



## “Vertical and Horizontal Imbalances in India: The Corrective Role of the Finance Commission”

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### Abstract

Fiscal federalism in India creates vertical and horizontal imbalances due to the unequal distribution of revenue powers and expenditure responsibilities between the Union and the States, as well as disparities among States in fiscal capacity and development. The Finance Commission of India, constituted under Article 280, plays a crucial role in correcting these imbalances through tax devolution and grants-in-aid. By applying criteria such as population, income distance, area, forest cover, and demographic performance, it promotes fiscal equalization, cooperative federalism, and balanced regional development. Although its recommendations have strengthened States' financial position, ongoing reforms are necessary to enhance fiscal autonomy and reduce persistent regional disparities.

### Introduction

India adopts a federal system of governance in which powers and responsibilities are constitutionally divided between the Union and the States. The financial relations between these two levels of government form the core of fiscal federalism. While the Constitution assigns major revenue-raising powers to the Union government, a significant portion of expenditure responsibilities—such as health, education, agriculture, and rural development—rests with the States. This structural arrangement often leads to fiscal imbalances. Vertical imbalance arises when States face a mismatch between their revenue resources and expenditure obligations, whereas horizontal imbalance refers to inequalities in fiscal capacity and development levels among different States.

To address these challenges, the Finance Commission of India was established under Article 280 of the Constitution as an independent constitutional body. Its primary function is to recommend the distribution of tax revenues between the Centre and the States (vertical devolution) and among the States themselves (horizontal devolution), along with grants-in-aid to support fiscal equalization. Through its periodic recommendations, the Finance Commission seeks to promote equity, efficiency, and cooperative federalism in India's financial system.

Over the years, successive Finance Commissions have refined the criteria for tax devolution and introduced performance-based incentives to strengthen fiscal discipline and balanced regional development. In this context, examining the nature of vertical and horizontal imbalances and evaluating the corrective role of the Finance Commission becomes essential for understanding the dynamics of fiscal federalism in India.

### Literature Review

**Singh and Srinivasan (2006)** examine the relationship between federalism and economic development in India, highlighting how institutional arrangements and intergovernmental fiscal transfers influence regional growth patterns. The authors argue that India's federal structure has played a significant role in accommodating diversity while promoting economic reforms and decentralization. They emphasize that fiscal transfers and revenue-sharing mechanisms are crucial in addressing regional disparities and maintaining macroeconomic stability. Furthermore, the study discusses how market-oriented reforms and state-level policy autonomy have contributed to differential growth trajectories across states. The authors conclude that while federalism has supported economic development, effective fiscal coordination between the Centre and States remains essential for reducing inequalities and ensuring balanced growth.

**Bagchi (2003)** provides a comprehensive analysis of public finance with particular emphasis on fiscal federalism, intergovernmental transfers, and the principles of equity and efficiency in resource allocation. The author discusses the theoretical foundations of taxation, public expenditure, and fiscal decentralization, highlighting the importance of aligning revenue powers with expenditure responsibilities in a federal system. Bagchi argues that fiscal



imbalances—both vertical and horizontal—are inherent in multi-tier governance structures and require well-designed transfer mechanisms to ensure equity and macroeconomic stability. The work underscores the role of constitutional and institutional arrangements in correcting disparities across regions and strengthening cooperative federalism. These insights are particularly relevant for understanding the corrective function performed by the Finance Commission of India in India's fiscal framework.

**Chelliah (1996)** analyzes fiscal and financial sector reforms in India with a focus on achieving sustainable economic growth through sound public finance management. The author emphasizes the need for rational tax policies, improved revenue mobilization, and fiscal discipline to address structural imbalances in the economy. Chelliah argues that persistent fiscal deficits and inefficient expenditure patterns weaken both macroeconomic stability and federal financial relations. The essays highlight the importance of reforming intergovernmental fiscal arrangements to ensure equitable resource distribution and enhance the financial autonomy of States. The study provides valuable insights into the necessity of institutional mechanisms, such as the Finance Commission of India, in promoting fiscal sustainability, correcting imbalances, and strengthening cooperative federalism in India.

**The Fifteenth Finance Commission (2021)** examines the evolving dynamics of fiscal federalism in India and provides recommendations for the period 2021–26 to address vertical and horizontal imbalances. The report retains 41% of the divisible pool of central taxes for States and refines the criteria for horizontal devolution by assigning weight to income distance, population (2011), area, forest and ecology, demographic performance, and tax effort. It emphasizes fiscal consolidation, performance-based incentives, and sector-specific grants, including those for health, agriculture, and disaster management. The Commission also stresses transparency, accountability, and strengthening local bodies to enhance cooperative federalism. Overall, the report highlights the central role of institutional fiscal transfers in promoting equity, macroeconomic stability, and balanced regional development across States.

**The Fourteenth Finance Commission (2015)** marked a significant shift in India's fiscal federal framework by substantially increasing the States' share in the divisible pool of central taxes from 32% to 42%. This recommendation aimed to enhance fiscal autonomy and strengthen cooperative federalism. The Commission emphasized greater untied transfers to allow States flexibility in designing and implementing development programs according to local priorities. It also focused on fiscal discipline, revenue deficit grants, and strengthening local bodies through enhanced grants. By promoting a more equitable and transparent devolution formula based on criteria such as population, area, income distance, and forest cover, the report contributed significantly to addressing both vertical and horizontal fiscal imbalances in India.

## Objectives of the Study

1. To examine the concept and theoretical framework of fiscal federalism in India.
2. To analyze the nature and causes of vertical fiscal imbalances between the Union and the States.
3. To study the extent and determinants of horizontal fiscal imbalances among Indian States.
4. To evaluate the constitutional role of the Finance Commission of India under Article 280 in addressing fiscal imbalances.
5. To assess the effectiveness of tax devolution and grants-in-aid as corrective mechanisms.
6. To examine the criteria adopted by successive Finance Commissions for horizontal distribution of resources.
7. To analyze the impact of Finance Commission recommendations on cooperative federalism and fiscal discipline.
8. To identify challenges and suggest reforms for strengthening fiscal equalization and balanced regional development in India.



## Methodology

### Research Design

The study adopts a descriptive and analytical research design to examine vertical and horizontal fiscal imbalances in India and the corrective role of the Finance Commission of India.

### Nature of Study

The research is primarily qualitative in nature, supported by secondary quantitative data wherever necessary.

### Sources of Data

- Secondary data collected from the Reports of various Finance Commissions (especially the Fourteenth and Fifteenth Finance Commissions).
- Government publications such as the Constitution of India (Article 280).
- Reports of the Reserve Bank of India on State Finances.
- Books, research articles, journals, and policy papers related to fiscal federalism.

### Data Analysis Method

The study uses content analysis and comparative analysis to evaluate the recommendations of successive Finance Commissions. Trends in tax devolution, grants-in-aid, and criteria for horizontal distribution are examined.

### Scope of the Study

The research focuses on the role of the Finance Commission in correcting fiscal imbalances during recent Commissions, particularly after economic reforms and the introduction of GST.

### Limitations of the Study

- The study relies mainly on secondary data.
- It does not include primary field surveys or interviews.
- The analysis is limited to available published reports and official data.

### Analysis

India's federal structure creates **vertical fiscal imbalance** because the Union government has greater revenue-raising powers, while States carry larger expenditure responsibilities. The Finance Commission of India corrects this through tax devolution and grants-in-aid, increasing States' share in central taxes and strengthening their fiscal capacity.

**Horizontal fiscal imbalance** arises due to differences in income levels, resources, and development among States. The Finance Commission addresses this through a formula-based distribution using criteria such as income distance, population, area, forest cover, and tax effort to promote fiscal equalization.

### Conclusion

India's system of fiscal federalism inevitably generates both vertical and horizontal fiscal imbalances due to the constitutional distribution of financial powers and functional responsibilities. While the Union government controls major revenue sources, States shoulder significant expenditure obligations, leading to vertical imbalance. At the same time, differences in economic development, resource endowments, and administrative capacity create horizontal disparities among States.

In this context, the Finance Commission of India plays a crucial constitutional and corrective role. Through tax devolution, grants-in-aid, and formula-based distribution criteria, it seeks to ensure equity, fiscal sustainability, and balanced regional development. Successive Finance Commissions have strengthened cooperative federalism by increasing States' share in central taxes and introducing performance-based incentives.

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