COVID-19 Context and the Fifteenth Finance Commission: Balancing Fiscal Need and Macroeconomic Stability

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Abstract

The objective of this paper is to understand the core recommendations of the Fifteenth Finance Commission in the context of COVID-19 pandemic. Given the macroeconomic uncertainties and rising fiscal needs, the commission focused on fiscal stability, equity and enhancement of fiscal space through higher borrowing with a fiscal exit plan for both Union and States.

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Although, constitutionally, the core mandate of any Finance Commission is the division of resources between the Union and States, while making recommendations, the Commission needs to take into consideration the prevailing macroeconomic situation, fiscal trends, and expenditure needs of all levels of governments. The Covid-19 induced macroeconomic uncertainties made assessment and quantification of fiscal needs a challenging task for the Fifteenth Finance Commission. The revenue uncertainty made assessment of resource envelope of the general government[2] extremely difficult. The Fifteenth Finance Commission provided alternative fiscal and macroeconomic scenarios and adopted a specific path for the quantification of need and availability of resources for the purpose of division of resources between the Union and States. Apart from its core task of division of resources, the Commission made important recommendations on fiscal management at all levels of government, including the framework of fiscal responsibility in the future.

Past Finance Commissions had introduced changes in both vertical and horizontal sharing of resources, and provided innovative recommendations, be it fiscal responsibility, local level fiscal decentralisation, or environment and climate change. What makes the Fifteenth Finance Commission award different than awards of past Finance Commissions? What has the commission done differently to factor in the impact of Covid-19? What can be the implications of some of these recommendations on federal fiscal transfers? These are the issues that are discussed in this paper. The idea of my paper is to give a perspective on what Fifteenth Finance Commission did vis-a-vis the mandated task defined in the terms of reference (TOR), keeping in view the uncertainties posed by the Covid-19 pandemic. This paper focuses on the core recommendations of the Fifteenth Finance Commission related to vertical and horizontal imbalance, and the fiscal responsibility framework.

When the Commission was constituted in 2017, the ToR of the Commission evoked a sharp response from a large number of states. The ToR mandated the Commission to use 2011 population figure for tax devolution instead of 1971 population figure, as was the practice in the past (see Rao 2021). The Fifteenth Finance Commission was also mandated to propose measurable performance-based incentives for efforts and progress made by states in moving towards replacement rate of population growth. The Commission was asked to provide various performance incentive grants to States. The TOR generated unprecedented controversy, including submission of a memorandum by a group of States

[2] In the present context, the General Government means Union and State governments.

to the President of India to change some of the provisions of the TOR[3]. However, the award of the Commission did not create any controversy or discontent. The Union government, as was done in the past, has accepted all the major recommendations. The Commission's award is a combination of continuity of past practices for stability of resource transfers and important changes. Since Covid-19 induced uncertainties related to health and economic recovery still remain a major concern, our attempt is to understand the perspective of the Fifteenth Finance Commission related to the Union and State finances.

This paper is divided in the following sections: Section I, discusses the vertical transfer and its stability. Section II discusses the horizontal devolution and equity. Section III analyses the approach of the Commission towards fiscal responsibility post Covid. Section IV summarises and concludes.

The Covid-19 Context

The Fifteenth Finance Commission observed that the Covid-19 crisis is the deepest recession since World War-II, and also the most complex, with both short- and long-term effects that differ across economic sectors. The commission also mentioned that the pandemic calls for a healthy resolution of the tension between the widely acclaimed subsidiarity principle, that argues in favour of dealing with issues at the most immediate level consistent with their resolution, and the interstate spill-over effects of public expenditure and growing Union's increasing intervention in areas relating to the State List and Concurrent List of the Constitution (Para 3.17).

In this context, if we examine the resource flow to the States recommended by the Fifteenth Finance Commission, the principle of subsidiarity remained the core, yet appropriate fiscal space is provided to the Union Government to perform functions that are nationally important. The Fifteenth Finance Commission considered stability and predictability of resources as the essential component of long-term fiscal management both at the Union and the State level. This particular aspect has been eloquently discussed in the paper by Jha. Jha highlighted five key principles that formed the basis of Fifteenth Finance Commission's recommendations: (i) adherence to the Constitutional mandate and addressing the terms of reference within that mandate; (ii) to ensure stability and predictability of finances for both the Union and the States through an optimum mix of devolution, grants and fiscal deficit limits; (iii) design grants to catalyse important public services, with greater flexibility and freedom in the choice of inputs keeping in balance

[3] For a review of various provisions of the TOR of the Fifteenth Finance Commission, refer to Rao (2021).

collaborative federalism; (iv) use performance-based incentives to reward and motivate innovation and reforms with outcomes linked to desired national objectives; and (v) rule-based fiscal consolidation with sufficient flexibility and resilience to advance development and growth objectives.

In its first report for the fiscal year 2020-21, The Fifteenth Finance Commission retained the vertical sharing of resources at the level recommended by the Fourteenth Finance Commission[4]. In its final report for 2021-26 also, the Commission kept the vertical share unchanged at 41 per cent of the divisible pool of taxes[5]. In the Commission's view "this level of vertical transfers will allow appropriate fiscal space for the Union to meet its demands as well as maintain an adequate level of unconditional resources for the States."

As is well known, in India's federal fiscal arrangement, Finance Commission transfer is the primary mode of Central transfers to the States. There are also other channels of central transfers. The total central transfers to states as percentage of Gross Revenue Receipts (GRR) of the Union government since 1984-85 is presented in table 1. In recent years, especially from 2015-16[6], the Finance Commission transfers accounted for about 70 per cent of all central transfers to States. It is important to note that total transfers to States accounted for almost 50 per cent of the GRR of the Central government in recent years, and this has been increasing since the award period of the Twelfth Finance Commission. This increase is both due to the increase in the share of tax devolution and non-Finance Commission grants[7]. However, the share of non-Finance Commission grants declined during the award period of the Fourteenth Finance Commission with a corresponding increase in the share of tax devolution.

[4] The Commission adjusted downward 1 per cent of the divisible pool for the newly carved out Union Territories of Jammu and Kashmir and Ladakh, thus keeping the balance share broadly equivalent at 41 per cent for the remaining twenty eight States

[5] Divisible pool comprises of all the taxes collected by the Union Government net of cesses, surcharges and cost of collections.

[6] The fiscal year 2015-16 was the first year for the Fifteenth Finance Commission's award period.

[7] With the abolition of the plan and non-plan distinction, the non-Finance Commission grants are mainly grants under centrally sponsored schemes and central sector schemes.

Table 1: Central Transfers to States

Finance Commissions	Percent of GRR					Share of FC transfers in total transfers (%)
	Tax Devolution	FC Grants	Total FC Transfers	Non-FC Grants	Total Transfers	
FC-VIII (1984-89)	20.28	2.52	22.80	15.34	38.13	59.80
FC-IX (1989-95)	21.36	3.42	24.78	14.67	39.46	62.80
FC-X (1995-2000)	21.36	2.34	23.70	11.61	35.32	67.10
FC-XI (2000-2005)	20.58	3.88	24.46	11.41	35.87	68.19
FC-XII (2005-10)	22.03	4.35	26.38	21.01	47.39	55.70
FC-XIII (2010-15)	23.80	4.00	27.80	20.50	48.30	57.56
FC-XIV (2015-20)	31.57	4.51	35.88	14.74	50.62	70.90

Source: Indian Public Finance Statistics and Report of FC-XV.

Three important implications can be drawn from this trend:

i. Vertical transfers (tax devolution + all grants) accounting for 50 per cent of the GRR is a reflection of significant decentralisation of spending of resources from the Centre to the States during the last four decades.

ii. The untied transfers has increased post the Fourteenth Finance Commission award as tax devolution has become the primary mode of transfer. This trend is expected to continue as the vertical share has remained unchanged during the Fifteenth Finance Commission award.

iii. The share of non-Finance Commission grants or the tied grants is primarily arising due to the Centrally Sponsored Schemes (CSS) and Central Sector Schemes. The nature and quantum of these schemes is a matter that falls outside the purview of the Finance Commissions' recommendations and depends on the Union Government priorities. However, an appropriate balance between untied and tied grants is needed and a continuous process in a federal system. Since CSS are based on the cost sharing principle between the Union and States, there is a need to ensure appropriate balance that provides fiscal autonomy to the states, and yet implement critically important national schemes decided by the Union Government. In this context, it is to be mentioned that the Union Finance Minister in her Budget Speech (2021) announced that "On the recommendation of the Fifteenth Finance Commission, we have undertaken a detailed exercise to rationalise and bring down the number of Centrally Sponsored Schemes. This will enable consolidation of outlays for better impact." An effective restructuring of CSS will free up resources both for the Union and States and will result in better fiscal management at the Union and State levels.

Stability with equity: The Horizontal Sharing

In order to examine the issue of horizontal equity addressed by successive Finance Commissions, we categorise States in three groups[8] : (i) high per-capita income States, (ii) middle per-capita income States, and (iii) and low per capita income States. This ranking is done based on the comparable per capita gross state domestic product (GSDP) data provided by successive Finance Commissions. It is important to note that, over the years, the per capita ranking of States have changed. Although Goa remained as the highest per capita income State, Kerala's ranking improved. Kerala was a middle-income state during the Twelfth Finance Commission award period. It became the 4th highest per capita income State of the country as per the data provided by Fifteenth Finance Commission. Such changes can also be observed for other States. This is presented in Figure 1. The ranking of West Bengal declined from 10 to 13, while that of Odisha improved from 15 to 11. Marked improvement in ranking can also be observed for Karnataka and Tamil Nadu (TN). Punjab's ranking slipped from second to ninth during the same period.

FIGURE 1: CHANGE IN PER-CAPITA COMPARABLE GSDP RANKING OF MAJOR STATES BETWEEN FC-XII AND FC-XV

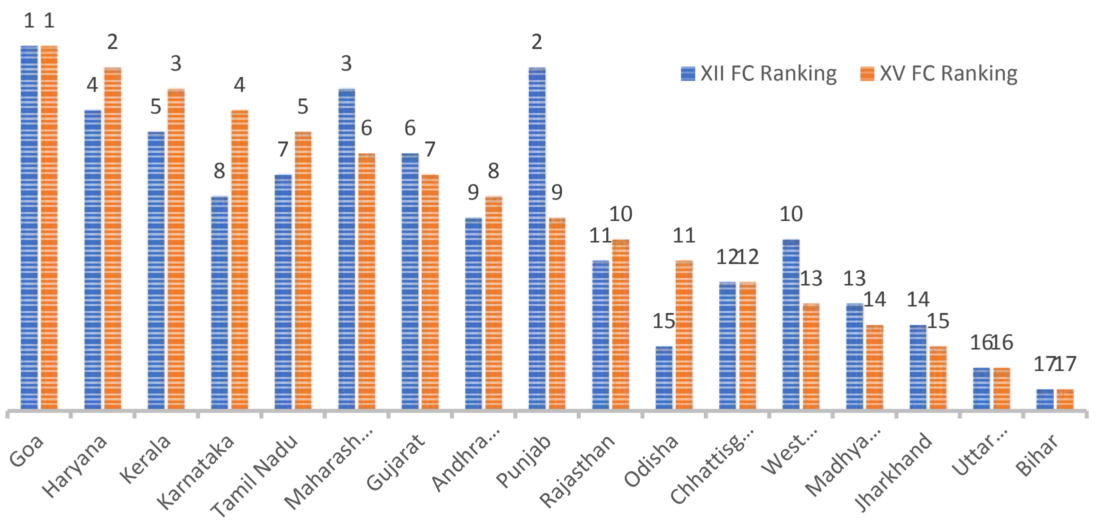


Table-2 provides various measures of dispersion of income of each group between the Twelfth Finance Commission and Fifteenth Finance Commission award period. As

[8] This categorisation is based on a judgement on ranking of per capita income into different groups of States. Top 5 Per capita income States are considered as high-income States, bottom 10 are considered as low-income category and rest are considered as middle-income States.

evident, the per capita income of top-five States increased 9 times during this period, for the middle-income category, the increase was 8 times, and for the low-income category states, the increase was 6 times. Also, the nominal GSDP growth remained highest for the top five States, followed by middle- and low-income States[9]. The coefficient of variation increased sharply for the middle-income category states during this period; while it reduced for the top 5 States; it remained almost constant for the bottom 10 States. Since Finance Commission transfers are primarily driven by the principle of equity with highest share assigned to the distance of per-capita income (Table-3), the changing per capita income ranking has important implications for horizontal distribution across states.

Table 2: Per Capita Growth Rates

Grouping	Average Per Capita GSDP – XII FC (Rs)	Average Per Capita GSDP – XV FC (Rs)	Total change in GSDP (%)	Average Growth Rate over 16 Years (%)	Coefficient of Variation – XII FC (%)	Coefficient of Variation – XV FC (%)
Top 5	32,528	2,95,120	907.27	14.78	41.53	39.54
Middle 13 States	19,929	1,62,973	817.76	14.04	10.67	21.13
Bottom 10 States	12,730	81,242	638.20	12.28	23.13	23.32

The Horizontal distribution presented in the Table 4 shows that over the years, the share of top 5 high-income States has declined. Between Twelfth and Fifteenth Finance Commission, the combined share of high income States declined from 8.152 per cent to 7.439 per cent. The middle-income category States' share increased from 34.166 per cent to 37.866 per cent. The combined share of bottom 13 States remained at around 55 per cent of the total devolution during the award period of the Twelfth Finance Commission to Fifteenth Finance Commission. It is important to note that there has been a change in ranking of States across these three categories. Within each category, there has also been a visible change in ranking. As evident from the Table 3, successive Finance Commissions responded to these change in two ways:-

i) By making horizontal distribution a dynamic one to ensure progressivity of transfer with the changing per-capita ranking of States[10].

[9] Per capita comparable GSDP at constant prices are not available.
[10] Per Capita ranking is a proxy for fiscal capacity. The objective of transfer is fiscal equalization to correct for fiscal and cost disabilities, not percapita income equalisation.

ii) The states at the bottom of the ladder of per-capita income received around 55 per cent of the total devolution showing stability in progressiveness of transfers.

The Fifteenth Finance Commission, on horizontal allocation, observed that " (T)his Commission seeks to harmonise the principles of expenditure needs, equity and performance in determining the criteria for horizontal sharing." This has been addressed by a combination of need, equity and performance-based criteria (Table-3). If we compare various indicators of horizontal distribution adopted by successive Finance Commissions, the equity remained the core criterion. However, the share of equity criterion reflected in income-distance declined between the Eleventh Finance Commission and Fifteenth Finance Commission from 62.5 to 45 per cent, with a corresponding increase in neutral indicator of need like population, and area-including forest cover.

Table 3: Criteria for inter se Distribution: Eleventh to Fifteenth FCs (%)

		XI FC (2000-05)	XII FC (2005-10)	XIII FC (2010-15)	XIV FC (2015-20)	XV FC – 1st Report (2020-21)	XV FC – Final Report (2021-26)
Need and Cost Disability	Population (1971)	10.0	25.0	25.0	17.5	-	-
	Population (2011)	-	-	-	10.0	15.0	15.0
	Area Adjusted	7.5	10.0	10.0	15.0	15.0	15.0
	Forest Cover	-	-	-	7.5	10.0	10.0
Equity	Income Distance	62.5	50.0	-	50.0	45.0	45.0
	Fiscal Capacity Distance	-	-	47.5	-	-	-
	Infrastructure Distance	7.5					
Performance	Tax Effort	5.0	7.5	-	-	2.5	2.5
	Fiscal Discipline	7.5	7.5	17.5	-	-	-
	Demographic Performance	-	-	-	-	12.5	12.5

Source: Reports of Finance Commissions (FC-XI to FC-XV)

Inclusion of forest cover was an important innovation made by the Fourteenth Finance Commission. This was not only retained by the Fifteenth Finance Commission, the share of it in the horizontal devolution formula was increased from 7.5 to 10 per cent. The paper by Chakraborty, while analysing mainstreaming of climate change commitments through

Finance Commission transfer has argued that "in the intergovernmental fiscal transfer mechanism in India, it is a significant step to incentivize the conservation of forest. However, the macro policy channel of this link is through the public expenditure priorities related to climate change commitments by the State governments."

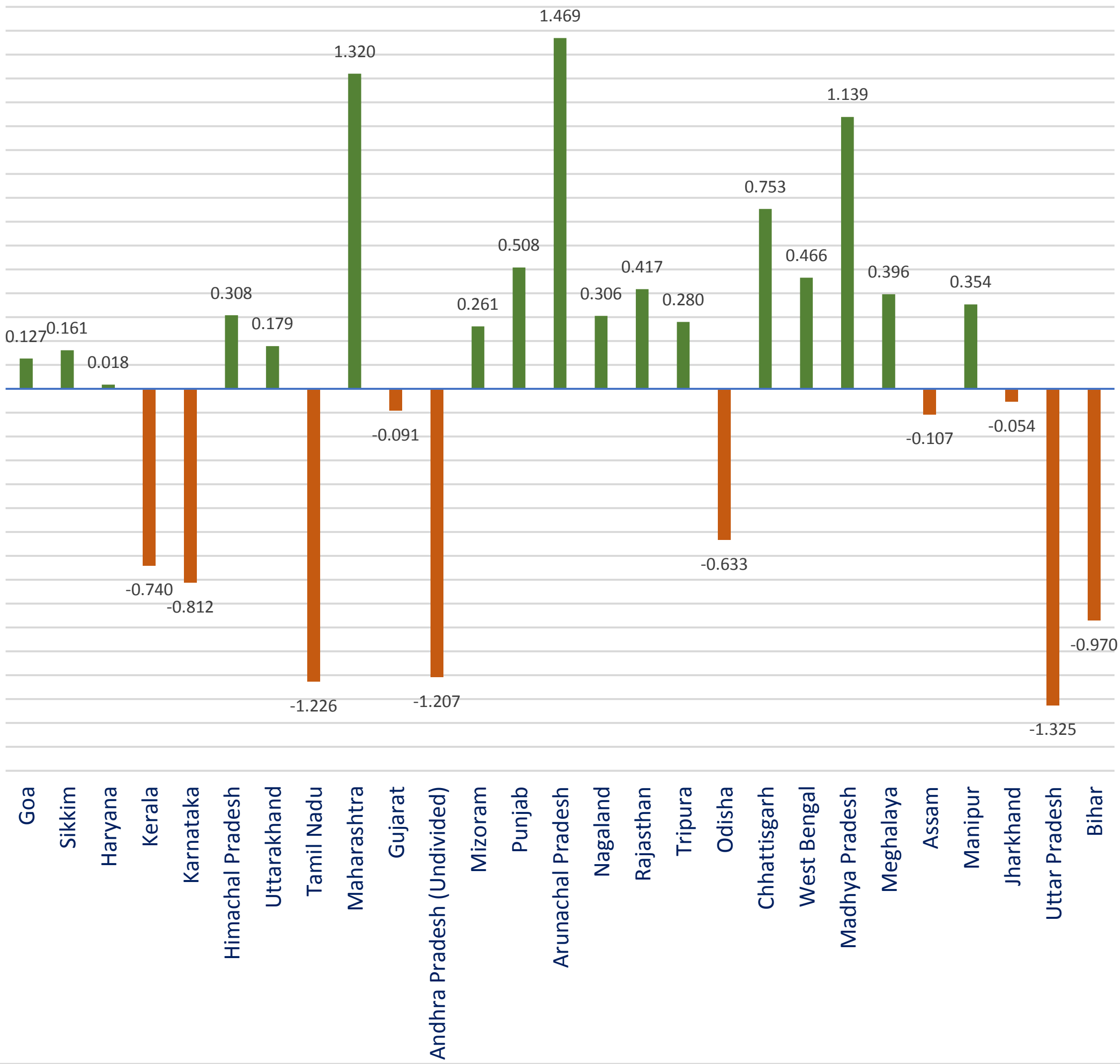
If we examine the changes in horizontal shares of states between Twelfth and Fifteenth Finance Commission award (Figure 2), it becomes evident that horizontal share of Kerala, Karnataka, Tamil Nadu, Gujarat, Andhra Pradesh, Odisha, Assam, Jharkhand, Uttar Pradesh and Bihar declined. For the rest, the horizontal share increased during this period. The paper by Rajakumar, while analysing the Fifteenth Finance Commission award for the North-Eastern States, observed that *inter-se* share of these States increased during the Fifteenth Finance Commission award period. The paper observed that "the total inter se share of these states has steadily increased in the last four Finance Commission awards, a sharp rise is noticed under the Fourteenth Finance Commission award by 1.759 percentage points over the Thirteenth Finance Commission award. Such a scale of increase was attributed to the inclusion of forest cover with a weight of 7.5% and enhancing the weight to area criteria to 15% from the erstwhile 10%. One state that benefited the most on account of this is Arunachal Pradesh, which continues to have attained a higher inter se share in the Fifteenth Finance Commission award as well. While the combined inter se share of NES went up, that of Assam went down further to 3.128% from 3.311% in the Fourteenth Finance Commission award. As noted above, the criteria of area, and forest cover and ecology have favoured these NES, thus, enhancing their inter se share in the horizontal devolution."

Table 4: Change in Per-capita Ranking and Horizontal Share

Per Capita Ranking	XII-FC	XIII-FC	XIV-FC	XV-FC
1	Goa	Goa	Goa	Goa
2	Punjab	Haryana	Sikkim	Sikkim
3	Maharashtra	Maharashtra	Haryana	Haryana
4	Haryana	Himachal Pradesh	Himachal Pradesh	Kerala
5	Himachal Pradesh	Punjab	Maharashtra	Karnataka
Share of top 5 States	***8.152***	***8.683***	***8.063***	***7.439***
6	Kerala	Gujarat	Gujarat	Himachal Pradesh
7	Gujarat	Kerala	Tamil Nadu	Telangana
8	Tamil Nadu	Tamil Nadu	Uttarakhand	Uttarakhand
9	Mizoram	Karnataka	Punjab	Tamil Nadu
10	Sikkim	Sikkim	Kerala	Maharashtra
11	Karnataka	Andhra Pradesh	Telangana	Gujarat
12	Nagaland	Mizoram	Arunachal Pradesh	Mizoram
13	Tripura	Tripura	Karnataka	Punjab
14	Andhra Pradesh	Uttarakhand	Andhra Pradesh	Andhra Pradesh
15	Jammu and Kashmir	West Bengal	Mizoram	Arunachal Pradesh
16	West Bengal	Meghalaya	Meghalaya	Nagaland
17	Manipur	Arunachal Pradesh	Nagaland	Rajasthan
18	Uttarakhand	Jammu and Kashmir	Rajasthan	Tripura
			West Bengal	Odisha
Share of Middle 13/14 States	***34.166***	***33.306***	***39.480***	***37.866***
19	Arunachal Pradesh	Nagaland	Chhattisgarh	Chhattisgarh
20	Meghalaya	Chhattisgarh	Jammu & Kashmir	West Bengal
21	Rajasthan	Manipur	Tripura	Madhya Pradesh
22	Chhattisgarh	Jharkhand	Odisha	Meghalaya
23	Madhya Pradesh	Rajasthan	Manipur	Assam
24	Assam	Odisha	Jharkhand	Manipur
25	Jharkhand	Assam	Madhya Pradesh	Jharkhand
26	Orissa (Odisha)	Madhya Pradesh	Assam	Uttar Pradesh
27	Uttar Pradesh	Uttar Pradesh	Uttar Pradesh	Bihar
28	Bihar	Bihar	Bihar	
Share of Bottom 10/9 States	***57.682***	***58.011***	***52.457***	***54.695***

Source: Finance Commission Reports, India

FIGURE 2: PERCENTAGE DIFFERENCES IN INTER-SE SHARES BETWEEN FC-XII AND FC-XV



The horizontal distribution cannot be fully understood unless one examines the distribution of revenue deficit grants[11]. Revenue deficit grants are given to cover post-devolution deficit of States (see Rao 2021). In other words, both tax devolution and revenue deficit grants are meant to cover the assessed revenue expenditure needs of States. If we consider the distribution of revenue deficit grant across States, until the Fourteenth Finance Commission, revenue deficit grants were mostly confined to the special category States. In the 14th Finance Commission award, a few general category

[11] Revenue deficit grants across States over time are not comparable. The revenue deficit grants for the Twelfth and Fifteenth Finance Commission covered non-plan revenue account deficit. The FC-XIV and FC-XV covered revenue deficit of States

States received revenue deficit grants. These States were Andhra Pradesh, Kerala, and West Bengal.

In the Fifteenth Finance Commission award, 17 States have received revenue deficit grants for the year 2021-22. Out of these 17 States, 8 are general category States. The revenue deficit grant increased from Rs. 74, 341 crore to Rs. 1,14,000 crore between 2020-21 and 2021-22. This increase in the revenue deficit grant is to the tune of around 70 per cent when compared with the recommended revenue deficit grant for the year 2020-2021[12]. Since revenue deficit grant are fixed in nominal terms, in the pandemic year, this would help resources flow to these States even if there is a fall in tax devolution due to the pandemic induced reduction in tax mobilisation of the Union Government. However, the share of revenue deficit grants constituted only less than 10 per cent of the total transfers and cannot compensate for the shortfall in revenue due to the reduction in taxes due to Covid-19 and consequent fall in tax devolution. Going forward, especially for the fiscal year 2021-22, a fall in the tax revenue of the Union can reduce aggregate resource flow to the States, resulting in larger fiscal imbalances. Given the fiscal uncertainties posed by the pandemic, subsequently, we discuss Fifteenth Finance Commission's recommendations on borrowing and fiscal responsibility of the Union and State governments.

Fiscal Responsibility and Fiscal Space

Given the revenue uncertainty, fiscal shock and rising expenditure need due to Covid-19, the Finance Commission considered 3 scenarios for its debt-deficit projections (Table 6). It also proposed allowing additional unconditional borrowing space for states in first 2 years of award period to compensate for loss in tax revenues. The Fifteenth Finance Commission observed that the pandemic has complicated fiscal management at the Union and state levels. The Finance Commission argued that there is a need for fiscal stimulus. According to the commission, liquidity problems can be solved by monetary policy, solvency problems can be solved only by fiscal policy. However, a robust expansionary fiscal policy to counteract the economic fallout of the pandemic will require an equally credible exit plan with a committed path of fiscal consolidation.

[12] Refer to the Fifteenth Finance Commission Report for the year 2020-21.

Table 5: Revenue Deficit Grants from 12th to 15th Finance Commission

State	Total XV-FC (2021-26)	Interim Report (2020-21)	Total XIV-FC (2015-20)	Total XIII-FC (2010-15)	Total XII-FC (2005-10)
Andhra Pradesh	30497	5897	22113	-	-
Arunachal Pradesh	-	-	-	2516	1357.88
Assam	14184	7579	3379	-	305.67
Bihar	-	-	-	-	-
Chhattisgarh	-	-	-	-	-
Goa	-	-	-	-	-
Gujarat	-	-	-	-	-
Haryana	132	-	-	-	-
Himachal Pradesh	37199	11431	40625	7889	10202.38
Jammu & Kashmir	NA	NA	59666	15936	12353.46
Jharkhand	-	-	-	-	-
Karnataka	1631	-	-	-	-
Kerala	37814	15323	9519	-	470.37
Madhya Pradesh	-	-	-	-	-
Maharashtra	-	-	-	-	-
Manipur	9796	2824	10227	6057	4391.98
Meghalaya	3137	491	1770	2811	1796.86
Mizoram	6544	1422	12183	3991	2977.79
Nagaland	21249	3917	18475	8146	5536.50
Odisha	-	-	-	-	488.04
Punjab	25968	7659	-	-	3132.67
Rajasthan	14740	-	-	-	-
Sikkim	1267	448	-	-	188.67
Tamil Nadu	2204	4025	-	-	-
Telangana	-	-	-	NA	NA
Tripura	19890	3236	5103	4453	5494.20
Uttar Pradesh	-	-	-	-	-
Uttarakhand	28147	5076	-	-	5114.68
West Bengal	40115	5013	11760	-	3044.72
Total	294514	74340	194821	51800	56855.87

Table 6: Range of Union Fiscal Deficit (% of GDP)

Scenario	2021-22	2022-23	2023-24	2024-25	2025-26
Recovery slower than assessed	6.5	6	5.5	5	4.5
If assessment holds	6	5.5	5	4.5	4
If recovery faster than expected	6	5.5	5	4	3.5

Source: FC-XV Report

The paper by Srivastava (2021) observed that "The centre's FRBMA has been rendered out of alignment because of the large departure of the general government debt-GDP ratio at the end of 2020-21, which is estimated to be more than 30% points higher than its target value of 60%. Given the history of correction in the debt-GDP ratio, bringing it down to 60% may prove to be extremely challenging. The average annual rate of change in the combined debt-GDP ratio over the period from 1990-91 to 2019-20 is 0.030% points of GDP with some patches where inter-year variations were relatively larger**.** This historical experience shows that achieving a reduction of more than 30% points would prove to be an uphill task. In recasting the fiscal consolidation framework, it will be useful to consider a feasible and realistic adjustment path to achieve the sustainable targets of debt and fiscal deficit."

A Comparative position of the fiscal consolidation path recommended by the Fifteenth Finance Commission for 2021-22 and the numbers reported by the Union and State governments (in aggregate) in their 2021-22 budgets is presented in table 7. While states in aggregate have budgeted their fiscal deficit and outstanding liabilities to be lower than that projected by the Fifteenth Finance Commission, their revenue deficits are higher than the Finance Commission numbers. The Union government budget estimates of revenue and fiscal deficit for 2021-22 are higher than the Finance Commission projections. While states in aggregate have projected a lower GSDP growth that is lower than the growth rate assumed by the Finance Commission, the Union government's growth estimates are on the higher side. The adherence to the fiscal consolidation path by both the Union and state governments would to a large extent depend upon how quickly the country can address the covid-19 pandemic by taking appropriate measures to mitigate its impact, including vaccinating the entire population.

Table 7: 15th FC Recommendations Vs Budget Numbers – Fiscal Year 2021-22

Indicators	**15th FC targets**		**2021-22 Budget numbers**	
	2020-21	**2021-22**	**2020-21RE**	**2021-22BE**
Union (% of GDP)				
GDP Growth (%)	-6.0	13.5	-4.3	14.4
Revenue Deficit	5.9	4.9	7.4	5.1
Fiscal Deficit	7.4	6.0	9.4	6.8
Total Liabilities	62.9	61.0	61.4	61.0
States (% of GSDP)				
GSDP Growth (%)	-5.9	13.5	2.5	11.1
Revenue Deficit	-0.1	-0.5	2.0	0.5
Fiscal Deficit	4.5	4.0	4.4	3.4
Total Liabilities	33.1	32.6	29.6	29.4

Notes: * (-) surplus/ (+) deficit; Data is for 26 state governments; Growth rate is in nominal growth
Source: 15th FC Report; Union and State Government budget documents

In a recent paper, Ardanaz et al 2021 observed that in 75 advanced and emerging economies "with either no fiscal rule or with a rigid fiscal rule, a fiscal consolidation of at least 2 percent of GDP is associated with an average 10 percent reduction in public investment. Instead, in countries with flexible fiscal rules, the negative effect of fiscal adjustments on public investment vanishes, which implies that flexible rules protect public investment during consolidation episodes."

In the context of European Union, Blanchard. e. al (2021) made the following observations:

"The European Union's fiscal rules have been suspended until at least the end of 2021. When they are reinstated, they will need to be modified, if only because of the high levels of debt. Proposals have been made—and more are to come— suggesting various changes and simplifications." The paper discusses "how one should think about debt sustainability in the current and likely future EU economic environment." According to Blanchard *et al (2021),* "it is an illusion to think that EU fiscal rules can be simple. But it is also an illusion to think that they can ever be complex enough to accommodate most relevant contingencies. This leads us to propose the abandonment of fiscal rules in favor of fiscal standards, that is, qualitative prescriptions that leave room for judgment together with a process to decide whether the standards are met. Central to this process would be country-specific assessments using stochastic debt sustainability analysis, led by national independent fiscal councils and/or the European Commission."

William G. and M Paulo (2021) argued that "The COVID-19 pandemic and the global economic contraction will put rule-based fiscal frameworks to the test. The severity of the shock will likely result in a temporary large deterioration in the fiscal deficit and public debt. Many countries are already activating escape clauses to deviate or suspend the fiscal rules. It will be important to ensure the use of this flexibility is temporary and done transparently, including explaining the size of the deviation and process to return to the rule, to preserve the credibility of the fiscal framework."

The Government of India's Economic Survey 2020-21 observed that "Amidst the Covid-19 crisis, fiscal policy has assumed enormous significance across the world. Naturally, the debate around higher Government debt to support a fiscal expansion is accompanied by concerns about its implications for future growth, debt sustainability, sovereign ratings, and possible vulnerabilities on the external sector." The Survey further noted that "For India and other EMEs, which have consistently grown their GDP at high rates over the last few decades, the relationship between debt and growth exhibits a clear direction of causality: Higher growth lowers debt-to-GDP ratios but lower debt does not necessarily lead to higher growth."

The Fifteenth Finance Commission envisions a next generation fiscal architecture and a system of intergovernmental fiscal transfers to enable India to utilize the opportunity presented by the crisis, to be ready, agile and to thrive in what lies ahead. The Fifteenth Finance Commission argued that the upward increase on Union and state debt positions is unavoidable at a time when growth destruction must be mitigated and income support extended and in the medium term, fiscal policies must be embedded in caution rather than exuberance, in restraint rather than profligacy. What would emerge, will depend on the actual quantum of fiscal shock due to COVID-19 and the fiscal need required for COVID response and recovery. The Fifteenth Finance Commission has taken a view that though necessary flexibility needs to be provided, there is a need to return to a sustainable fiscal management for macro stability and growth when we take a medium-term view.

Conclusions

The Fifteenth Finance Commission, while making its recommendations, factored in COVID-19 induced shocks. However, the way COVID-19 is unfolding, some of the assumption made with regard to the resource envelope of both Union and States may deviate by a significant margin from the assessed revenue position made by the Fifteenth Finance Commission. If the Union Budget 2021-22 numbers are considered, fiscal deficit is going to be much higher than what the commission has assessed for the same year. Although, at the State level, the level of deficit for 2021-22 (BE) is estimated at 3.4 per cent, this is much lower than what the Fifteenth Finance Commission has recommended for the States. Any fiscal readjustment needs to consider this asymmetry for appropriate rebalancing of the fiscal path of the Union and State Governments. Finally, the public expenditure composition of the Union and States is different due to the constitutional assignment of functions. Most redistributive expenditures are in the functional domain of States. A contraction at the State level can have adverse distributional consequences. Protecting States' fiscal space and enhancing macroeconomic stability by controlling general government deficit may help to achieve the medium-term goal of providing critical re-distributive support without creating macroeconomic instability.

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