# Are Federations Moving Towards More Rational Forms of Equalization?

## The Cases of India and Russia

*Shefali Dhingra*
*Vladimir Nazarov*

## 1. Introduction

The subject of fiscal federal relations has gained considerable importance in both India and Russia in the twenty-first century. It has thrown up several debatable issues with regard to resource generation and distribution as well as allocation of expenditure responsibilities. The goal of governments of both countries is to achieve the objective of equity by narrowing down the horizontal and vertical imbalances. The aim of this paper is to analyse the cases of India and Russia and find out whether or not these countries are moving towards more rational forms of equalization.

The case of India is used to describe the various provisions for narrowing down horizontal and vertical imbalances. It captures important issues on fiscal federalism and highlights various challenges the country faces with regard to the achievement of the equity objective.

In the case of Russia the discussion concentrates only on the federal equalization transfers because it is the impact of this financial instrument that is the most doubtful.

## 2. The Case of India

India is a union of states having all characteristics of a federation with 28 diverse and distinct states besides 7 Union Territories. The Indian Constitution assigns separate subjects to the states (in the state list) and centre (in the Union list) to legislate upon. The subjects listed in the concurrent list fall under the jurisdiction of both the centre and the state.

The distribution of revenue powers and the allocation of expenditure responsibilities at different governmental units results in two built-in imbalances: vertical and horizontal. In order to correct these imbalances, Article 280 of the Indian Constitution provides for a Finance Commission every five years to make recommendations on the transfer of resources from the centre to the state, in the form of tax-sharing, grants-in-aid and loans.

It is the objective of this part of the paper to examine the equalizing effect of these transfers and the impact they have on the autonomy of the states.

### 2.1 *Powers of Taxation and the Tax Sharing Arrangement*

According to the Constitution, the centre has powers to tax income (other than agricultural income), production and manufacture of goods and services and all international transactions. The states, on the other hand, have the authority to tax sale of goods, agricultural income, holding and sale of property and certain specified services like the sale of electricity. The centre has an advantage in levying taxes but the states have a share in the central taxes which is determined by the Finance Commissions.

In the 1950s, personal income tax was to be compulsorily shared and the sharing of Union excise duties was optional. Since then successive Finance Commissions have raised the share of states in income tax from 50 per cent to about 85 per cent and excise duties from 20 per cent to 45 per cent. The Tenth Finance Commission brought about more equalization when it recommended that states share all the Union taxes. The Eleventh Finance Commission determined states' share in central taxes at 29.5 per cent. The Twelfth Finance Commission raised it to 30.3 per cent.

Over the past three decades, horizontal equalization has increased. Relatively better-off states like Maharashtra, Punjab, Tamil Nadu, Kerala and Gujarat, have lost out materially as their shares have come down by over 20 per cent during the period between the Fifth and Twelfth Finance Commissions. The share of the north-eastern states as well as that of Bihar, Madhya Pradesh, Rajasthan, Uttar Pradesh states (BIMARU) has gone up, the latter on account of weights attached to poverty. The weight of population has also been raised by the Eleventh Finance Commission from 10 per cent to 25 per cent. The Finance Commissions over the years have tried to meet the equity objective by assigning weights to factors which will take more resources to the poorer states.

The successful introduction of value added tax (VAT) by 30 states and Union Territories and the fiscal responsibility and budget management legislation enacted in 2003, appear to have made further inroads into state-level fiscal reforms, making them less dependent on the centre for their fiscal needs. The decision to implement state-level VAT was taken after sustained intergovernmental considerations by the Empowered Committee (EC) of State Finance Ministers in June 2004, during which a broad consensus was reached on the introduction of VAT from 1 April 2005. By April 2007, all states except Uttar Pradesh have implemented VAT in lieu of a sales tax. The initial tax collections through VAT have been encouraging, recording 13 per cent and 23 per cent growth rates, respectively, during 2005-6 and 2006-7. Further equalization is sought by the central government's announcement of a compensation package under which the states are compensated for revenue loss on account of VAT introduction at the rate of 100 per cent of revenue loss during 2005-6; 70 per cent during 2006-7 and 50 per cent during 2007-8.

## 2.2 *Grants from the Centre*

Equalization grants from the centre to the states include the following:

### 2.2.1 *Grants in Aid of Finance Commission Recommendations*

Under Article 275(1) of the Constitution, different sums may be determined for different states and would be charged to the Consolidated Fund of India. Over the years, after the Seventh Finance Commission, there has been increasing evidence of equalization, as can be seen from the fact that the share of the grants out of total transfers to the states has steadily gone up. It was 7.72 per cent during the Seventh Finance Commission. The Twelfth Finance Commission has raised the same to 18.87 per cent. The share of grants, though small for all states put together, is significant for smaller states.

The grants in aid can be classified as follows:

*Revenue gap grants.* These are equalizing transfers that are used to correct the vertical imbalance. Finance Commissions make assessment of the revenues and expenditures of the states on the basis of their historical expenditure and some norms. These grants play a very significant role in the finances of certain states. Some of them get more than 75 per cent of their revenue from the central transfers. This gap filling approach, however, encourages the states to overproject their revenue gaps expecting the Finance Commission grants to fill the same.

*Specific purpose grants.* These are factored in while assessing the revenue gap and are thus over and above the vertical gap. They are also known as conditional grants. The states often complain that these grants lead to a reduction in their autonomy. The Twelfth Finance Commission has taken note of the matter and has recommended that the Ministry of Finance generally refrain from attaching any additional conditions with these grants.

Under this category, the Twelfth Finance Commission has also sought to correct horizontal imbalances by recommending equalization grants for two specific expenditure sectors, education and health. A part (15 per cent in the case of education and 30 per cent in the case of health and family welfare) of the distance of the state's expenditure from the average group expenditure is sought to be equalized.

### 2.2.2 *Plan Grants*

The centre has exerted its influence on the expenditure pattern of the states through the Planning Commission. The Planning Commission, which is the apex body set up by the central government, provides funds to the states under Article 282 of the Constitution. Plan grants and loans to the states for financing their development programmes under the Five-Year Plan and Annual Plans were initially project-based, but were eventually based according to an agreed formula known as the Gadgil Formula. Central Plan Assistance to States Plan can be broadly classified into two categories: Central Assistance (Domestic) and Additional Central Assistance for Externally Aided Projects (EAPs). Central Assistance (Domestic) includes not only the Normal Central Assistance (NCA), but also other additional central assistance to states for other Programmes, in particular Basic Minimum Services (BMS), Slum Development, Area Programmes, and Accelerated Irrigation Benefit. These grants are normally referred to as discretionary grants. Discretionary assistance is purely at the discretion of the Planning Commission and the Ministry of Finance. They may include State Plan Grants and Centrally Sponsored Schemes (CSS).

In 1969, the National Development Council decided that the central assistance to the states for schemes on subjects under their jurisdiction would be given in block form and not be linked to any scheme or project and that scheme-based assistance (CSS) would be continued for a limited time, and would not exceed one seventh of the block assistance. Post-1969, the block assistance to states included 70 per cent loan and 30 per cent grants (the loan-to-grant ratio for certain categories of states was 10 : 90). This, however, led to problems of accumulation of debt among states. The Twelfth Finance Commission provided relief in the matter and from 2005-6, the assistance to state plans in block grants began to be given in grant form only. This, however, does not apply to the CSS which has a small loan component; and that too has gone down over the years. The following table shows the classification of state plan grants by component (only the grant portion). It can be observed that normal central assistance, which is only true block form of non-discretionary assistance, is now less than 50 per cent of central assistance to state plans.

**Classification of State Plan Grants in its Components (grant portion only)**

(*Rupees in tens of millions*)

| *Name of the Scheme* | *Grant Outlays 2004-5 (RE)* | *Share of Assistance 2004-5* |
|---|---|---|
| Normal Central Assistance | 11702.84 | 42.72 |
| Area Programmes | 2182.50 | 7.97 |
| Additional Central Assistance for Externally Aided Projects | 3106.00 | 11.34 |
| Special Programmes | 8014.53 | 29.25 |
| Discretionary | 2390.63 | 8.73 |
| Total | 27396.50 | 100.00 |

*Source:* Garg 2005.

### 2.2.3 *Non-Plan Grants*

These schemes are in addition to the grants transferred to the states under the Finance Commission recommendations. Examples of such programmes are schemes for police modernization and jail modernization. There are also indirect transfers to the states. For example, the procurement of food grains at higher-than-market prices. However, a study of these transfers is beyond the scope of this paper.

So far the discussion points to increasing equalization over the years. However, attention must be drawn to the following issues to get an insight into the future challenges that India faces with respect to the equalization process and whether or not the same is rational.

*Lower levels of equilibrium*. The freight equalization policy in India that ensures that the railways charge a uniform freight on coal and steel transportation throughout the country has enjoyed strong support in the past. Admittedly, it was intended to help resource poor states, but it came at a cost. The first cost was pulling down better-off states rather than pulling up poorer states. This is because on account of this policy, the administered price of basic inputs is equalized all over India. This deprived the mineral rich states the small advantage they had in the industrialization process on account of their resource endowments. While the policy may have narrowed the horizontal imbalances between states, it has done so by bringing the well-off states down to the level of the poorer states rather than the other way around. Thus, a lower rather than higher level of equilibrium is achieved. A second, and perhaps higher, cost is the inefficiency it introduced at the aggregate level. Instead of producing power at the pit-head, for example, coal was transported across the country to set up a power plant in a remote area. Hence, it can be seen that though there is equalization, it does not necessarily produce rational outcomes.

*Competition among states*. There is competition among states to attract investment. The investment of the private sector, especially industry, would go to a state that has the best business infrastructure. Since the resources of states are limited, there is a possibility that federal transfers meant for welfare activities like rural development may be diverted towards development of business infrastructure, such as roads. To enhance the quality of living in a state, both business and social infrastructure development is important but the difficult task is to seek a balance between the two and ensure that one does not suffer at the cost of the other. At this point it may be noted that it is unrealistic to expect industry alone to bear the brunt of backward area development. Wherever there is no economic rationale to set up a manufacturing unit, it is better not to do so. Instead, the primary sector or the services sector could be developed in these pockets depending on the competitive advantages that the area has. The role of the government should be to identify the potential of each district and to develop infrastructure, on the one hand, and human capital on the other, through investment in health and education. It is widely agreed that governments must focus on what they and they alone can do–produce public goods and merit goods. But the nature of public goods and merit goods is changing. Infrastructure, which was once considered a pure public good, has now acquired the attributes of a private good because of newer technology and financial engineering products.

*Special category states*. The ten special category states (Hill States) are heavily dependent on the centre because they have unorganized economies and small industrial sectors. On account of geographical factors their unit cost of providing public services is very high and their revenue raising capacity is lower than other states. Furthermore, most of them are located in border areas and frequently experience bouts of social and economic destabilization. Providing reasonable levels of public service at reasonable cost in these states is one of the major challenges before the policy makers.

*Royalty payments*. Central policies on royalty payments have affected the autonomy of states. The centre has a right to extract minerals from the states, but has to pay royalties on the material extracted. Yet the royalty payments are fixed by the centre and are very low compared to the price of the minerals. Revision of payments in terms of inflation is taken only after long intervals. The states have no say in the matter. The centre is thus accused of not giving the states their due share in the rising prices of minerals extracted.

The above discussion has given us evidence to both support and question the progress of equalization in India. However, there is increasing evidence of the narrowing-down of vertical and horizontal imbalances over the years. The determined efforts made by successive Finance Commissions as manifest in their recommendations and a conscious effort made by the central government to accept and act on them substantiates this point. This only leads us to conclude that the Indian Union is moving towards more rational forms of equalization.

## 3. The Case of Russia

*– What is the worst defeat? – It's the victory!*

This quotation from the great Indian epic *Mahabharata* is used as an epigraph for this part of the paper because it reflects quite well the paradox of equalization formula evolution in Russia. The "victory" in terms of equalization process means making the allocation of transfers more formula-driven (instead of policy driven), more transparent, accurate and predictable to the regional governments. Recently, in order to engage this victory the Ministry of Finance made a series of changes in the equalization formula. These amendments took place in 2005, 2007 and now the newest equalization formula for three-year budget period 2008-10 has already been approved by the Government of the Russian Federation. The purpose of these amendments was to rationalize the equalization system:

- to ensure a consistent level of service delivery across all the regions;
- to ensure that all regions obtain a certain fiscal capacity to meet the needs of population;
- to encourage regional governments to improve their financial discipline;
- to smooth the rapid fluctuations in provincial revenues and equalization transfers, and ensure long-term predictability;
- to promote economic growth; and
- to promote amalgamations.

All the amendments were aimed at worthy goals but the result is quit controversial: the formula becomes more complicated, and its influence on regional government behaviour, and regional fiscal autonomy and equity is unpredicted. So the aim of this part of the paper is to answer the question of why achieving these goals in developing rational forms of equalization may lead to the controversial results.

First of all it is necessary to describe briefly the evolution of equalization system in Russia, the current formula, its basic problems, and the newest amendments. Russia is a federative state with high geographic and ethnic diversity which consists of 83 subjects of the Russian Federation (regions). The current disparities among the regions in economic development and fiscal capacity are enormous. The gap between the richest and the poorest regions is more than 45-fold in terms of gross regional product per capita and 280-fold in terms of taxes collected per capita. Many regions heavily rely on federal financial aid. For example, in 2006 the share of federal transfers (excluding compensation to regional governments for implementing federal mandates) in regional budgets revenues exceeds 20 per cent for 45 regions and surpasses 60 per cent for nine regions. So the role of equalization grants in smoothing fiscal disparities among the regions cannot be overestimated.

The Federal Fund of Financial Support to Regions (FFSR), created in 1994, is the main source of equalization allowance for the low-income regions. The formula for distributing the FFSR among the regions has been significantly changed many times since 1994. The most important changes are described below.

## 3.1 *Estimation of a Region's Fiscal Capacity Evolution*

In calculating FFSR distribution, the fiscal capacity is determined as a ratio between tax capacity and an expenditure needs index.

$$FC = \frac{TC}{ENI},$$

where *FC* is fiscal capacity; *TC* is tax capacity; and *ENI* is the expenditure needs index

Before 2000 both tax capacity and the expenditure needs index were calculated using data of actual regional revenues and expenditures. For example to figure out the tax capacity of the regions in 1999, the Ministry of Finance used the amount of taxes collected in 1997 together with certain indices (e.g. inflation, rate of growth). Using actual data about regional revenues and expenditures had a negative influence on the fiscal behaviour of the regional governments. They could raise their expenditures, do nothing to increase their revenues and be rewarded for such behaviour by an increase in equalization transfers. Since 2000, a shift towards more rational forms of equalization was made: the Ministry of Finance began to calculate tax capacity and the expenditure needs index by using an estimation of a region's fiscal capacity based on federal statistical data which could not be misrepresented by regional governments. Estimation of a region's tax capacity was based on value-added by different economic sectors; estimation of expenditure needs became was based on the objective differences in salaries, prices, demographic and socio-economic factors, climate and other objective factors that influenced the per capita cost of providing the same service in different regions. This reform increased the regional governments' interest in raising their tax capacity and decreasing the costs of public services provision.

But while the 2000 reform solved many problems of making the equalization formula more rational, it created other problems. First of all the value added by different economic sectors appeared not to be an accurate indicator to reflect the regional tax capacity because of the tax immigration problem. Big corporations which have their business in many regions could use the transfer pricing to declare all their profits in one region if there were any incentives to do so. Some regional governments in turn did their best to create such incentives for businesses to pay taxes on their territory. According to the Tax Code the regional rate of enterprise profit tax may vary from 13.5 to 17.5 per cent. Another incentive was the subsidies for business from the regional budgets, allowing regional governments to entice big corporations to pay tax in their own region. Although such regions obtained additional tax revenues (at the cost of their neighbours) they did not lose in terms of equalization transfers because their value-added per capita was still below the national average. This problem received its partial solution only in 2007. According to the newest equalization formula for the three-year budget period 2008-10 the regional tax capacity is determined as a sum of separately calculated tax bases used by regional government (not value-added as a generic tax base for both federal and provincial governments).

The next problem which the 2000 reform created was the great complexity of measuring the expenditure needs index. This index was designed to estimate all the objective factors and conditions in many spheres of the public sector (education, health care, sport, public transport, etc.). The result was the measurement of the normative expenditures for providing different public goods and services in all regions. The expenditure needs index was so complex mostly because of the problem of unfunded mandates. Federal laws created expenditure obligations for regional governments without providing appropriate funds to finance these obligations. The federal government tried to finance some part of these obligations in the poor regions by using different coefficients in calculating the expenditure needs index, but this was largely unsuccessful. The weights of different coefficients for estimating the costs of different public services and goods provision were chosen by the Ministry of Finance. There was always a great struggle between the regions to persuade the federal Ministry of Finance to choose such weights for these coefficients to maximize the entitlements for a particular region. When in 2005 the problem of unfunded mandates was mainly solved, the necessity for such complex measurement of regional needs was eliminated. In 2005 the expenditure needs index was simplified and now it reflects only the regional scale of prices depending on three factors: consumer prices, salaries and costs of communal services. This appears rational as one ruble in the regions of the Northern Caucasus (the southern part of Russia with warm climate, good transport infrastructure and low labour costs) is worth more than one ruble in Chukotka (the north-eastern region of Russia with cold climate, irregular transport facilities and high labour costs).

In the future this index may be simplified again. It may include only a coefficient of consumer prices in the region to the national average level. This could be done already, as the regional indexes of consumer prices, salaries and costs of communal services are highly correlated in Russia (the correlation ratio varies from 0.86 to 0.95). But the Ministry of Finance cannot do so because too many regions disagree on how the equalization formula should work. Each regional government complains that its special conditions are not taken into account Because of the complexity of the formulas, however, the federal government is able to give the appearance of accommodation without affecting the end result. Thus one of the reasons why it is very difficult for federations to move to more rational form of equalization lies in the fact that it's always more profitable for politicians to complicate the equalization formula than to simplify it. The federal government cannot impose an ideal formula that all regions would support. But when the formula is simpler it is easier for the regional governments to speculate about their special conditions being ignored. When the formula is extremely complex it appears that the federal government is taking everything into account, while in reality, in terms of money transferred, there are still winners and losers among the regions.

### 3.2 *The Rule of Equalization Evolution*

Between 1994 and 1996 equalization grants were allocated in two parts. One part of the equalization grants was allocated among all poor regions, the other part to the poorest regions. The criteria of defining the regions as "poor" or "poorest" were not clear and since the period between 1997 and 1999 all grants were distributed among poor regions according to relatively universal formulas. But there remained the question of why there could not be one formula to allocate all FFSR. On the one hand, the federal government did not collect enough revenue to ensure that regional governments had sufficient funds to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. The federal government should spend 2.6 times more on transfers to the regions to bring their budget capacities up to the national average. On the other hand, the differences in budget capacity among regions were growing extremely fast and some regions were unacceptably poor. Thus in 2000 the Ministry of Finance came back to the idea of two parts to the FFSR, but this time on the basis of a formula. One part of equalization transfers (80 per cent of the total amount) was allocated to all regions whose per capita fiscal capacity before equalization was less than the national average, with equalization payments proportionate to the size of the difference between the national average and regional fiscal capacity. The remaining 20 per cent was allocated to the poorest regions to increase their budget capacity up to a certain uniform level.

The equalization rule presented in Figure 1 shows the negative influence on fiscal behaviour in the poorest regional governments. The regions with a budget capacity between points 1 and 2 had the same budget capacities after equalization, although they were

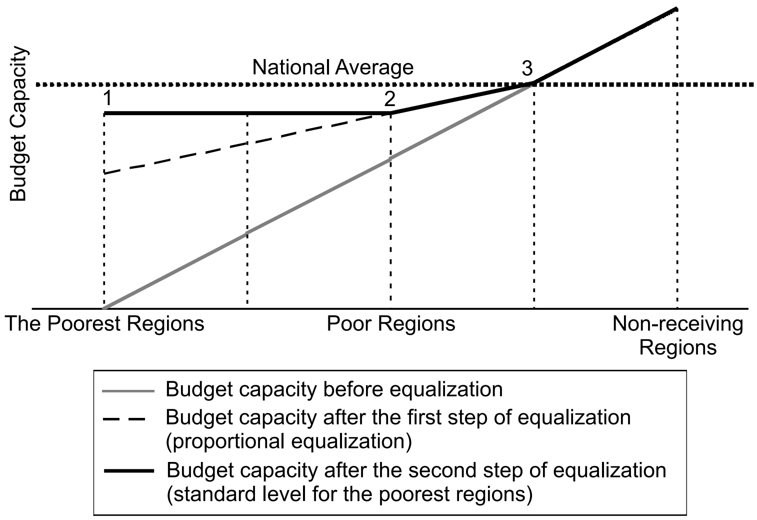



Figure 1: The Equalization Rule, 2000-4

different before equalization. In 2004, 34 regions in such a position were able to ignore economic growth promotion, as the federal government guaranteed them a certain level of budget capacity. In 2005 this anomaly of the equalization rule was eliminated.

The data in the Figure 2 demonstrates that in 2005-6 all the equalization payments were proportional: the greater the difference between the equalization criteria and the regional budget capacity, the greater the equalization payments. The Ministry of Finance used two equalization criteria. First, transfers were made to the poorest regions, whose budget capacity was lower than 60 per cent of the national average (the first equalization criterion). These transfers made up 85 per cent of the difference between the regional budget capacity and the first equalization criteria. In the second stage of equalization, the remaining part the FFSR was distributed among all regions whose budget capacity was lower than the national average. Using two equalization criteria permitted the federal government to reach a balance between strong financial aid to the poorest regions and providing a reasonable level of equalization to the all provinces. The first part of the equalization was kept low in order to avoid overspending in the poorest regions (in 2005-

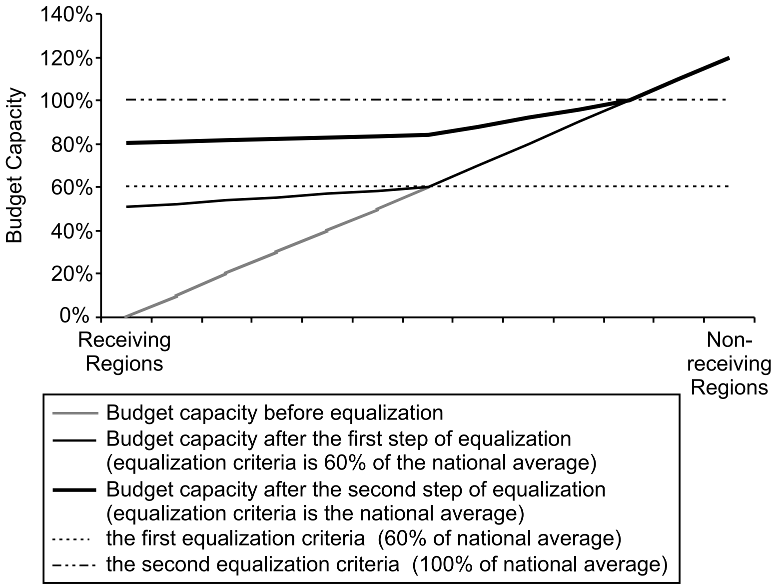


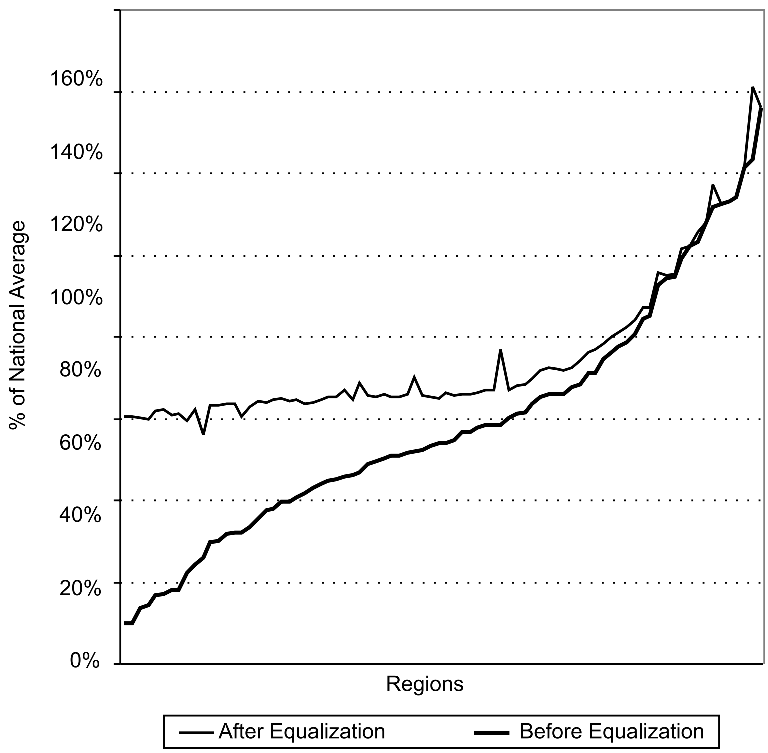

Figure 2: The Equalization Rule, 2005-6

6, 44 per cent of the FFSR was spent on proportional equalization to the poorest regions). The golden rule in 2005 was that those regions with a higher fiscal capacity to begin with were able to preserve their advantage after equalization. This outcome was even fixed in legislation through the Budget Code. Accordingly, regions were interested in raising their fiscal capacity because they received more in tax revenue than they lost as a result of equalization.

Of course the equalization formula in 2005-6 had its own disadvantages. For example, fiscal capacities were calculated on a value-added basis, rather than by using data from different tax bases. But it was nonetheless more rational than the most recent equalization formula used for the 2008-10 budget period.

A friend of the great Russian author Fonvisin, upon reading his new play, wrote to the author “you should die because you won’t be able to write better!” Unfortunately, the same may be true of the Ministry of Finance. Since 2005, instead of making the equalization formula more rational, it simply became more complicated and controversial. For example, by attempting to achieve goals which had nothing to do with the objectives of equalization, the Ministry of Finance had to break its own golden rule of equalization. Figure 3 presents the budget capacity of regions before and after equalization in 2008.

The data in the Figure 3 above demonstrates the vibration of the curve reflected fiscal capacity after equalization. As can be seen from Figure 3, the regions with a higher budget capacity do not maintain their advantage after equalization and are therefore discouraged from increasing their fiscal capacity. In other words, their interest in economic growth has been diminished. This leads to the question of why the golden rule of 2005 was broken. Paradoxically the golden rule was broken to increase the interest of




*Source:* The RF Ministry of Finance, authors' calculations.

Figure 3: The Budget Capacity of Regions Before and After Equalization in 2008

regional governments in economic growth. Before 2007, regional governments always speculated that the equalization formula discouraged them from promoting economic growth because there was a negative correlation between growth of gross regional product and equalization payments. Even though such a correlation existed in many other federal countries, the issue became politicized. First of all, old data on gross regional product were used in the equalization formula. For example, the data on gross regional product in 2002, 2003 and 2004 were used to calculate the regional fiscal capacity in 2006. So there was (and still is) a time gap between the growth of gross regional product or tax bases and the corresponding decrease in equalization transfers. Surely, any rational regional government would prefer the big increase in tax revenues today over the relatively small reduction in equalization transfers in the future. Second, it was impossible for regional governments to predict how the decline of gross regional product would affect the growth of equalization payments (to do so they would have had to predict the change in gross regional product in all regions and then calculate their benefit or loss accordingly). So the formula for allocating the FFSR in 2005-6 did not discourage regional governments from promoting economic growth in their territories. Certainly the equalization formula did not imply a direct reward for the regions with high economic growth; but then economic growth promotion is not the basic task of an equalization programme. It is sufficient if the equalization programme does not discourage regional economic growth and does not negatively influence the fiscal behaviour of regional governments. In 2005-6 such an equalization programme was in place. But the political pressure for change was so high that the President in his address to the Russian Parliament mentioned that the equalization formula should be changed in order to promote economic growth. The Ministry of Finance had to oblige and in 2006 it changed the equalization formula for the fiscal year 2007. In 2007 the equalization included direct bonuses for the regions with high rates of economic growth. But as it was said before, this amendment broke the golden rule and the regions with higher budget capacity before equalization sometimes did not preserve their advantage after equalization. So the question remains as to whether this amendment of the equalization formula encouraged or discouraged the regional governments to promote economic growth. The situation of economic growth promotion by the means of equalization transfers became worse than in 2007 when the decision was made to calculate the tax capacity by tax bases instead of on a value-added basis. As emphasized before, in Russia there were many cases of significant tax migration from one region to another. One of the reasons to use the tax base instead of value-added to determine regional tax capacity was to not pay excessive equalization transfers to the regions which drained away their neighbours' tax base. But in the case of tax immigration, when the regional corporate income tax base is growing much faster than in the entire Russian Federation, that this isn't reflected in the equalization formula. Thus the newest equalization formula paradoxically encourages not economic growth but tax migration.

### 3.3 *The Newest Equalization Formula and its Conflicting of Goals*

The most recent equalization formula approved by the federal government, and valid for the 2008-10 period, is presented as a rational solution that will achieve a variety of useful aims. As it has been described above, however, two of the goals—preventing excessive transfers to regions that undercut their neighbors' tax base, and promoting regional economic growth—are contradictory within a single equalization formula. As a result, neither of them will be accomplished.

The equalization payments to many regions will rapidly decline because of the new way to calculate tax capacity. The Ministry of Finance provides additional transfers to compensate some part of these losses, which seems reasonable at first glance. But at the same time, the Ministry of Finance tries to force regional governments to improve their financial discipline. There is a correlation between the share of compensation and some financial discipline indicators, such as debt levels and the rate at which of budget revenues grow. Thus the compensation effect is diminished. The attempt to encourage regional governments to improve their financial discipline by means of equalization transfers leads to a paradox: that the richer regions receive more equalization transfers than the poorer regions because the richer regions have lower debt levels and a higher rate of revenue growth. So in 2008 a significant part of equalization transfers will be sent not to poor but rich regions. This is a strange way to reach the main goal of equalization—to ensure the potential of all regions to provide a similar level of service to citizens.

The Russian equalization formula also pursues the goal of promoting amalgamation of regions. It may be rational to merge a net-receiving region with non-receiving one into a single non-receiving region. But it isn't clear that this aim should be pursued through the equalization formula. For example, Arhagel'skaja oblast' (a receiving region) refused to amalgamate with Nenezkii okrug (a non-receiving region). But the federal government accounted the equalization payments for Arhagel'skaja oblast' as if it had amalgamated with Nenezkii okrug. As a result Arhagel'skaja oblast' lost nearly $32 million of its equalization payments.

To ensure that all regions obtain a certain fiscal capacity to meet the needs of population the Ministry of Finance imposes an assured level of fiscal capacity. This also sounds quite reasonable and may help to determine the volume of equalization fund. But it is too difficult politically to maintain a very low assured level of fiscal capacity, and impossible or at least very dangerous for the federal government to impose a high assured level of fiscal capacity. So the Ministry Finance imposes the assured level of fiscal capacity at the medium level of regional fiscal capacity, with ten richest and ten poorest regions excluded. Though it may appear high, in the reality the assured level of fiscal capacity is reasonably low (near 60 per cent of the average fiscal capacity of all regions), but the way to determine it is unreasonably sophisticated. It is interesting that the Canadian Department of Finance once used the same trick to spend less money on equalization and at the same time to show that the fiscal capacity of receiving provinces was increased to the average level. In order to do it they used the data from five provinces instead of all of them. Now in Canada another method has been found to spend the limited amount of equalization transfers and create the illusion that all provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. This is done by accounting for only half of natural resource revenues in the equalization formula. So the rich, oil-extracting province of Alberta has a lower fiscal capacity for the purposes of the equalization formula, and hence the national average fiscal capacity level is lower as a result. So it becomes possible to use a limited level of equalization transfers and nonetheless give the impression that all receiving provinces have post-equalization fiscal capacity equal or even higher than ten-province standard. It is also interesting that in the Canadian equalization formula the golden rule of equalization is also sacrificed in favour of a doubtful attempt to achieve other goals (in the Canadian case to encourage resource extraction in poor provinces).

Thus it is quite clear that Russia is not moving directly towards a more rational form of equalization. The main reason for this sad fact is that the equalization formula becomes captive to irrational political bargaining. Regional governments are interested in receiving more equalization transfers. They have opposing views on the issue of what the equalization formula should look like based on their own preferences, and pressure the federal government accordingly. The Ministry of Finance in turn is interested in two things. First of all, it prefers to spend less on equalization and to restrict the equalization obligations in the future. Secondly, it would like to avoid the political pressure from regional governments. So the result is not a rational form of the equalization but a mixture of political interests reflected in the equalization formula. From this, it is quite clear why three great ailments of equalization formulas exist:

- Equalization formulas pursue too many goals, which reflect the different demands of different regional interest groups.
- There are many exceptions from the straight logic of equalization (to provide reasonably comparable levels of public services at reasonably comparable levels of taxation) because the Federal Ministry of Finance tries to please all regional

governments and to implement different federal policies and approaches into the equalization formula.

- The excessive complexity of equalization formulas reflects the fact that the Ministry of Finance tries to please all regional governments without committing additional money. Instead, they try to make an attractive picture of an equalization process that benefits all regions.

Thus the problem has only a political solution. The Federal Ministry of Finance should be strong and rational enough to fight for rational forms of equalization. It should explain to all stakeholders (voters, Parliament, regional governments, the press, the academic community) that the main goal of equalization is to equalize the differences in fiscal capacity between regions to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. The Ministry of Finance should emphasize that the equalization formula is one-goal instrument. It is like a shovel which is made to dig, not to save you from the rain or to make coffee—only to dig. So every financial instrument should be used to achieve a certain useful purpose, and which would not prevent other useful purposes from being achieved.

So a strong and rational Ministry of Finance should say to regional governments that the equalization formula is made to equalize the differences in fiscal capacity among the regions; not to directly promote regional economic growth in the short-term; nor to promote oil extraction (for which regional governments may, for instance, improve the investment climate, or reduce taxes); and not to smooth the rapid fluctuations in provincial revenues (for which the regional stabilization funds, the debt market and other instruments are at hand). It won't even make coffee—besides, it's cheaper to use a coffee machine.

## 4. Conclusion

An examination of the case of India and Russia with regard to the equalization objective has thrown up interesting observations. Both countries in the last ten years have endeavoured to achieve the equity objective.

In India's case, successive Finance Commissions have managed to bring about equity by reducing the horizontal and vertical imbalances. However, the reduction of these imbalances in some cases has not taken place in a rational manner. Policies like freight equalization have encouraged the achievement of lower rather than higher levels of equilibrium. They have penalized the better performing states in order to make them compete at the same level as the less well-off states. However, there is increasing evidence of the narrowing down of vertical and horizontal imbalances over the years. This only shows that the Indian Union is moving towards more rational forms of equalization. The Indian experience of appointing a Finance Commission every five years to make recommendations on the transfer of resources from the centre to the states might be useful for the Russian Federation, to make the system more stable and predictable to regional governments. In the case of Russia, we may make different conclusions in depending on the length of the observed period. If we compare the initial point of the equalization programme in 1994 with the recent formula, great progress apparent. But it is an illusion that there is constant progress in terms of the equalization programme's rationality. In developing its equalization programme, Russia has made some steps back—and the main problem is in the fact that these steps are presented as victories for rationality.

## References

Bagchi, Amaresh (2001), "Fifty years of Fiscal Federalism in India: an appraisal", Kale Memorial lecture delivered at Gokhale Institute of Politics and Economics, Pune, 8 December.

Gaidar, Ye, V. Mau et al., "Interbudetary Relations and Subnational Finance", *Russian Economy in 2006, Trends and Perspectives*, issue 28, pp. 115-16. http://www.iet.ru/publication.php? folder-id=44&publication-id=92721

Garg, Subhash (2006), "Transformation of Central Grants to States", *Economic and Political Weekly*, vol. 41, issue 48, 2 December, pp. 4977-84.

——— (2005), "Fiscal Federalism at work in India", NIPFP Paper, New Delhi.

Isaac, T.M. Thomas and R. Ramakumar (2006), "Why do the States not spend?", *Economic and Political Weekly*, vol. 41, issue 48, 2 December, pp. 4965-76.

Ministry of Finance (2004), "Report of the Twelfth Finance Commission (2005-10)", Government of India, New Delhi.

Ministry of Finance (2007), "Economic Survey 2006-7", Government of India, New Delhi.

Minassian, Teresa Ter (1997), "Fiscal Federalism in Theory and Practice", IMF, Washington, D.C.

Nirmal, Amit (2004), "Study on Transfer of Resources from Center to States (1978-9 to 2002-3)", Ministry of Statistics and Programme Implementation, Government of India, New Delhi.

Rao, Govinda M. and Tapas K Sen (1996), "Fiscal federalism in India: Theory and Practice", NIPFP, New Delhi.

Singh, Nirvikar and T.N. Srinivasan (2006), "Federalism and economic development in India: an assessment", Munich Personal RePEc Archive, MPRA paper no. 1273, posted 06, October.

Singhi, M.C. and P. Anuradha Balaram (1997), "Studies in Industrial Development", paper no. 21, Ministry of Industry, Office of the Economic Adviser, March.

Watts, Ronald L. (1999), "Comparing Federal Systems", McGill-Queen's University Press, Kingston and Montreal.