PERSPECTIVES

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Regional Imbalance under Federal Structure: A Comparison of Canada and India

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Executive Summary

The problem of regional disparity in economic development in geographically large democratic countries gets inseparably linked with macro public policies and the economic philosophies behind them. Two such countries, India and Canada, are considered in this paper. Although the two countries share several common features, they differ considerably in the size of the population, nature of the federation, constitutional provisions defining property rights on minerals and revenue sharing arrangements between the centre and the states, and the economic philosophy behind the macro policies of the governments.

This paper addresses the issue of regional imbalance under federal structure in a comparative perspective. The following variables are used to analyse the regional problem:

- worker rate
- capital productivity
- capital intensity
- industrial structure.

The paper argues that free and barrier-less mobility of population and goods across the states in Canada has resulted in the regional problem getting diluted and less intense. In India, on the other hand, the economic philosophy behind macro policies has throughout been of direct intervention with emphasis on ensuring equity across regions. As a result, the problem of fiscal transfers from the centre to the states has become more complicated and less manageable in India than in Canada. The degree of autonomy and economic independence of provinces is far more in Canada than the states in India. Studies of regional disparity in the levels and rates of economic development in the two countries revealed that:

- capital intensity or capital-labour ratio was the major determinant of the regional disparity in the level of economic development
- technology or capital productivity was the main factor behind the disparity in regional growth rates.

The government policies have to consider these findings while investing or encouraging investments in the lagging regions. The other revelations of the study are as follows:

- In India, the federal-fiscal transfers are used as a mechanism to address the regional problem through direct governmental intervention.
- In Canada, most tax-bases are directly shared by the centre and provinces with the rates differing.
- In India, the tax-bases are allocated to the centre and states by the constitution.
- The horizontal and vertical equity concepts are more relevant for Canada where both the layers of governments run in surplus and are not compelled to borrow in order to meet expenditures. In India, on the other hand, a majority of the states depend on the central government for borrowing due to their perennial deficits.
- In Canada, the provinces and the centre directly borrow from the market as per their credibility which is not the case in India where most states lack credibility in the market.

Confusion regarding the notion of horizontal balance and regional equity leads the Indian political system to focus on the direct governmental intervention rather than market orientation. The Canadian experience suggests an urgent need to change the attitude, mindset, and philosophy behind the macro policies to achieve better and faster results on regional disparity reduction.

KEY WORDS

Regional Disparity

Federal-Fiscal Transfers

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Equity

Finance Commission

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There are several similarities and differences between Canada and India. While most of them are well-known, we begin by highlighting some of the relevant ones. Both Canada and India are geographically large countries. In terms of area, Canada is the second largest country and India is the seventh largest country in the world. In terms of population, however, while India is the second most populous country in the world with a population of about 1,100 million, Canada is among the less populated major countries with only 32 million people. Thus, Canada has less than 3 per cent of India's population. Although both these countries have a democratic federal structure, they differ considerably in their federal-fiscal relations. In Canada, but for the equalization transfers, federal-fiscal relations are outside the constitution. In India, on the contrary, almost all major federal-fiscal relations are a part of the constitution. In Canada, provinces have voluntarily formed a federation with the conviction that they would benefit from the federation. In India, states are seen as the second layer of administration and governance. Canada has fewer provinces with only Ontario and Quebec accounting for almost two thirds of the country's population and income. Alberta and British Columbia, along with Ontario and Quebec, together account for more than 85 per cent of Canada's GDP and population. India, on the contrary, does not have such regional concentration of population and economic activities. It has 29 states with the largest state accounting for only 16 per cent of the country's population. Regional concentration of GDP in the country is even lesser. The two countries differed substantially in their political ideology and economic philosophy during the second half of the 20th century. However, since the acceleration of economic policy reforms in 1991 in India, the distance between them has considerably narrowed in this regard.

In this paper, we make an attempt to address the issue of regional imbalance under federal structure comparing the situation in Canada and India. We begin by defining the regional problem in a country and then examining the role of population transfers among regions. For reasons of political autonomy, administrative facility, and crucial policy control, we take a province in Canada and a state in India as a regional unit for our arguments.

REGIONAL IMBALANCE AND MIGRATION

Geographically vast countries invariably face the problem of regional disparity because natural endowments, climate, and physical conditions would significantly differ across regions. As a result, economic opportunities are not uniformly available to population residing in different regions. The regional problems get manifested through several symptoms like significant differences among regions in levels of per capita incomes, levels of unemployment rates, physical quality of life, human development, property prices, and so on. The regional disparities lead people from the relatively poor regions to migrate out to relatively better-off regions since there are likely to be only a few or no barriers to movement of people within a country. However, such a movement of population presupposes a fully democratic political system and a homogeneous and culturally tolerant and integrated society. China, for instance, is a large country. The country faces severe regional problems with the eastern coastal regions being highly prosperous, urban, and growth-oriented while the western hinterland being poor, rural, and underdeveloped. Yet, migration within China from the west to the east is not fully allowed as it does not have a completely democratic political system.

On the other hand, although India is politically a fully democratic country, its linguistic and cultural diversity is so vast that people with low literacy and skill levels find it difficult, if not impossible, to move from one region to far-off regions within the country. Educated and highly skilled workers find it easy and therefore, do migrate from one region to another within and even outside the country. Since such workers do not constitute a very large proportion of population in the lagging regions, the equalizing channel through population migration does not work effectively and efficiently in India.

The case of Canada is very different in this regard. It is relatively a more homogeneous society because it is a country of recent origin compared to India. To give an example of India's diversity, even a currency note in India carries 16 different languages compared to only two effective languages used in Canada. Moreover, the Canadian society has a greater proportion of literacy and education and, therefore, the population in Canada is more mobile within and outside the country. The democratic system in Canada does not hinder this mobility in any explicit way. It is because of such reasons that economic incentives do operate successfully in Canada which, in turn, dictate population transfer in and out of regions. Canadian scholars have come up with several micro level studies to establish the role of wage-rate differentials inducing such population transfers. Analysing the data over 1951 to 1981, it was possible to find support for the wage-differential hypothesis of population transfer even with the provincial macro level data in Canada (Dholakia, 1994). Thus, the regional problem in Canada has not assumed serious dimensions because of free population mobility. The lagging Canadian regions have net out-migration of population over time which ensures better resource availability for the remaining population. As a consequence, the extent of regional disparity in the income levels in Canada is considerably low. The ratio of the lowest to the highest provincial per capita income in 2002 was only 1.88 in Canada compared to a similar ratio of about 4.5 in India.

Free mobility of population, moreover, ensures faster growth of the leading regions both in terms of income and population. Therefore, Canada tends to have a larger population in better-off states. Only Quebec appears to be an exception. It is a large province and a relatively lagging region. A closer examination, however, would reveal that it is not an exception to our argument. It is perhaps the only region in Canada with substantial linguistic barriers that can hamper free mobility of population. It, therefore, corroborates rather than contradicts our argument.

In a democratic federal structure, free mobility of workers and population among constituent states or provinces is fundamentally never disallowed. But, as stated earlier, the socio-cultural factors can severely restrict such movements accentuating the problem of regional imbalances. In such a situation, as the basic theorem of inter-regional and international trade suggests, if trade in goods and services produced in different regions is freely allowed across regions, it can substitute the movement of people and, hence, can significantly mitigate the problem of regional disparity in the country. This is because, under normal circumstances, free trade in goods and services would lead to equalization of factor rewards like wages and profits. However, it is not necessary that in all democratic federations, free mobility of goods and services across regions would exist. This could be on account of either externally imposed quantitative restrictions on inter-regional trade in goods and services or entry taxes like octroi and other specific taxes on movement of goods. Very often, this depends on the philosophy of the governments and the political economic ideology of the government. In Canada, such restrictions and barriers to inter-regional trade are practically non-existent. In India, on the other hand, the quantitative restrictions on inter-regional trade existed over a long period of time. Only recently these restrictions have been removed. Even the price-based or tax-based restrictions existed throughout the period after Independence. There have been serious efforts to remove or reduce these barriers through tax reforms like introduction of a uniform value added tax (VAT) and removal of central sales tax (CST) and octroi. Thus, in future, India may not have barriers to inter-regional trade. If it happens, regional problem in India is likely to get mitigated to some extent.

In the democratic federal structure, however, the existence of regional problem, whether or not apparently mitigated by the high mobility of population or goods, is always a potent source of political tension and frictions. Even in Canada, this problem is considered serious because the lagging regions tend to lose their workers and population because of which the provincial governments could lose their revenues and votes. As often argued by provinces, this happens because of differences in the natural endowments, climate, and physical conditions which invariably would make the provision of public services to their population more costly and simultaneously erode or reduce their tax-bases. There is, therefore, a persistent demand for direct government intervention to alleviate this problem on equity grounds — a consideration that is politically always justified in a federation. The demand for direct government intervention is even more vociferous and intensely felt in India where regional imbalance in income and economic opportunity is far worse than in Canada. We now briefly consider determinants of regional disparity in the levels and rates of economic development in India and Canada based on past research.

DETERMINANTS OF REGIONAL DISPARITY

In the context of a strong demand for government's direct intervention to reduce regional disparities in various spheres arising out of lagging regions in a large nation, we must identify factors and determinants of regional disparity which can be directly influenced by the government policies. Since the political ideology and economic philosophy in Canada and India were considerably different for most of the time during the second half of the 20th century, the framework of analysis of the regional imbalance in the two countries also differs substantially. In Canada, to a large extent, *laissez-faire* or market orientation, particularly in such matters, has resulted in the Canadian scholars concentrating mostly on micro studies and micro-level determinants. In India, however, studies have considered framework involving more macro-level and policy-oriented determinants. We can consider the following variables to analyse the regional problem in India as well as Canada:

- worker rate which measures economic opportunities available for people to work in the economy
- capital productivity by sectors which reflects the technology
- capital intensity by sectors which represents factor proportions and shows investment effort made in the economy
- industrial structure measured in terms of the employment pattern in the economy.

These factors can be shown to be the component factors of a region's per capita income and appropriately analysed with standard statistical techniques if comparable data over time and regions are available.

The regional analysts in Canada have not considered this type of framework using such macro aggregates. Comparable long-term data on those aggregates for Canadian provinces are not available and hence one has to make considerable effort first to build the required estimates and then analyse the data. However, this exercise of building the required estimates for the Canadian provinces was carried out for a period of 30 years from 1951 to 1981 and the estimates were readily available (Dholakia, 1989 and 1994).

The results of this exercise are quite revealing. The analysis of the regional disparity in income levels in the four benchmark years of 1951, 1961, 1971, and 1981 shows that, while the extent of regional inequality of incomes declined considerably over the 30-year period, rankings of provinces have remained more or less the same. Prince Edward Island and Nova Scotia are the most lagging provinces where all the component factors are unfavourable implying that their problem is one of relative backwardness on all fronts. Alberta, on the other hand, has all the factors which are favourable; Ontario has all but factor proportions favourable; and British Columbia has all but industrial structure favourable. The analysis of the level of regional disparity shows that its basic determinant seems to be capital intensity or factor proportions. Since government policies — particularly public investments — are critical in governing the extent of investment effort and hence factor proportions in the regions, there is a strong demand for direct government interventions to deal with the regional problem in Canada. A similar exercise was carried out in India for the 20-year period from 1961 to 1981 (Dholakia, 1985) and even here, the basic determinant for the regional disparity in the level of income among states turns out to be capital intensity or factor proportions. Thus, the demand for direct government intervention in India for reducing regional imbalances is quite understandable.

It is the analysis of the differentials in the rates of economic growth among regions that is more striking. First of all, the growth pattern in different provinces of Canada has undergone significant changes over the decades of the 50s, 60s, and 70s. The contribution of worker rate in explaining the growth differentials considerably declined over time. Changes in industrial structure and variation therein played a significant role on margin. However, the major determinant of the regional inequality in the rates of economic growth turned out to be capital productivity or technology and not capital intensity or factor proportions. The Canadian regional data show that regional growth disparities are governed more by the technological and structural factors than by the opportunity and attitude of the people to work and the capital investments *per se*. An analysis of the Indian regional data also shows similar results (Dholakia, 1985). Thus, if technology in the lagging regions is not properly managed, mere pumping in investment and raising the capital intensity in those regions would not result in reducing the regional disparity. Therefore, the government policy intervention has to consider the technology aspects as well. Similarly, it should also attempt to influence the industrial and employment structure in the lagging regions to alleviate their condition. This brings us to the discussion of federal-fiscal relations in the two countries.

FISCAL TRANSFERS AND VERTICAL BALANCE

Apart from the direct investments made by the central government in a region, the other option to promote public investment in a region is to operate through increased federal transfers. Both these options depend on the precise institutional arrangements to divide the fiscal responsibilities as well as the revenues between the centre and the regions. As noted earlier, most of these arrangements in Canada do not have constitutional status whereas they are an integral part of the constitution in India. As a result, most of the tax-bases are common or shared between the federal and the provincial governments in Canada whereas there are hardly any tax-bases directly shared in India. Tax-bases are allocated to the state and the union governments distinctly by the constitution in India. Among the large countries, Germany, Brazil, and Russia have one or the other type of tax-revenue sharing instead of tax-base sharing arrangements between the union and the state governments (Ter-Minassian, 1997) as in India where almost all major taxes of the centre, viz., personal income tax, corporate income tax, excise duty, customs duty, and service tax, are subject to tax-revenue sharing arrangements with the states.

In Canada, on the other hand, all tax-bases except for the customs duty are shared between the federal and the provincial governments. Moreover, provinces can have different tax rates and their own schedules reflecting their desired degree of progressivity. This can give rise to what is known as 'vertical externality.' Since the tax-base is common between the federal and the provincial governments, any extreme tax rates fixed by either level of the government can have positive or negative impact on the tax-base and thereby on the tax-revenue of the other level of the government. These issues are often resolved through negotiations between the federal and the provincial governments to agree to share the tax-room within the estimated tax-base. In order to transfer revenues to provinces, the federation can decide to transfer tax-points to provinces by cutting its federal rate and vacating tax-room for provinces.

In terms of the division of responsibilities, the federal government has control over the usual supra-regional activities like foreign affairs, defence, international trade, airlines, railways, money, banking, and employment insurance whereas the provincial governments are in charge of the local activities like education, health, municipal institutions, social welfare, police, and highways besides natural resources. The rest of the activities are joint or common responsibilities of the two levels of governments (Rangarajan and Srivastava, 2004). The division of responsibilities is very similar between Canada and India except in the case of natural resources like coal, crude oil, gas, lignite, iron ore, etc. While in Canada, all such major minerals are under the provincial list, in India, they are under the central list. Only the minor minerals are under the state list. This major difference between the two countries has direct implications on regional imbalance. In Canada, Alberta has gained tremendously in terms of income and expansion of economic activities primarily due to the well-defined property rights on its petroleum resources. In contrast, in India, Assam, Gujarat, and Maharashtra for oil and gas and Bihar and Orissa for coal and iron ore have not benefited to the extent they could have because of the not so well-defined distribution of property rights.

The mismatch of the divisions of responsibilities and resources between the federal and the provincial governments is referred to as vertical imbalance. In most of the federations, such an imbalance would generally exist. In Canada too, vertical imbalance exists though the degree is far less — almost one-third — than in India (Rangarajan and Srivastava, 2004). In order to correct such an imbalance, federal transfers are made to provinces. For example, the Canadian Health and Social Transfers usually provided resources to all provinces on the basis of population. Based on their analysis of fiscal transfers in Canada, Rangarajan and Srivastava (2004) find that these transfers, in recent years, are sufficient to remove any remaining vertical imbalance not only from the provincial angle but also from the federal angle. In fact, their study indicates that both the tiers of the government are running a surplus enabling them to retire their debt after meeting their expenditure obligations.

In India, however, the situation is quite different as both the tiers of the government face serious deficit to meet their respective expenditures. Federal transfers reduce the extent of deficits of states only at the cost of increasing the deficits for the centre. Thus, the Indian case depicts a genuine resource deficiency if we assume that all government expenditures are necessary, useful, and productive. However, this assumption may not be justified particularly because we find a clear evidence of the primary expenditures — expenditure other than interest payment — to be directly dependent on the total revenue receipts of the state government with a well-defined lag structure (Karan, 2005). This raises the issue of moral hazard and questions about federal transfers and horizontal imbalances that we discuss in the next section. Moreover, since both the centre and the state governments are forced to borrow in order to meet their respective expenditure obligations, it raises concern about fiscal sustainability and tolerance of public debt of the two tiers of the government. We take up this issue in the subsequent section.

FISCAL TRANSFERS AND HORIZONTAL BALANCE

In 2001-02, the federal revenue as a proportion of GDP was 15.4 per cent in Canada compared to 12.2 per cent in India. However, transfers to provinces were hardly 15 per cent of the total federal revenue in Canada against 35 per cent in India. As a result, the federal transfers to provinces as a percentage of GDP were only 2.4 per cent in Canada but 4.3 per cent in India. Out of this, the equalization grants for horizontal balance accounts for hardly one-fifth to one-fourth in Canada (Rangarajan and Srivastava, 2004). Since 1982, such equalization grants have been included in the constitution of Canada with the explicit objective of equalizing fiscal capacities of provinces. The concept of equalizing fiscal capacities is to ensure comparable level of public services at comparable level of taxation among the provinces (Section 26(2) of the Constitution Act). Such a concept of horizontal balance does not necessitate equal per capita expenditures on public services across provinces but relates it proportionally to the tax effort in the province. Private provision of public services could also occur with lower tax effort in a province depending on the economic philosophy and political ideology. Although the concept of horizontal balance is very similar in India, clarity on the principle of 'unequal treatment of unequals' is lacking. Similarly, the possibility of private provision of public services and consequent lower tax effort in some states is also not adequately recognized in India. Moreover, horizontal balance and equity are overwhelming concerns in all federal transfers in India. As a result, almost three-fourth to four-fifth of all federal transfers is in the nature of equalization payments with regional equity concerns.

After studying the formulae actually used in Canada for equalization payments, Rangarajan and Srivastava (2004) tend to agree with the Canadian scholars like Barro (2001) and Courchene (1984) who find fault with the current method. In their opinion, the representative tax system (RTS) with 33 distinct revenue bases has the potential of distorting the fiscal capacity scores of provinces whereas a macroeconomic approach can avoid most of those incentive-based problems provided a sound and suitable macro indicator of the provincial revenue base is identified. Rangarajan and Srivastava (2004) also find 'resemblances' of the deviation criterion used by the Indian Planning Commission and the distance criterion used by the Indian Finance Commissions for deciding the horizontal distribution of resources with the proposed macro approach by the Canadian scholars. However, despite the meticulous statistical system developed in Canada, it is very difficult, if not impossible, to find a satisfactory and suitable macro indicator for measuring the fiscal capacity scores of provinces. Gross provincial domestic product (GPDP), the most comprehensive and readily available indicator of the taxable capacity of provinces, suffers from as many as 14 problems identified by Statistics Canada, an independent organization. Although Rangarajan and Srivastava (2004) have taken note of these problems, they continue to use the same indicator and the methodology with minor variation in weights in their 12th Finance Commission Report (2005) in India.

In India, a macro approach is used more out of compulsion rather than choice. Since the statistical base in Canada is provided by Statistics Canada, it produces not only comparable and recent data on required aggregates promptly but also collects data on individual tax and non-tax revenue bases by provinces. In India, the statistical base is provided by a government body, viz., Central Statistical Organization (CSO) and other relevant government agencies for sector-specific indicators. As a result, the information is generally outdated and pertains to standard concepts irrespective of their usefulness. For instance, the latest estimates of state income available in March 2005 are for the year 2002-03. Similarly, although it was clearly pointed out (Dholakia, 2003) and recognized by the Chairman, 12th Finance Commission (Rangarajan and Srivastava, 2004) that the right concept of state income as a macro indicator is the personal disposable income and not GSDP, what continues to be supplied by the CSO is GSDP at factor cost. It was shown with the help of estimates for the Gujarat state that GSDP at factor cost is a useless and an inconsistent macro indicator for the purpose (Dholakia, 2003a). If data availability or estimation of personal disposable income for states is problematic, the per capita private consumption expenditure readily available from the NSS survey is a close proxy and can serve the purpose better (Dholakia, 2003). The 12th Finance Commission, however, still continued to use the same irrelevant and inconsistent macro indicator in its report (2005).

Moreover, neither the CSO nor the numerous central government tax collecting agencies has collected and collated data on the bases and rates of the tax and non-tax revenues by states in India. Thus, institutions such as the Finance Commission, the Planning Commission, and the government line departments are forced to use only macro indicators instead of more appropriate revenue bases for allocating resources. As a result, the concept of horizontal balance effectively used in India gets inseparably linked with the relatively low income originating in a state and with the actual revenue deficits faced by the state governments. The concepts like total taxable resources, effective tax rates, efficiency of the state government expenditure to provide public services, and the effective degree of public service provision in a state are not even attempted to be measured leave alone considering them in deciding the allocation of resources in India. It is, therefore, not surprising to find that such 'equalizing payments' in India hardly serve their stated objectives. Such criticisms have been regularly made since the early 80s (Nair, 1983; Dholakia, 1985) without much success largely on account of India's statistical system and its heavy dependence on the government agencies.

FISCAL DEBT AND REGIONAL IMBALANCE

The concepts of horizontal and vertical equity in a federal structure would be meaningful when the federal and regional governments are not compelled to borrow in order to fulfil their expenditure obligations. For the past few years, the federal government and the provincial governments in Canada have been running fiscal surpluses to retire their debts. These concepts are, therefore, relevant in Canada. In India, however, both the tiers of the government are perennially running fiscal deficit leading to increases in their debts. The concepts of vertical and horizontal balances, therefore, are less relevant in India. This is more so because, unlike Canada, the states in India heavily depend on the centre for their borrowings in the sense that they cannot borrow without the centre's approval. Until recently, the states used to borrow directly from the centre and now they borrow through the centre. Thus, unlike Canada, the Indian states have always been getting their borrowings with explicit protection or implicit guarantee from the centre. In Canada, the provinces can borrow directly from the market both domestically and from abroad. They get their loans on terms dictated entirely by the credit ratings they receive. There is, therefore, a clear pressure exerted by the market for showing fiscal prudence and discipline. In India, because of the implicit guarantee of the centre, states have no incentive for fiscal prudence and discipline. This problem of moral hazard would result in unnecessarily higher public debt for both tiers of the government together. However, the combined public debt in Canada relative to its GDP was 83 per cent in 2001 whereas it was only 75 per cent in India in 2002-03.

The explanation for this paradox lies in the differences of the overall growth rates in the economy relative to the interest rate. The Indian growth rate is in the range of 6 to 7 per cent in real terms and 12 to 13 per cent in nominal terms. The Canadian growth is less than half this rate. With interest rates falling sharply in India, the current fiscal situation is comfortably sustainable even with the present level of fiscal deficits simply because the growth prospects are very high (Ram Mohan, Dholakia and Karan, 2005). In Canada, on the contrary, the fiscal situation becomes sustainable largely because of increased fiscal discipline and improved fiscal prudence on the part of the governments. However, the macro parameters have compelled the Canadian federal and provincial governments to become fiscally more responsible and prudent thanks to their exposure to the market directly. In India, on the other hand, favourable macro parameters have delayed the fiscal and governance-oriented reforms. The 12th Finance Commission has recommended some important measures for debt management of states. So far, the central government alone had taken large benefits of high growth and reduced interest rates. Now, the centre is asked to share and pass on these benefits to states also. However, the system is still not making the borrowings of states independent of the centre. The problem of moral hazard is still remaining largely unaddressed. The main consideration of the 12th Finance Commission appears to be the issue of horizontal equity because different states in India have not only different fiscal capacity but also different ability to borrow from the market. Several states in India lack credibility in the market on a stand-alone basis. If they are unable to borrow to bridge their fiscal gaps, it would create tremendous political pressure on equity grounds under the democratic federal structure. This is because both the central and the state governments in India are running perennial deficits and are compelled to borrow in order to meet their expenditure obligations as noted earlier. The solution requires fundamental change in the system of federal transfers in India and not incremental and marginal modifications as generally attempted by the Finance Commissions and the Planning Commission.

CONCLUDING REMARKS

The Canadian experience has shown that it is possible under the democratic federal structure to achieve both the vertical and horizontal balance in fiscal matters although the macro parameters are not very favourable. This is because the Canadian system works on market philosophy and allows the economy and the population to adjust to the incentives and signals provided by the market. The degree of direct intervention for ensuring equity across regions is consciously kept at a lower level and property rights in major minerals are also created and left with the regions where they occur. Free mobility of population and goods makes the regional problem diluted and less intense. The problem of fiscal transfers to that extent becomes more manageable. The rules of the game are so clearly defined and supported by a meticulous data set on different revenue-bases by provinces that the federal government is not seen to be controlling and dictating the fiscal behaviour of provinces through the transfers.

In India, there is a need to clear the confusion surrounding the notion of horizontal balance and regional equity. In our fiscal transfers formulae, there is no weightage to the contribution or the revenue-base that a region has the responsibility to nurture and grow. On the contrary, there are strong disincentives for the major contributors by inversely relating the transfers to some macro proxy for the contribution. Of course, these proxies are not appropriate and can further vitiate the incentives to the better performing and efficient states. There are some efforts though to introduce reforms and correct the incentive structure but they are too slow and too minor to create a strong impact. Even simple recommendations to link the transfer of resources to the state's own revenues and to allow limited autonomy to the performing states to borrow directly from the market (Dholakia, *et al*., 2005) have not been accepted by the 12th Finance Commission in letter and spirit. Indian polity still seems to have a deep faith in the direct intervention by the government and a categorical disbelief in the benefits that the markets can bestow. India has a lot to learn from Canada not only about what it has done, but more importantly, about why and how it has done it. It is more a question of changing the attitude, mindset, and philosophy.

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