Subtheme Paper

Fiscal Federalism and Regional Equity

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Abstract

Federalism is a political construct, but fiscal federalism seeks to derive principles that can be applied for optimal allocation of functions among different levels of government. The issue of regional equity can in one sense be treated as a direct offshoot of the tension between political and fiscal federalism. But even if a federation sticks closely to the form book and achieves a near-optimal situation of distribution of fiscal competencies, issues relating to regional equity will surface. The resultant mismatch between resource raising capacity and expenditure responsibilities calls for equalizing fund transfers which create their own perverse incentives and distortions.

In terms of vertical fiscal imbalance, regional equity requires non-discriminatory treatment of subnational units, while sharing tax proceeds or making general purpose grants and enforcement of equitable rules in overlapping areas of taxation and spending within the competitive federalism model. In terms of horizontal imbalance among constituent states, the dilemma while making general and specific purpose grants relates to whether equalization should be done among regions or among individuals.

These issues have been considered in this paper within the three overall approaches to fiscal federalism that have evolved over time: cooperative federalism, competitive federalism and "market-preserving" federalism. Vertical fiscal imbalance is

inevitable even in federations that closely adhere to the theoretical ideal and it raises difficult questions concerned with symmetrical treatment of regions; some of them have been discussed with reference to specific situations in existing federations. Degrees of disparity vary among federating units also in approaches to horizontal equalization. The objective of individual equity conflicts with that of regional equity and these are closely related to concepts concerning the degree of freedom that should be exercised by subnational units to respond to local preferences. This issue has also been discussed while examining equalization mechanisms in some federations.

1. Political Federalism and Fiscal Federalism

Federations are set up when, in K.C. Wheare's terminology, many states seek unity without unification, by sharing legislative and executive powers through a constitutional contract enforced by an independent judiciary. Fiscal federalism, however, refers to the theory which lays down how the three budgetary functions of allocation, redistribution and stabilization should be performed by different government levels within a country for optimal, efficient economic performance and growth. Principles of fiscal federalism will apply even when there are no formal federal structures; they can also be drawn upon to draft fresh federal constitutions.

2. Equity Concerns: Vertical Fiscal Imbalance

Fiscal federalism has, over the years, moved from concepts of co-operative and competitive federalism to the notion of "market preserving" federalism, under which there are positive and negative incentives for good economic performance. The notion of equity in fiscal federal theory is generally couched in the language of vertical and horizontal imbalances. Vertical fiscal imbalance arises when assignments of fiscal competences are made between federal and subnational governments looking at their comparative advantage in performing budgetary functions. It is measured as the ratio of transfers to states' total revenue, but whether tax shares should be excluded if they are independently determined entitlements is debatable. (In Australia, the federal GST is voted by the Commonwealth Parliament after it is approved by the states and proceeds accrue to them, and in India tax shares are determined by a constitutional body, the Finance Commission.) The extent of vertical fiscal imbalance varies widely among federations: in 2000-1, federal transfers accounted for 46 per cent of state revenues in India, 45 per cent in Australia, 44 per cent in Germany, 30 per cent in Brazil and USA, 25 per cent in Switzerland and 20 per cent in Canada.

Vertical fiscal imbalance can be minimized by allocating direct taxes like income and corporate tax and taxes on external trade like import and export duties to the federal government and motor vehicles tax, taxes on property transactions and piggyback taxes on income to provincial governments, and taxes on immovable property to local communities. Commodity taxes like sales tax and selective excises were once considered suitable for provincial governments. Global experience with value added taxation indicates, however, that centralized levy and administration and sharing of tax proceeds among fiscal jurisdictions help to preserve the common national market and avoid ticklish issues related to taxation of interstate trade. But a centralized VAT would substantially dilute fiscal responsibility at the state level. Rate harmonization among states is achievable through consensus as well as competition as is happening in India and Brazil. Borrowing powers can be shared by different levels of government, but there may be need for interjurisdictional coordination and management for external as well as internal public debt obligations.

On the expenditure side, redistribution and stabilization functions in the classical Musgravian mould are best performed by the federal government and the allocative function shared largely between national and provincial governments. Defence, foreign affairs, inter-state trade and commerce and similar countrywide responsibilities should fall within the federal list of legislative powers.

Nevertheless, there will continue to be vertical fiscal imbalance when major revenue raising competences remain with higher order governments and major expenditure responsibilities with subnational governments. In operating federations, there are further anomalies and compromises as theory is not fully reflected in practical politics. Creative solutions developed under different federal situations generate perverse fiscal incentives and distort expected policy outcomes. But experience has also made federations move closer to the ideal situation through a process of judicial interpretation, legislation and negotiation to promote economic efficiency.

The Australian Commonwealth has converted a transitory wartime arrangement to centralize income taxes into permanent transfer of powers by the states to the federal government by linking centralized levy with grant entitlement. When the goods and service tax (based on the principle of value addition) was introduced by the Commonwealth government in 1999, it was voted as a federal tax although rates have to be approved by the states and tax proceeds accrue to them. State taxes on wealth (like death duties) have withered away in Australia and courts have deprived the states of sumptuary excises.

Canada and Switzerland, however, continue to remain highly decentralized from the fiscal point of view. Movement of the fiscal system towards greater economic efficiency in Canada has taken place without dilution of its federal character. Joint occupancy by the federal and provincial governments of the fields of personal and corporate income taxation and commodity taxation has been leavened by tax collection agreements which enable the federal Canada Revenue Agency to collect many of these taxes for most provinces. In the case of Switzerland, Articles 128 to 134 of the 1999 constitution, which allocate tax sovereignty among different government levels, vest the power to levy indirect taxes (VAT and special consumption taxes) with the cantons. In respect of direct taxes, however, two Swiss federal laws provide for harmonized definition of the tax base and common lists and definitions of possible deductions (though not their amounts), while federal jurisprudence prohibits double taxation and unjustified tax rebates. At the cantonal level, therefore, the gross tax base and the list of deductions are identical, but the tax rate schedule and the actual amount of deductions are decided by the cantonal Parliament. For the rest, the Swiss practice is one of joint taxation with problems of competition, coordination and harmonization. In India, the power to tax individual incomes derived from agriculture is vested in state governments as also domestic commodity taxes (sales taxes and some excises).

Constitutional distribution of expenditure powers in federations follows the distribution of legislative and administrative powers. These powers may themselves not be assigned together; the federal constitutions of Switzerland, Germany and India assign some fiscal powers by separating the power to levy tax from that of administering it. On the expenditure side too, responsibilities allocated to states like health, education and social security, demand far greater public resources than can be raised by exercising the powers given to them.

3. Regional Equity Concerns for Provinces vis-à-vis the Federal Government

At the federal-subnational interface, regional equity implies equitable fiscal treatment of different regions. In this context, there are at least two obvious issues:

- mechanisms used to correct vertical fiscal imbalance should as far as possible be nondiscriminatory among regions and
- levies raised by different provinces should not obviously discriminate against taxpayers of other regions.

Federal constitutions and agencies set up to regulate intergovernmental transfers take note of both these requirements in most federations. Vertical fiscal imbalance is generally corrected by tax sharing mechanisms for federal levies and general purpose transfers from the federal government to the states. The interests of regional equity (but not necessarily of equity among individuals) are served when criteria applied in such mechanisms strengthen regional governments in a uniform manner without curtailing their discretion and capacity to deploy transferred or shared resources to respond to local preferences. From this viewpoint, tax sharing based on the source of revenue principle would suit the requirements of regional equity. In India, before the tax sharing mechanism was rationalized under the 80th constitutional amendment of 2000, the source principle was applied at different times for sharing the proceeds of some shareable taxes.

This criterion should be applied when the power to levy a tax has been contracted out as an agency function to the federal government by provincial governments, but in India, although the power to levy and collect additional excise duty on textiles, sugar and tobacco was contracted out by the states to the central government as an agency function, the proceeds are shared under the normal Finance Commission formula and not on the origin principle. Most of the Canadian provinces have entered into an agreement with the federal government to levy and collect income tax jointly. Quebec, however, does not participate in this arrangement, collecting its own GST (VAT) as also the federal tax. In Switzerland too, the agency obligation is at the cantonal level for it is they who are legally bound to collect federal income and corporate taxes. In the case of general purpose transfers, which increase the resources of states without reducing their power to deploy them, however, the criteria used are usually aimed at equalizing fiscal capacities. The issues that arise have implications from the point of view of horizontal fiscal imbalance. General purpose grants determined solely on the basis of population may probably be nondiscriminatory from the point of view of individuals, but are not necessarily so from the regional equity viewpoint. The power of the Commonwealth government in Australia in respect of VAT (GST) is not in fact run as an agency function and the distribution of the proceeds is not based on source or even population; it is in line with the horizontal equalization exercise conducted by the Commonwealth Grants Commission.

Asymmetrical treatment of regions can become a live issue when the constitution itself (generally for political and historical reasons) offers special treatment to a specific province or region. This is the case in India, for example, under Article 370 of the constitution which provides a special legislative regime for the State of Jammu and Kashmir to respond to the requirements of its Instrument of Accession to the Indian Republic. The federal Parliament is empowered, therefore, to exercise its legislative powers within the Union List as well as the concurrent list only after consultation with the state government subject to Presidential interpretation and guidance. Similar situations have arisen while federalizing unitary political structures in both Spain and Belgium. There is scope for substantial organizational and power asymmetry among Spanish subnational units called Autonomous Communities. Due to historical arrangements safeguarded by the constitution, two of them—the Basque country and Navarra—even enjoy their own privileged system of financing. In Belgium too, the constitution as well as the Special Majority Law on Institutional Reform have enabled federated entities to exercise different levels of competences. The German speaking community unlike the Flemish (French speaking) community does not exercise power over language policy, nor does it possess "constitutive authority" (the limited right to modify organizational rules imposed by special institutional reform laws). Article 138 also permits the French-speaking community alone to transfer power to the Walloon region (with regard to its powers in the unilingual French language region) and to the French-speaking community commission (with regard to its powers in Brussels) without special majority law. Article 139 allows the Walloon region to transfer certain regional responsibilities to the German-speaking community to exercise them in the German-speaking region. These asymmetries have refocused Belgian federalism around "community federalism" in the north and "regional federalism" in the south and allowed the capital region of Brussels to retain its distinct status. Increasingly, such arrangements will become inevitable to hold together federations consisting of provinces with differing needs for integration and amalgamation.

From the purely fiscal angle, however, inequitable access of different regions to federal grants can arise as a consequence of negotiated political compromise. An example in this regard is that of the so-called "special category" states in India, a list of 11 eastern, north-eastern and northern states, which share perhaps only one characteristic—they are all "nonviable" smaller states with an international border. Inclusion in this group has entitled such states to concessional access to federal grants for most transfers (general purpose as well as special purpose grants), even though many of them would not qualify for special treatment under normal criteria relating to state domestic product or human development applicable to such transfers. There are murmurs and demands for similar treatment from larger but more backward states but by and large the special treatment has been accepted nationwide as the necessary price of inclusion of these states within the federal compact. Expectedly, however, the policy has created a culture of dependence in these states which is contrary to the canons of autonomy and accountability essential for good fiscal policymaking and efficient administration.

Non-discriminatory treatment by subnational governments of taxpayers and producers of other jurisdictions is a universal formal stipulation in federal constitutions as this is a basic prerequisite for protecting the common national market. The power of the Australian commonwealth under section 90 of the constitution to establish a single uniform tariff policy has permitted it to prevent states from imposing protectionist burdens on inter-state trade and commerce. Similarly, Article 133 of the Swiss constitution forbids taxes in the form of tariff barriers which could impede the free movement of goods between the cantons. Part XIII of the Indian Constitution (specifically Articles 301 to 304) safeguards nationwide freedom of trade and commerce, but the federal Parliament is empowered to impose restrictions in the public interest. Article 303 bars all legislatures from making laws which favour any regional discrimination except to deal with a situation of scarcity in any part of the country. (This provision has indeed been used continuously over the years.) State taxes on goods manufactured in other parts of the country should not discriminate against similar goods manufactured within the state.

The concept of competitive federalism envisages arrangements for fair competition among subnational units. Such rules could determine the principle on which a tax base with inter-state implications is to be apportioned among them, where adjudication responsibilities for disputes lie, etc. These rules may be formulated by the federal government itself in consultation with states but the responsibility of making and enforcing them would rest with the federal government, subject, of course, to judicial interpretation. Since judicial relief is likely to be sought only in rare cases, this gives federal governments substantial influence over state policies. In a highly decentralized federation like Switzerland characterized by overlapping tax powers, it is the Federal Court of Justice, which has done horizontal coordination by focusing on avoidance of double taxation as well as prevention of evasion of progressive taxes by taxpayers with taxable activities across jurisdictions through geographical splitting of the tax base. The manner in which rules are framed and interpreted can even implicitly set uniform standards across the country. Strict interpretation of environmental legislation could raise the bar for all states while low tax rates or lax administration in one state could reduce rates and efficiency in neighbouring areas too and unleash "a race to the bottom".

In practice, therefore, while raising resources, subnational governments attempt to manipulate statutory provisions to favour their own residents. The preferred technique is "tax exportation", which is possible particularly under non-VATable multipoint or first point cascading commodity taxation. Economic distortions resulting from such mechanisms result in suboptimal inefficient decisions regarding the location, structure and scale of production and distribution units for goods and services. Since movement to a more efficient rational system could shift the tax burden to domestic consumers, it is likely to be strongly resisted. The Indian experience with introducing VAT is a good example of how such situations develop. Tax exportation by producer states has been a rampant feature of state level first or multi point sales taxes since the fifties. This has distorted locational and other business decisions and led to the evolution of ingenious (though perhaps desirable) forms of evading cascading state levies by practices like consignment and agency transfers. More than a decade has elapsed since the recommendation to move to a dual destination based VAT was made by the Bagchi committee in 1994. Over years of advocacy and negotiation, the more blatant forms of preferential treatment of local producers through sales tax credits for investment have been reluctantly abandoned by Indian states. When state level VAT was finally introduced in 2005, the initial proposal to restrict it to domestic producers was also diluted. Much still remains to be done to rationalize the taxation of inter-state trade before the "tax exportation" issue is finally settled and some degree of non-discriminatory fiscal treatment is possible among different regions.

4. Regional Equity in the Context of Horizontal Fiscal Imbalance

The second type of imbalance referred to in federal fiscal theory is horizontal imbalance. The concept of horizontal equity developed by Buchanan as well as Boadway and Flatters applies to equity among residents of different subnational jurisdictions within a federation, not regional equity. Taking comprehensive income as the index of well being, it is argued that the income tax levied by federal governments cannot ensure horizontal equity as its base does not take into account the redistributive effect of the fiscal operations of subnational governments. These operations cannot be distributionally neutral except in the unlikely case of benefit taxes. When quasi-public services of such governments are financed by resource rents or source-based taxes as against residence-based taxes, net fiscal benefits will vary. Residents in resource rich high income regions will have higher benefits and their higher public consumption will not be included in determining the tax base of the federal government.

Boadway and Flatters adopt a broad as well as a narrow view of horizontal equity. The former approach stipulates that the fiscal system should be equitable across the country vis-à-vis the actions of all governments and persons equally well off before federal and subnational actions must also be so afterwards. To achieve this, transfers should be made in such a manner that each province is enabled to provide the same level of public services at a given tax rate (as in a unitary state). Under the narrow view, federal fiscal action is only expected to ensure horizontal equity on the basis of distributional effects established after state fiscal action has been taken. When we consider the requirements of regional equity, however, we are concerned primarily with the broader notion of horizontal equity in which the federal government's aim should be to equalize the capacity of states to provide the same level of public services at a given rate and leave it to the states themselves to then determine how to respond to local taxing and spending preferences.

5. Range of Regional Disparities

The range of regional disparities varies among federations. Opportunities for mobility and investment that become available for capital and labour after the federation is established also help to reduce disparities over time. Canada is among the most diverse of federations with most of its population concentrated in two large provinces, although the range of dispersion in per capita income is reduced if natural resource revenues are discounted. Switzerland has 6 cantons out of 26 which have a low per capita income. Poverty in Indian states is largely concentrated in the BIMARU group in north and central India (Bihar, Madhya Pradesh, Rajasthan, and Uttar Pradesh) while states of the south and west are by and large considered to be better off. Although Australia is substantially heterogeneous in area and population, GDP per head is largely homogeneous. Large disparities demand measures to equalize fiscal capacities without impinging on subnational powers, a task which has been tackled in different ways in these federations.

6. Causes of Horizontal Regional Imbalances

A fundamental cause of regional disparity is divergence in natural resource endowments in different provinces. Fiscal federal experience indicates, however, that the determining issue is the possibility of exploiting such resources to augment the budgetary capacity of subnational governments. A case in point is mineral wealth like oil, coal and other deposits on which royalties are raised for the public exchequer. If subnational governments are largely free to levy royalties in mineral rich areas, their budgetary resources often need little supplementation through compulsory levies. Much depends, however, on how the regulatory and fiscal power to control natural resource exploitation is shared by different government levels.

In Canada, section 92 of the original British North America Act of 1867 had vested provinces with the power to manage and sell public land and its forest resources and the additional clause (section 92A) enacted in 1982, providing for taxation of non-renewable natural resources, forestry resources and electrical energy has confirmed their right to levy royalties. As a consequence, discovery of onshore oil reserves in Alberta in 1948 has enabled this province to overtake Ontario and Quebec on the provincial GDP ranking list and shed its dependence on equalization transfers. Such budgetary affluence has substantially reduced the fiscal burden of the citizens of Alberta, as they can now enjoy high levels of public goods with very little income tax liability. Nova Scotia and Newfoundland which continue to receive equalization payments also enjoy significant oil royalties. In Australia too, Western Australia has joined the donor states of New South Wales and Victoria because of its buoyant mining royalty tax base.

A diametrically different situation exists in India where the power to raise royalties from mineral deposits has not been solely vested in state governments. The power to regulate mines and mineral development in the state list of the constitution has been made subject to powers given to the federal government in the Union list to regulate and develop oil fields and mineral oil resources and regulate mines and mineral development (the latter power can be exercised if legally declared to be in the public interest). States can also levy taxes on mineral rights only subject to limitations imposed by central laws relating to mineral development. Federal legislation for developing and regulating mines and minerals has taken over much of the space available for states to realize resources from mineral wealth. Only "minor" minerals (which are defined under the central act) can be regulated and taxed through state rules. Not only are royalty rates for minerals with major revenue potential like petroleum, iron ore and coal determined by the federal legislature, the speed and manner of exploitation of minerals deemed to be critical for industry or defence are also controlled by the central government. Hence, although state governments raise and fully utilize royalty revenues, there are severe limitations on states rich in mineral deposits to determine how they should exploit this wealth to realize revenues in the long and short term. A constant and legitimate grievance of these states is inadequate increase in royalty rates for major minerals and non-adherence to the periodicity prescribed in the law for rate revision, since policies are being applied in a *dirigiste* environment to benefit users and public sector companies. As a consequence, there is no correlation between natural resource endowment and budgetary surplus in India. In fact, some of the best endowed states in terms of exploitable natural resources like Bihar, Orissa (both rich in mineral deposits like coal and iron ore) and Assam (rich in petroleum) are among the least developed parts of the country and continue to be major recipients of largesse from the federal kitty in terms of general and special purpose transfers.

A similar situation exists in the case of regions rich in hydro-electric and forest resources, which demand adequate compensation for the ecological costs of exploitation (submersion of land, denudation, etc.) on behalf of other beneficiary states. The call for greater power to equitably exploit their rich hydro-electric and forest resources is becoming strident in the mountain states of the north (like Himachal Pradesh and Uttarakhand) and north-east, which today run high budget deficits and depend substantially on central grants. Inefficient levies in the form of exportable cesses on electricity generation are being proposed in such states but no clear view has been evolved on this issue by the central electricity regulatory authority where the principal actor is the federal government owned generation company. Current policies demand early review so that affected states do not introduce distorting levies of different kinds to export their budgetary burden to users in developed industrialized states.

The pace and level of exploitation of natural resources at the time of creation of the federation are also responsible for regional imbalances. Fragmented administrative structures in political units existing in pre-independence India have resulted in differential developmental levels in different parts of the country, sometimes cutting across frontiers of reorganized states too. Almost all rivers flowing through the southern state of Tamil Nadu, for example, had been harnessed for irrigation purposes under the British government, while dams are only now being proposed in some of the upper reaches of the same rivers in adjoining states (Karnataka and Kerala). The substantial investment needed for the purpose has prior claim on the limited budgetary resources of these states, particularly when failure to exploit riparian resources could result in permanent loss of the right to use the water. One consequence is that Tamil Nadu has been able to devote public funds to building up a good network of schools and public health institutions much earlier and faster than Karnataka, thereby compounding its original developmental advantage. Such initial conditions have been a source of regional disparity in many federations, but they tend to get adjusted over the years in response to public resource raising and expenditure choices.

Fiscal federal literature presupposes that macroeconomic control remains at the federal level, since freedom to access capital markets and budget mismanagement on the part of subnational governments could jeopardize efforts to stabilize the economy. In reality, however, budgetary commitments of such governments are often too rigid for short term adjustments and some degree of national consensus is desirable on growth targets and strategy. Within limits, subnational governments enjoy considerable leeway to determine their growth path. This is the case even in a formal "planned" economy like that of India. The degree of such divergence will depend on the looseness of the federal compact, but porous fiscal barriers across states and the possibility of "voting with the feet" can help to ensure that investments are made in line with resource endowments to take advantage of large unified markets. Nevertheless, in a developing economy, growth strategies adopted by states might accentuate other kinds of inequities, calling for inducements from the federal government to ensure that minimum entitlement levels are assured for all segments of the population throughout the country through equalization measures like specific purpose grants.

In India, post-independence developmental strategies adopted by the states of Punjab and Kerala were diametrically different, as reflected in the electoral choices of their voters. Kerala moved left and preferred to raise the literacy levels and health status of its population by public funding, social security and advanced labour legislation (which drove private investment away to neighbouring states with laxer regimes). Its per capita income stagnated while it notched up scores equal to those of highly developed nations on other aspects of human development. Punjab on the other hand channeled budgetary resources into irrigation and agricultural growth. It rose to the top in terms of per capita income but literacy and public health statistics continue to be dismaying. Equalization in terms of central incentives has become essential to induce Punjab to devote funds to improving the literacy levels of neglected groups like women and other deprived classes.

Varying capacities to raise revenue from the same sources or differing costs of providing the same services in subnational units can also be a fertile ground for regional imbalances in federations. Taxable capacity is primarily a function of state income and transfers of different kinds can be used to equalize this capacity. In practice, however, other factors also affect the ability of a state to raise revenue and these need to be addressed.

In Australia, the Capital Territory, which is a high income area receives large grants from the Commonwealth Grants Commission because it is disabled from levying payroll and property taxes on employees and property holdings of the Commonwealth government under the constitutional principle of immunity of instrumentalities of governments (section 114). Again, available tax handles may not be effective enough to tap a productive sector and yield revenue. This is the case, for example, in the Indian state of Punjab where agriculture is a major contributor to state income for which even if the state desires, it may be unable to develop an effective mechanism to tax agricultural income. The power to levy income tax in the country is truncated in an unsatisfactory fashion, with taxation of agricultural income left to states and that on non-agricultural income being undertaken by the federal government. Return-based taxation of agricultural income has not proved feasible in most countries except for large commercial farms. India is no exception and plantations run mainly by corporates are the main sources of agricultural income tax. Other options to tap agricultural income are based on standardized, simplified *forfait* (presumptive) methodology for which institutions are badly designed and generally ineffective. Commodity cesses and market fees could siphon off some of the surplus accruing to agriculturists but this is a generally unsatisfactory method. In Punjab, where most of the wheat and rice produced is in fact compulsorily "procured" by government agencies through a cost-plus pricing method for being supplied through government fair price shops under the public distribution system in other regions, indirect taxes on agricultural produce simply get exported. The resultant disconnect between taxation and expenditure is also contrary to all good principles of public finance and this has affected fiscal accountability and responsibility in Punjab.

Administrative capacity could be a limiting factor under some conditions, particularly when new states or provinces are created in existing federations for reasons of administrative convenience or cultural homogeneity or additional subnational units are added to existing federations. The new entities are often at a disadvantage vis-à-vis developed existing states in the federation. Such a situation calls for substantial assistance in terms of funds, training and technical assistance to build up over time a structure of governance that can respond to voters' preferences. This may perhaps be the best justification for asymmetrical assistance extended today to "special category" states in India.

7. Equalization and Horizontal Regional Equity

In fiscal federal theory, horizontal fiscal imbalance should be addressed by equalization transfers (mainly general and specific purpose grants). The former are aimed at offsetting the fiscal disadvantages arising from lower fiscal capacity and the higher unit cost of providing public services in different states. This is achieved by unconditional grants equivalent to the difference between what a state ought to spend to provide specified normative levels of public services and the revenue it can raise at a given standard tax effort. Extension of specific purpose grants to compensate for spillover effects is equivalent to attempts to establish level fiscal conditions necessary for effective competitive federalism. Primarily, however, such grants are extended for good reasons to provide a uniform level of core public goods across the country. To achieve this purpose, grants should be open-ended and at matching rates; ideally, a variety of matching ratios should be available to obtain the desired response from all states. From this point of view, the aim of specific purpose grants is equity among individuals of different states, not just regional equity. This distinction between general and specific purpose grants cannot, however, be drawn in federal countries, since criteria and procedures used for both are often meant to equalize entitlements of individuals as well as regions, as can be seen in the following examples.

Canada has unconditional equalization transfers and in addition some general purpose grants for health and social services. The unconditional equalization grants referred to in section 36 of the Canadian constitution focus primarily on the normative equalization of taxing (or overall resource raising) capacity. They do not attempt to list services for which equalization is to be done and they do not attempt to equalize for differential needs, or the cost of providing public services in the ten provinces. Under the federal equalization programme, until recently equalization grants were based on a formula calculating the average per capita yield from thirty-three tax bases with compensation going to the provinces in which the per capita yield was below the average of the five middle income provinces. In 2007, on the advice of an expert panel, this was changed to include the fiscal capacity of all 10 provinces, but the effect of including wealthy Alberta in the calculations was moderated by reducing the rate of resource revenues inclusion from 100 to 50 per cent. Together these enriched the equalization standard significantly. In addition under the Canada Health and Social Transfer arrangements, there are general purpose grants in support of health and social expenditures in the provinces which also have had an equalizing effect in them. The health transfers are tied to adherence by provinces to the five general principles of the Canada Health Act—public administration, comprehensiveness, universality, portability and accessibility. This transfer has in principle an equal per capita value for all provinces with part of the transfer being a transfer of federal tax points.

Switzerland has no constitutional provisions for equalization, which is done under the 1959 federal law, the agricultural aid policy and assistance to mountain areas. The law aimed at providing minimum acceptable levels of certain public services without much heavier tax burdens in some cantons than in others. Fiscal imbalance was seen in terms of differences in revenue-raising capacities of cantons as well as relative unit costs of providing the defined service level was above the national average. Eventually, however, because of the difficulty in defining needs, average versus minimum provision and relative costs, which induced strategic behaviour in recipient governments, three out of four indicators used in the formula for computing the financial capacity of cantons refer to revenue-raising abilities; the four indicators are per capita national income, the inverse of the tax burden, per capita tax revenues from different sources weighted by indices of tax burden for comparability and an approximation of the cantons' expenditure requirements, taking into account population density and the relative importance of each canton's agricultural surfaces in mountains and in plains. Many items of cantonal expenditure benefit from conditional federal grants, built around a basic rate, which represents the federal interest in minimum standard requirements for cantonal public services (varying according to incentive or some technical criteria like economies of scale, spillovers, congestion costs, etc.) to which an equalization supplement is added, inversely related to the recipient canton's index of financial capacity. There are also equalization components in the three revenue sharing programmes of the federal government for the federal direct tax, the withholding tax and part of federal customs duties on petrol and motor fuel.

The Indian system of intergovernmental transfers operates through multiple channels. Finance commissions appointed on a quinquennial basis under Article 280 of the constitution recommend tax sharing percentages and formulae and provide for equalizing "gap" grants. Budgetary estimates of states are redone to assess their likely revenue gaps and this process is gradually taking on a normative hue. The need to provide basic minimum standards of key public services strongly influences the process of assessing expenditure needs, but "gap" grants are not tied to utilization patterns and reports. The practice of the Finance Commission extending special purpose grants was originally started when the seventh such Commission felt that "non-Plan" ("non-developmental") requirements in regulatory administrative departments of states, which needed upgrading (like police, law courts and general administration) were being overlooked by the central government which focused its specific purpose grants on "Plan" ("developmental") activity. The latest (Twelfth) Finance Commission has gone a step further and extended specific purpose grants to selected states even for developmental sectors like education. Most of the other central government grants to states are made within the national Plan. The Planning Commission makes general purpose grants according to a formula (tied to population, tax effort and need) approved long back by the state Chief Ministers at the National Development Council. But most Plan grants today are specific purpose, meant to ensure minimum levels of performance by states in a large number of sectors. Within these, debate to both increase as well as reduce the centrally sponsored schemes has continued for several decades. State governments plan their own priorities and strategies to meet the needs of their people with the twin objective of accessing the maximum possible level of central largesse with minimum adherence to conditionalities and reporting requirements.

Commonwealth grants to states in Australia are made under section 96 of the constitution, the key player being the Commonwealth Grants Commission (CGC) set up in 1933. Equalization is based on the perception that a state suffers a disability when its revenue capacity or cost of delivering services is worse than the mean for all states due to reasons that are beyond its power such as remoteness, congestion or differential prices of wages or supplies. The aim is thus to make it possible for a state by reasonable effort to function at a standard not appreciably below that of other states, by giving it the capacity to provide the average standard of state public services, assuming that it does so at an average level of operational efficiency and makes an average effort to raise revenue from its own sources. However, general purpose grants recommended by the Commonwealth Grants Commission have been accused by

Australian commentators of equalizing only the financial capacities of states and not therefore being aligned with indices of individual equity like GDP per capita. Seen from this viewpoint, however, such grants seem to satisfy the requirements of regional equity, since they grants reflect what actually affects the financial capacities of state governments, given the services that states in general provide and the revenues they raise. From a different angle, however, since the grants take into account the equalization effect of all special purpose federal transfers, the latter lose their incentive effect. Hence, while federal priorities and choices are "imposed" on states by CGC transfers, they are still given the freedom to utilize transfers in response to local priorities.

This is indeed the key concern of general purpose grants in all federations: there is no way of ensuring that states utilize them for providing the services which have given rise to their needs assessment, so that requirements of individual equity for which these transfers are made are met. The problem is compounded by the fact that availability of general purpose transfers creates perverse incentives for continuing dependency of state governments on federal assistance, except in the case of transfers which are tapered off over a specific time period during which a recipient state is expected to raise its standards of public services to acceptable levels. To avoid such incentives for states to become or remain inefficient, the CGC tries to weight only costs that governments cannot change, e.g. those deriving from climate or sparseness of population.

The issue of regional equity would, therefore, arise in the context of fiscal federalism only after taxing and spending competences are shared as closely as possible in line with theoretical precepts for efficient and responsive budgetary policy. To enable subnational units to function equitably within a cooperative/competitive federal environment, rules for symmetrical treatment of regions as well as "horizontal coordination" of their overlapping tax statutes need to be laid down by the constitution, statute, jurisprudence or the federal government. States should also be disabled from resorting to discriminatory practices like "tax exportation". Tax revenue raised by the federal government by exercising powers enjoyed by state governments on their behalf must be transferred to states based on the source of revenue principle. General purpose grants should be used for equalizing regional disabilities over which states have little or no control like remoteness, distances, etc., and they should be given without conditions so that state governments can respond to local preferences. When such grants are determined after taking into account special purpose transfers, the driving principle is no longer regional but individual equity. Special purpose grants should, therefore, be superimposed at a later stage if the federation seeks a further degree of equalization at the level of individuals. Nevertheless, in one sense at least transfers extended to correct spillovers could also be viewed as a mechanism to provide a level playing field among competing jurisdictions within a federation.