The federal fiscal system and operation of intergovernmental transfers in India have for long been considered to be having adverse impact on responsible inter-temporal budgetary choices of the State Governments and generating perverse incentives effect on States’ fiscal operations. These conclusions are based, mostly, on evaluation of the Indian fiscal federalism against the normative theories while empirical results remained by and large unsettled. This thesis is an attempt to conduct an empirical investigation into the alleged perverse incentives effect of intergovernmental transfers on the budgetary choices and fiscal outcomes of the States. The empirical results are based on data of 14 major Indian States which accounts for 85 percent of the total population of India, 84 percent of the combined budgetary transactions of the State Governments and 84 percent of the total Central transfers to States. The period we considered is from 1980-81 to 2003-04 spanning 24 years. The research questions that we seek to answer are the following:

1. How major fiscal variables of the States respond to intergovernmental transfers and whether these transfers have adverse effect on the inter-temporal budgetary choices of the States?

2. Have intergovernmental transfers and the associated institutional mechanisms been generating perverse incentives effect for the fiscal management by the States and if they do, where this effect manifest, ex-post.

The first two essays (Chapter 2 and 3) are descriptive chapters which provide the background and context to the research problem. Chapter 2 attempts critical institutional description of India’s fiscal federalism against related theory and the notion of efficient fiscal
system while keeping in mind the social and political compulsions behind the constitutional provisions and existing institutional arrangements. In Chapter 3, the operation of Centre-State transfers in India through various institutions, the design, and the quantum and trends are discussed in relation to the normative theory of intergovernmental transfers and related empirical literature. A juxtaposition of India's federal fiscal system and the operation of intergovernmental transfers against these normative theories inevitably give the impression that fiscal transfers are not disposed to fostering accountability and responsible fiscal behaviour in State Governments.

In Chapter 4 we build a fiscal response model based on which we derived a set of empirical estimation equations to inquire into the effect of Central transfers on the budgetary choices of the States. The effect of Central transfers, their design and institutional mechanism on major fiscal variables are estimated to ascertain where the alleged perverse incentives manifest, ex-post. Intergovernmental transfers are found to have stimulative effect on States' expenditure and they also induced increased tax effort on State Governments. It is observed that States tends to raise the level of their net borrowings with the increase in Central transfers implying perverse incentives for fiscal management. This, on the supply side, appears to be reflecting the softening of the hard budget constraint associated with common pool problem and on the supply side, the deficit bias of annual incremental plan outlays. While our results show no evidence of substitution effect of States' own-tax revenue for Central transfers, there is strong evidence of Central transfers adversely affecting own non-tax revenue of the States. We argue that this is suggestive of allocative inefficiency as a result of centralized resource allocation.