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Fiscal Federalism, Efficiency Versus Equity Concerns

Context

- The Finance Commission is a cornerstone of India’s **fiscal federalism**, created to correct the imbalance between a fiscally stronger Union and financially constrained States.
- Its role extends beyond revenue distribution to promoting **fiscal equity, equalisation and cooperative federalism**.
- The 16th Finance Commission (FC-16), covering 2026–31, marks a significant shift by retaining States’ tax share at **41%** while restructuring grants.
- Its emphasis on fiscal discipline and performance raises an important question: **can efficiency replace equalisation?**

Constitutional Logic of Grants-in-Aid

- Article 275 recognises that formula-based tax devolution alone cannot address India’s vast inter-State disparities.
- States face different geographical, demographic and economic challenges.

- Kerala's human-capital investments, Punjab's contribution to **national food security**, the high infrastructure costs of hill States and connectivity constraints in the north-east illustrate these differences.
- **Grants-in-aid** were therefore designed as instruments of equalisation, enabling States with special needs to maintain essential services.
- The 14th and 15th Finance Commissions retained **Revenue Deficit Grants (RDGs)**, sector-specific and State-specific grants for this purpose.

The FC-16's Departure from the Traditional Approach

- FC-16 recommends approximately **₹9.47 lakh crore** in grants, compared with ₹10.1 lakh crore under FC-15.
- Their share in total Finance Commission transfers falls sharply from **4% to 8.3%**. More importantly, RDGs, sector-specific grants and State-specific grants have been removed, with grants concentrated on local bodies and disaster management.
- The rationale is **fiscal discipline**: RDGs may create moral hazard by encouraging weak revenue mobilisation or excessive expenditure.
- While this concern is legitimate, treating States as fiscally comparable overlooks major differences in their revenue capacity and structural constraints.

The Problem of Unequal Fiscal Capacity

- Aggregate fiscal indicators can conceal serious **inter-State disparities**.
- A State with strong revenues cannot compensate for another facing geographical disadvantages, weak economic capacity or high social-sector obligations.
- RDGs were intended to address precisely these structural differences.
- Their withdrawal could therefore disproportionately affect States whose fiscal difficulties are not necessarily the result of poor governance.
- Fiscal discipline must distinguish between **inefficiency and structural disadvantage.**

The Asymmetry of Cesses and Surcharges

- The treatment of RDGs becomes more contentious when contrasted with **Union cesses and surcharges**, which remain outside the divisible pool.
- FC-16 proposes a grand bargain under which the Centre would gradually merge cesses into the divisible pool in exchange for States accepting a lower devolution share.
- This creates an asymmetry: **States face greater fiscal discipline while the Union retains fiscal flexibility**.
- Such an arrangement could reinforce rather than correct the existing vertical fiscal imbalance.

A Double Burden on Disadvantaged States

- The States' share remains at **41%**, despite demands from 18 States to raise it to 50%.
- At the same time, the weight assigned to **income distance** falls from 45% to 42.5%, while **contribution to GDP** receives a 10% weight.

- Although rewarding economic performance can encourage growth, it may disadvantage poorer States with greater developmental needs.
- Combined with the abolition of RDGs, some States could face a **double burden of reduced devolution** and fewer compensatory grants, potentially widening regional inequalities.

Performance-Based Grants and Local Governments

- FC-16's allocation of nearly **₹7.2 lakh crore to local governments** is significant.
- Linking grants to water, sanitation, revenue mobilisation and audited accounts can strengthen **accountability and institutional capacity**.
- However, excessive conditionality can reduce **fiscal autonomy**.
- The shift from need-based equalisation to performance- and compliance-based transfers must therefore be balanced with adequate untied resources.

Efficiency Versus Equity

- The central challenge is balancing **efficiency with equity**. Performance-based transfers can encourage fiscal prudence, better governance and revenue mobilisation.
- Yet an excessive focus on performance risks penalising States whose disadvantages are structural.
- A sustainable model should therefore **reward high-performing States while supporting structurally disadvantaged States**.
- Fiscal responsibility and equalisation should reinforce, rather than undermine, each other.

The Larger Federal Question

- The Finance Commission's broader purpose is to manage the economic tensions within a highly diverse federation.
- The contrasting treatment of RDGs and cesses raises concerns that the **burden of fiscal adjustment may increasingly fall on States**.
- If States are required to strengthen fiscal discipline while the Union retains considerable control over non-shareable revenues, the framework could gradually strengthen **Union fiscal primacy** instead of correcting vertical imbalance.

Way Forward

- Future Finance Commissions should adopt **a balanced approach.**
- **Need-based transfers** should coexist with performance incentives, while fiscal discipline should distinguish genuine structural constraints from poor financial management.
- Greater transparency is needed regarding **cesses and surcharges**, and local governments should receive both accountability mechanisms and sufficient fiscal autonomy.

Conclusion

- The FC-16’s emphasis on **fiscal discipline, performance and accountability** addresses genuine weaknesses in India’s fiscal system.
- However, eliminating RDGs and other targeted grants amid persistent State-level disparities creates concerns about fiscal equalisation.
- India needs a fiscal federal framework that **rewards performance without abandoning solidarity**, promotes discipline without undermining autonomy, and encourages growth without widening regional disparities.
- Ultimately, **fiscal federalism is an instrument of national integration**. Its legitimacy depends on ensuring that States perceive the federal system as both efficient and fair.

Fiscal Federalism, Efficiency Versus Equity Concerns FAQs

Q1. What is the primary constitutional role of the Finance Commission?

Ans. The Finance Commission is responsible for promoting fiscal federalism by ensuring equitable distribution of financial resources between the Union and the States.

Q2. Why were Revenue Deficit Grants (RDGs) introduced?

Ans. Revenue Deficit Grants were introduced to provide targeted financial support to States facing structural fiscal disadvantages that tax devolution alone could not address.

Q3. Why is the removal of RDGs under the 16th Finance Commission criticised?

Ans. The removal of RDGs is criticised because it may reduce financial support for fiscally weaker States and widen regional disparities.

Q4. What concern arises from the Finance Commission’s treatment of cesses and surcharges?

Ans. The Commission imposes stricter fiscal discipline on States while allowing the Union greater flexibility through cesses and surcharges, creating a potential fiscal imbalance.

Q5. What is the key lesson from the 16th Finance Commission’s recommendations?

Ans. India’s fiscal federalism should balance efficiency with equity by rewarding high-performing States while supporting those with genuine structural disadvantages.

Source: The Hindu

A Climate Resilience Pathway Between India and China

Context:

- Extreme weather has struck both India and China this year. Delayed monsoon followed by intense rainfall caused severe flooding in Mumbai, Surat, Assam, and Odisha.

- China’s Guangxi, Shaanxi, and Gansu provinces faced similar deluges. Experts link these events to climate change.
- Against this backdrop, a Chinese climate envoy’s April 2026 visit to New Delhi has revived questions about whether shared climate vulnerability can open a new, low-risk avenue for India-China cooperation.
- This article highlights how the shared climate vulnerabilities of India and China can create a pragmatic avenue for bilateral cooperation.
- It examines the impacts of extreme weather, the history of climate engagement, complementary strengths in resilience planning, financing challenges, and the potential for climate resilience to rebuild trust despite broader diplomatic differences.

Shared Climate Vulnerabilities

- India and China face **strikingly similar climate stress**. Rapid urbanisation has eaten into wetlands, forests, and permeable land, replacing them with concrete.
- Outdated drainage, poor waste management, and shrinking green cover have worsened flooding and waterlogging in cities.
- Coastal megacities in both countries face compounding threats — extreme rainfall, storm surges, and rising seas.
- Inland cities battle heatwaves, droughts, and flash floods in rapid succession.
- Left unaddressed, these risks disrupt supply chains, dent productivity, and strain public health systems.

A History of Climate Engagement

- Cooperation between India and China on climate issues is not new. From the early 1990s to 2020, both sides signed joint statements and MoUs on disaster management, covering floods, earthquakes, and droughts.
- These pledged joint research, hydrological and seismic data sharing, and exchange of governance practices.
- **Sister-city agreements** — Delhi-Beijing, Mumbai-Shanghai, and Chennai-Chongqing — were meant to translate these commitments into action.
- However, recurring diplomatic tensions meant most of this cooperation stayed on paper.

Complementary Strengths

- China and India bring different but complementary strengths to the table:
    - **Chin**a has **embedded resilience into core urban and rural planning**, using data-driven approaches for transport, housing, and drainage systems.
    - **India** excels in **adaptive, community-led governance** — visible in early warning systems, heat action plans, cool roofs, and nature-based solutions.
- Exchange at the municipal level — on sponge cities, drainage modernisation, and waste management — could help both sides learn from each other.
- Rural livelihoods, agricultural resilience, and joint hydrological modelling for the shared Himalayan ecosystem also offer scope for collaboration, especially since water-sharing agreements between the two countries lapsed in 2022.

The Financing Challenge

- Both countries depend heavily on public funds for climate adaptation, leaving a **significant financing gap**.
- Bridging it requires greater private capital through blended finance, municipal bonds, and credit enhancement tools.
- But these markets remain underdeveloped, held back by weak local capacity and regulatory gaps.
- Knowledge exchange between India and China on financing models could help build these ecosystems and, in turn, shape climate resilience standards for the wider Global South.

Conclusion

- Climate change respects no borders, and India and China’s shared vulnerabilities offer a rare opening for trust-building.
- Moving beyond past diplomatic setbacks, disaster resilience and urban planning present a pragmatic, low-risk pathway for renewed engagement, cooperation, and mutual learning.

A Climate Resilience Pathway Between India and China FAQs

Q1. Why is climate resilience emerging as a new area of cooperation between India and China?

Ans: Both countries face similar climate threats, making climate resilience a practical, low-risk avenue for cooperation through disaster management, urban planning, and knowledge sharing.

Q2. What common climate vulnerabilities do India and China face?

Ans: Rapid urbanisation, shrinking green spaces, outdated infrastructure, floods, heatwaves, droughts, and rising sea levels threaten cities, livelihoods, public health, and economic productivity.

Q3. What strengths can India and China contribute to climate resilience cooperation?

Ans: China contributes data-driven urban resilience planning, while India offers community-based adaptation, early warning systems, heat action plans, and nature-based climate solutions.

Q4. Why is climate adaptation financing a major challenge for both countries?

Ans: Heavy reliance on public funding, underdeveloped private finance markets, limited municipal bonds, and regulatory gaps create significant barriers to climate adaptation investments.

Q5. How can climate cooperation strengthen India-China relations?

Ans: Collaboration in disaster resilience, hydrological modelling, urban planning, and financing can build trust, encourage mutual learning, and support sustainable development despite diplomatic differences.

Source: TH
