

VERTICAL FISCAL IMBALANCE AND THE FINANCIAL INDEPENDENCE OF LOCAL BUDGETS: THEORETICAL FOUNDATIONS AND INSTITUTIONAL MECHANISMS

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Abstract. This article examines the concept of vertical fiscal imbalance and its impact on the financial autonomy of local budgets from both theoretical and institutional perspectives. The study is grounded in fiscal federalism theory, intergovernmental fiscal relations, and the processes of centralization and decentralization. Vertical fiscal imbalance is interpreted as a mismatch between revenue and expenditure assignments across different levels of government, and its implications for transfer dependency and fiscal autonomy are analyzed. The paper also distinguishes between de jure and de facto fiscal decentralization. Based on the findings, institutional mechanisms aimed at strengthening the financial independence of local budgets are proposed.

Keywords: vertical fiscal imbalance, fiscal federalism, local budgets, financial autonomy, intergovernmental transfers, fiscal decentralization, institutional mechanisms.

INTRODUCTION

In the modern fiscal policy system, issues related to effective public finance management and the promotion of regional development occupy a central place. Particularly in the context of deepening fiscal decentralization processes, the problem of vertical fiscal imbalance has become an important scientific and practical issue. Vertical fiscal imbalance manifests itself as a discrepancy between revenue sources and expenditure responsibilities among different levels of government. This discrepancy directly affects the degree of financial independence of local budgets.

According to the theory of fiscal federalism, public finance is formed based on the distribution of powers and resources between central and local levels of government. In the ideal model, each level of governance should possess sufficient revenue sources to finance the expenditure obligations assigned to it. However, in practice, in many countries revenue powers are largely concentrated at the central level, while more expenditure responsibilities are assigned to local authorities. As a result, vertical fiscal imbalance arises, which leads to a high level of dependence on intergovernmental transfers.

A key aspect of vertical fiscal imbalance is that it may limit the financial autonomy of local budgets. If local governments do not have sufficient authority to generate their own revenues, they become dependent on transfers allocated from the central budget. This situation may weaken fiscal discipline, reduce the efficiency of resource utilization, and limit economic initiative. At the same time, the transfer system serves as an important instrument for balancing financial disparities among regions and ensuring social equity. Therefore, it would be incorrect to evaluate vertical fiscal imbalance from a one-sided perspective.

In the scientific literature, vertical fiscal imbalance is generally interpreted as a mismatch between revenue and expenditure assignments. However, the practical manifestation of this concept is often associated with the gap between de jure and de facto fiscal decentralization. De jure decentralization reflects the powers defined by legal and regulatory frameworks, while de facto decentralization represents the real level of financial autonomy in practice. In many countries, although certain taxes are assigned to local budgets, the authority to set or modify tax rates remains at the central level. This significantly limits real fiscal independence.

In the Republic of Uzbekistan, significant reforms have been implemented in recent years to liberalize fiscal policy and strengthen the role of local budgets. A number of regulatory and legal measures aimed at improving intergovernmental fiscal relations, expanding the revenue base of local budgets, and optimizing the transfer mechanism have been adopted. Nevertheless, a high level of dependence on transfers remains in some regions. This situation highlights the necessity of conducting an in-depth analysis of vertical fiscal imbalance and improving its institutional mechanisms.

The main objective of this article is to systematically analyze the theoretical foundations of vertical fiscal imbalance and to reveal its impact on the financial independence of local budgets. In addition, within the framework of fiscal federalism and intergovernmental fiscal relations theory, institutional mechanisms for reducing vertical fiscal imbalance are proposed. The results of the study provide a theoretical basis for improving fiscal policy and enhancing the efficiency of local financial management.

The structure of the article is as follows: the next section reviews the scientific literature related to the topic; the research methodology is then presented; this is followed by an analysis of the institutional mechanisms of vertical fiscal imbalance and its impact on the financial independence of local budgets; finally, conclusions and practical recommendations are provided.

LITERATURE REVIEW

Vertical Fiscal Imbalance (VFI) is considered one of the key categories within the theory of fiscal federalism. In academic literature, this concept is generally interpreted as a mismatch between revenue sources and expenditure responsibilities among different levels of government. The issue of VFI is particularly relevant for countries undergoing fiscal decentralization processes, as it directly affects the level of financial independence of local budgets.

One of the founders of the fiscal federalism theory, Wallace E. Oates (1972), emphasizes that the distribution of governmental powers between central and local authorities should be based on the principle of efficiency. According to his approach, local governments are able to allocate resources more efficiently because they possess better knowledge of regional needs and preferences. At the same time, Oates notes that when revenue sources are highly centralized, the fiscal autonomy of local governments may become limited.

Richard A. Musgrave and Peggy B. Musgrave (1989) justify the distribution of fiscal powers based on the three fundamental functions of public finance: allocation, redistribution, and stabilization. According to their framework, the functions of redistribution and macroeconomic stabilization are more effectively performed at the central government level, while the financing of local public services is more efficiently carried out at the local level. However, when expenditure responsibilities are assigned to local authorities while revenue sources remain concentrated at the central level, vertical fiscal imbalance emerges.

Vito Tanzi (1995) analyzes vertical fiscal imbalance from the perspective of macroeconomic stability and argues that excessive dependence on transfers may weaken fiscal discipline. He introduces the concept of a “soft budget constraint,” suggesting that if local governments expect additional financial support from the central government, their fiscal responsibility and incentives for efficient resource management may decline.

Richard M. Bird and Michael Smart (2002) examine the role of transfer systems in reducing vertical fiscal imbalance. Their research shows that equalization transfers can help mitigate financial disparities among regions. At the same time, they point out that poorly designed transfer mechanisms may distort fiscal incentives and reduce financial accountability. Therefore, the transfer system should be structured in a way that supports fiscal discipline while maintaining local financial autonomy.

Anwar Shah (2007) considers vertical fiscal imbalance as one of the key indicators in assessing the effectiveness of fiscal decentralization. He distinguishes between de jure and de facto fiscal decentralization, emphasizing that powers granted through legal and regulatory frameworks do not always correspond to actual financial autonomy in practice. In many countries, although local taxes formally exist, the authority to determine tax rates remains centralized, which limits real fiscal independence.

Reports by the Organisation for Economic Co-operation and Development (2020) recommend evaluating the level of vertical fiscal imbalance through the analysis of the ratio between revenue and expenditure assignments. According to the OECD methodology, a high level of VFI exists when subnational governments are unable to finance a significant share of their expenditures from their own revenues.

In the context of Uzbekistan, scientific studies have also raised the issue of expanding the revenue base of local budgets and reducing their dependence on transfers. Researchers emphasize the importance of increasing the share of tax revenues within local budgets, improving the transfer system, and expanding fiscal powers at the local level. However, the comprehensive analysis of vertical fiscal imbalance based on theoretical and institutional mechanisms has not yet been sufficiently developed.

The literature review indicates that the relationship between vertical fiscal imbalance and the financial independence of local budgets is a complex and multi-factorial process. Although existing scientific approaches have clarified the theoretical foundations of the problem, developing institutional mechanisms adapted to national conditions remains an urgent task. Therefore, this article proposes institutional mechanisms aimed at reducing vertical fiscal imbalance and strengthening the financial independence of local budgets.

RESEARCH METHODOLOGY

This study is aimed at analyzing the relationship between Vertical Fiscal Imbalance (VFI) and the financial independence of local budgets from both theoretical and institutional perspectives. The research methodology is based on the theory of fiscal federalism, the concept of intergovernmental fiscal relations, and approaches to fiscal decentralization. Methodologically, the study employs systematic analysis, comparative analysis, an institutional approach, and conceptual modeling methods.

At the first stage of the research, the theoretical foundations of the concept of vertical fiscal imbalance were clarified. VFI is interpreted as a mismatch between revenue and expenditure assignments among different levels of government. To represent this relationship, the following general ratio was applied:

$$VFI = 1 - \frac{\textit{Subnational Own Revenues}}{\textit{Subnational Total Expenditures}}$$

This formula reflects the ability of subnational governments to finance their expenditures using their own revenue sources. A higher value of the indicator implies a higher level of vertical fiscal imbalance.

At the second stage, the concepts of de jure and de facto fiscal decentralization were examined separately. De jure decentralization reflects the powers granted through legal and regulatory frameworks, while de facto decentralization indicates the actual level of financial autonomy in practice. To identify the difference between these two dimensions, the discrepancy between normative fiscal powers and the actual structure of revenues was analyzed.

At the third stage, the mechanism through which vertical fiscal imbalance influences the financial independence of local budgets was conceptually modeled. In this context, the following factors were considered as an interconnected system:

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- centralization of revenue powers;
- assignment of expenditure responsibilities to the subnational level;
- the share and conditionality of intergovernmental transfers;
- fiscal incentives and the “soft budget constraint” effect.

The research also applies an institutional analysis approach, examining the interaction between the transfer system, tax authority distribution, and budgetary discipline. The VFI indicator was compared with the financial independence of local budgets, and their interrelationship was theoretically explained.

This methodology makes it possible to consider vertical fiscal imbalance not merely as a statistical ratio but as an institutional system of fiscal incentives and constraints. Consequently, it provides a methodological basis for developing mechanisms aimed at strengthening the financial independence of local budgets.

ANALYSIS AND RESULTS

The research findings demonstrate that Vertical Fiscal Imbalance (VFI) is an important factor in shaping the financial independence of local budgets. Based on theoretical and institutional analysis, it was determined that the mismatch between revenue powers and expenditure responsibilities limits fiscal autonomy at the local level and leads to a high degree of dependence on intergovernmental transfers.

Economic Essence of Vertical Fiscal Imbalance. The analysis shows that vertical fiscal imbalance mainly arises in two situations:

1. when revenue sources are highly concentrated at the central level;
2. when expenditure responsibilities are assigned to the subnational level.

If subnational governments cannot cover a significant portion of their expenditures from their own revenues, they become dependent on transfers. This situation indicates a high level of the VFI indicator. Under conditions of high VFI, the financial independence of local budgets becomes largely nominal, while real fiscal autonomy remains limited.

At the same time, the results of the analysis suggest that vertical fiscal imbalance should not always be interpreted as a purely negative phenomenon. A certain level of VFI may contribute to ensuring fiscal system stability, implementing the redistribution function, and reducing disparities between regions. However, an excessively high level of VFI weakens fiscal discipline and reduces incentive mechanisms within the fiscal system.

Gap Between De Jure and De Facto Decentralization. The research findings also reveal a significant difference between de jure and de facto fiscal decentralization. Although some taxes are formally assigned to local budgets in legal and regulatory frameworks, the authority to determine or modify tax rates may remain at the central level. This situation restricts real financial independence.

Even when the level of de jure decentralization appears relatively high, vertical fiscal imbalance may persist if de facto revenue-generating capacities remain limited. Therefore, when evaluating financial autonomy, it is necessary to consider not only formal fiscal powers but also the actual structure of revenues, the share of transfers, and the real scope of tax authority exercised by local governments.

Transfer System and the “Soft Budget Constraint”. One of the key institutional consequences of vertical fiscal imbalance is the “soft budget constraint” phenomenon. If local governments are confident that they will receive additional financial support from the central government, they may not maintain adequate fiscal responsibility. As a result, expenditure efficiency decreases and fiscal discipline weakens.

The analysis indicates that the negative effects of vertical fiscal imbalance can be significantly reduced if the transfer system is designed based on incentive-oriented principles. In particular, it is important to ensure a balanced share of unconditional transfers, introduce performance-based

financing mechanisms, and apply transfer formulas linked to fiscal discipline indicators. Such an approach strengthens the financial stability of local budgets while expanding their capacity for independent decision-making.

According to the research findings, reducing vertical fiscal imbalance should primarily be achieved through institutional reforms. These reforms should include expanding tax powers at the local level, balancing revenue and expenditure assignments, and redesigning the transfer system based on equalization and incentive principles. In addition, strengthening fiscal discipline monitoring mechanisms and increasing de facto fiscal autonomy represent important policy directions.

From a theoretical perspective, the objective is not to completely eliminate vertical fiscal imbalance but rather to maintain it at an optimal level. An optimal level of VFI should ensure fiscal stability while simultaneously supporting the financial independence of local budgets (Figure 1).

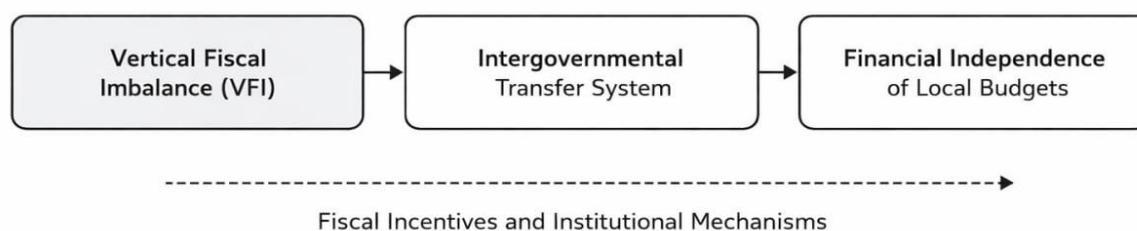


Figure 1. A conceptual model of the relationship between vertical fiscal imbalance and the financial independence of local budgets¹

This model illustrates the mechanism through which vertical fiscal imbalance influences the financial independence of local budgets through the intergovernmental transfer system. In the model, transfers appear as an institutional instrument that shapes the level of financial autonomy through fiscal incentives and governance mechanisms.

CONCLUSION AND RECOMMENDATIONS

This study was devoted to the theoretical and institutional analysis of the relationship between vertical fiscal imbalance and the financial independence of local budgets. The analysis conducted shows that the mismatch between revenue powers and expenditure responsibilities is one of the key factors limiting real fiscal autonomy at the local level. Under conditions of vertical fiscal imbalance, local budgets remain dependent on transfers from the central government in order to fully finance their expenditure obligations.

The research findings confirm that the complete elimination of vertical fiscal imbalance is not always appropriate. A certain level of imbalance performs an important redistributive function and helps mitigate financial disparities between regions. However, an excessively high level of imbalance may weaken fiscal discipline, intensify the “soft budget constraint” phenomenon, and reduce local initiative. Therefore, it is necessary to ensure an optimal balance within the fiscal system.

Another important conclusion concerns the gap between de jure and de facto fiscal decentralization. Powers granted through legal and regulatory frameworks do not always correspond to real financial independence in practice. Although certain taxes are formally assigned to local budgets, the authority to determine tax rates often remains at the central level, which restricts genuine fiscal autonomy. Consequently, when evaluating fiscal decentralization, it is necessary to consider not only formal regulatory criteria but also the actual structure of revenues, the real application of tax powers, and the degree of dependence on transfers.

Based on the research results, the following practical recommendations are proposed:

¹ author's development

First, it is necessary to balance revenue and expenditure powers. The expenditure responsibilities assigned to local governments should correspond to their available revenue base.

Second, expanding tax authority at the local level can enhance real fiscal autonomy. Granting local authorities the right to differentiate tax rates for certain taxes would strengthen fiscal responsibility and improve revenue collection efficiency.

Third, the intergovernmental transfer system should be improved based on incentive-oriented mechanisms. It is advisable to incorporate fiscal discipline indicators, revenue base expansion, and efficient use of public funds into transfer formulas.

Fourth, strengthening fiscal monitoring and reporting systems can reduce the risks associated with the “soft budget constraint.” Improving transparency and accountability mechanisms will enhance the quality of local financial management.

Managing vertical fiscal imbalance at an optimal level is an essential condition for ensuring the financial independence of local budgets. The theoretical and institutional approaches proposed in this study can contribute to improving fiscal policy and strengthening regional financial stability.

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