscal risks and stimulating the economy.

1. INTRODUCTION

The global macroeconomic outlook has continued to improve, with resilient growth and a steady moderation in inflation. However, significant risks remain, as on-going geopolitical and trade tensions may increasingly undermine investment and drive import prices up. While some countries have begun easing monetary policy, the pace and extent of these reductions will likely remain data-dependent to ensure that underlying inflationary pressures are sustainably managed.

Building on the projection tools developed by the OECD Network on Fiscal Relations (OECD, 2023b) and drawing on economic developments across OECD and G20 economies as captured in the OECD Economic Outlook (November 2024) (OECD, 2024d), this note provides an updated

[1] Projections are based on the OECD *Economic Outlook* (OECD, 2024d) published in December 2024. This note was prepared by Acauã Brochado and Bruno Leal, collaborators to the Network on Fiscal Relations, with inputs from Pietrangelo De Biase, under the supervision of Sean Dougherty, Head of the Network Secretariat. We are grateful for comments on the document from delegates of the Network as well as OECD colleagues Bert Brys (CTP), Isabelle Chatry (CFE) and Boris Cournède (ECO).

intergovernmental fiscal outlook and discusses key implications.

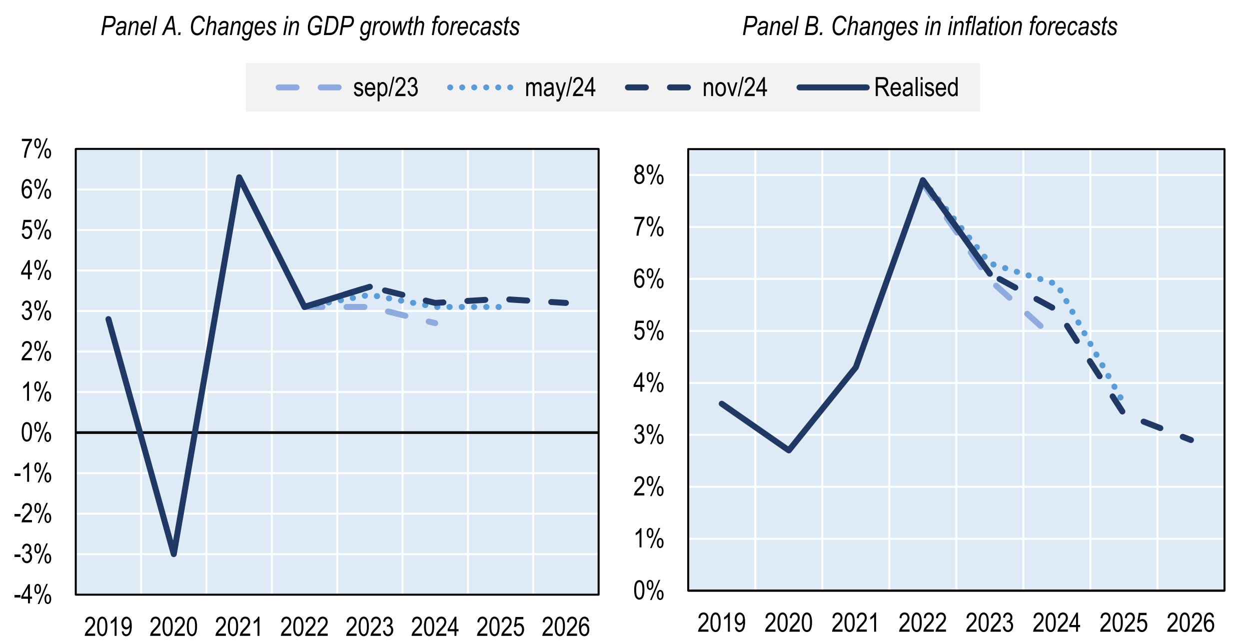
The following sections show that revenue forecasts are growing at a slightly slower pace (on average), however with some strong positive and negative cases, especially for 2024 estimates, and accelerating in 2026. Expenditure pressures are mounting, and debt exposure to interest rate movements is raising financing costs and interest payments. In 2023, the fiscal balances of SNGs in the OECD have moved into negative territory not seen for a decade. Those are unevenly distributed across countries and jurisdictions, but the overall trends of higher spending growth due to inflation and higher borrowing costs are affecting most (if not all) SNGs. The deficit trend calls for attention from central governments, who would benefit from closer monitoring of subnational finances and debt portfolios to avoid having to support them in times of needed fiscal consolidation (Brochado & Dougherty, 2024).

2. ECONOMIC CONTEXT

2.1. GDP growth stabilises, and inflation moderates amid slight monetary easing

The global economy continues to be resilient, with GDP growth stabilising at 3.2%, 3.3%, and 3.2% for 2024, 2025, and 2026, respectively, in line with earlier forecasts (Figure 1 – Panel A). Demand will be supported by a scenario of lower inflation, continuing employment growth, and a more accommodating monetary policy. Growth differences across G20 economies are likely to persist in the near-term but will reduce as robust growth starts to ease in the United States and Brazil, while gaining pace in countries like Australia, Canada, and Germany. China, India, and Indonesia are expected to maintain strong GDP growth. (OECD, 2024d).

Figure 1. Growth and inflation outlook for the G20



Source: OECD Quarterly National Accounts (Database), OECD Economic Outlook (November 2024), OECD Economic Outlook (May 2024), and OECD Economic Outlook Interim Report (September 2023).

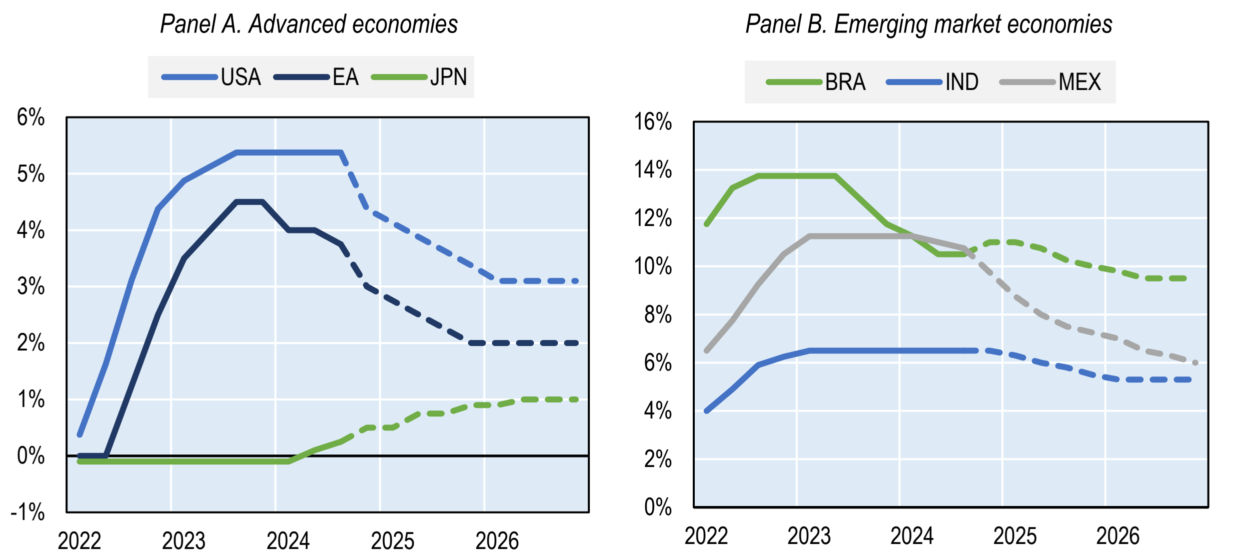
Compared with previous estimates where inflation pressures were more pronounced, inflation is now moderating, as seen in Figure 1 – Panel B. Headline inflation for G20 countries is expected to decline further from 5.4% in 2024 to 3.4% and 2.9% in 2025 and 2026, respectively. In nearly all major economies, inflation is expected to return to target levels by late 2025 or early 2026 (OECD, 2024d).

Although inflation is cooling, underlying pressures persist, especially in service sectors, driven by labour costs, and greater geopolitical uncertainty. As a result, interest rates will need to stay cautiously restrictive for some time, with substantial cuts unlikely in the near term. Risks of financial market disruptions remain, particularly if the disinflation trajectory deviates from current projections (OECD, 2024d).

2.2. Monetary policy is expected to ease, but fiscal challenges persist

As inflation continues to decline, central banks in advanced economies, including the United States and the euro area, have begun gradually lowering policy rates (Figure 2 – Panel A). However, the extent of these reductions will remain data-dependent to ensure inflation stays under control. While interest rates are projected to decline significantly through 2025, they are expected to stabilise in 2026 and remain above pre-pandemic levels, particularly in emerging markets (Figure 2 – Panel B). In certain cases, such as Brazil, unexpected economic growth and inflationary pressures may require central banks to temporarily halt or reverse the rate reduction cycle to preserve price stability (OECD, 2024d).

Figure 2. Policy interest rates in the major economies

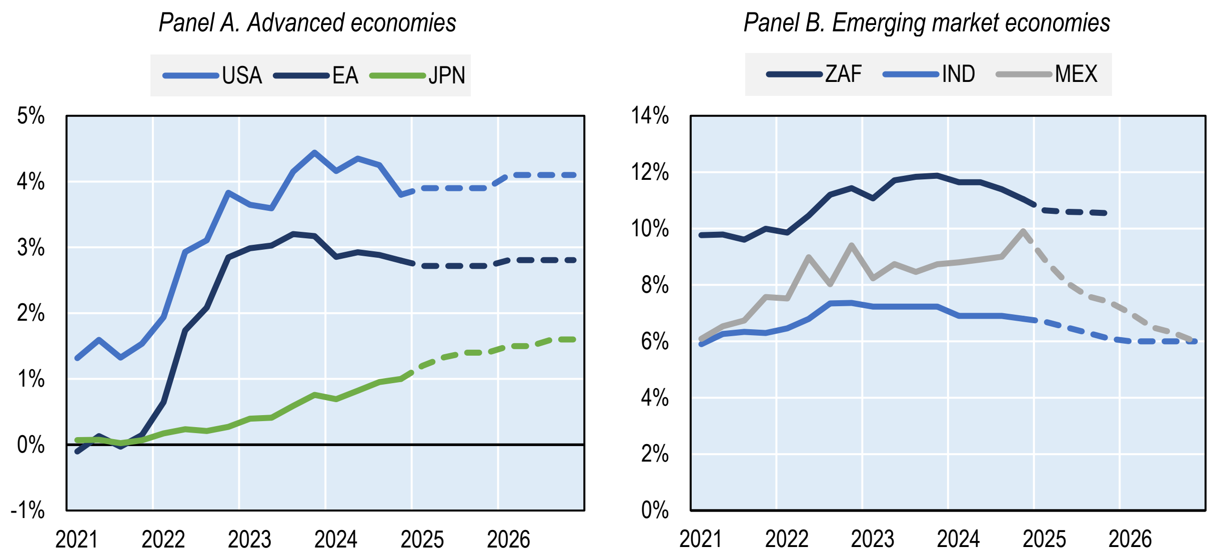


Note: Main refinancing rate is used for the Euro Area (EA).
Source: OECD Economic Outlook (November 2024).

However, even if monetary policy rates are starting to come down, long-term interest rates are still significantly higher than in the previous decade (Figure 3). These long-term rates are important determinants of borrowing costs, especially for those who issue fixed-rate bonds. Therefore, fiscal challenges persist, as the transition from low-yield debt to higher-cost issuance drives up debt service costs (Brochado & Dougherty, 2024).

Governments will need to intensify efforts to control spending and enhance revenue generation through comprehensive tax reforms, such as eliminating tax exemptions and increasing property and environmental taxes, to stabilise debt burdens (OECD, 2024d). Without decisive action, the fiscal space to respond to future economic shocks could become significantly constrained.

Figure 3. Long-term interest rates in the major economies



Note: 10-year yields. Data for Brazil was not available.
Source: OECD Economic Outlook (November 2024).

3. THE UPDATED SUBNATIONAL FISCAL OUTLOOK

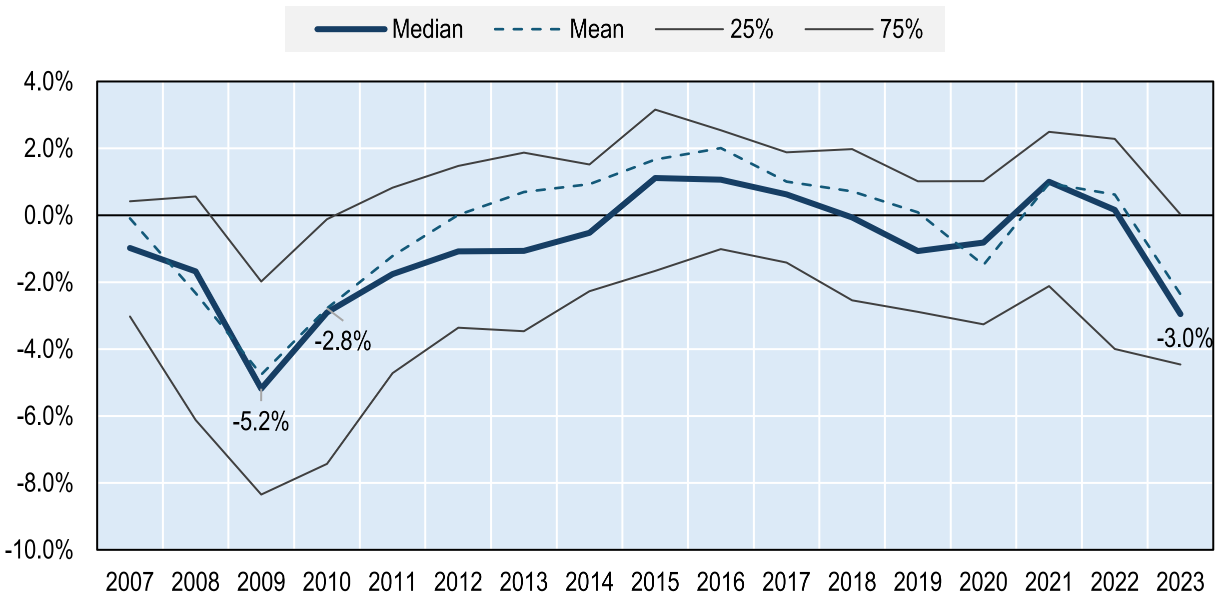
3.1. SNGs median fiscal balances in 2023 reach negative territory not seen since 2010

As recent Intergovernmental Fiscal Outlooks have emphasised, central governments usually absorb most macroeconomic shocks, while SNGs tend to maintain their fiscal accounts closer to balanced. Figure 4 depicts the median, mean and quartiles of the fiscal deficits of subnational governments in the OECD as a percentage of their respective total revenues. It shows how, for example, SNGs even improved their balances during the COVID-19 pandemic, also because of sizeable support from the centre.

However, again, as previous issues of this report have already warned, with the reversal of central government support, economic growth below pre-pandemic levels, and mounting spending pressures (with immigration, energy prices, higher wages, and inflation in general), SNG fiscal balances have been trending downwards since the peak observed in 2021. In 2023, they reached a negative territory not seen since the end of the Global Financial Crisis in 2009-2010.

These higher fiscal deficits are in part (if not mostly) financed by debt. In the current high-interest rate scenario, with borrowing costs considerably above what was observed in the previous decade, this movement calls for close attention (Brochado & Dougherty, 2024). Depending on the debt structure, interest expenditures might rise significantly (see Section 3.3), bringing deficits further down, reinforcing the trend. This is especially true for SNGs with less autonomy to increase taxes or reduce expenditures.

Figure 4. Fiscal balances of SNGs as a share of revenues



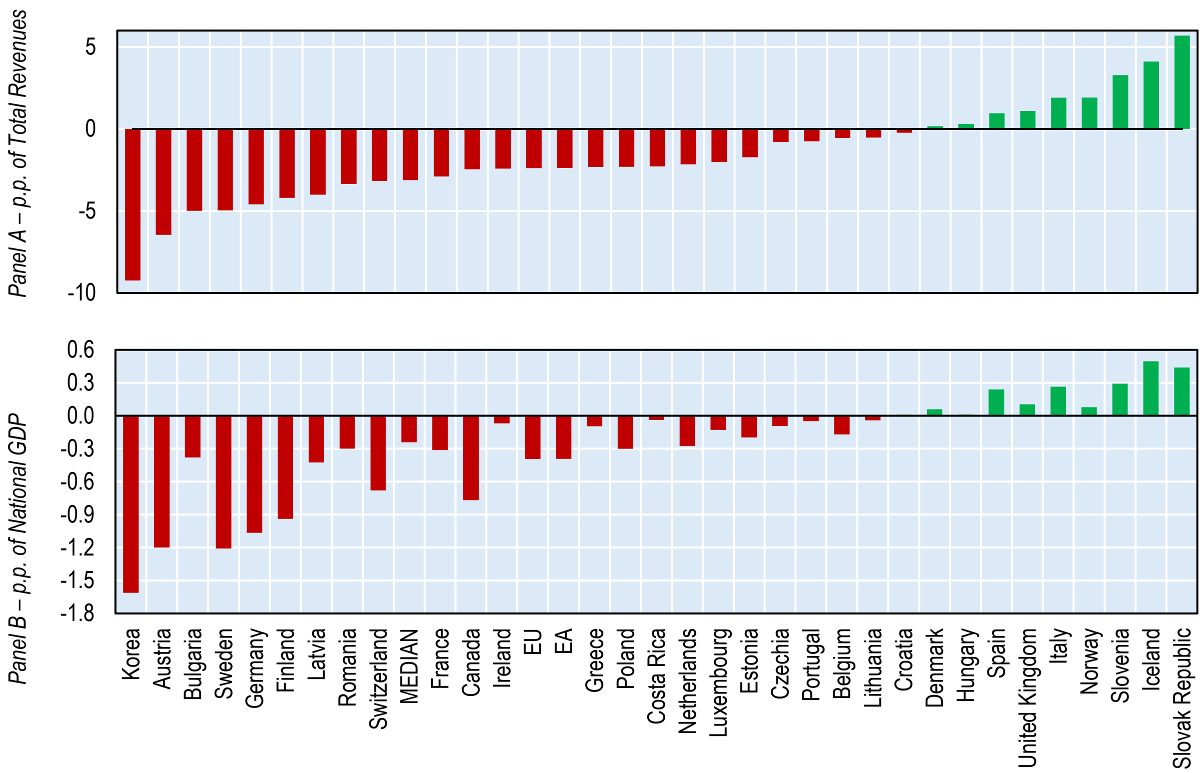
Note: Median, mean, 25% and 75% percentiles of OECD countries. Deficit as a share of total SNG revenues.
Source: OECD – System of National Accounts, Table 12 – Net lending (+) / Net borrowing (-).

While the trend is evident when examining medians and quartiles, analysing individual countries offers additional valuable insights. Figure 5, Panel A, shows the changes in fiscal balances observed between 2022 and 2023, in percentage points of SNGs' total revenues. Negative changes are predominant. Out of the 32 countries in the sample, 23 experienced a negative change, while only nine managed to avoid a deterioration of their fiscal position. On the negative side, Korean SNGs saw their aggregate fiscal balance decline by 9% of their revenues that year, the steepest drop in the sample. Austria followed with a 6% decline, while Bulgaria, Sweden, Germany, and Finland recorded decreases ranging from 5% to 4%.

On the positive side, the Slovak Republic experienced the most significant improvement, with SNGs' fiscal balances increasing by almost 6% of their revenues. Iceland and Slovenia followed, with 4% and 3% gains, respectively.

In Figure 5, Panel B, the graph shows the changes in fiscal deficits in percentage points of GDP. This perspective shows how the deficit changes may have impacted (or still might) the overall fiscal stance of the general government. In Korea, Austria, Sweden, Germany, and Finland, SNGs' fiscal deficits declined by around 1.0 p.p. of GDP. SNGs in Switzerland and Canada also experienced significant declines of between 0.7 and 0.8 p.p. of GDP. The highest positive change according to this measure was in Iceland, where the SNG deficit improved by 0.5 p.p. of GDP.

Figure 5. Changes in fiscal balances of SNGs between 2022 and 2023



Note: Change in percentage points of total revenues. EA = Euro area
Source: OECD – System of National Accounts, Table 12 – Net lending (+) / Net borrowing (-).

3.2. Mixed revisions for 2024 revenue growth, a downward shift in 2025, more stable in 2026.

While most SNGs already saw their fiscal balances worsen in 2023, slower economic growth in the current and next year is expected to keep their revenues growing slower than before the pandemic. In 2026, however, SNGs in most countries may see a slight pick-up in revenue growth. Using estimated tax buoyancies (*i.e.* the sensitivity of government revenues to economic activity) for each country and OECD projections for real GDP growth in G20 countries, we can forecast SNG revenues for the near future.

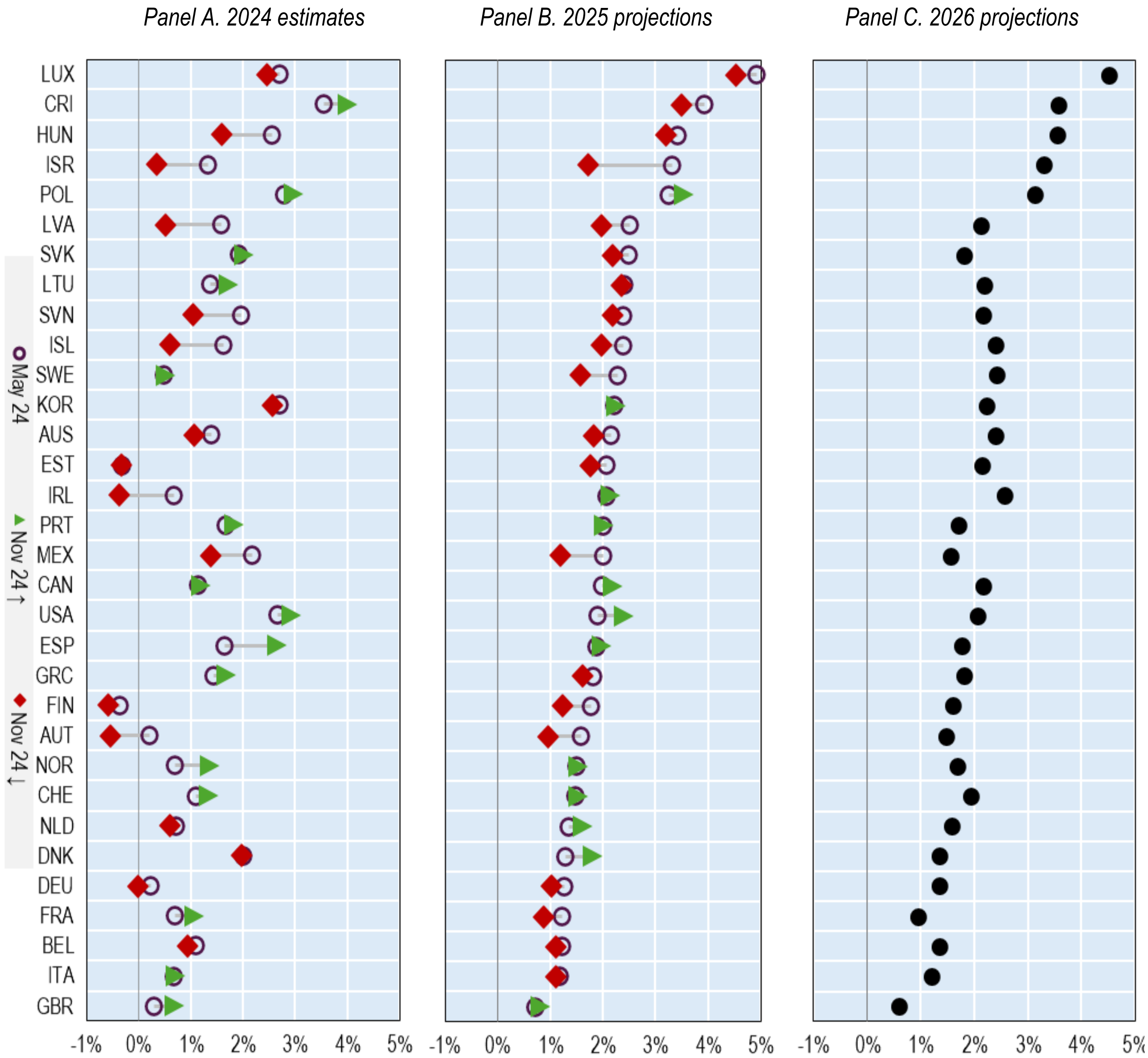
Figure 6 compares the latest updated SNG own revenue growth estimates using data from the last OECD Economic Outlook of November 2024 (OECD, 2024d), with those that would have been forecasted using data from the previous Economic Outlook, of May 2024 (OECD, 2024c).

For 2024, revisions in GDP growth projections were relatively small and in mixed directions (Figure 6, Panel A). The bigger changes were, however, to the downside, with six countries seeing changes of around 1 percentage point (Hungary, Iceland, Ireland, Israel, Latvia, and Slovenia). The main exception is Spain, where 2024 SNG revenues are now estimated to grow substantially more than previously projected.

For 2025, SNG revenues are projected to grow by around 2% in real terms in most countries. For Costa Rica, Hungary, and Poland, SNG revenue is projected to grow by more than 3%, while in Luxemburg, projected growth is close to 5% in real terms. However, Austria, Belgium, France, Finland, Germany, Italy, Mexico, and the United Kingdom are expected to see more modest growth of around 1% (Figure 6, Panel B).

For 2026, SNG revenue real growth projections in most countries hover around 2%. Only in two countries (the United Kingdom and France) are revenues expected to grow below 1% in real terms. Conversely, only five countries would see SNG real revenues grow by more than 3% (Costa Rica, Israel, Hungary, Luxembourg, and Poland).

Figure 6. SNGs own revenues' annual growth in real terms



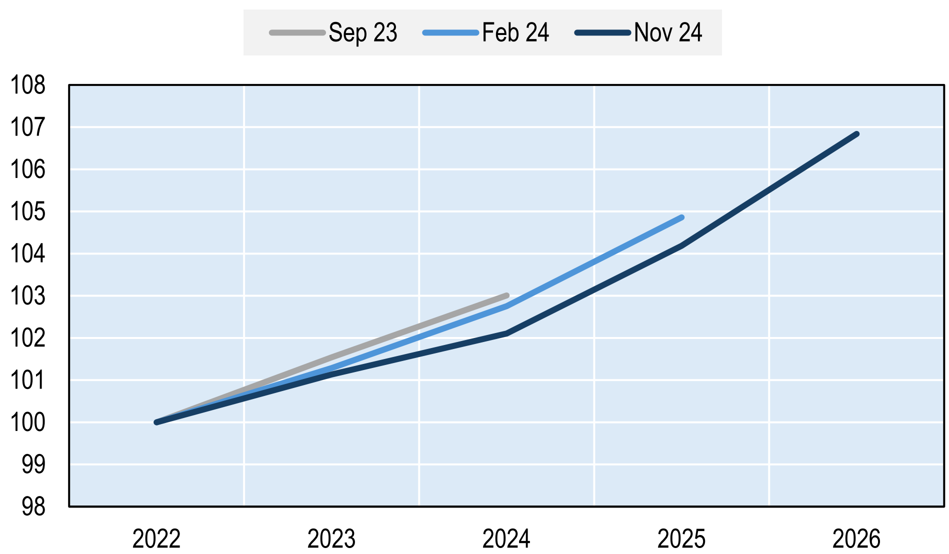
Note: Blue hollow dots represent estimates using May 2024 Economic Outlook. Green and red dots represent current estimates using November 2024 Economic Outlook (OECD, 2024), with positive and negative changes, respectively. Solid dark blue dots represent current projections for 2026, using November 2024 Economic Outlook (OECD, 2024). Uses consolidated own revenues. Projections used the mean group estimator for each type of tax revenue from Dougherty & De Biase (2021). SNGs' own revenues refer to total revenues minus transfers received from other levels of government – they therefore include own tax and non-tax revenues, such as user fees and charges.
Source: Authors' calculations based on OECD (2024d), OECD National Accounts and OECD Fiscal Decentralisation database.

Overall, when looking at the median projections for 2024–2026, the current estimates reflect a further slowdown in growth in 2024 and 2025 but with a pick-up in 2026, which should bring median revenue growth slightly above the previously projected trend. Median estimates suggest SNG revenues will grow by 1.0% in 2024, 2.0% in 2025, and 2.5% in 2026 (Figure 7).

There are two main risks to these projections. On the positive side, many SNGs derive a significant portion of their revenues from taxes on services, and the services sector has consistently outperformed the goods sector, both in real and nominal terms, since the pandemic (OECD, 2023a and 2024d). The projections discussed here do not consider this effect, which could lead to some upside surprises for SNGs with a strong focus on services. On the downside, however, high interest rates continue to restrain one of the most crucial tax bases for SNGs – property taxes[2] – by keeping a downward pressure on real estate values and transaction volumes, as property prices in many OECD economies remain well below previous levels, despite initial upticks in some countries (OECD, 2024d).[3]

Figure 7. Trends in forecasted SNG's own revenues

Median trajectory of SNG's revenues from 2022 to 2025, expected in current and previous Outlooks



Note: The index is set to 100 in 2022. Median estimates for each year. Uses consolidated revenues. Projections used the mean group estimator for each type of tax revenue from Dougherty & De Biase (2021). SNGs' own revenues refer to total revenues minus transfers received from other levels of government – they, therefore, include their own tax and non-tax revenues, such as user fees and charges.

Source: Authors' calculations based on OECD Economic Outlook – Interim (September 2023), OECD Economic Outlook – Interim Report (February 2024), OECD Economic Outlook (November 2024), OECD System of National Accounts and OECD Fiscal Decentralisation Database.

3.3. On the expenditure side, we still can see interest payments increase by up to 1% of GDP

As discussed in the previous issue of this Intergovernmental Fiscal Outlook (OECD, 2024b), the scenario of a long period with higher interest rates can become a serious threat to highly indebted SNGs. While, at first, inflation can help reduce debt-to-revenues ratios,[4] when debt is large and interest rates rise, the overall result can be higher debt.

As of 2022, six countries (Austria, Estonia, Ireland, Mexico, Netherlands, and Spain) had aggregate SNG debt-to-revenues above 250% (Brochado & Dougherty, 2024).[5] With such a level of debt, in a

[2] Refer to the paper by Dougherty, De Biase and Lorenzoni (2022), for a detailed discussion on SNG revenue composition across OECD countries.

[3] This does not mean that property taxes are necessarily declining, as SNGs infrequently reassess property values.

[4] Provided debt is not mainly inflation-linked.

[5] Also, the United Kingdom, Canada, Norway, and Belgium show numbers above 200% (Brochado & Dougherty, 2024).

hypothetical stress scenario, should interest rates on the whole outstanding stock rise by 5 p.p. (close to what has been observed for monetary policy rates between 2021 and 2023), annual spending for debt service would grow by 12.5 p.p. of revenues, potentially inducing major fiscal challenges (OECD, 2024b).

However, the degree and speed at which rate increases will translate into higher debt service accrual and payments depend crucially on SNGs' debt profile in terms of maturity and indexation, which varies significantly across countries and jurisdictions (Brochado & Dougherty, 2024).

Figure 8 shows estimates of the growth in SNGs' expenditures with interest payments for three scenarios. Since systematic information on actual past and current borrowing costs for SNGs is scarce, the exercise focuses on the changes (not levels) of sovereign short and long-term rates for each country.[6] The idea is to capture the change from a low-interest rate environment to the current high rates scenario. For this, the calculations use the difference between the average rates observed in the period 2015 to 2020, and the average between 2022 and 2023 for short and long-term rates in each country. A stress scenario also looks at a hypothetical change of 5 percentage points in borrowing costs for all countries (OECD, 2024b).[7]

The calculations consider the shares of floating and short-term debt, as well as the shares of debt-to-GDP and debt-to-own revenues (Brochado & Dougherty, 2024). For this hypothetical exercise, the authors assume that all bank loans (assumed floating) and all short-term bonds are refinanced with these higher interest rates, in the three scenarios described above.

Using 2022 debt stocks, the United States and Canada show low risk, even as highly decentralised federations, mainly because of the low share of short-term and floating-rate bonds. Czechia, Hungary, Slovenia and Greece follow them. On the other hand, Austria, Estonia, Ireland, and Spain stand out, with high estimates in relation to SNGs' own revenues, and Australia, Austria, Belgium, Finland, and Spain have high ratios in relation to their national GDP. These countries' SNGs can be seen as more vulnerable to interest rate movements (OECD, 2024b).

It is important to note, however, that these estimates do not consider intra-SNG heterogeneity inside each country.[8] Therefore, even in countries that show low risk in this exercise, there might be some SNGs with higher interest rate exposure. Conversely, in countries where SNGs rely heavily on transfers, the measure in percentage points of own revenues discussed here does not reflect the full picture. Additionally, certain assumptions used in the simulations in Figure 8 might be unrealistic for some countries. In Spain, for example, the vast majority of loans are composed of long-term, fixed-rate contracts with the central government, sizably reducing SNGs' current exposure to interest rate movements.

Although monetary authorities across the globe have begun to ease policy, the rates are generally at a significantly higher level compared to the ones observed in the years prior to 2021 (OECD, 2024d). Especially long-term interest rates are still significantly higher than in the previous decade. This is because, with the end of quantitative easing and yield curve management, in addition to higher policy interest rates, the term premium is expected to rise and stay higher for the foreseeable future. These long-term rates are important determinants of borrowing costs, especially for those who issue fixed-rate bonds. This will continue to pressure borrowing and financing costs upwards in the short run, especially for SNGs with higher deficits.[9]

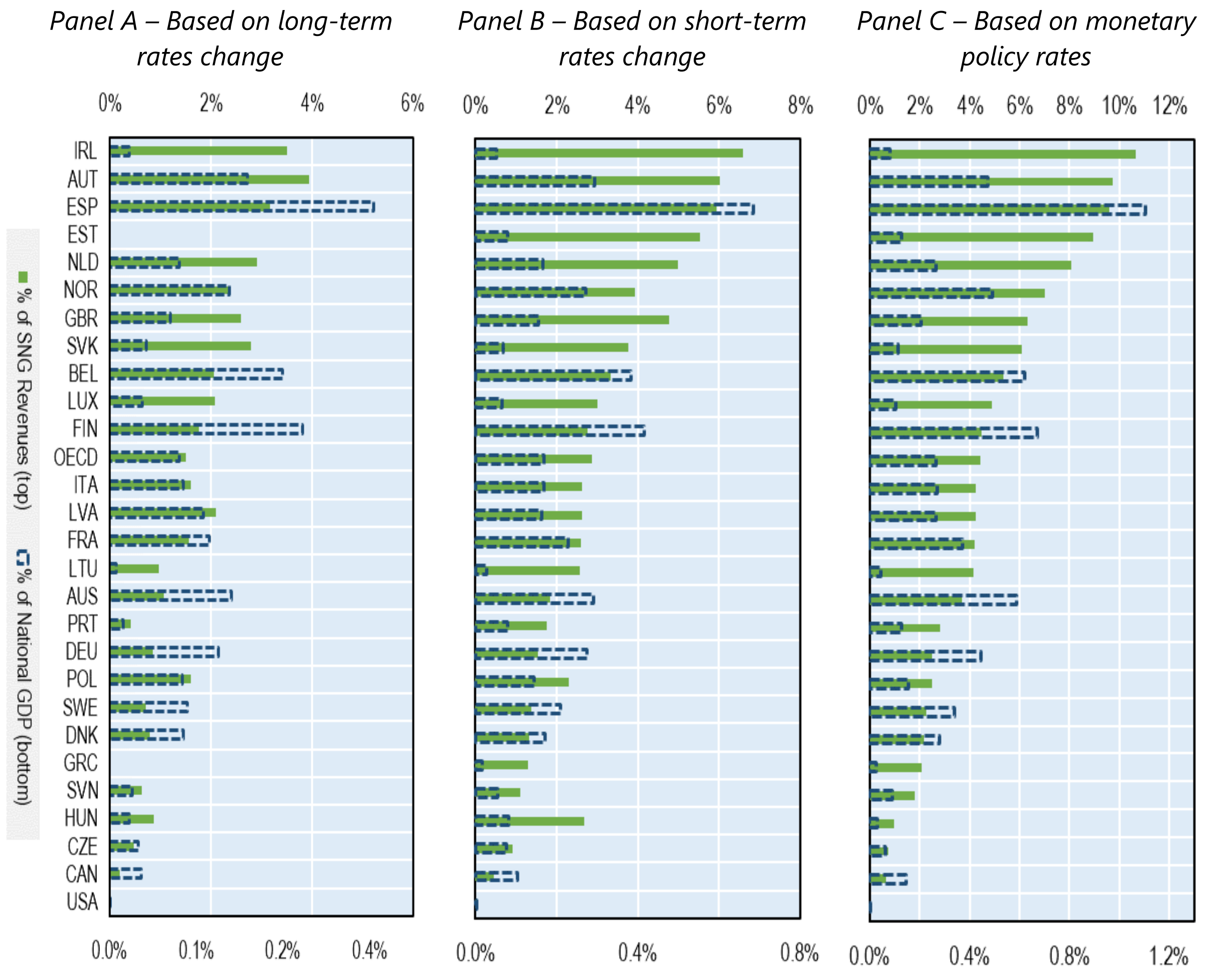
[6] Implicitly the assumption is that spreads between SNG and sovereign borrowing costs remain stable in this period or fluctuate less than rates in absolute terms.

[7] Consistent with the movements in monetary policy rates seen in 2022-2023 in most OECD economies.

[8] Brochado & Dougherty (2024) do a detailed exercise on these lines for SNG debt securities.

[9] See, for example, the case of Australian states in Foo et al. (2024).

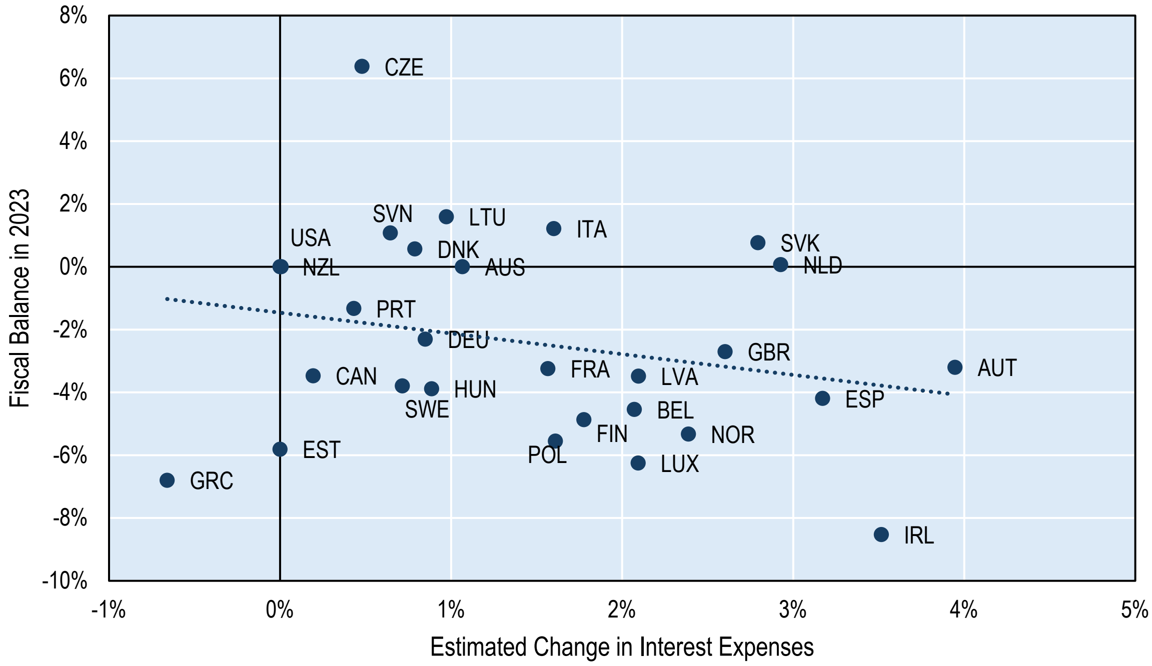
Figure 8. Simulated growth in annual interest expenses: three scenarios



Note: Bars represent estimated growth in interest expenditures, in percentage points of SNG own revenues (**green**, top axis) and national GDP (**blue** dashed, bottom axis).
Source: Based on the approach in Brochado & Dougherty (2024).

The effect of higher borrowing costs might have already affected SNGs' fiscal balances in 2023. Figure 9 shows a scatter plot with the estimates of potential changes in interest expenses, as in Figure 8, together with the fiscal balances observed in 2023, as in Figure 4. In general, there is a slightly negative correlation, illustrated by the negative sloped linear trend-line shown. In short, SNGs in countries more exposed to high interest rates, as of 2022, tend to have produced lower fiscal balances.

Figure 9. SNG fiscal balances and potential changes in SNG interest expenses



Note: Fiscal balances in per cent of total revenues and interest expenses in per cent of own revenues. Where 2023 data was not available, 2022 was used – in Australia, Chile, Indonesia, Israel, Japan, Mexico, New Zealand, Turkey, and the United States.
Source: OECD – System of National Accounts, Table 12 – Net lending (+) / Net borrowing (-); Brochado & Dougherty (2024).

4. ADDITIONAL MONITORING: KEY ISSUES TO WATCH[10]

4.1. In the United States, state and local governments are issuing record volumes of bonds

In the United States, state and local government borrowers are on track for a record year in municipal bond sales, having issued over USD 442 billion in long-term debt so far in 2024. This figure represents a more than 42% increase compared to the same period in 2023, highlighting a significant surge in borrowing activity (Shah & Querolo, 2024).

This increase in municipal bond issuance is enabled by a high demand for bonds, with investors eager to secure higher yields before anticipated interest rate cuts by the Federal Reserve. Long-term municipal bond issuance is up more than one-third compared to the pace seen in 2023, indicating a robust demand for financing among local authorities as they seek to fund essential projects and services (Moran & Braun, 2024).

While US SNGs have, in general, more favourable debt portfolios, with low shares of floating rates or short-term debt, which makes the US estimates shown in Figure 8 indicate that there is a low risk of rising interest expenses; nevertheless, a high issuance of new debt, due to higher current deficits, or higher debt-financed investments, pushing up this risk. On the other hand, most US SNGs' bonds are issued under tax exemptions (Brochado & Dougherty, 2024), which significantly brings down effective borrowing costs for states and municipalities (Spreen & Gerrish, 2022), probably dampening the high interest rates effect.

[10] Prepared with input from selected AI tools (Claude and Perplexity) for summary of reporting on SNGs in respective regions. All information and citations were checked by the authors.

4.2. Stability and Growth Pact and the challenges for EU subnational governments

The reformed Stability and Growth Pact (SGP), set to take effect in 2025, introduces stricter fiscal oversight for EU member states, covering the general government and, thus, with implications for central and subnational levels of government. The new framework emphasises medium-term debt reduction, according to detailed countries' fiscal-structural plans that impact budgetary decisions at all levels of government (De Lemos Peixoto & Loi, 2024). However, the path is far from easy amid pressures to expand various expenses such as healthcare, increased public sector wages, investments in green transition projects, and climate adaptation infrastructure.

As interest rates remain elevated, SNGs are experiencing rising debt servicing costs, squeezing their budgets. This challenge is compounded by the end of pandemic-related support from central governments, where regions and municipalities face the dual pressures of reduced financial inflows and rising expenditure needs, particularly in regions with lower own-revenue capacity.

The EU's green transition objectives require significant investments in energy efficiency, renewable energy and sustainable transport. SNGs are on the frontlines of implementing these projects but often lack sufficient financial resources.

Access to EU funds, such as the Cohesion Fund and the Recovery and Resilience Facility, is crucial but remains administratively complex. If that wasn't enough, recently started discussions about expanding the scope of the Cohesion Fund to include defence-related expenditures, generally carried out by central governments, which may reduce future resources available for SNGs (Financial Times, 2024).

Climate change further exacerbates fiscal stress for local governments. Increasingly frequent extreme weather events, such as floods, heatwaves, and storms, are driving up disaster response costs and infrastructure repair.

Balancing mandated fiscal consolidation with the pressing needs for investment in the green transition, the digital transformation, and the rise in healthcare costs represent a substantial challenge for EU member states and their subnational entities.

4.3. China's transition to on-balance debt, managing fiscal risks and stimulating the economy

China's local governments face mounting pressures as they attempt to transition away from off-balance sheet borrowing through Local Government Investment Vehicles (LGIVs). The Chinese Ministry of Finance estimates hidden debt reached 2 trillion USD (14 million CNY) by end-2023 (SCMP, 2024), while local authorities struggle with declining land sales revenue – traditionally a key funding source – amid a property market slowdown. This situation has exposed the underlying vertical fiscal imbalance between central and local governments, as local authorities lack diversified revenue sources while bearing substantial responsibility for public services and infrastructure.

The central government has responded with both regulatory and fiscal measures. In November 2024, the Standing Committee of the National People's Congress approved measures to strengthen debt oversight and raised the debt ceiling by 6 trillion yuan to 35.5 trillion yuan. High levels of new financing and refinancing continue to pressure Chinese SNG debt, highlighting the need for more comprehensive fiscal reforms. These reforms may include gradually bringing LGIV obligations into local government budgets and establishing frameworks for managing unsustainable debt.

The challenge ahead lies in balancing immediate fiscal support needs with longer-term structural reforms to address these enduring imbalances. Strengthening fiscal rules at the subnational level and addressing revenue-expenditure mis-matches are preferable to discretionary short-term solutions, notably by giving local governments more tax autonomy (OECD, 2021).

4.4. Brazil's tax reform with debt renegotiations to rebalance federalism

Brazil is undertaking significant reforms that will reshape its fiscal federalism. A bill initiated in the Senate, where it has already been approved and now under discussion in the Chamber of Deputies, proposes a comprehensive state debt renegotiation program (PROPAG), offering extended maturities and reduced interest rates for states' debt with the federal government. The program includes incentives tied to asset privatisation and increased investments in public services across education, security, infrastructure, climate change, and other areas. States must also commit to fiscal rules limiting primary expenditure growth (Câmara dos Deputados, 2024). This approach, while aiming to free up resources for public services, raises questions about long-term fiscal sustainability.

Simultaneously, the recently-approved Constitutional amendment introduces a comprehensive tax reform, replacing the state-controlled ICMS and four other taxes with a dual VAT system regulated at the national level. While the previous ICMS system allowed states significant flexibility, it also fostered interstate fiscal competition and severe economic distortions.

The transition to the new VAT framework will address these pressing issues but may also potentially reshape the balance of fiscal powers both vertically – between federal, state, and local governments – and horizontally – among states and municipalities. This shift requires careful implementation to maintain effective federal-state-municipal fiscal relations, align incentives, and ensure stable revenue streams for subnational governments. Accordingly, the new framework already imposes phased implementation and includes mechanisms like compensatory funds, to facilitate a smooth transition.

4.5. Fiscal pressure on India's states may require robust reforms

Indian states are grappling with escalating fiscal pressures due to a confluence of factors. The cessation of the Goods and Services Tax (GST) compensation in June 2022 has significantly impacted state revenues. This compensation, introduced to offset revenue losses from GST implementation, ended at a time when many states were already struggling with slowing revenue growth. The 15th Finance Commission had recommended revenue deficit grants to assist states during this transition; however, these grants are being phased out, exacerbating fiscal challenges. The 16th Finance Commission, currently deliberating on fiscal frameworks for the post-2025 period, has been tasked with addressing these concerns. Its recommendations will help guide restructuring intergovernmental transfers and fiscal equalisation to mitigate the fiscal imbalances across states.

Compounding these fiscal strains are the increasing occurrences of climate change-induced disasters. States such as Assam, Andhra Pradesh, Maharashtra, Karnataka, and Bihar have faced severe floods and droughts, leading to substantial demands for disaster relief and infrastructure rehabilitation. A report by the Council on Energy, Environment and Water (CEEW) indicates that over 80% of India's population resides in districts highly vulnerable to hydro-meteorological disasters, underscoring the extensive fiscal risks posed by climate change. Incorporating climate resilience into fiscal frameworks is expected to feature prominently in the 16th Finance Commission's proposals.

Additionally, the financial health of state-owned enterprises (SOEs) remains a concern. Many SOEs, particularly in the power sector, have accumulated significant debts, posing contingent liabilities for state governments. The 16th Finance Commission is anticipated to address the liabilities of SOEs and provide guidelines to states for better financial oversight. Tackling these issues comprehensively will require enhanced fiscal discipline, disaster preparedness, and robust reforms to ensure sustainable subnational finances in India.

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