VISION IAS

ECONOMY
PART 1

NATIONAL INCOME ACCOUNTING

Contents

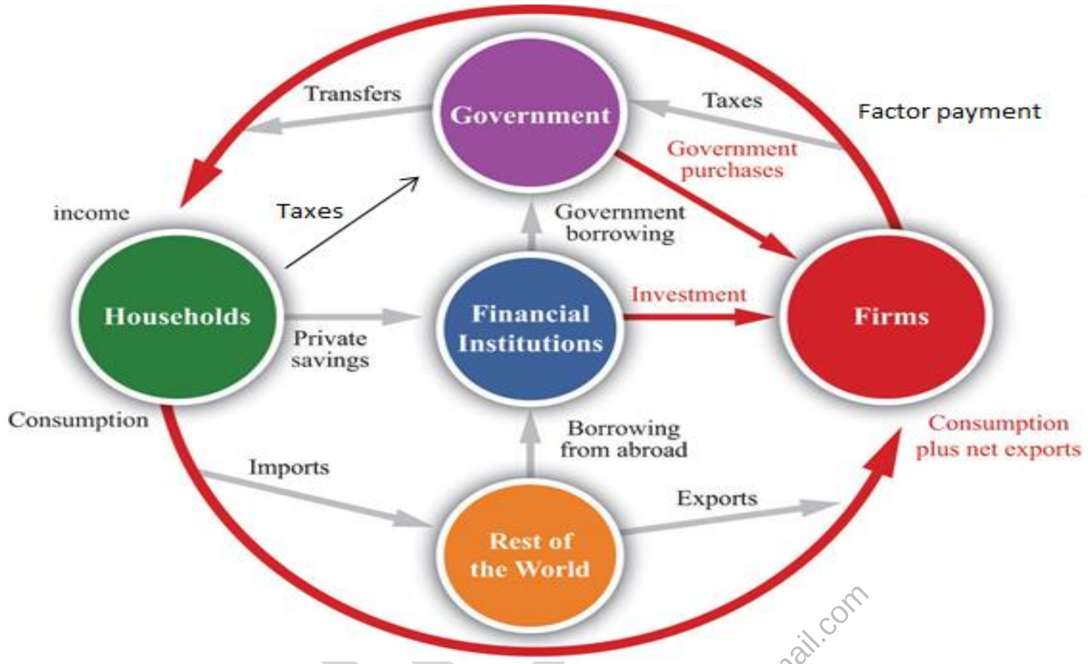
Student Notes: 2021

1. National Income Accounting

National Income Accounting or NIA refers to methods or techniques used to measure the economic activity in a national economy as a whole. As one can calculate income for a single person or an entity, the same can be done for a country also.

In an economy, households buy goods and services from firms, and firms use their revenue from sales to pay wages to workers, rent to landowners, and profit to firm owners. GDP equals the total amount spent by households in the market for goods and services. It also equals the total wages, rent and profit paid by firms in the markets for the factors of production.

The following Circular Flow Diagram shows the flow of resources (money) in an open economy:



The diagram describes all the transactions between households and firms in a simple economy. It simplifies matters by assuming that all goods and services are bought by households and that households spend all of their income.

Money continuously flows from households to firms and then back to households.

GDP measures this flow of money. It can be computed for an economy in one of the following ways:

- By adding up the total expenditure by households (Expenditure Method)
- By adding up the total income (wages, rent, profit) paid by firms (Income Method)
- By adding up the total value of all final goods and services produced in the economy (Output / Value Added Method)

Since all expenditure in the economy ends up as someone's income, GDP is the same regardless of how we compute it.

1.1. Significance of National Income Accounting

- **International Comparison:** National Income Accounting measures growth rate and development of nations, which can be used to compare standard of living of different countries.
- **Business Decisions:** It reflects the relative contribution and potential of various sectors of the economy which guides the business class to plan for future production.

- **Policy Formulation**: It throws light on the distribution of income and resources in the economy, which helps government in proper allocation of resources to bring equality and development in nation.
- **Policy Evaluation:** The income accounting identifies specific economic achievements and failures which helps people of the nation in evaluating the policies of the government.
- **Annual Budget**: It shapes the budgetary policy of the Government, makes the borrowing and tax policy in order to neutralize the fluctuations of income and employment. The government takes to deficit or surplus budget to arrest depression or inflation in an economy.
- **National statistics** gives clear picture of how the national expenditure is divided into investment and consumption.

2. Concepts of National Income

Over a period of time four ways to calculate the income of a nation have been developed by the economists. These four ways to calculate the national income of a nation are **GDP, GNP, NDP and NNP**.

2.1. GDP or Gross Domestic Product

GDP or Gross domestic product refers to total market value of all the final goods and services produced in an economy in a given period of time. For India, this time period is from 1st April to 31st March. This means it measures the value of final goods and services produced **within a geographic boundary** regardless of the nationality of the individual or firm.

For instance, cars manufactured in India by Japanese company will be included in Indian GDP. Similarly, the Jaguar cars manufactured in UK by Tata will not be counted in India's GDP.

It refers to only **final** output of such goods and services. The rule that only finished or final goods must be counted is necessary to avoid double or triple counting of raw materials, intermediate products, and final products. For example, the value of automobiles already includes the value of the steel, glass, rubber, and other components that have been used to make them. To be precise, we define the following:

a) **Final Output**: Goods and Services purchased for final use.
b) **Intermediate Goods**/Factors of Production/Raw Materials: Products used as input in the production of some other product. There are two ways to take into account double counting:
   i. Calculate only the value of the final product.
   ii. Calculate the value added at each stage of production, from the beginning of the process to the end. Specifically, it is derived by subtracting the value of the intermediate good from the value of the sale.

2.1.1. Real GDP and Nominal GDP

Nominal GDP refers to current year production of final goods and services valued at **current year prices**.

Real GDP on the other hand refers to the current year production of goods and services valued at **base year prices**. Such base year prices are **constant prices**.

Real GDP is a much better way to calculate the GDP because in a particular year GDP may be bloated up because of high rate of inflation in the economy. Real GDP, therefore, allows us to determine if production increased or decreased, regardless of changes in inflation and purchasing power of the currency.

To explain it better, consider an economy which produces only apples. In a particular year, say

2010, there were 100 apples produced in the economy and the cost of each apple was 1$. The nominal GDP of the economy in 2010 will be 100$ (multiplying 100 by 1$). After 5 years, the production of apples reduced to 50 apples in a year. However, the prices increased to 3$. Then nominal GDP for 2015 will be 150$ (multiplying 50 with 3$). It shows increase in GDP even though production got decreased.

Now consider year 2010 as base year. Then, the real GDP for the year 2010 will be 100$ and for the year 2015 will be 50$ (multiplying 50 with prices of 2010). The decline in real GDP is in proportion to decline in production in the economy. Thus, real GDP represents better picture of any economy than nominal GDP.

The concept of base year has been covered in greater detail in subsequent sections.

2.2. GNP or Gross National Product

The concepts of **GNP or Gross National Product** and GDP are closely related. As mentioned above, GDP reflects the goods and services produced within the boundaries of the country by both citizens and foreigners. GDP focuses on where the output is produced rather than who produced it. On the other hand, GNP is a measure of the value of output produced by the nationals of a country irrespective of the geographical boundaries. It refers to the output of Indian citizens both within India and in all other countries of the world.

To make it simpler, a few examples have been considered here. Microsoft is a US based firm. When it opens up a production utility in India, value of output from that utility is added to India's GDP, but it is not added while calculating GNP of India. Similarly, when Indian companies such as Infosys or TCS produce services in the US, the value of those services are not added in the Indian GDP but they are utilized while calculating the Indian GNP. **GDP** is about **where** production takes place. **GNP**, on the other hand, is about **who** produces them.

GNP = GDP + Net Factor Income from Abroad. In case of an economy with great levels of inflows of FDI and very less outgoing FDI, the GDP would generally be more than the GNP. On the other hand, if in an economy, more of its nationals move abroad and generate economic activity when compared to foreigners who come in and perform any economic activity, its GNP would be larger than its GDP. **In India's case, GNP is lower than its GDP as net income from abroad has always been negative in India.**

Even though GDP is a figure which is prominently used by economists across the world, some economists criticize it for not reflecting the true state of a nation's economy. GDP takes into account the profits earned in a nation by overseas companies that are remitted back to foreign investors. If these remitted profits are very large compared with earnings from the nation's overseas citizens and assets, the GNP will be significantly below GDP. The difference between GDP and GNP of a nation also reflects how much the outside world is dependent on its products and how much it depends on the world for the same.

2.2.1. Net Factor Income from Abroad

Net Factor Income from Abroad (NFIA) is the difference between the aggregate amount that a country's citizens and companies earn abroad, and the aggregate amount that foreign citizens and overseas companies earn in that country.

In short, **Net Factor Income from Abroad = GNP – GDP**.

Net foreign factor income in most of the countries is very small since factor payments earned by citizens and those paid to foreigners more or less offset each other.

2.3. Why GDP is the Most Acceptable Indicator Worldwide?

- GDP growth (as a measure of economic growth) is a major contributor to welfare and GDP tends to be correlated with several other measures of 'development', such as literacy and healthcare provision.
- As currently defined, it has a clear methodology and is relatively easy to calculate.
- Since it is a monetary/mathematical/accounting calculation with an established methodology, it is objective (in contrast, such things as 'happiness' and 'political freedom' are subjective and difficult to measure).
- It is widely used and all GDP calculations are made using broadly the same methodology. This facilitates cross-country and over-time comparisons.
- Given its long history and standard methodology, it is reasonably well-understood by policy-makers.

2.4. Depreciation

In the process of production, all machines and equipment used to produce other goods, are subject to some wear and tear. In economic parlance, this loss of capital which every economy has to suffer is called as **Depreciation**.

A part of capital goods produced in the economy must be devoted to replace this wear and tear. Otherwise, the productive capacity of a nation would be depleted. This replacement of the capital used is **Capital Consumption Allowance**.

In this scenario, the investment expenditure of the firms is made up of two parts. One part is to buy new capital goods and machinery for production. It is called **Net Investment** because the production capacity of the firms can be expanded.

Another part is spent on replacing the used-up capital goods or the maintenance of existing capital goods. The expenses incurred for this are called **Depreciation Expenditure**.

The total investment by firms comprising these two amounts is called **Gross Investment**.

Gross Investment = Net Investment + Depreciation

Or, **Net Investment = Gross Investment – Depreciation.** The Net investment increases the production capacity and output of a nation if it is positive. This can easily be verified at the level of a single plant: the number of new machines installed in any given year must be greater than the machines that have been used up during that year.

The governments decide and announce the rates by which assets depreciate and a list is published, which is used by the different sections of the economy to determine the real levels of depreciations in different assets.

2.5. NDP or Net Domestic Product

Net Domestic Product (NDP) is the GDP calculated after adjusting the value of 'depreciation'. This is, basically, net form of the GDP, i.e. GDP minus the total value of the 'wear and tear' (depreciation) that happened in the assets while goods and services were being produced.

NDP = GDP – Depreciation.

The NDP of an economy is always less than it's GDP, because the Depreciation can never be reduced to zero and will always be positive.

2.6. NNP or Net National Product

The Net national product (NNP) is equal to gross national product (GNP) minus Depreciation.

NNP = GNP - Depreciation

The concept of NDP and NNP are not used to compare different economies because the method of calculating depreciation varies from nation to nation.

2.7. The concept of Market Price and Factor Cost

Market price refers to the actual transacted price of goods and services. It includes the indirect taxes which raise the prices and subsidies which lower the price.

Factor cost refers to cost of all factors of production used or consumed in producing goods and services. It includes rent for land, interest for capital, wages for labor and profit for entrepreneurship. It is the actual production cost at which the goods and services are produced by the firm. Thus, indirect taxes are excluded and subsidies by the government are included while calculating Factor Cost.

In other words, Factor Cost (FC) = Market Price – Net Indirect Taxes

Where, Net Indirect Taxes (NIT) = Indirect Taxes – Subsidies

Therefore, **Factor Cost = Market Price - Indirect Taxes + Subsidies**

Using this concept, the GDP at factor cost can be calculated by subtracting Net Indirect Tax from GDP at Market Price.

Or, GDP at Factor Cost = GDP at Market Price – Net Indirect Tax

Or, GDP at Factor Cost = GDP at Market Price – Indirect Tax + Subsidies

Similarly, GNP at Factor Cost = GNP at Market Price – Net Indirect Tax

NDP at Factor Cost = NDP at Market Price – Net Indirect Tax

NNP at Factor Cost = NNP at Market Price – Net Indirect Tax

2.8. National Income (NI)

The National income is a measure of the sum of all factor incomes earned by the citizens of a country for their land, labor, capital, and entrepreneurial talent, whether within the country or abroad. It is equal to the **Net National Product (NNP) at Factor Cost**. It is obtained, as explained above, by deducting Net Indirect Tax from NNP at Market Price.

National Income at Factor Cost = NNP at Market Price – Indirect Taxes + Subsidies

The reasons for choosing NNP at factor cost as National Income are:

- NNP shows the income earned by all citizens of country. This makes sense, since the earnings of foreigners should not be included in the India's national income. Thus NNP is preferred over NDP.
- Factor Cost is used because Net Indirect Taxes like sales taxes, excise taxes are not the payments for factors of production.
- There is lack of uniformity in taxes among the countries.
- The goods are not printed with their prices in developing countries like India.

2.9. Transfer Payments

Transfer payments refer to payments made by the government to individuals for which there is no economic activity produced in return by these individuals. A few examples of transfer payments include old age pensions, scholarships etc.

2.10. Personal Income (PI)

Personal income includes all income which is received by all the individuals in a year. It also includes transfer payments such as LPG subsidy. The welfare payments are received by households, but they are not elements of national income because they are transfer payments.

Similarly, in national income accounting, some income is attributed to individuals, which they do not actually receive such as undistributed profits, employee's contribution for social security, corporate income taxes etc. These are part of national income but are not received by individuals. Therefore, they are to be deducted from national income to estimate the personal income. Thus Personal income is:

PI = NI + transfer payments — Corporate retained earnings, income taxes, social security taxes.

2.11. Disposable Personal Income (DPI)

Disposable personal income refers to the amount, which in actual is at the disposal of individuals to spend as they like. It is the amount which is left with the individuals after paying personal taxes such as income tax, property tax, professional tax etc. Therefore, Disposable Personal Income = Personal Income—Personal Taxes.

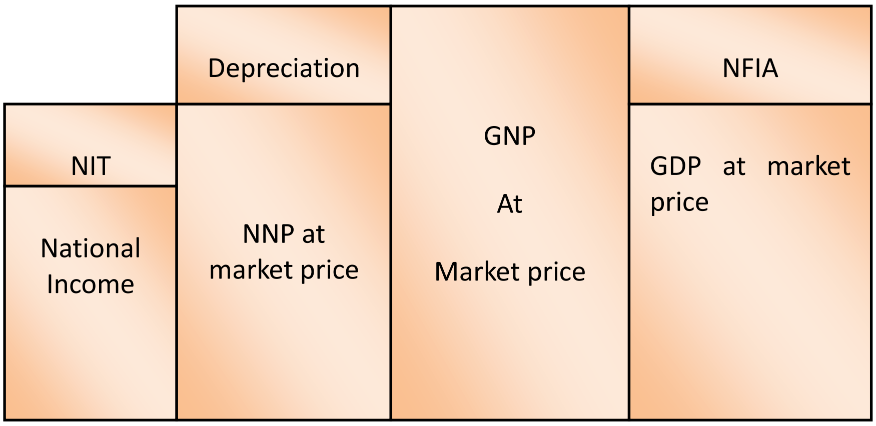
DPI = PI — Personal Taxes.

This concept is very useful for studying and understanding the consumption and saving behavior of the individuals. It is the amount, which households can spend and save.

Disposable Income = Consumption + Savings

The important equations we have discussed so far are given below:

- National Income = NNP at Factor Cost
- NNP at Factor Cost = NNP at Market Price – Net Indirect Tax
- NDP at Factor Cost = NDP at Market Price – Net Indirect Tax
- Net Indirect Taxes (NIT) = Indirect Taxes – Subsidies
- NNP = GNP – Depreciation
- NDP = GDP – Depreciation
- GNP = GDP + Net Factor Income from Abroad



3. Factors Affecting National Income

Several factors affect the national income of a country. Some of them have been listed below:

1. **Factors of Production:** Normally, the more efficient and richer the resources, higher will be the level of National Income or GNP.
2. **Land:** Resources like coal, iron and timber are essential for heavy industries so that they must be available and accessible. In other words, the geographical location of these natural resources affects the level of GNP.
3. **Capital:** Capital is generally determined by investment. Investment in turn depends on other factors like profitability, political stability etc.
4. **Labour and Entrepreneur:** The quality or productivity of human resources is more important than quantity. Manpower planning and education affect the productivity and production capacity of an economy.
5. **Technology:** This factor is more important for nations with fewer natural resources. The development in technology is affected by the level of invention and innovation in production.
6. **Government:** Government can help to provide a favorable business environment for investment. It provides law and order, regulations.
7. **Political Stability:** A stable economy and political system helps in appropriate allocation of resources. Wars, strikes and social unrests will discourage investment and business activities.

4. Comparing National Income Across Countries

To compare GDP between two countries having different currencies in use, GDP figures must first be converted into a common currency. The conversion of currency can be done using exchange rates. These exchange rates express the national currency's quotation in respect to foreign ones. For example, if exchange rate of dollar is 60 Rupees then the Indian GDP of 120 trillion Rupees would be worth 2 trillion Dollars.

4.1. Types of Exchange Rates

Economists distinguish between two exchange rates: nominal exchange rate and real exchange rate. Let's discuss each in turn and see how they are related.

Nominal Exchange Rate is the relative price of the **currencies** of two countries. For example, if the exchange rate between the U.S. dollar and the Indian Rupee is Rs. 60 per dollar, then you can exchange one dollar for 60 Rupees in world markets for foreign currency. When people refer to "the exchange rate'' between two countries, they usually mean the nominal exchange rate.

Nominal exchange rates are established on currency financial markets called "**forex markets**", which are similar to stock exchange markets.

Real Exchange Rate is the relative price of the **goods** of two countries. That is, the real exchange rate tells us the rate at which we can trade the goods of one country for the goods of another. The real exchange rate is sometimes called the terms of trade.

Till now we have discussed the bilateral exchange rates which facilitate conversion of one's currency into other. There is a concept of Effective Exchange Rate which describes the relative strength of a currency relative to basket of other currencies.

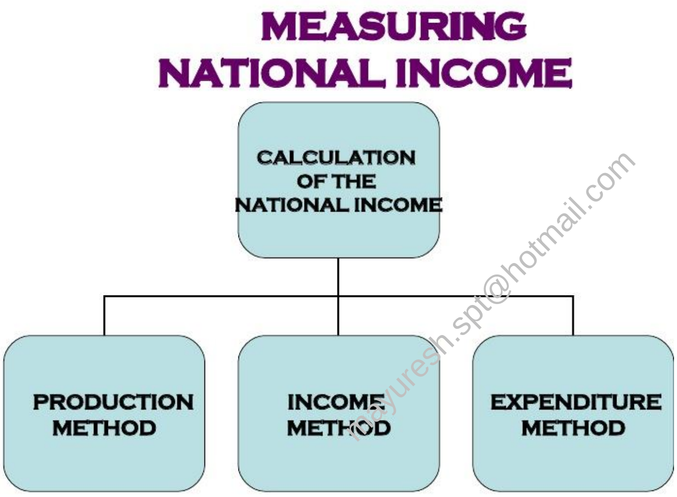
Thus, the **Nominal Effective Exchange Rate** (NEER) is the weighted average value of nominal exchange rate of the rupee against the currencies of major trading partners of India. On the other hand, the **Real Effective Exchange Rate** (REER) is the weighted average of Real Exchange Rates of Rupee against the currencies of major trading partners of India.

The weights are determined by the importance that a home country places on all other currencies traded within the pool, as measured by the balance of trade. Unlike NER and RER, NEER and REER are not determined for each foreign currency separately. Rather, each is a single number that expresses what is happening to the value of the domestic currency against a whole basket of currencies. It gives some reference or benchmark about how the currency is performing in relation to the rest of the world as a whole, rather than just individual countries.

Even though Indian GDP calculated in rupees can be converted to dollars using market determined exchange rate but such an exercise has its own limitations. Such a market determined exchange rate only takes into account exports and imports and neglects non-traded GDP, which produced and consumed domestically. In such a situation, the concept of **Purchasing Power Parity (PPP)** is used.

The Purchasing Power Parity tells us how much of a basket of internationally traded goods and services can be bought with Indian rupee in India vis-à-vis how much of the same basket can be bought in the US with the help of a dollar. Therefore, whereas the market determined exchange rate might be Rs 60 for a US dollar, the PPP exchange rate may show this parity at Rs 30 for a US dollar. This ultimately results in a greater GDP at PPP rates when compared to GDP at market rates for India.

5. Measurement of National Income



In India, GDP is estimated by Central Statistical Office (CSO). There are three different ways of estimating the national income of a country, these three methods are:

1. Value Added Method (or the Product Method)
2. Income Method
3. Expenditure Method

Which method is to be employed depends on the availability of data and purpose.

5.1. Value Added Method

Under the value added or production method, the GDP is calculated at market prices, which is the total value of outputs produced at different stages of production. It needs to be mentioned that caution should be taken to take Final Goods and not Intermediate Goods, as it will result in Double Counting.

Some of the goods and services **included** in production are:

- Goods and services sold in the market.
- Goods and services not sold but supplied free of cost.
- Services provided by the agents.

For example, in a Cycle Manufacturing Unit, computing the total value of cycles produced in a year, the final value of the cycle (Multiplied by total no of units produced) which is ready to be marketed for sale will be taken, not the cost of intermediate goods which are used in the process of manufacture, as it will result in double counting. Suppose the market price of a cycle is Rs. 2000 which includes, say, profit margin of Rs. 200 besides the cost of manufacturing of Rs. 1800. This 1800 includes all costs including components and parts etc. (these are intermediate goods which are used in the process of production.) If the costs of parts etc. are also taken while computing final value of total units produced, it will give inflated figure and hence result in double counting error. Similarly, at macro level, while computing the national Income under Value Added Method the value of final goods and services should be taken up to avoid the double counting error as the cost of Intermediate Goods are already counted in the final value of the product.

Some of the goods and services **not included** in production are:

- Second hand items and purchase and sale of the same. Sale and purchase of used cars, for example, are not a part of GDP calculation as no new production takes place in the economy.
- Production due to illegal activities.
- Non-economic goods such as air and water.
- Transfer Payments such as scholarships, pensions etc. are excluded as there is income received, but no good or service is produced in return.
- Imputed rental for owner-occupied housing is also excluded.

5.2. Income Method

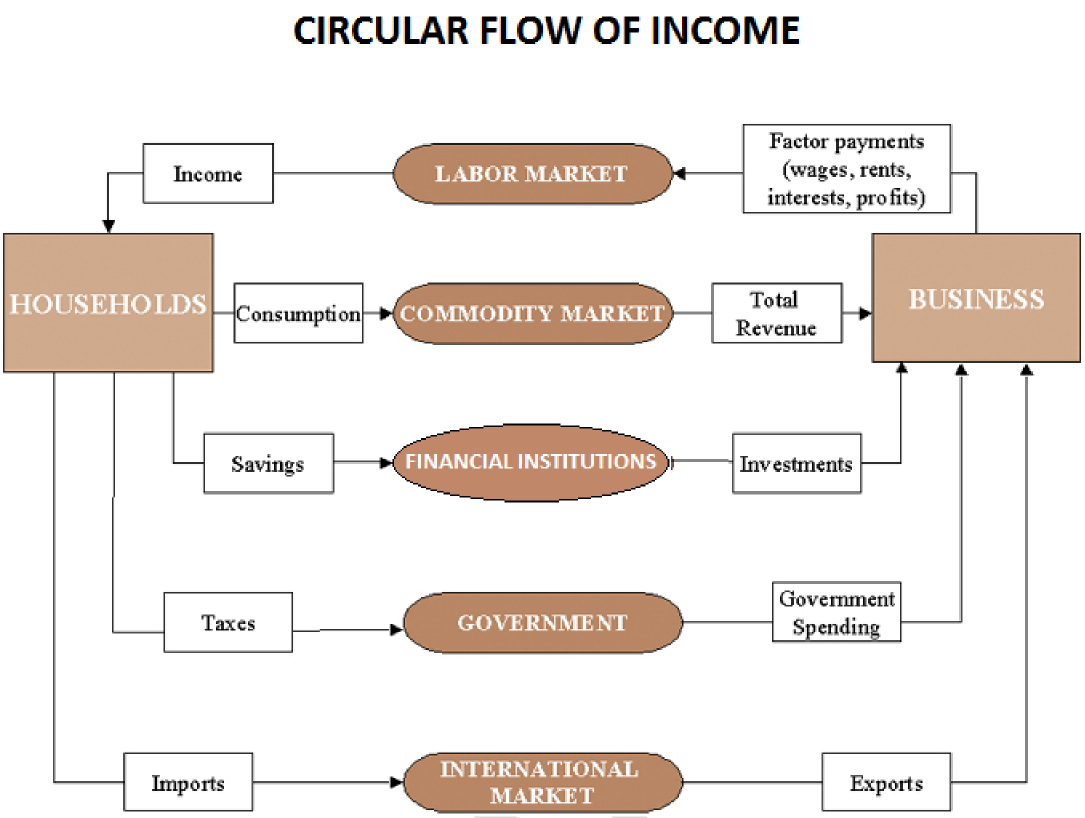
This approach focuses on aggregating the payments made by firms to households, called factor payments. This gives the National Income, defined as total income earned by citizens and businesses of a country.

There are four types of factors of production and four types of factor incomes accordingly i.e. Land, Labour, Capital and Organization as Factors of Production and Rent, Wages, Interest and Profit as Factor Incomes correspondingly.

We need to add indirect taxes, less subsidies and add depreciation to get GDP.

GDP = Wages+ Interest + Rent +Profit + Dividend + Indirect Taxes-Subsidies+ Depreciation

The term Profit can be further sub-divided into: profit tax; dividend to all those shareholders; and retained profit (or retained earnings).



Such an approach is adopted in India to calculate the contribution of services sector to the economy.

Any income corresponding to which there is no flow of goods and services or value added, it should not be included in calculation by Income method.

5.3. Expenditure Method

The expenditure method measures the final expenditure on GDP. Amount of Expenditure refers to all spending on currently-produced final goods and services only in an economy. In an economy, there are three main agencies, which buy goods and services. These are: Households, Firms and the Government

This final expenditure is made up of the sum of 4 expenditure items, namely:

a) **Consumption (C):** Personal Consumption made by households, the payment of which is paid by households directly to the firms which produced the goods and services desired by the households.
b) **Investment Expenditure (I):** Investment is an addition to capital stock of an economy in a given time period. This includes investments by firms as well as governments sectors.
c) **Government Expenditure (G)**: This category includes the value of goods and service purchased by Government. Government expenditure on pension schemes, scholarships, unemployment allowances etc. **are not included** in this as all of them come under **transfer payments.**
d) **Net Exports (X-IM):** Expenditure on foreign made products (Imports) are expenditure that escapes the system, and must be subtracted from total expenditures. In turn, goods produced by domestic firms which are demanded by foreign economies involve expenditure by other economies on our production (Exports), and are included in total expenditure. The combination of the two gives us Net Exports.

GDP= C+I+G+X-IM

5.4. Application of Various Methods

Each approach gives a different perspective on the economy. However, the fundamental principle underlying national income accounting is that, all three approaches give identical measurements of the amount of current economic activity.

We can illustrate why these three approaches are equivalent with the help of an example.

Imagine an economy with only two businesses, called Khanna Fruits and Sharma Juices. Khanna Fruits owns and operates orange groves. It sells some of its oranges directly to the public. Rest of these oranges are sold to Sharma Juices which is involved in the production and sale of orange juice. The following table shows the transactions of each business during a year.

Khanna Fruits	
Wages paid to Khanna Fruits employees	Rs. 15,000
Taxes paid to government	5,000
Revenue received from sale of oranges	35,000
Oranges sold to public	10,000
Oranges sold to Sharma Juices	25,000
Sharma Juices	
Wages paid to Sharma Juices employees	Rs. 10,000
Taxes paid to government	2,000
Oranges purchased from Khanna Fruits	25,000
Revenue received from sale of orange juice	40,000

Product Method

Khanna Fruits produces output worth Rs. 35,000 and Sharma Juices produces output worth Rs. 40, 000. However, measuring overall economic activity by simply adding Rs. 35,000 and Rs. 40,000 would "double count" the Rs. 25,000 of oranges that Sharma Juices purchased from Khanna Fruits and processed into juice. To avoid this double counting, we sum value added rather than output: Because Sharma Juices processed oranges worth Rs. 25,000 into a product worth Rs. 40,000, Sharma Juices value added is Rs. 15,000 (40,000 – 25,000). Khanna Fruits doesn't use any inputs purchased from other businesses, so its value added equals its revenue of Rs. 35,000. Thus total value added in the economy is Rs. 35,000 + Rs. 15,000 = Rs. 50,000

Income Approach

As seen before, the (before-tax) profits of Khanna Fruits equal its revenues of 35,000 minus its wage costs of Rs. 15,000. The profits of Sharma Juices equal its revenues of Rs. 40,000 minus the Rs. 25,000 the company paid to buy oranges and the Rs. 10,000 in wages to its employees. Adding the Rs. 20,000 profit of Khanna Fruits, the Rs. 5,000 profit of Sharma Juices, and the Rs. 25,000 in wage income received by the employees of the two companies, we get a total of Rs. 50,000, the same amount determined by the product approach.

Expenditure Approach

In this example, households are ultimate users of oranges. Sharma Juices is not an ultimate user of oranges because it sells the oranges (in processed, liquid form) to households. Thus ultimate users purchase Rs. 10,000 of oranges from Khanna Fruits and Rs. 40,000 of orange juice from Sharma Juices for a total of Rs. 50,000, the same amount computed in both the product and income approaches.

Output or Value added method is primarily used in the registered manufacturing units and primary sector in India. Income method is used in services sector. Whereas, the expenditure method is adopted to calculate the contribution of Real Estate Sector.

The product method is the principal method used in underdeveloped economies, whereas income method is generally used in developed economics for the estimation of national income.

5.5. Base Year, GDP Deflator

GDP Deflator: It is a tool to measure the inflation comprehensively. It represents the ratio of GDP at current prices to GDP at constant prices. GDP deflator is published on a quarterly basis since 1996 with a lag of two months. It is because of this very reason that economists prefer the use of WPI or CPI for deflating nominal price estimates to derive real price estimates.

Essentially **GDP deflator = (Nominal GDP/Real GDP) * 100**.

Unlike the WPI and the CPI, GDP deflator is not based on a fixed basket of goods and services, it covers the whole economy. One of the other advantages of GDP deflator is that changes in consumption patterns or the introduction of new goods and services are automatically reflected in the deflator, such a feature is missing in WPI/CPI.

Base Year: To make the calculation of GNP/GDP easier, economists use a price index to find the real GNP/GDP. A Price index is a number showing the changes in the overall level of prices. It shows a change in the general price level of an economy. Base year is the year used as the beginning or the reference year for constructing an index, and which is usually assigned an arbitrary value of 100.

The Indian Government has changed the base year for calculating national accounts to 2011-12 from 2004-05. The basis for selection of the base year are:

- **Stability** of macroeconomic parameters. It has to be a normal year without large fluctuations in production, trade and prices of goods and services.
- **Data availability**: Data available for the year should be reliable.
- **Comparability**- so that same parameters should be in use in both the years. Therefore, it should be a recent year and not go long back into history.

5.6. Difficulty of Measurement (With Special Reference to India)

Economists face a number of problems while calculating the National Income some of them are:

a) **Non-Monetization of transactions**: When National Income is calculated it is generally assumed that any products or services would be exchanged for money. But in India especially in rural areas, a large number of economic transactions occur in the form of barter. Such activities are difficult to account for in the GDP estimates therefore resulting in lower levels of GDP than actual.

b) **Unreported Illegal Income**: A major part of Indian Economy operates as hidden or parallel economy and the income generated in this goes unreported. As per a study, black economy accounts for about 40% of total income generated in the country. This poses a great problem to calculate accurate GDP estimates.

c) **Non-availability of data about households, small producers etc.:** A large number of producers carry out production at a family level or run household enterprises. Data about these enterprises is very difficult to find. NIA does not include care economy such domestic work and housekeeping. Even the valuable work done by housewives in India is not accounted as a part of GDP estimates.

d) **Absence of data on growing service sector:** In India, service sector has witnessed an exponential growth rate. However, value addition in several parts of service sector industry are not based on accurate reporting and hence underestimated in national income measures.

6. Recent Developments in GDP Measurement

- The growth rate will now be measured by **GDP at constant market prices**, which will henceforth be referred to as 'GDP'. This is the international practice. Earlier, growth was measured in terms of growth rate in GDP at factor cost at constant prices.
- The sector-wise estimates of gross value added (GVA) will now be given at **basic prices** instead of factor cost.
- Use of **MCA21 database** which is the annual accounts of companies filed with Ministry of Corporate Affairs. It will expand the coverage of corporate sector both in manufacturing and services. Also, the database for manufacturing companies will help account for activities other than manufacturing undertaken by these companies
- Comprehensive coverage of the financial sector by inclusion of information from the accounts of stock brokers, stock exchanges, asset management companies, mutual funds and pension funds, and the regulatory bodies – SEBI, PFRDA and IRDA.
- Improved coverage of activities of local bodies and autonomous institutions, covering around 60 per cent of the grants/transfers provided to these institutions.

6.1. Gross Value Added

Gross value added (GVA) is defined as the value of output less the value of intermediate consumption. Value added represents the contribution of labour and capital to the production process. The **GVA at basic prices** will include production taxes and exclude production subsidies available on the commodity.

On the other hand, **GVA at factor cost** includes no taxes and excludes no subsidies and **GDP at market prices** include both production and product taxes and excludes both production and product subsidies. When the value of taxes on products (less subsidies on products) is added, the sum of value added for all resident units gives the value of gross domestic product (GDP).

The above concept is summarized in the following equations:

GVA at basic prices = CE + OS/MI + CFC + production taxes less production subsidies

GVA at factor cost = GVA at basic prices - production taxes less production subsidies

GDP = ∑ GVA at basic prices + product taxes - product subsidies

The terms used in above equations are discussed below.

- **CE**: compensation of employees. It refers to the total gross (pre-tax) wages paid by employers to employees for work done
- **OS**: operating surplus. It represents the excess amount of money generated by enterprise after paying labour input costs. It is the capital available to repay their creditors, to pay taxes and eventually to finance all or part of their investment.
- **MI**: mixed income. This is similar to the concept of operating surplus but applied to unincorporated enterprises such as small family businesses like farms and retail shops or self-employed taxi drivers
- **CFC**: consumption of fixed capital. It represents the amount of fixed assets used up, during the period under consideration. This concept is different from depreciation as unlike depreciation, it is not measured at 'historic cost' (original price), but at current market value.

- **Production taxes or subsidies**: These are paid or received with relation to production and are independent of the volume of actual production. Some examples of production taxes are land revenues, stamps and tax on profession. Some production subsidies are subsidies to Railways, input subsidies to farmers.
- **Product taxes or subsidies**: They are paid or received on per unit of product. Some examples of product taxes are excise tax, sales tax, service tax and import and export duties. Product subsidies include food, petroleum and fertilizer subsidies.

7. Debates Around GDP and Other Indices

7.1. Economic Growth versus Development

Traditionally, economic growth is treated as a measure of improvement in quality of lives of the citizens of a country. Economic growth per se is calculated in the form of growth in GDP year over year. However, the achievement of high growth – even high levels of sustainable growth – must ultimately be judged in terms of the impact of that economic growth on the lives and freedoms of the people. It must be noted that the economic growth in several countries has not transformed into better quality of lives for the people.

Let us take the example of India. India has witnessed rapid economic growth in last two decades. Over this period of rapid growth, while some people, particularly among the privileged classes, have done very well, many more continue to lead unnecessarily deprived and precarious lives. It is not that their living conditions have not improved at all, but the pace of improvement has been very slow for the bulk of the people, and for some there has been remarkably little change. While India has climbed rapidly up the ladder of economic growth rates, it has fallen relatively behind in the scale of social indicators of living standards, even compared with many countries India has been overtaking in terms of economic growth.

For example, over the last two decades India has expanded its lead over Bangladesh in terms of average income (it is now about twice as rich in income per capita as Bangladesh), and yet in terms of many typical indicators of living standards (other than income per head), Bangladesh not only does better than India, it has a considerable lead over it (just as India had, two decades ago, a substantial lead over Bangladesh in the same indicators).

Another typical example is that of the Gulf Countries, which have witnessed rapid economic growth but they have done rather poorly on development indicators.

Therefore, several economists today define economic development differently from what the world meant by economic growth. For economists, development indicates the quality of life in the economy which might be seen in accordance with the availability of so many variables such as:

- The level of nutrition.
- The expansion and the reach of healthcare facilities—hospitals, medicines, safe drinking water, vaccination, sanitation, etc.
- Education levels

From the above discussion it is clear that today, economists believe that higher economic growth may not necessarily transform into higher economic development. But at the same time economic growth and development go hand in hand and one cannot survive without the other.

When we use the term growth we mean numerical increase in some parameters and when we use the term development we mean numerical as well as qualitative progress. If economic growth is properly used for development, it results in accelerating the growth and ultimately in greater population coming under the arena of development. Similarly, high growth with low development and ill-cared development finally results into fall in growth. Thus, there is a circular relationship between growth and development.

7.2. Other Arguments Against GDP as a Parameter to Judge Progress

- **Gender disparities not indicated:** For this a GII or Gender Inequality Index has been devised in recent years.
- **Does not measure sustainability of growth**: Growth in a country may be also at the cost of hefty exploitation of natural resources.
- **Condition of poor is not indicated:** As an example, even though Indian economy grew at a rate of over 7-8% in last decade the food inflation was at the highest levels adversely affecting the poorest strata of the society.
- **Economic inequality not revealed by GDP**: GDP does not reveal the economic inequality, which is created as a side effect of economic growth. Inequality in earnings has doubled in India over the last two decades which were incidentally the years of highest GDP growth also.
- **Other intangibles not measured**: Does not value intangibles like leisure, quality of life etc. since quality of life is measured by many other intangibles except the materialistic things provided by economic growth.

For the reasons mentioned above, several economists have tried to create replacements for GDP which try to address the above criticisms regarding GDP. Some of these indices include HDI, HPI (human poverty Index), GNH (Gross National Happiness Index), Green GDP etc.

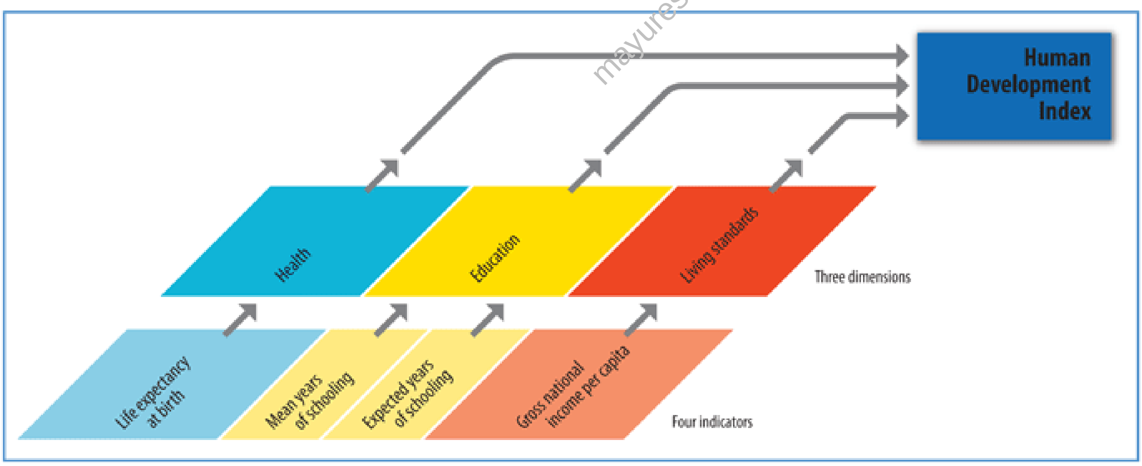
7.3. Other Indices to Measure Development

7.3.1. HDI or Human Development Index

United Nations Development Programme (UNDP) published its first Human Development Report (HDR) in 1990. The report had a human development index (HDI) which was the first attempt to define and measure the levels of development. The index focuses on longevity, knowledge and decent living standards.

Components of the Human Development Index

The HDI—three dimensions and four indicators



- **Standard of living**: to be indicated by the real per capita income adjusted for the differing purchasing power parity (PPP).
- **Knowledge:** to be measured by indicators related to the level of education:
  - educational attainment among the adults (given 2/3rd weightage).

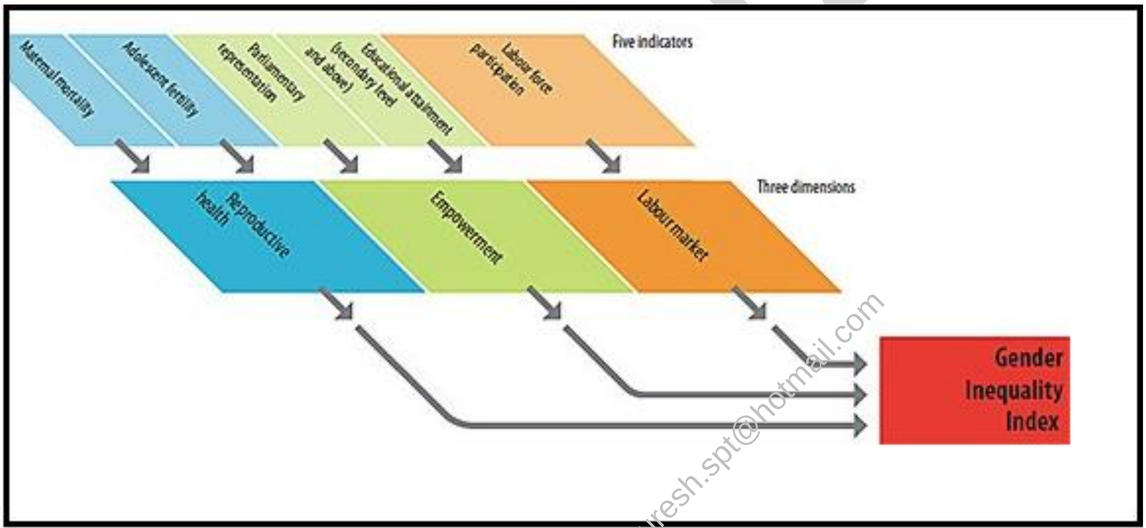
- school enrollment (given 1/3rd weightage).
- **Longevity:** Life expectancy to be calculated at the time of birth.

The HDI is the geometric mean of normalized indices for each of the above three dimensions. Initially reported for 14 countries, the UN's 2016 report presented HDI results for 188 countries. India ranked 131th in 2016 Human Development Report with HDI score of 0.624 in the medium human development category. India's current score is up from 0.428 in 1990, i.e. an increase of 46% between 1990 and 2016.

7.3.2. Gender Inequality Index (GII)

The GII is an inequality index. It shows the loss in potential human development due to disparity between female and male achievements in two dimensions, empowerment and economic status, and reflects a country's position relative to normative ideals for the key dimension of women's health. Overall, the GII reflects how women are disadvantaged in these dimensions.

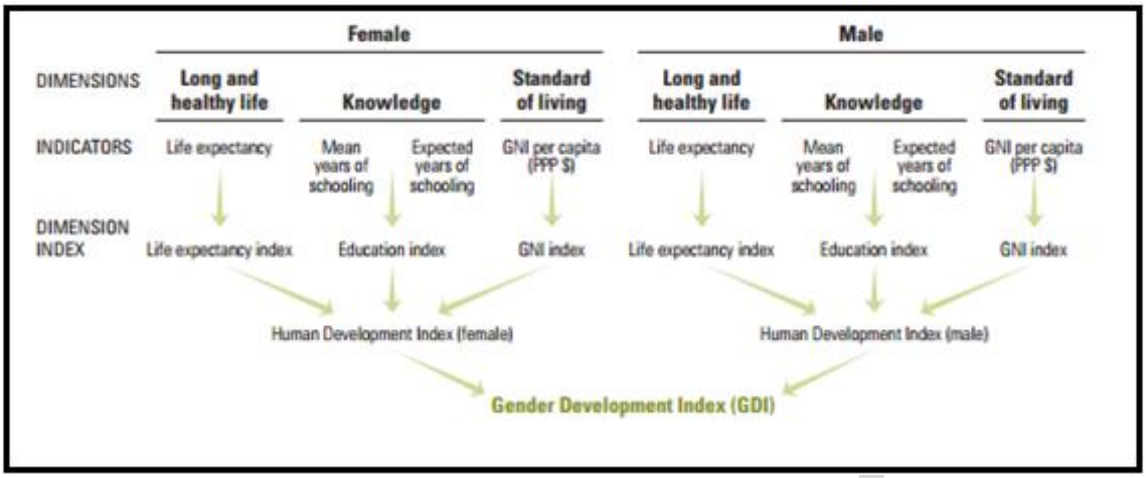
There is no country with perfect gender equality – hence all countries suffer some loss in achievements in key aspects of human development when gender inequality is taken into account. The GII ranges between 0 and 1 and higher GII values indicate higher levels of inequalities.



7.3.3. Gender Development Index (GDI)

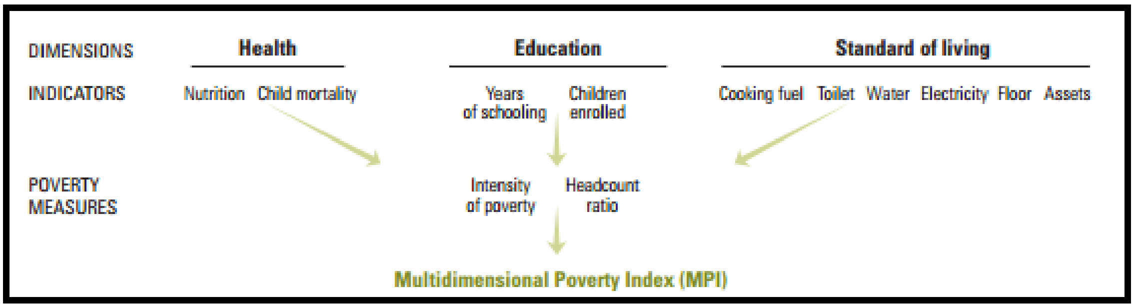
The GDI measures differences between male and female achievements in three basic dimensions of human development:

- **Health**, measured by female and male life expectancy at birth;
- **Education**, measured by female and male expected years of schooling for children and female and male mean years of schooling for adults ages 25 and older; and
- **Equitable command over economic resources**, measured by female and male estimated earned income.



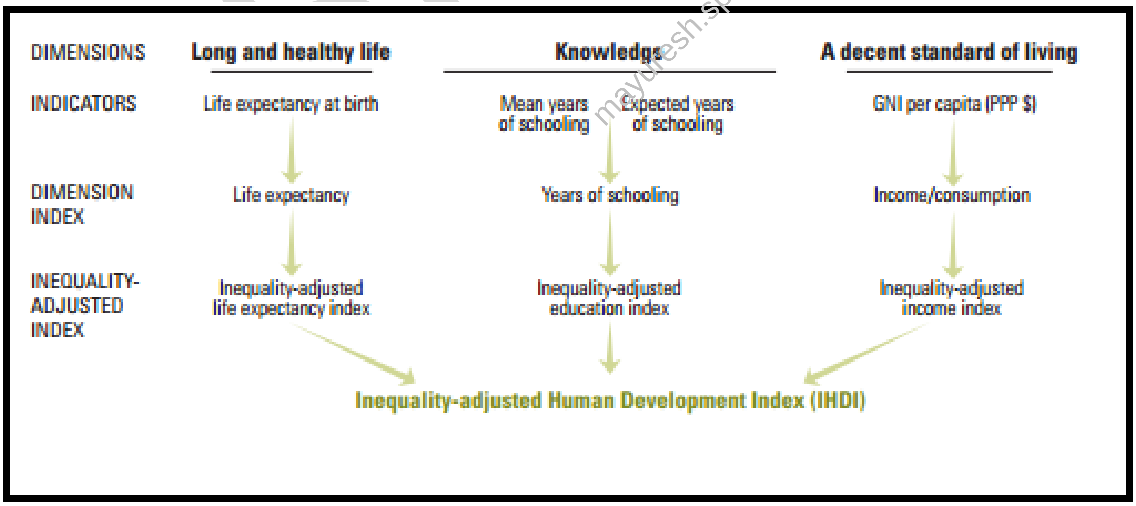
7.3.4. Multidimensional Poverty Index (MPI)

The Multidimensional Poverty Index (MPI) identifies multiple deprivations at the household and individual level in health, education and standard of living. The MPI offers a valuable complement to income-based poverty measures.



7.3.5. Inequality-Adjusted Human Development Index (IHDI)

The IHDI takes into account not only the average achievements of a country on health, education and income, but also how those achievements are distributed among its population.



7.3.6. Green GDP

Green GDP is an index of economic growth with the environmental consequences of that growth factored in. From the final value of goods and services produced, the cost of ecological degradation is deducted to arrive at Green GDP.

Green GDP calculations have been developed for countries as diverse as Australia, Canada, China, Costa Rica, Indonesia, Mexico, Papua New Guinea, and the US, although none of these efforts have resulted in regular reporting of the results.

In 2009, the Government of India had announced its intention to unveil “green GDP” figures that account for the environmental costs of depletion and degradation of natural resources into the country’s economic growth figures. Subsequently, the Ministry of Statistics and Programme Implementation set up an expert group in 2011 led by Partha Dasgupta to work out a framework for green national accounts in India. However, the process is yet to be completed.

7.3.7. Gross National Happiness

With many of the world's countries about as unhappy as they can get because of their dwindling GDP figures, the tiny nation of Bhutan has gone in the opposite direction. Officials in Bhutan came up with a different indicator, called gross national happiness (GNH). The country's beloved former king, Jigme Singye Wangchuck, envisaged the concept of gross national happiness since 1972, and the country adopted it as a formal economic indicator in 2008. Beginning in November 2008, all the economic factors started measuring gross domestic product analyzed for their impact on Bhutan's residents' happiness. The factors of production are still there such as unemployment, agriculture, retail sales but GNH represents a paradigm shift in what's most valued by Bhutanese society compared to the rest of the world. In short, happiness matters, not money. Following parameters are used in the GNH:

- Higher real per capita income.
- Good Governance.
- Environmental Protection.
- Cultural Promotion

7.3.8. Human Poverty Index or HPI

HPI is an index, which focuses solely on amount of poverty in a country. This index has been developed by United Nations. For HPI, deprivations in longevity are measured by the probability at birth of not surviving to age 40; deprivations in knowledge are measured by the percentage of adults who are illiterate; deprivations in a decent standard of living are measured by two variables: the percentage of people not having sustainable access to an improved water source and the percentage of children below the age of five who are underweight.

HPI focuses attention on the most deprived people and deprivations in basic human capabilities in a country, not on average national achievement. The human poverty indices focus directly on the number of people living in deprivation presenting a very different picture from average national achievement. It also moves the focus of poverty debates away from concern about income poverty alone.

7.3.9. Genuine Progress Indicator

While GDP is a measure of current income, GPI is designed to measure the sustainability of that income. GPI uses the same personal consumption data as GDP but make deductions to account for income inequality and costs of crime, environmental degradation, and loss of leisure and additions to account for the services from consumer durables and public infrastructure as well as the benefits of volunteering and housework. By differentiating between economic activity that diminishes both natural and social capital and activity that enhances such capital, the GPI and its variants are designed to measure sustainable economic welfare rather than economic activity alone. Proponents of the GPI see it as a better measure of the sustainability of an economy when compared to the GDP measure. Since 1995 the GPI indicator has grown in stature and is used in Canada and the United States.

8. Vision IAS GS Mains Test Series Questions

1. "A new way of measuring GDP created the world's fastest-growing major economy overnight". In the context of India analyse the benefits and concerns raised by the new methodology adopted to calculate GDP figures by the Central Statistical Organisation.

Approach:

The question requires and understanding of how GDP is calculated and what the new changes amount to. Answer should be structured as follows:

- As introduction briefly enumerate the salient features of changes made.
- Discuss the key benefits as argued by the government sources and Media debates
- Concerns should be linked to the extent to which the new data reflects reality, include concerns raised by the RBI and other economic observers

Answer:

GDP is the total value of goods and services produced within the country during a year. The calculation so far was based on factor or basic cost, the new method:

- Takes into account market prices paid by consumers.
- Introduces the concept of Gross Value Added (GVA) at the aggregate and various sectoral levels.
- Changes base year 2004-05 to 2011-12.

According to the arguments put forward these changes would have the following benefits:

- It is in line with international practice which involves calculation at market costs.
- The move is expected to better capture the changing structure of the Indian economy. e.g. New GDP series will be based on data from MCA21, bringing in more companies from the unlisted and informal sectors as compared to the Annual Survey of Industries used till now.
- The base year change ensures that the products and services included in the GDP calculation do remain contemporary and reflect the present state of the economy e.g. the latest change in base year has included the recycling industry which didn't figure in the earlier GDP computations.
- Global investors use growth prospect numbers to allocate their investment allocations between countries - GDP is a key metric here. So news that India's GDP growth has averaged 6 per cent for the last three years and not 4.6 per cent as thought earlier, may help investors view India in a more favourable light.

The revised methodology, however, poses several concerns as well:

- The revision has bumped up India's growth numbers sharply and put them at odds with other leading indicators of industrial activity, such as the Index of Industrial Production (IIP), which still shows weakness.
- While the new GDP shows 5.3 per cent growth in manufacturing in 2013-14, the actual performance of NSE-listed companies in the manufacturing space shows that earnings have been declining in the last two years (by 4 per cent in 2013-14).

Overall the changes put the Indian economy in a better light than was thought previously. The concerns on the other hand relate to the disparity in other figures that do not corroborate the positive story brought about by new changes. The need is to disseminate information in a better way and bring the major indicators in tune with each other.

9. Previous Years UPSC GS Mains Questions

1. Distinguish between Gross Domestic Product (GDP) and Gross National Product (GNP). (92/II/8a(A)/3)
2. Explain per capita income as a measure of economic growth. (98/II/8b(A)/3)
3. What is meant by 'Quality of life'? (98/II/8c(A)/3)
4. What is the difference between gross National Product and New National Product? (98/II/8f(A)/3)
5. Explain per capita income as a measurement of economic growth. (00/II/6c/2)
6. What is green GNP? (01/II/6c/2)
7. What is Green GDP? (05/II/6m/2)

MONEY AND BANKING

Contents

1. Money

1.1. Money or Credit Creation Process

The process of *money creation* is a crucial concept for understanding the role that money plays in an economy. Its potency depends on the amount of money that banks keep in reserve to meet the withdrawals of its customers. This practice of lending customers' money to others on the assumption that not all customers will want all of their money back at any one time is known as *fractional reserve banking*.

We can illustrate how it works through a simple example. Suppose that the bankers in an economy come to the view that they need to retain only 10 percent of any money deposited with them. This is known as the *reserve requirement*. Now consider what happens when a customer deposits Rs. 100 in Bank X. This deposit changes the balance sheet of Bank X and it represents a liability to the bank because it is effectively loaned to the bank by the customer. By lending 90 percent of this deposit to another customer the bank has two types of assets: (1) the bank's reserves of Rs. 10, and (2) the loan equivalent to Rs. 90.

Now suppose that the recipient of the loan of Rs. 90 uses this money to purchase some goods of this value and the seller of the goods deposits this Rs. 90 in another bank, Bank Y. Bank Y goes through the same process; it retains Rs. 9 in reserve and loans 90 percent of the deposit (Rs. 81) to another customer. This customer in turn spends Rs. 81 on some goods or services. The recipient of this money deposits it at the Bank Z, and so on.

This process continues until there is no more money left to be deposited and loaned out. The total amount of money 'created' from this one deposit of Rs. 100 can be calculated as:

New deposit/Reserve requirement = Rs. 100/0.10 = Rs. 1,000

It is the sum of all the deposits now in the banking system. Also note that the original deposit of Rs. 100, via the practice of reserve banking, was the catalyst for Rs. 1,000 worth of economic transactions. That is not to say that economic growth would be zero without this process, but instead that it can be an important component in economic activity.

The amount of money that the banking system creates through the practice of fractional reserve banking is a function of 1 divided by the reserve requirement, a quantity known as the *money multiplier*. In the case just examined, the money multiplier is 1/0.10 = 10.

In our simplistic example, we assumed that the banks themselves set their own reserve requirements. However, in some economies, the central bank sets the reserve requirement, which is a potential means of affecting money growth. In any case, a prudent bank would be wise to have sufficient reserves such that the withdrawal demands of their depositors can be met in stressful economic and credit market conditions.

1.2. Definition of Money

The process of money creation raises a fundamental issue: What is money? In an economy with money but without promissory notes and fractional reserve banking, money is relatively easy to define: Money is the total amount of gold and silver coins in circulation, or their equivalent. The money creation process above, however, indicates that a broader definition of money might encompass all the notes and coins in circulation *plus* all bank deposits.

More generally, we might define money as any medium that can be used to purchase goods and services. Notes and coins can be used to fulfill this purpose, and yet such currency is not the only means of purchasing goods and services. Personal cheques can be written based on a bank chequing account, while debit cards can be used for the same purpose. But what about time deposits or savings accounts? Nowadays transfers can be made relatively easily from a savings account to a current account; therefore, these savings accounts might also be considered as part of the stock of money. Credit cards are also used to pay for goods and services; however, there is an important difference between credit card payments and those made by cheques and debit cards. Unlike a cheque or debit card payment, a credit card payment involves a deferred payment. Basically, the greater the complexity of any financial system, the harder it is to define money.

Because financial systems, practice, and institutions vary from economy to economy, so do definitions of money; thus, it is difficult to make international comparisons. Still, most central banks produce both a narrow and broad measure of money, plus some intermediate ones too.

The most generic definition of money is that it is **any generally accepted medium of exchange**. A ***medium of exchange*** is any asset that can be used to purchase goods and services or to repay debts. Money can thus eliminate the debilitating double coincidence of the "wants" problem that exists in a barter economy.

However, for money to act as this liberating medium of exchange, it must possess certain qualities. It must:

- be readily acceptable
- have a known value
- be easily divisible
- have a high value relative to its weight; and
- be difficult to counterfeit.

1.3. Functions and Significance of Money

Medium of exchange: In almost all market transactions in our economy, money in the form of currency or cheques is a medium of exchange; it is used to pay for goods and services. The use of money as a medium of exchange promotes economic efficiency by minimizing the time spent in exchanging goods and services. It eliminates the problem of going and finding services provided by specialized people a practice prevalent in barter system. The time spent in trying to exchange goods or services is called a *transaction cost*. In a barter economy, transaction costs are high because people have to satisfy a "**double coincidence of wants**"—they have to find someone who has a good or service they want and who also wants the good or service they have to offer.

Unit of account: Another important role of money is to provide a unit of account; that is, it is used to measure value in the economy. We measure the value of goods and services in terms of money, just as we measure weight in terms of kilos or distance in terms of meters. In barter system this advantage is missing as one cannot calculate and compare the prices of two different entities available in the market.

Store of Value: Money also functions as a store of value; it is a repository of purchasing power over time. A store of value is used to save purchasing power from the time income is received until the time it is spent. This function of money is useful, because most of us do not want to spend our income immediately upon receiving it, but rather prefer to wait until we have the time or the desire to shop. Even though there exists a number of means to store value such as house, jewelry, stocks etc. yet money has the most liquidity and acceptability of them all.

Standard of Deferred Payments: Money facilitates not only the current transactions of goods and services but also their credit transactions. It facilitates credit transactions when present goods are exchanged against future payments. In the modern world, the bulk of deferred payments are stipulated in money terms only. Examples in this regard are repayment of loan along with interest, pensions, rents, salaries, insurance premium, etc. Money could be an effective standard of deferred payments only if value of money itself does not change. If prices increase or decrease sharply, resulting in large fluctuations in the value of money, it would make money a poor standard of deferred payments.

Distributor of National Income: Money helps in the distribution of national output among the people who have contributed in its production. In a modern society people co-operate together as workers, owners of capital, landlords, etc., to produce goods. The resultant output is, therefore, to be distributed among all of them in the form of wages and salaries, interest, rent, etc. In the absence of money it would not always be possible to distribute such an output, particularly in case of indivisible goods, e.g. a machine. With the help of money we can overcome such a problem.

1.4. Kinds of Money

In a modern economy, the quantity of money in existence consists of (1) Currency component and (2) Deposit money component

1.4.1. Currency Component

Currency component includes coins and paper currency.

Coins refer to all metallic money. The few things to note about coins are:

- Coins are **token money.** Token money is the money the face value of which is more than the intrinsic value.
- The right of minting coins is the monopoly of the government.
- They are useful for making transactions of small value.
- They constitute a very small component of modern money.

Currency notes refer to paper money. The few things to note about paper currency are:

- In India, virtually all paper money in circulation consists of notes issued by RBI.
- Currency notes have a very small intrinsic value of their own.
- It is inconvertible, i.e., there is no compulsion for central bank to exchange it for gold. After world war I, almost all countries abandoned gold convertibility.
- All notes carry the legend: 'I promise to pay the bearer the sum of ten rupees' (signed by the Governor of RBI).

Though the value of the paper and the metal itself is less than its net worth, yet people accept such notes and coins in exchange for goods, which are apparently more valuable than these. This is because the value of the currency notes and coins is derived from the guarantee provided by the issuing authority of these items. As every currency note bears on its face a promise from the Governor of RBI that if someone produces the note to RBI, or any other commercial bank, RBI will be responsible for giving the person purchasing power equal to the value printed on the note. The same is also true of coins. Currency notes and coins are therefore called **fiat money** as it is issued on the fiat (order) of the government. They are also called **legal tenders** as they cannot be refused by any citizen of the country for settlement of any kind of transaction.

However, recently the Government of India took the step to **demonetize** Rs. 500 and 1000 currency, which means that the legal tender of currency units was declared invalid from the specified date. Demonetization of currency means discontinuity of the said currency from circulation and replacing it with new currency.

1.4.2. Deposit Money Component

Deposit money or the bank money refers to the deposits held with the banks on the basis of which cheques could be drawn. Such deposits can be of two types:

- **Demand deposits** - They are payable by the bank on demand from the accountholder
- **Time deposits** - Other deposits, e.g. fixed deposits, have a fixed period to maturity and are referred to as time deposits.

However, a cheque is not a legal tender. A person can legally refuse to accept payment by cheques as there is no guarantee that a cheque will be honoured by the bank in case of insufficient deposits with it.

1.5. Money Supply in India

Money supply refers to total supply of money in active circulation in a given country's economy at a given time. It refers to the money held by 'public' which includes all economic units (private individuals, business firms and institutions). It does not include the producers of money (RBI, government, commercial banks) to avoid double counting.

Money supply is considered an important instrument for controlling inflation by some of the economists. Economists analyze the money supply and develop policies revolving around it through controlling interest rates and increasing or decreasing the amount of money flowing in the economy. Money supply data is collected, recorded and published periodically by the RBI.

1.5.1. Measures of Money Supply

There are several measures for the money supply, such as M_1, M_2, M_3 and M_4.

M_1

M_1 = Currency with public (coins, currency notes etc.) + net demand deposits held by the public with commercial banks

It includes all those financial assets which are generally accepted as means of payment. M_1 is also called as **narrow money** because we have defined money supply here in a narrow definition of money which emphasizes the medium of exchange function and therefore includes only those assets which are highly liquid. The word 'net' implies that only deposits of the public held by the banks are to be included in money supply. The interbank deposits, which a commercial bank holds in other commercial banks, are not to be regarded as part of money supply. The demand deposits on the other hand are the money deposited by the people in banks and other deposits with the RBI. People issue cheques against these deposits in the banks.

M_2

M_2 = M_1 + Post office saving deposits

Post office savings deposits are **far less liquid** than commercial bank savings. Savings deposits with post office can be withdrawn on demand, but have the following restrictions:

- Chequable portion of these deposits is very small.
- There are restrictions on number of withdrawals in any week.
- There is a maximum limit on the amount of any single withdrawal (unless **an** advance notice is given to the post office).

Consequently, post office savings deposits cannot serve as a medium of exchange and are less liquid than the savings deposits with the commercial bank. **Both M_1 and M_2 are known as narrow money**.

M_3

$M_3 = M_1$ + Net time deposits of public with the banks

Some economists believe that time deposits should be included in the money supply as they are an important form of store of value as in the case of fixed or timed deposits the depositors can borrow from the banks against them. Also, in some cases the depositors are allowed to withdraw their deposits after foregoing some interest and paying a penalty. It is also known as **broad money** as it included wider definition of money. The basic difference between M_1 and M_3 is the treatment of timed deposits with the banks. Narrow money excludes the timed deposits of the public with the banking system on the ground that they are incoming earning assets and not liquid in the real sense.

M_3 is the most commonly used measure of money supply. It is also known as **aggregate monetary resources**

M_4

$M_4 = M_3$ + Total Post office deposits (includes fixed deposits with the post offices but excludes National Savings Certificates)

M_3 and M_4 are both known as **broad money**.

Of all the components stated above, currency component is highly liquid followed by demand deposits (easily converted to money on demand). Saving deposits with post-office are next in the line of liquidity. Likewise, the degree of liquidity is less in case of time deposits because they can be converted into cash without loss of money only at the time of maturity. **These gradations are in decreasing order of liquidity**. M_1 is most liquid and easiest for transactions whereas M_4 is least liquid of all.

1.5.2. High Powered Money

The total liability of the monetary authority of the country, RBI, is called the monetary base or high powered money. It consists of currency (notes and coins in circulation with the public and vault cash of commercial banks) and deposits held by the Government of India and commercial banks with RBI. If a member of the public produces a currency note to RBI the latter must pay her value equal to the figure printed on the note. Similarly, the deposits are also refundable by RBI on demand from deposit-holders. These items are claims which the general public, government or banks have on RBI and hence are considered to be the liability of RBI.

1.6. Factors affecting Money Supply in India

Money supply with the public is influenced mainly by the central bank of country and its commercial banks, which in turn changes the preference of the public for holding cash balances vis-a-vis deposits in the banks. These influences on money supply can be summarized by the following key ratios:

The currency deposit ratio: The ratio of money held by the public in currency to that they hold in bank deposits. It reflects people's preference of liquidity. It is a purely behavioural parameter which depends, among other things, on the seasonal pattern of expenditure. For example, cdr increases during the festive season as people convert deposits to cash balance for meeting extra expenditure during such periods.

The Reserve deposit ratio: Banks hold a part of the money people keep in their bank deposits as reserve money and loan out the rest to various investment projects. Reserve money consists of two things – vault cash in banks and deposits of commercial banks with RBI. Banks use this reserve to meet the demand for cash by account holders. Reserve deposit ratio (rdr) is the proportion of the total deposits, commercial banks keep as reserves. Keeping reserves is costly for banks, as, otherwise, they could lend this balance to interest earning investment projects. However, RBI requires commercial banks to keep reserves in order to ensure that banks have a safe cushion of assets to draw on when account holders want to be paid.

RBI uses various policy instruments to bring forth a healthy rdr in commercial banks. The first instrument is the Cash Reserve Ratio which specifies the fraction of their deposits that banks must keep with RBI. There is another tool called Statutory Liquidity Ratio which requires the banks to maintain a given fraction of their total demand and time deposits in the form of specified liquid assets. Apart from these ratios RBI uses a certain interest rate called the Bank Rate to control the value of rdr. Commercial banks can borrow money from RBI at the bank rate when they run short of reserves. A high bank rate makes such borrowing from RBI costly and, in effect, encourages the commercial banks to maintain a healthy rdr.

Through its fiscal policy, the government also fleets, some extent, the supply of money. Finer details of this aspect have been dealt with in the document on monetary policy.

2. Banking

Banks are financial institutions that accept deposits and make loans. Included under the term *banks* are firms such as commercial banks, savings and loan associations, mutual savings banks, and credit unions. Banks are the financial intermediaries that the average person interacts with most frequently. A person who needs a loan to buy a house or a car usually obtains it from a local bank. Most people keep a large proportion of their financial wealth in banks in the form of savings accounts, or other types of bank deposits. Because banks are the largest financial intermediaries in our economy, they need to be understood well. The following three functions are essential in making a financial institution a bank:

- **Accept deposits** - Banks accept deposits from the public at large which are repayable on demand and withdrawable by cheque or otherwise
- **Lending** - Banks uses these deposits for lending to others and undertaking investment in securities.
- **Creation of money** – It is the unique characteristic of commercial banks. Their debts circulate as money in the economy. Banks have the power to destroy and create money through lending activities. Money created by bank is known as deposit money or bank money.

None of these alone are sufficient to make a financial institution a bank. However, the RBI has in recent times given license for two new types of banks- **Payment Banks** and **Small Finance Banks** - as differentiated banks.

2.1. Indian Banking System

In India, the organized banking sector is categorized into many different ways. Usually there are categorized as below:

- Regional Rural Banks
- Co-operative Banks
- Commercial Banks

2.1.1. Regional Rural Banks (RRBs)

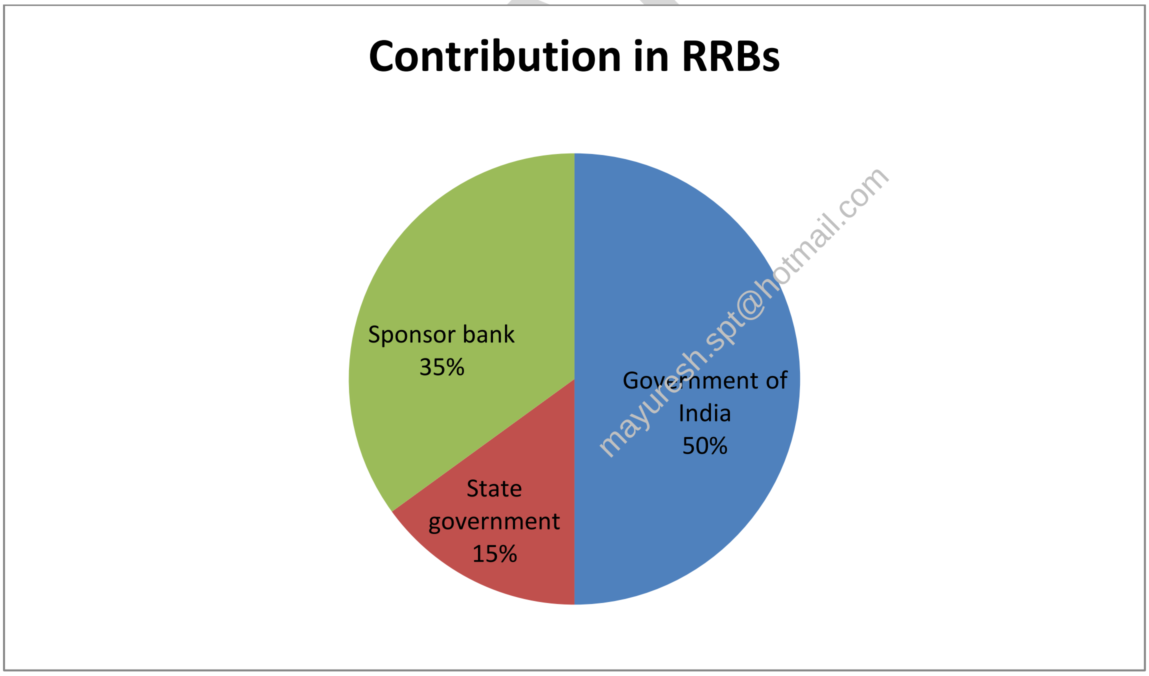
Regional rural banks came into being in the 1970s with the objective of providing deposit and credit facilities to the people in rural areas especially weaker sections like the small and marginal farmers, agricultural laborers, small entrepreneurs etc. Therefore, they are also usually knows as 'Small Man's Bank.' Even though these banks count as the scheduled commercial banks but their focus and reach is generally limited to a district or two. Some of the examples of Regional Rural Banks are Assam Gramin Vikash Bank, Allahabad UP Gramin Bank, Baroda Gujarat Gramin Bank etc.

- These banks are set up by the public sector banks and the PSB which set up a particular RRB is called sponsor bank of that RRB. It is required to subscribe to the share capital of RRBs, train their personnel and provide managerial and financial assistance.
- RRBs were set with following aims:
  - To increase the credit flow to rural areas
  - To lend to weaker sections at concessional rates

From 1997, RRBs were freed to lend outside the target group. Now merging of RRBs is going on as many of the RRBs became unviable or less profitable. Therefore, weak banks are being merged with efficient banks. Now, they gain more autonomous powers also.

The priority sector lending target for RRBs is 75% of the total outstanding loans.

The Government of India, the concerned State Government and the bank, which had sponsored the RRB contribution to the share capital of RRBs is shown in the chart below:



2.1.2. Cooperative Banks

Cooperative bank is an institution established on the basis of cooperative principles and dealing in ordinary banking business. They are called cooperative banks as these have cooperation of stakeholders as motive. Some points to be noted about cooperative banks are:

- They are established by state laws - registered under the Cooperative Societies Act, 1912.
- These are regulated by the Reserve Bank of India under the Banking Regulation Act, 1949 and Banking Laws (Application to Co-operative Societies) Act, 1965.
- If some individuals come together, they can establish a cooperative bank.

- They are established with the aim of funding agriculture and allied sectors and to finance village and cottage industries.
- They lend as well as accept deposits.
- They operate on the principle of 'one person one vote' in decision making.
- Unlike commercial banks, who are driven by profit, co-operative banks work on a "no profit, no loss" basis.
- NABARD is the apex body for cooperative sector in India.

NABARD

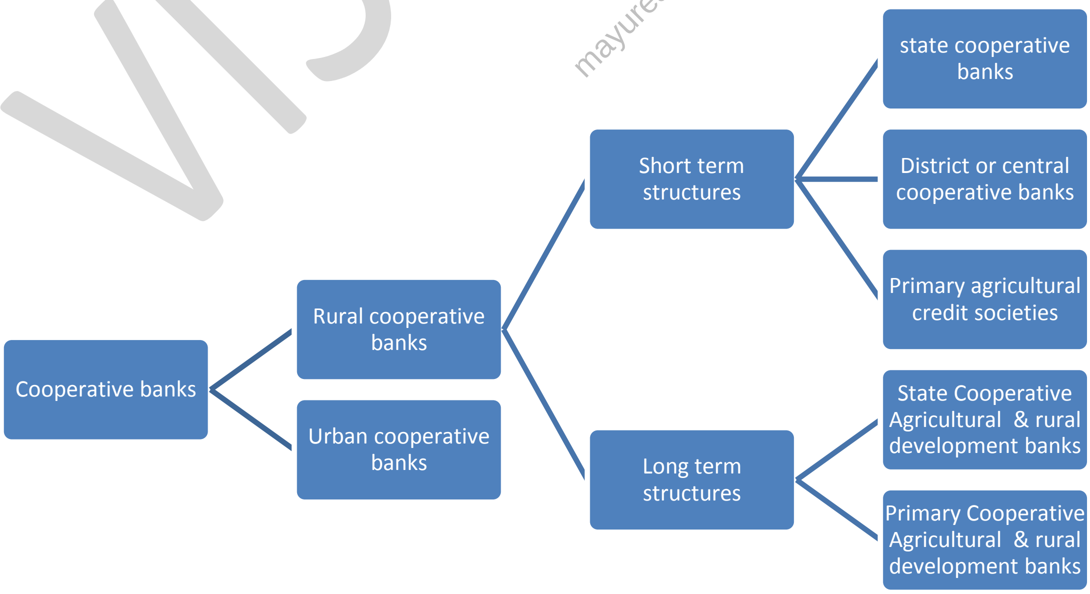
The National Bank for Agriculture and Rural Development (NABARD) was set up as an apex Development Bank with a mandate of facilitating credit flow for the promotion and development of agriculture, small-scale industries, cottage and village industries, handicrafts and other rural crafts.

NABARD also **acts as a co-ordinator** in the operations of rural credit institutions, assists the government, the Reserve Bank of India and other organisations in matters pertaining to rural development, offers training and research facilities to banks, co-operatives, and organisations working in the realm of rural development and helps the state governments in achieving their targets of providing assistance to institutions in agriculture and rural development.

NABARD also **acts as a regulator** for co-operative banks and Regional Rural Banks (RRBs). One of the most important role of NABARD is **capacity building** of partner agencies and development institutions. NABARD provide facilities for training, for dissemination of information and the promotion of research including the undertaking of studies, researches, techno-economic and other surveys in the field of rural banking, agriculture and rural development. It provides technical, legal, financial, marketing and administrative assistance to any person engaged in agriculture and rural development activities. Thus historically, NABARD has played an important role in alleviation of poverty in the rural areas of the country and continues to do so.

2.1.2.1. Types of Cooperative Banks

The cooperative banks are divided into urban and rural, which are further divided into short term structures and long term structures as shown in the chart below:



2.1.2.2. Urban Cooperative Banks

The term Urban Co-operative Banks (UCBs), though not formally defined, refers to primary cooperative banks located in urban and semi-urban areas. These banks, till 1996, were allowed to lend money only for non-agricultural purposes. This distinction does not hold today. These banks were traditionally centred around communities, localities work place groups. They essentially lent to small borrowers and businesses. Today, their scope of operations has widened considerably.

Challenges faced by UCBs

UCBs' limited ability to mobilise resources coupled with inability to formulate their respective policies for investment of their surplus resources because of restrictions reduces the scope of UCBs. They also face problems of low level of recovery, high transaction cost and rising competition. Their autonomy is also questioned because of zealous regulation by government through nomination of board of director and deputation of government officials to cooperatives.

R Gandhi committee on urban cooperative banks

Few important recommendations of the report are as follows:

- **Business Size and Conversion of Multi-State UCBs into joint stock bank:** A business size of 20,000 crore or more may be the threshold limit beyond which a UCB may be expected to convert itself into a commercial bank. The conversion need not be de jure compulsory. However, the types of businesses to be undertaken by those choosing not to convert may remain within the limits of plain vanilla products and services and hence, growth will be at a much slower pace. Their expansion in terms of branches, area of operations and business lines may thus be carefully calibrated.
- **Conversion of UCBs into Small Finance Banks (SFBs):** Smaller UCBs with business size of less than 20,000 crore willing to convert to SFBs can apply to the Reserve Bank for conversion provided they fulfil all the eligibility criteria and selection processes prescribed by the Reserve Bank and further provided that the licensing window for SFBs is open.
- **Issues of fresh licenses:** Licenses may be issued to financially sound and well-managed co-operative credit societies having a minimum track record of 5 years which satisfy the regulatory prescriptions set by the Reserve Bank as licensing conditions. For providing banking access in unbanked areas, the Reserve Bank may put in place an appropriate set of incentives for existing banks to open branches there.
- **Board of Management (BoM) in addition to Board of Directors (BoD)**: Putting in place a BoM as suggested by the Malegam Committee has to be one of the mandatory licensing conditions for licensing of new UCBs and expansion of existing ones. This recommendation has been accepted by the RBI in 2018.
- **Depositors as voting members**: The depositors ought to have a say on the Boards of UCBs. For this, a majority of the board seats may be reserved for depositors by making suitable provisions in the bye-laws.

Should large UCBs be converted into commercial banks?

Also, when UCBs become large and spread in different states, the cohesion required among members diminishes due to lack of familiarity and commercial interests overtake the collective welfare spirit. Also some UCBs are even bigger than the smaller commercial banks in terms of deposits, advances, and total assets. So, RBI should have more powers over it like any other commercial bank because its failure may greatly impact economy. Thus, they should be converted to commercial banks as also recommended by Gandhi committee report .

2.1.2.3. Rural Cooperative Banks

Short term structures – They lend up to one year. They lend for cultivation activities and provide working capital to buy seeds, fertilisers etc. The short term structures have a three tier set up:

- **State cooperative banks (SCB)** – Each state has its own SCB. It is the apex body for cooperative banks in a particular state. They act as intermediary between RBI and NABARD on one side and District or central cooperative banks and Primary agricultural credit societies on the other.
    - They get loan from RBI at concessional rate
    - It gives grants to cooperative banks in the state

  Now the intermediation of these banks is abolished by a memorandum of understanding between RBI and these banks. Now, RBI has direct dealing with low tier banks.
- **District or central cooperative banks** - It operates at district level. There are two types of central or district cooperative banks:
    - Cooperative banking union – Its membership is open to only cooperative societies
    - Mixed central cooperative bank - Its membership is open to both cooperative societies and individuals.

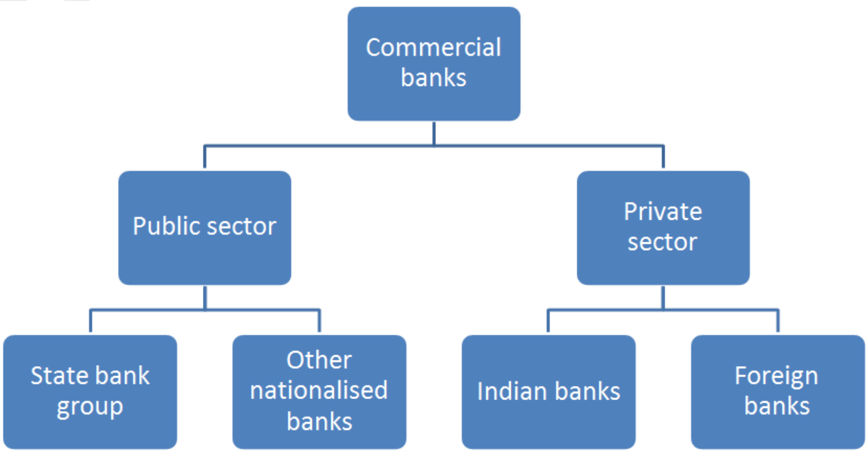
  They get loan from SCBs and they grant loans to PACs and individuals
- **Primary agricultural credit societies (PACs)** – It operates at village level. It gives loans to its members as individuals.

Long term structures – They lend for medium term and long term which ranges from 1.5 to 25 years. They lend for land development, purchase of agricultural equipments, redemption of old debts etc. They initially were called as mortgage banks, then land development banks and now they are called as Cooperative Agricultural and Rural Development Banks (CARDBs). It is a two tiered structure:

- State CARDBs
- Primary CARDBs

2.1.3. Commercial Banks

They are run on commercial basis. They are created for a profit motive. They accept deposits, give loans and provide other financial services to earn profit. These are regulated under Banking regulation act 1949. They consists of both public sector banks and private sector banks (as shown in chart below)



2.1.3.1. Public Sector Banks

These are those banks in which the majority ownership is with government. Majority ownership means shareholding of >51%. All the PSBs were not started by the government of India. Some banks in the hands of private sector were nationalized and made public sector banks.

- **State bank group –** It means State Bank of India and its associates. SBI is the largest Public sector bank in the country. Previously major part of SBI's share was held by RBI. But to endow RBI with only regulatory functions, its shares were transferred to the Government of India.
    - Eight banks of erstwhile princely states were brought under SBI as its associates:
        - State Bank of Bikaner – merged with State Bank of Jaipur later
        - State Bank of Jaipur
        - State Bank of Hyderabad
        - State Bank of Mysore
        - State Bank of Travancore
        - State Bank of Indore
        - State Bank of Patiala
        - State Bank of Saurashtra – merged with SBI later
    - Now all associates have been merged under one consolidated SBI and with this its market share has been increased to 22% from 17%. It would improve the economies of scale, better management of liquidity, technological know-how, quality of products, professional standards. It would also lead to diversification of customers and assets, international recognition, improved customer service etc.
    - However, there are chances that it could lead to losing regional focus.
- **Other nationalized banks –** The nationalization was carried out in two phases in 1969 and then 1980. The total nationalised banks in the country are 19. Some examples are – IDBI, Indian bank, Dena Bank etc. Therefore, total number of Public sector commercial banks are (1+6+19) = 26.

  Before Nationalization kicked in, several sectors of the economy such as agriculture, small-scale industries and weaker sections of the society were relatively ignored by the banking system of the country. For example, the agricultural sector only received 2.1% of the total credit as it stood in March 1967 compared to a humungous 64% for the industry. The banking facilities were earlier concentrated mainly in the urban areas. Though there were some banks in the rural areas, they were mainly for deposits and the money was used to lend in the urban areas. Even in the urban areas, the banking facilities were enjoyed by the rich people. The banks were mainly owned by industrialists and they used these banks to mobilise deposits of people and themselves got a loan from these banks.

  The Government of India had, therefore, to impose some control over banks with a view to prevent monopolistic trends, concentration of economic power and misuse of economic resources. Thus the basic goal of social control was to achieve the social ends without taking over the banks into public ownership.

Some of the **objectives of nationalization of the banks** in 1980 were:

- To mobilize savings of people to the maximum possible and to utilize them for productive purpose.
- To ensure that the banking operations are guided by a larger social purpose and are subject to close public regulations;
- To ensure that the legitimate credit needs of private sector industry and trade, big and small, are met;

- To ensure the needs of the productive sector and in particular, agriculture, small scale industry, self-employed professionals are met;
- To actively foster the growth of the new and progressive class of entrepreneurs and create fresh opportunities for hitherto neglected and backward areas in different parts of the country; and
- To curb the use of bank credit for speculative and for other unproductive purposes.

Since the nationalization some of the impacts observed include:

- branch expansion to areas other than the major urban centers of the country,
- growth of farm credit
- finance provided to small scale industry has increased
- increased growth of deposits
- credit to weaker sections has gone up.

2.1.3.2. Private Sector Banks

It consists of both Indian banks and the foreign banks. Few examples of private banks are ICICI, Axis, HDFC bank etc.

- **Indian banks –** These are classified by RBI as old banks and new banks for the convenience of comparing performance of all Indian banks.
  - **Old banks –** The banks except those were nationalized continued to be in the hands of privates. These private banks and those which were set up before 1990s are called old banks
  - **New banks –** Banks set up in private sector in 1990s and after are called new banks. Latest by 2014 RBI issued license for new banks. It also came up with the proposal of small banks and payment banks. The RBI observes these banks as "niche" or "differentiated" banks with the common objective of furthering financial inclusion

Differentiated banks focus on different areas and develop competence in that. RBI has already issued licenses for small finance banks and payment banks. The third category is wholesale and long term finance banks (WLTF).

2.1.3.3. Small Finance banks

It will provide a whole suite of basic banking products such as deposits and supply of credit, but in a limited area of operation. Thus, they can be said to be a scaled down versions of commercial banks, with both deposit-taking and loan-making functions. They can sell forex, mutual funds, insurance, pensions and can also convert into a full-fledged bank. They are established mainly for the growth of agriculture and Micro, Small and Medium industries.

Resident individuals/professionals carrying 10 years of experience in banking and finance and companies and societies owned and controlled by residents will be eligible to set up small finance banks. SFBs have a minimum paid up capital of Rs.100 crore.

Recently micro lenders, Suryoday and Utkarsh, have started Small Finance Banks (SFBs). They are offering interest rates of more than 6% (as compared to 4% offered by commercial banks) for savings bank deposits.

2.1.3.4. Payment Banks

In August 2015, the Reserve Bank of India (RBI) gave approval to private entities to open payments banks that will widen the reach of banking services and push the government's goal of financial inclusion. Payments banks will accept deposits of up to Rs 1 lakh. They can issue ATM/debit cards but not credit cards. The promoter's minimum initial contribution to equity capital will have to be at least 40% for the first five years.

It will provide a limited range of products – acceptance of demand deposits and remittances of funds, but will have a widespread network of access points particularly to remote areas. The network can be

- through bank branches or
- through business correspondents (BCs) or
- through networks provided by others

The payments banks will target financially excluded customers like migrant workers, low-income households and tiny businesses. They will not be in the business of lending, so they will be shielded from the risks that conventional banks are exposed to.

2.1.3.5. Wholesale and Long-Term Finance Bank

It will be a combination of long term-lending institution and an investment bank with proposed minimum capital of Rs 1,000 cr. They can't accept savings deposits. They can raise money from current accounts, bulk fixed amounts and bonds. It will enable companies to get long-term financing easily. It may help in relieving banking system from increasing stressed assets due to infrastructure sector. As specialized institutions, they will be in a much better position compared with commercial banks in evaluating and funding long-term projects. It will further enhance competition, which will lead to more efficient allocation of financial resources.

However, consideration should be given that their operational autonomy is maintained and licenses are given on the basis of ability to build such a highly specialized bank.

Foreign banks – India opened the doors for foreign banks after 1991. They set up either branches or wholly owned subsidiaries. Some of the **foreign banks** operating in the country include Deustche Bank, Bank of America, Citibank, HSBC, Royal Bank of Scotland etc.

The framework for foreign banks latest issued by RBI stress upon — the formation of wholly-owned subsidiaries (WOS) for furthering their business in India. The RBI guidelines make it clear that the WOS model is what the regulator would prefer the foreign banks to have. Suitable incentives are being given to new as well as existing players operating through their branches in India to adopt the subsidiary route and incorporate locally. If foreign banks took this route, the regulator would treat them in a par with Indian banks. They would be given capital gains tax and stamp duty benefits and allowed to acquire local private banks.

However, changes in priority sector lending (PSL) norms that would follow such a move were a bone of contention. Before applying to RBI, some foreign lenders had urged that these norms be relaxed. The central bank said as was the case with their Indian counterparts, foreign banks would have to offer 40 per cent of their loans to priority sectors. Of this, 18 per cent have to be offered to the farm sector. Earlier, the cut-off for foreign lenders in the PSL segment was 32 per cent (for foreign banks with more than 20 branches, it was 40 per cent). But they would have to adhere to the 40 per cent norm within five years of setting up wholly-owned subsidiaries.

RBI had said foreign banks that entered India after August 2010 would have to mandatorily convert their branches into wholly-owned subsidiaries.

2.1.3.6. Problems of Commercial Banks in India

Though the commercial banks made significant progress in terms of branch expansion, deposit mobilisation, loans to priority sector and weaker sections of the society, they are still facing a number of problems in different respects.

1) **Problems in Branch Expansion**: Banks were asked to open their branches in rural and backward areas where minimum infrastructure facilities like roads, communication, transport, education, safe buildings for bank operations were not available. In some places there was a problem of even security to the bank employees.

2) **Problems in Deposit Mobilisation:** There has been heavy competition among public sector banks in deposit mobilisation as all of them have been providing the same service. Banks also face competition in mobilising deposits from National Savings Organisation, Non-Banking Companies, Unit Trust of India, Mutual Funds etc. It is felt that despite their efforts, deposit mobilisation efforts of banks have not been adequate to meet the needs of the present economic needs. It was also criticised that the schemes of deposit mobilisation of banks are not suited to the needs of the prospective depositors in rural areas.
3) **Absence of Coordination**: For providing finance to the same borrowers, there are several financial agencies like commercial banks, cooperative banks, regional rural banks and state financial corporation. In view of these multiple organisations and absence of coordination among these institutions it has resulted in duplicate financing, over-financing or under-financing.
4) **Inadequate Finance to Agriculture:** Though the commercial banks have made spectacular efforts to meet the financial needs of the agricultural sector and its allied activities, still a more vigorous effort is required as the total assistance of commercial banks to agricultural sector is not even 10% of their needs.
5) **Inadequate Banking Facilities in Rural Areas:** The number of banks in rural areas is quite inadequate compared to the needs of banking services, as is evident from the fact that only 5 per cent of the villages are covered by the banks.
6) **Regional Imbalances:** Though the commercial banks have spread their branches in different parts of the country, these are not equally distributed. According to Reserve Bank of India's Report about half of the branches are concentrated in the Southern and Western regions. The states like Assam, Jammu & Kashmir, Manipur, Nagaland, Orissa, Tripura, Uttar Pradesh and West Bengal may be termed as under banked areas.
7) **Low Profitability:** Financing of priority sectors, opening branches in rural as well as unbanked and backward areas, granting loans to weaker sections at low rate of interest, increase in cost of salaries and establishment and increase in overdue resulted in decline in the rate of profitability of most of the commercial banks in India. The low profitability is also caused due to increase in costs, inefficiency, bureaucratic attitude, absence of effective cost control, increase in Statutory Liquidity Ratio and Cash Reserve Ratio etc.
8) **Low Efficiency:** Nationalisation of banking industry has brought in all the limitations of public sector to it. These are bureaucratic attitude of the managers, absence of initiative, red-tapism, inordinate delays, lack of commitment, responsibility, indifference to work etc. These result in low efficiency of the banks.
9) **Political Pressure:** Nationalisation of banks has brought political interference and political pressure at all levels of the banks. The political pressure results in poor selection of staff, granting loans and advances to undeserving, etc.
10) **Problems of Liberal Credit Policy:** Liberal Credit Policy, which is essential to meet the credit requirements of the weaker sections, agricultural sector, etc. resulted in insecurity of bank funds and ultimately of depositors money. Liberal credit policy has also resulted in poor recovery of funds and absence of recycling of bank funds.

2.2. Indian Banks Abroad

Like foreign banks set up in India, Indian banks set up their branches or subsidiaries in foreign countries. Both public and private sector banks have branches abroad.

Offshore banking units are located in Bahamas, Cayman islands, Channel islands, Mauritius. Off shore banks are banks located in a country that has more generous tax laws.

2.3. Another way of classification of banks

Another better way of categorizing the Indian banks is **scheduled** and **non-scheduled** banks. All commercial, RRBs and state cooperative banks are classified like this.

Scheduled banks are those banks which are mentioned in the **second schedule of the RBI Act**, 1934. These banks have to **meet certain minimum criteria** such as

- a minimum paid up capital and reserves of total aggregate value not less than Rs.5 lacs.
- These banks have to also satisfy the RBI that their functions would be carried out in the interests of their depositors.

The facilities enjoyed by scheduled banks are:

- They are eligible for obtaining debt/loans on bank rate from RBI
- They get automatic membership of clearing house
- They can avail the facility of rediscount of first class exchange bills from RBI

Any bank which fulfilled these conditions and got listed in the second schedule, on violating these principles will be descheduled.

Non-scheduled banks - on the other hand are those that have not been included in the second schedule of the RBI Act. As of today there are only three non-scheduled banks in the country. These banks also have to follow the conditions regarding CRR but can keep it with itself. These banks are not eligible for loan from RBI, but become eligible under emergency conditions.

2.4. Banks v/s Non- Banking Financial Companies (NBFCs)

2.4.1. What is NBFC?

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 engaged in the business of loans and advances, acquisition of shares/ stocks/ bonds/ debentures/securities issued by Government or local authority or other marketable securities of a like nature, but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property.

NBFCs lend and make investments and hence their activities are akin to that of banks; however there are a few differences as given below:

- NBFC cannot accept demand deposits;
- NBFCs do not form part of the payment and settlement system and cannot issue cheques drawn on itself
- deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation is not available to depositors of NBFCs, unlike in case of banks.

No NBFC can commence or carry on business of a non-banking financial institution without obtaining a certificate of registration from the Reserve Bank of India and without having a Net Owned Funds of Rs. 25 lakhs.

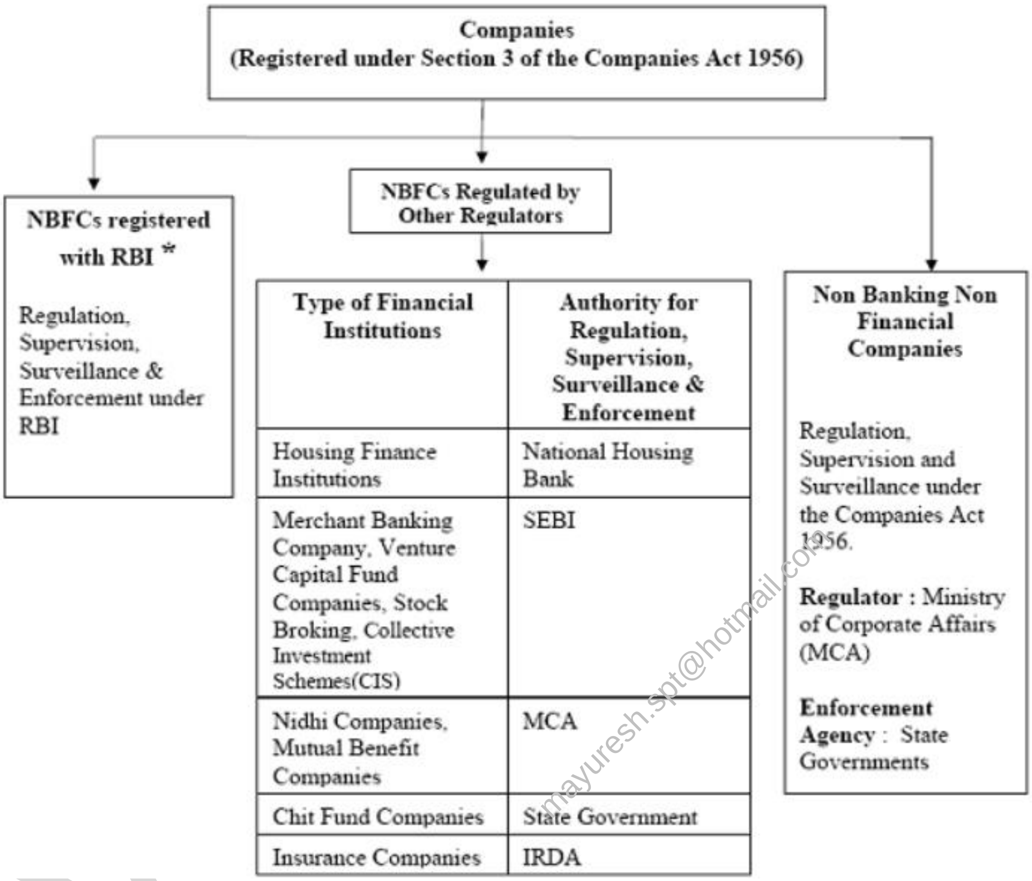
NBFCs can be classified into two broad categories, viz., (i) NBFCs accepting public deposit (NBFCs-D) and (ii) NBFCs not accepting/holding public deposit (NBFCs-ND). Residuary Non-Banking Companies(RNBCs) are another category of NBFCs whose principal business is acceptance of deposits and investing in approved securities.

2.4.2. Regulators of NBFC

In terms of the powers given to the Bank, to obviate dual regulation, certain categories of NBFCs which are regulated by other regulators are exempted from the requirement of registration with RBI viz. Venture Capital Fund/Merchant Banking companies/Stock broking companies registered with SEBI, Insurance Company holding a valid Certificate of Registration issued by IRDA, Nidhi companies as notified under Section 620A of the Companies Act, 1956, Chit companies as defined in clause (b) of Section 2 of the Chit Funds Act, 1982,Housing Finance Companies regulated by National Housing Bank, Stock Exchange or a Mutual Benefit company.

The following chart shows different regulators for different types of NBFCs

Overview of Regulators of Non-Banking Companies



Nidhi company

A Nidhi company, is one that belongs to the non-banking Indian Finance sector and is recognized under section 406 of the Companies Act, 2013. Their core business is borrowing and lending money only between their members. Reserve Bank of India is empowered to issue directions to them in matters relating to their deposit acceptance activities. Basically a “Nidhi” means a company which has been incorporated as a Nidhi with the object of:

- Cultivating the habit of thrift and savings amongst its members,
- receiving deposits from, and lending to, its members only, for their mutual benefit,

General restrictions on Nidhi companies are that no Nidhi shall:

- Carry on the business of Chit Fund, Hire Purchase Finance, Leasing Finance, Insurance or Acquisition of Securities issued by anybody corporate;

- Issue - Preference Shares, Debentures or Any Other Debt Instrument by any name or in any form whatsoever; Open any Current Account with its members;
- Acquire another company by; Purchase of securities or Control the composition of the Board of Directors of any other company in any manner whatsoever or Enter into any arrangement for the change of its management, unless it has passed a special resolution in its general meeting and also obtained the previous approval of the Regional Director having jurisdiction over Nidhi;
- Carry on any business other than the business of borrowing or lending in its own name;
- Accept Deposits from or lend to any person, other than its members;
- Pledge any of the assets lodged by its members as security;
- Take Deposits from or lend money to anybody corporate;
- Enter into any Partnership Arrangement in its borrowing or lending activities;
- Issue or cause to be issued any advertisement in any form for soliciting deposit;
- Pay any brokerage or incentive for mobilizing deposits from members or for deployment of funds or the granting loans.

But in recent times, certain chit fund scam (done in money market and capital market material) has happened by these which calls for greater regulation of these companies.

2.4.3. Increasing Influence and Regulatory Problems of NBFCs

The non-banking financial sector has evolved considerably in terms of operations, variety of market products and instruments, technological sophistication, etc. In recent years, the NBFCs have assumed increasing significance and have added considerable depth to the overall financial sector. The regulatory responses on the part of RBI have also kept pace with the evolution of this sector. In particular, regulation has adequately addressed the issue of depositor protection, a major concern of RBI.

The regulatory regime for NBFCs is lighter and different in many respects from that for the banks. The steady increase in bank credit to NBFCs over recent years means that the possibility of risks being transferred from the more lightly regulated NBFC sector to the banking sector in India can no longer be ruled out

The size of the NBFC sector based on total assets is about Rs 12.5 trillion, which is about 13% of the banking sector, whose size is about Rs 96.7 trillion by total assets. Therefore, although it is difficult to argue that the individual failure of any of the NBFCs poses a systemic risk because of the smallness of the individual sizes, it is not possible to rule out that their collective failure may pose a systemic risk to the financial system, especially in light of the bank-finance NBFC linkages.

NBFCs at times charge high interest rates from their borrowers. Reserve Bank of India has deregulated interest rates to be charged to borrowers by financial institutions (other than NBFC- Micro Finance Institution). The rate of interest to be charged by the company is governed by the terms and conditions of the loan agreement entered into between the borrower and the NBFCs. However, the NBFCs have to be transparent and the rate of interest and manner of arriving at the rate of interest to different categories of borrowers should be disclosed to the borrower or customer in the application form and communicated explicitly in the sanction letter etc.

2.4.4. Usha Thorat Committee

The Reserve Bank of India (RBI) released the Usha Thorat committee report on non-banking finance companies or NBFCs. Some key recommendations of the committee are:

Tier I capital of NBFCs to be at 12% So far, NBFCs capital adequacy requirement is at 15% wherein there is no stringent stipulation of tier I or tier II capital. If the recommendation is accepted, every NBFC has to have a minimum tier I capital or equity capital of 12%.

Liquidity ratio to be introduced for 30 days. RBI has recommended maintaining a liquidity ratio of for 30 days. This means an NBFC has to set aside cash balance equivalent to its debt payments due every month. The measure is perceived to be important to check asset liablity mismatch of NBFCs.

NBFCs may be given benefits under SARFAESI Act Under Securitisation and Reconstruction of Financial Assets And Enforcement of Security Interest or SARFAESI Act, an NBFC would not move to the court to auction underlying assets to recover loan dues. It will just publish a newspaper notice before such auction.

NBFCs may be **subject to regulations similar to banks** while lending to stock brokers and merchant banks and similar to stock brokers, as specified by the Securities and Exchange Board of India (SEBI), while undertaking margin financing.

NBFCs with assets of Rs. 1000 crores and above should be inspected comprehensively on an annual basis with an annual stress test carried out to ascertain their vulnerability.

2.4.5. Steps Taken by RBI Regarding NBFCs

In November 2014, in a bid to bring NBFC norms in line with those of banks, RBI had unleashed tighter rules for NBFCs. According to the new guidelines, NBFCs will require higher minimum capital, have less time to declare bad loans, and a board-approved fit and proper criteria for appointment of directors.

The new norms, which would be implemented in a phased manner, were made applicable for NBFCs that manage funds worth Rs 500 crore and for those that accept public deposits.

In the interest of depositors, RBI has evolved a regulatory framework the salient features of which are outlined below

- Registration of an NBFC with the RBI merely authorizes it to conduct the business of NBFC. RBI does not guarantee the repayment of deposits accepted by NBFCs. NBFCs cannot use the name of the RBI in any manner while conducting their business.
- NBFCs which accept deposits should have minimum investment grade credit rating granted by an approved credit rating agency for deposit collection, except certain Asset Finance (equipment leasing and hire purchase finance) companies and Residuary Non-Banking Companies (RNBCs),
- NBFCs cannot offer
  - A rate of interest on deposits more than that approved by RBI from time to time (at present 12.5%).
  - Accept deposit for a period less than 12 months and more than 60 months
  - Offer any gifts/incentives to solicit deposits from public.

2.5. Banking Reforms in India

2.5.1. Narasimham Committee I (1991)

This committee was headed by Mr. M. Narasimham, who was the 13th Governor of RBI. This committee was appointed against the backdrop of the Balance of Payment Crisis. It was set up to analyze all factors related to financial system and give recommendation to improve its efficiency and productivity. Some of the important recommendations of the committee were:

- **Reduction in CRR and SLR.**

- **Interest Rate Deregulation:** The Committee observed that the prevailing structure of administered rates was highly complex and rigid and called for deregulating it so that it reflects the emerging market conditions. However, it warned against instant deregulation and suggested gradual deregulation over a period of time.
- **Structural Reorganization of Banks:** the Committee believed that the structure should consist of 3-4 Banks (including SBI) becoming International Banks, 8 to 10 national banks with a nationwide network of branches engaged in universal banking, Local banks operations would be generally confined to a specific region, Rural banks (including RRBs) to the rural areas predominantly engaged in financing of agriculture and allied activities.
- **Establishment of ARF tribunal:** The committee recommended the establishment of an Asset Reconstruction Fund (ARF) which would take over the proportion of the bad and doubtful debts from the banks and financial institutes. All bad and doubtful debts of the banks were to be transferred in a phased manner to ensure smooth and effective functioning of the ARF. The committee also suggested the formation of special tribunals to recover loans granted by the bank
- **Allowing Banks to raise Capital:** The Committee recommended that profitable banks and banks with good reputation should be permitted to raise capital from the public through the capital market. Regarding other banks, the government should subscribe to their capital or give a loan, which should be treated as a subordinate debt, to meet their capital requirements.

2.5.2. Narasimham Committee II

It was setup by the Finance Ministry of the Government of India under the chairmanship of Mr. M. Narasimham in 1998. Its aim was to review the progress of the implementation of the banking reforms since 1992 with the aim of further strengthening the financial institutions of India. The Committee's Report focused on issues like size of banks and capital adequacy ratio.

- **Need for a Stronger Banking System:** It recommended the merger of strong banks, which will have a "multiplier effect" on industry. It also supported that two or three large strong banks be given international or global platform to work on.
- **Stricter norms for NPAs:** Some of the PSBs had NPAs as high as 20 percent of their assets. For successful rehabilitation of these banks, the committee recommended Narrow Banking Concept. As per this, the weak banks were to be allowed to place their funds only in short term and risk free assets.
- **Greater Autonomy for the PSBs:** Greater autonomy was proposed for the public sector banks in order for them to function with equivalent professionalism as their international counterparts. The Committee recommended: GoI equity in nationalized banks be reduced to 33% , RBI to relinquish its seats on the board of directors of these banks, review of functions of banks boards with a view to make them responsible for enhancing shareholder value through formulation of corporate strategy and reduction of government equity
- **Capital Adequacy Norms:** To improve the inherent strength of the Indian banking system the committee recommended that the Government should raise the prescribed capital adequacy norms to improve their Risk absorption capacity. The committee targeted raising the capital adequacy ratio to 9% by 2000 and 10% by 2002. The Committee recommended penal provisions for banks that fail to meet these requirements.

Implementation of Recommendations

To implement these recommendations, the RBI in Oct 1998, initiated the second phase of financial sector reforms on the lines of Narasimham Committee-II report. RBI raised Capital Adequacy Ratio by 1% and tightened the prudential norms for provisioning and asset classification in a phased manner (discussed later). It also targeted to bring the capital adequacy ratio to 9% by March 2001.

In October 1999 criteria for "autonomous status" was identified by March 1999 and 17 banks were considered eligible for autonomy. The Committee's recommendations let to introduction of a new legislation in 2002, Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002(SARAFESI Act 2002). Some of the recommendations like reduction in Governments equity to 33%, the issue of greater professionalism and independence of the board of directors of public sector banks are still awaiting Government follow-through.

During the 2008 economic crisis, performance of Indian banking sector was far better than their international counterparts. This was credited to the successful implementation of the recommendations of the Narasimham Committee-II with particular reference to the capital adequacy norms and the recapitalization of the public sector banks. Impact of the two committees has been so significant that the financial-economic sector professionals have been applauding there positive contribution.

2.6. Issue of Non-Performing Assets (NPAs)

The issue of NPAs has gained immense importance as there is a surge in stressed assets in banking in the recent times.

2.6.1. What are Non-Performing Assets (NPA's)

Non-performing assets, also called non-performing loans, are loans, made by a bank or finance company, on which repayments or interest payments are not being made on time. Generally speaking, NPA is any asset of a bank which is not producing any income. Once the borrower has failed to make interest or principal payments for 90 days the loan is considered to be a non-performing asset.

But in terms of Agriculture / Farm Loans; the NPA is defined as under: Short duration crop loan : Loan is termed as NPA in this scenario if the loan either in terms of installment or interest is not paid for 2 crop seasons, it would be termed as NPA. Example: Agri loans such as paddy, jowar, Bajra etc. For Long Duration Crops, the above would be 1 Crop season from the due date.

2.6.2. Categories of NPAs

Standard asset – when borrower regularly pays his dues regularly and on time.

Banks are required to classify non -performing assets further into the following three categories based on the period for which the asset has remained non-performing and the realisability of the dues:

Special mention account – If the borrower does not pay for 90 days after end of a quarter; the loan becomes an NPA and it is termed as special mention account.

Sub-standard Assets - a sub-standard asset is one which has remained NPA for a period less than or equal to 12 months. Such an asset will have well defined credit weaknesses that jeopardise the liquidation of the debt and are characterised by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected.

Doubtful Assets - an asset is classified as doubtful if it has remained in the sub-standard category for a period of 12 months. A loan classified as doubtful has all the weaknesses inherent in assets that were classified as sub-standard, with the added characteristic that the weaknesses make collection or liquidation in full, – on the basis of currently known facts, conditions and values – highly questionable and improbable.

Loss Assets - A loss asset is one where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.

2.6.3. How to Reduce NPAs

Before giving loans

- **Credit information of the borrowers** - In addition, to address the issue of information asymmetry as also to identify the problem early, a Central Repository of Information on Large Credits (CRILC) to collect, store, and disseminate credit data to lenders, was set up. Under this arrangement, banks are reporting credit information on all their borrowers having aggregate fund-based and non-fund based exposure of ₹50 million and above with them.
- **Cautioned treatment to defaulters** - while considering their support to accounts under stress, banks should make proper distinction between willful – defaulters/non-cooperative/ unscrupulous borrowers on the one hand, and on the other hand, borrowers defaulting on their debt obligations due to circumstances beyond their control.
- **Proper structuring of loans** - To facilitate banks to offer long term project financing, which may ensure long term viability of infrastructure and core industries sector projects by smoothening the cash flow stress in initial years of such projects, the Reserve Bank has issued guidelines on flexible structuring of long term project loans with periodic refinancing option.

After declaring asset as an NPA

- **A comprehensive framework by RBI** - The Reserve Bank of India had released a comprehensive 'Framework for Revitalising Distressed Assets in the Economy'. The Framework outlines a corrective action plan which includes:
    - early identification of problem cases,
    - timely restructuring of accounts which are considered to be viable, and
    - taking prompt steps by banks for recovery or sale of unviable accounts.
- **Revival of the viable entities** - timely support through restructuring in genuine cases is called for with the objective to preserve the economic value of viable entities and minimise the losses to the creditors and other stakeholders.
- **Debt Recovery Tribunals –** To recover security interest fastly, these tribunals along with appellate tribunal were established.
- **Invoking legal provisions -** The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act has provisions for the banks to take legal recourse to recover their dues.
- **Selling the NPAs to SCs/RCs** (securitisation companies/ reconstruction companies) registered under the SARFAESI Act. SCs/RCs are expected to do a specialised task of recovering and reconstructing the NPAs thereby reducing the NPAs in the system. Only a few out of 15 registered SCs seem to be successful.
- **JLF (joint lenders' forum):** To build incentives and disincentives. Borrowers and lenders have to reach a conclusion about the prompt corrective action plan. After the conversion, all lenders under the JLF must collectively hold 51% or more of the equity shares issued by the company
- **Lok Adalats:** Lok Adalat mechanism offers expeditious, in-expensive and mutually acceptable way of settlement of disputes. Government has advised the public sector banks to utilize this mechanism to its fullest potential for recovery in Non-performing Assets (NPAs) cases.

2.6.4. Recent Initiatives

2.6.4.1. Prompt Corrective Action Framework

- Prompt Corrective Action allows the RBI to pose certain restrictions on a bank when certain limits are breached.
- These restrictions may include halting branch expansion, stopping dividend payments, special audit and more.
- The risk thresholds that are taken into account are asset quality, profitability, NPA limit and the like.
- PCA was first issued by the RBI in May 2014 and has recently been revised in April 2017.

2.6.4.2. Indradhanush Plan

- It is an umbrella scheme for banking reforms which includes seven elements
- **Appointment**: Separating post of Chairman and Managing Director to bring more professionalism.
- **Bank Board Bureau:** a body of eminent professionals and officials, with various important functions like recommending for selection of heads, helping banks in developing strategies and plans, advising banks on strategies of consolidation, etc.
- **Capitalization:** by infusion of equity capital
- **De-stressing:** Strengthening Asset Reconstruction Companies and Establishment of six New debt recovery tribunals (DRCs) and creation of a Central Repository of Information on Large Credits (CRILC) by RBI to collect, store and disseminate credit data to banks.
- **Empowerment:** Non-interference in the functioning of public sector banks and encouraging them to take decisions independently; keeping the commercial interest of the organization in mind.
- **Framework for accountability**: through key performance indicators for state-run PSBs
- **Governance reforms: "Gyan Sangam"** a conclave of PSBs and Financial institutions attended by all major stake-holders.

2.6.4.3. Other Measures

For securitisation companies

- **Transparency in working of SCs -** The RBI has recently taken various steps to improve the system's ability to deal with distressed assets of banks and financial institutions.
    - The Reserve Bank has issued various guidelines relating to the operations of SCs/RCs as also to make transactions between them and banks more transparent for prevention of collusions with promoters in buy back deals.
- **Increased FDI cap -** foreign direct investment cap on SCs/RCs has been increased from 49 per cent to 74 per cent under the automatic route.

For banks

- **Capacity building of banks –** There is a need for emergence of additional technical capabilities of banks to undertake evaluation of projects, restructuring schemes, etc. undertaken under JLF. Reserve Bank through the Centre for Advanced Financial Research and Learning has taken initiative to organise capacity building program for bankers.
- **Strategic Debt Restructuring:** - Provide lenders 51% equity control in a company that fails to repay even after its debts are rejigged to give the management a second chance. It Will come into force if the corporate debt restructuring (CDR) mechanism fails.
- **5/25 norms:** Permitted banks to structure loans for 25 years while giving them the flexibility to revise rates or sell the asset to another bank every five years in infrastructure.
- **Banking regulation ordinance 2017 -**

For borrowers

- **Insolvency and bankruptcy code –** It will reduce the delay in resolution of insolvency or bankruptcy cases and improving recoveries of the amount lent. Thus, it will help in facilitating the efficient flow of capital across the economy. It will streamline the process which is otherwise regulated by multiple laws such as the Companies Act, SARFAESI Act, Sick Industrial Companies Act.
- Salient Features of the law :
  - It Fixed a timeline of 180 days, extendable by another 90 days, to resolve cases of insolvency or bankruptcy.
  - **A new regulator** — The Insolvency and Bankruptcy Board of India (IBBI) to regulate professionals/agencies dealing with insolvency and informational utilities.
  - **National Company Law Tribunal (NCLT)** to adjudicate bankruptcy cases over companies, limited liability entities while **Debt Recovery Tribunal (DRT)** to adjudicate cases over individuals and unlimited liability partnership firms.
- **Formation of bad bank –** A separate entity that would buy the NPAs and work towards suitably disposing off freeing up banks books for fresh lending. It has been successfully implemented in many western European countries post the 2007 financial crisis France etc. However, in case of India certain issues need to be taken care of such as majority stakes with government may render the Bad Bank facing same issues of governance and capitalization as PSBs

2.6.5. Issues Needing Further Intervention

- **Effective exit policy –** For accounts which are beyond revival, banks should have a well - defined loan recovery policy which sets down the manner of recovery of dues depending upon the circumstances of each account. Banks may resort to either opt for legal avenues or non-legal avenues for exiting the account.
- **Judicial delays -** An important factor affecting recovery performance of SCs/RCs is the delay in judicial process: be it under SARFAESI Act or at the level of debt recovery tribunals. A fast and efficient judicial system is a sine qua non for effective resolution of NPAs.
- **Low recovery performance** - On the recovery side, the performance is not very encouraging. As on March 31, 2015, the average recovery rate (assets resolved as a per cent to assets acquired) of SCs/RCs was at 31.0 per cent.
- **Non-transparent auction process by banks for the sale of NPAs to ARCs -** The RBI has also advised that the banks using auction process for sale of NPAs to ARCs should be more transparent
- **Banks possessing small share in loan forming JLF –** reluctant to do independent analysis, often goes by what the largest shareholder is saying. It may not have enough in-house capability for independent analysis and even if it does have, its say will be minute considering the size of shares it owns
- **Pricing of NPAs -** Investors in stressed asset portfolios expect high returns, based on high-risk, high-reward principle which SCs/RCs find impossible to offer if the assets being acquired are not realistically priced.
- **Transparency in official numbers** - a clear and transparent assessment and communication of the problem. Official numbers on non-performing assets are being questioned by an increasing number of observers; this is a clear manifestation of distrust.
- **Infuse more capital into banks**, even if it is based on performance, is a hugely risky move without full transparency. Apparently well-performing banks may suddenly show themselves to be worse than reported. Any move to re-capitalise the banks should only be made once full transparency is achieved

- **Improving management and governance of banks -** there is no action on the recommendations of the committee chaired by P J Nayak, which call for much more fundamental governance reforms.
- **Decentralised decision making from government to PSB boards -** Rajan said. He said more decisions need to be decentralised from the government to the PSB boards, once they have been fully professionalised.
- **asset reconstruction company (ARC) -** The Union finance ministry and the Niti Aayog have recommended that the government set up an asset reconstruction company (ARC) and transfer troubled assets of the banking sector to its books. This will clean up the balance sheets of banks.

2.6.6. Steps Advised by Finance Standing Committee of the Parliament

Finance standing committee of parliament's recommendation on NPAs in its report has been adopted on 5th February 2016. Some of its key recommendations include:

Forensic audit

- The committee has called for immediate forensic audit of all restructured loans that had turned into bad debts. Forensic audit is also required for willful defaults

Revive Development Financial Institutions (DFIs)

- The panel also recommended the development of a "vibrant bond market" to finance infrastructure products.
- Batting for large infrastructural projects, it said the Centre should revive Development Financial Institutions for long-term financing of such projects

Reveal the names of Willful defaulters

- The panel asked the apex bank to form empowered committees at the level of RBI, banks and borrowers to monitor large loans.
- Name and shame the defaulters - There is no justification of keeping the names secret and asked the RBI to amend its guidelines, it added.
- It also recommended that a change in management must be made mandatory in cases involving willful default.

2.7. Some Important Terms

White Label ATMs:

White Label ATM or White Label Automated Teller Machines or WLAs are owned and operated by Non-Bank entities. From such White Label ATM customer from any bank will be able to withdraw money, but will need to pay a fee for the services. These white label automated teller machines (ATMs) will not display logo of any particular bank and are likely to be located in non-traditional places.

Shadow Banks: Shadow Banks refer to those organizations that function like banks but are outside the banking regulation. They help in providing quick source of credit to the public but have been criticized because they lead to a creation of a bubble and on the defaulting on loans by the borrowers it leads to a crisis as one witnessed in the US.

Core Banking Solution - CBS is networking of branches, which enables Customers to operate their accounts, and avail banking services from any branch of the Bank on CBS network, regardless of where he maintains his account. The customer is no more the customer of a Branch. He becomes the Bank's Customer.

Bhartiya Mahila Bank:

Although initially reported as a bank exclusively for women, the bank allows deposits to flow from everyone, but lending will be predominantly for women. It has been decided to merge Bhatiya Mahila Bank with State Bank of India. Some salient features of Bhartiya Mahila Bank are:

- Bank will offer 4.5% interest on saving deposits
- It will not insist on collateral since most title deeds are in name of male family members.
- It will lend to micro businesses like catering, crèches & for upgrading kitchens in households
- The bank aims to have Rs. 60,000 crore business and 775 branches by 2020.
- It will provide loans primarily to women, and will give low-cost education loans for girls.
- Key positions, including treasury head and security head, held by women.

SARFAESI Act 2002: Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (Sarfaesi Act) is the most potent tool in the hands of banks for recovering bad loans (NPAs). The SARFAESI Act empowers banks and financial institutions to recover their non-performing assets without intervention of courts.

The Act provides three alternative methods for recovery of non-performing assets — securitisation, asset reconstruction and enforcement of security — without the intervention of courts. According to the RBI's Report on Trend and Progress of Banking in India, 2012-13, banks have recovered Rs 18,500 crore through the SARFAESI route. Also, in terms of efficiency, the Act has proved to be more effective than the debt recovery tribunals (DRTs) or mediation by Lok Adalats.

Lead bank Scheme: Till 1960s, the Banking needs of the rural areas in general and backward in particular were not taken care of by the Commercial Banks. Lead Bank Scheme (LBS) was introduced in 1969, based on the recommendations of the Gadgil Study Group.

The basic idea was to have an "area approach" for targeted and focused banking.

It refers to scheme under which, one of the commercial banks(like SBI, Axis, ICICI) act as a lead bank and coordinates the activities of another financial institutions like cooperatives banks for efficient functioning and rapid development at district level.

A high level committee chaired by RBI Deputy Governor Usha Thorat was constituted to review and revitalize this scheme. The Opinion of this committee is that full financial inclusion is possible only if it makes a facility of opening of no frill accounts backed by other specialized services.

Banking Ombudsman: Banking Ombudsman is a quasi-judicial authority functioning under India's Banking Ombudsman Scheme 2006, and the authority was created pursuant to a decision by the Government of India to enable resolution of complaints of customers of banks relating to certain services rendered by the banks. From 2002 until 2006, around 36,000 complaints have been dealt by the Banking Ombudsmen.

Banking Ombudsman provides a forum to bank customers to seek redressal of their most common complaints against banks, including those relating to credit cards, service charges, promises given by the sales agents of banks, but not kept by banks, as also, delays in delivery of bank services. The bank customers would now be able to complain about non-payment or any inordinate delay in payments or collection of cheques towards bills or remittances by banks, as also non-acceptance of small denomination notes and coins or charging of commission for acceptance of small denomination notes and coins by banks.

DOMESTIC SYSTEMICALLY IMPORTANT BANKS (D-SIBS): The Reserve bank of India (RBI) has identified State Bank of India (SBI), ICICI Bank and HDFC Bank as domestic systemically important banks (D-SIBs). SIBs are perceived as certain big banks in the country. They enjoy a huge customer base are perceived as 'Too Big to Fail (TBTF)'. As they command such a huge consumer base as well have NBFC subsidiary therefore they have expectation of government support at the time of distress.

EXIM BANK: Export-Import Bank of India is a wholly owned Govt. of India entity setup in 1982 for financing, facilitating and promoting foreign trade of India. The EXIM bank extends Line of Credit (loC) to overseas financial institutions, regional development banks, sovereign governments and other entities abroad. Thus, the EXIM Banks enables buyers in those countries to import developmental and infrastructure, equipment's, goods and services from India on deferred credit terms. The bank also facilitates investment by Indian companies abroad for setting up joint ventures, subsidiaries or overseas acquisitions.

INSOLVENCY AND BANKRUPTCY BOARD: The Centre has constituted a four-member Insolvency and Bankruptcy Board of India (IBBI) under the Ministry of Corporate Affairs. The main activity of IBBI would be to regulate the functioning of insolvency professionals, insolvency professional agencies and information utilities under the Insolvency and Bankruptcy Code 2016.

PRIORITY SECTOR LENDING CERTIFICATES (PSLCS): RBI has permitting the issue and trading of PSL certificates, whereby banks can buy and sell such credits to manage their priority sector lending requirements

3. Vision IAS GS Mains Test Series Questions

1. Digital currency represents a decentralized form of money that is more secure, more fungible and more functional than anything we've seen before. Examine.

Approach:

- In brief explain the arguments provided by proponents of digital currencies regarding independence from a central authority and focus on peer to peer transaction. Technicalities of digital currency are not required.
- In second part of the answer discuss the importance of central banks and the risk of digital currencies.
- Accordingly conclude.

Answer:

The nature of money changed after the Bretton Woods Conference in 1944, when most countries tied the value of their currencies to the US dollar, rather than to gold or silver. When the US went off the gold standard in 1971, all currencies essential became fiat moneys, with their value derived from the governments that issue them rather than from commodities. Thus, global financial system is decided by small group of bankers and this gives enormous control to central banks over economic activity. Therefore, many people object to the concept of fiat money.

In this context, innovating the concept of money through a digital currency which is more decentralized and democratic has been a recurring theme in technology circles. This can be understood for the following:

- **Low transaction fee:**
  - The core innovation is that digital currency uses **consensus in a massive peer-to-peer network to verify transactions**. Thus, there is vast potential in using digital currency as a medium of exchange at a much lower cost than Visa and Mastercard.

- It also transacts business instantaneously, so there is no "float" (i.e. the bank can't keep money in limbo while it earns interest on it) and because processing is automated, fees can be lowered substantially.

- **No central authority:** The supply of Bitcoin is capped. So no one can create unlimited Bitcoins. There's no Federal Reserve or other central bank that can intervene.
- **Impervious to attack:** Digital currencies have a widely distributed ledger, so it's much more impervious to attack than a centralized institution like a bank.

However, there are issues with digital currency. For example,

- **Volatility of currency:** Bitcoin's, the most famous digital currency, popularity led to a massive speculative bubble, rising in value to almost $1000 and then crashing down to under $400.
- There are apprehensions that digital currency can be used to finance illegal activities due to anonymity of the transaction.

Thus, there is much uncertainty associated with Digital currencies. Many think that this may be the future of world economy while others are afraid that it can destroy economies. However, if digital currency works and people starts trusting it to work without the middlemen i.e. central authorities, the way world's economy functions could be transformed for better.

2. ***Examine the reasons for poor performance of public sector banks in India. Give an account of the steps taken by the government and RBI to improve their performance. Also analyse whether the risks arising from the consolidation of the Indian banking sector outweigh the potential longer-term benefits.***

Approach:

- Briefly describe the poor performance of PSBs.
- Enumerate the reasons for this. Mention the impact of the reason you give.
- Next, mention the steps taken by the Government and RBI. Be specific.
- Finally, mention the risks posed by consolidation. Give a balanced opinion.

Answer:

PSBs face multiple concerns related to their performance regarding declining profits, deteriorating asset quality, risky capital position and poor governance. On top there are problems of corruption and human resource which have exacerbated these concerns. The **reasons** for the poor performance are multi-dimensional.

- The economic slowdown in recent years has affected prime borrowing sectors of PSBs i.e. iron and steel, infrastructure, aviation and mining. PSBs are often forced to lend to the unviable projects of these sectors, leading to a rise in NPAs. NPAs require greater provisioning and reduce the bank's capacity to lend to productive sectors.
- The corporate debt restructuring of bad loans of companies leaves the PSBs in a poor financial position. This also hides the magnitude of the imminent problem.
- The poor performance of PSBs is also seen as a governance issue. The appointment of heads of banks involves lobbying by vested interests and is often delayed.
- Dual regulation by RBI and the Finance Ministry has left little autonomy for PSBs.
- Interference by the vested interests has pervaded a culture of non-compliance of best practices to evaluate feasibility of loans and undertaking proper KYC.

To enhance their performance, the **government** has initiated the Indradhanush framework. This comprehensive effort will focus on seven critical areas of

  - appointments,
  - setting up a Bank Board Bureau,
  - capitalization,
  - de-stressing PSBs and strengthening risk control measures,
  - empowerment of bank management,
  - development of a Framework of Accountability, and
  - governance reforms.
- The **RBI** has issued guidelines for quicker recognition and resolution of stressed assets. It has developed a Corrective Action Plan for recovery or sale of unviable accounts. It has lightened norms for Asset Reconstruction Companies by increasing cash stake of ARCs in assets purchased by them. These measures are expected to tackle the issue of increasing NPAs.

Issues in consolidation: The current weak economic environment makes the consolidation process risky because of a high number of stressed assets.

On the other hand, apart from a balance sheet size increase (SBI's will be Rs.37 lakh crore post merger, and push it into top 50 globally), synergies in business and treasury operations, branch rationalisation and the access to tap into cheaper funds are expected to prune the merged entity's costs. This will result in efficiency gains and higher quality of services.

Bank consolidation should not be done to overcome short-term problems faced by certain PSBs. Further, existence of large sized banks will have systemic and moral implications as it may require government bailouts during time of stress.

The government should take into mind the risks involved and take steps accordingly. Creating large banks should not be the sole objective and it must be ensured that consolidation is carried out in a well calibrated manner.

3. The advent of differentiated banking marks the beginning of a radical overhaul of the banking structure that would address the abysmal levels of financial inclusion in India. Elaborate. What are the possible issues that could impede the functioning of these banks?

Approach:

- In introduction provide a brief picture of financial inclusion in India.
- Then bring out the concept of differentiated bank.
- Subsequently, analyse how differentiated bank could address the abysmal levels of financial inclusion in the country.
- Finally, analyse the issues that could impede the functioning of these banks.
- In conclusion suggest a way forward.

Answer:

In last two decades, the reach and scope of banking has increased, but the huge demand for financial services remains unfulfilled. It is a matter of concern that even with 150 domestic commercial and over 2,700 co-operative sector banks operating in the country, just about 40 per cent of the adults have formal bank accounts.

Thus, even while the efforts to ensure financial Inclusion through the existing set of banks continue, the concept of differentiated bank has been introduced. Differentiated banks are distinct from universal banks as they function in a niche segment. It could address the abysmal levels of financial inclusion in following ways-

- Commercial banks are largely interested in funding large and medium corporations or giving out loans for home and vehicle purchases and have neglected smaller segments. Differentiated banking models like payment bank and small bank can fulfil the gaps.
- Differentiated banks will allow customers to directly take deposits, which will bring down their cost of funds and translate into lower interest rates for clients.
- These banks may be in a better position to exploit the huge business opportunity in funding small and medium enterprises.
- Also the RBI expects them to be high technology-low cost operators, while also will bring innovations in service delivery.

Some issues which could impede functioning of these banks-

- Many niche-banking models typically depend on inter-bank liquidity, and wholesale funding which is a potential source of risk and vulnerability and maintaining systematic stability and protecting the interest of depositors.
- Full penetration of no-frills accounts may prove to be a constraint in their pursuit of deposit accounts.
- Differentiated banks will have to persuade a large number of potential customers to either switch from commercial banks or open up a second account.
- Beyond this, on the loan side of the business, as they seek to grow their lending volumes, they will be in direct competition with the priority sector mandates of commercial banks

For these new categories to be given a fair chance of success there is a need for some re-alignment of roles and responsibilities between different categories of banks in relation to no-frills accounts and priority sector loans.

4. The proposal of floating Bad Bank has its merits. However, in Indian context, making it a success poses significant challenges. Discuss.

***Approach*:**

- In the introduction, give an overview of the problem which has given rise to the proposal of bad bank and also explain the idea of bad bank briefly.
- Write about the merits and challenges associated with the bad bank.
- In the conclusion, mention the way forward.

***Answer*:**

Non Performing Assets in Public Sector Banks is around 8 percent. The high NPA robs off the profit and thus dampens the credit growth. To solve this problem Bad Banks have been proposed. The NPAs will be transferred to Bad Banks. The bad bank will manage these NPAs in suitable ways — some may be liquidated, others may be restructured, etc. The idea of bad banks has following merits:

- Getting NPAs off the books will help the PSB management focus on new business instead of having to expend their energies on trying to effect recoveries.
- A bad bank will be better focussed on the task of recovery.
- If bad bank is a private entity, it can also bring in superior expertise.

However, in Indian context, the bad banks may face the following challenges:

- If the government is the majority stake holder in the bad banks, it will be difficult for the government to find huge money. Considering the immediate recapitalization demands that would arise, public debt levels would be impacted. Also, a government-owned bad bank appears to be transferring the problem from one part of the government to another.

- If a private player holds the majority stakes in bad banks, the pricing of bad loans will become a major issue. The high price will not be viable. For the low price, the bad bank will be accused of selling at low cost to boost the profit of the private player.
- Bad banks were typically intended for situations where projects were not viable. There is also a concern that bad banks may not be suitable for India wherein a big chunk of NPAs at PSBs pertains to projects that are viable. These projects have not gone through to completion for reasons that are mostly extraneous to the project, such as problems in land acquisition or environmental clearance.

Therefore, bad banks is also associated with challenges and may not be able to solve the NPA crisis alone. The most efficient approach would be to design bad bank solutions tailor-made for India's bad loan problem.

- It should be based on a criterion as any such exercise creates a moral hazard which should be eschewed.
- There have to be strict performance criteria for the banks selling such assets. This can be through a multi-stage approach where these assets are bought piecemeal by the bad bank based on how future incremental assets perform.
- A competitive approach should prevail among the banks so that they work hard to qualify for the sale of bad assets to the bad bank.

5. Comment on the problem of rising Non Performing Assets (NPAs) in India, with particular reference to public sector banks. Examine the effectiveness of the steps taken by the government in recent times to deal with this problem.

Approach:

- Briefly highlight the NPA problem of India and its causes.
- Discuss in detail how PSBs are affected by NPA and its implication on Indian economy.
- Mention steps taken by government to deal with the problem.
- Discuss the effectiveness of these steps.

Answer:

The entire Indian economy is witnessing a rise of Non-Performing Assets (NPAs). More than Rs. 7 trillion worth loans are classified as Non-Performing Loans in India, which roughly translates to near 10% of all loans given. The key reasons cited for this are: unplanned expansion of Indian corporate houses during boom periods and the Global financial crisis impacting corporate performance and thus, stressing their balance sheets.

The severity of NPA problem is much higher in Public sector banks (PSBs) as compared to private banks because:

- PSBs have more exposure in the sectors — infrastructure, steel, textiles, aviation, and mining —which have contributed towards a big rise in NPAs.
- Inefficient borrower screening, credit appraisal and post-disbursement supervision.
- Lack of effective loan recovery mechanisms.

Such huge levels of NPAs cripple the whole economy as banking sector raises interest rates, reduces funding to nation-building projects resulting into increased unemployment and lowering of GDP growth. To address the problem of NPAs, the government took several measures such as:

- Mission Indradhanush to transform PSBs.
  - Established Bank Board Bureau for appointments to PSBs, developing strategies for raising funds and overseeing consolidation of PSBs.
- Announced Rs. 70,000 Crore for recapitalisation of banks.
- RBI has over the past few decades come up with a number of schemes such as Corporate Debt Restructuring (CDR), formation of Joint Lenders' Forum (JLF), flexible structuring for long-term project loans to infrastructure (or 5/25 Scheme), Strategic Debt Restructuring (SDR) scheme and Sustainable Structuring of Stressed Assets (S4A) to check the menace of NPAs.
- Asset Quality Review was conducted for early identification of the assets and preventing them from becoming stressed by appropriate action.
- Insolvency and Bankruptcy Code Act, 2016 to tackle the Chakravyuaha challenge of the exit problem in India.
- The Banking Regulation Act has been amended to give the RBI more powers to monitor bank accounts of big defaulters.
- The SARFAESI Act, 2002 was amended in 2016 for quick recovery of stressed assets.

However, these measures have seen limited progress in tackling NPAs.

- The schemes like S4A has limited applicability as most corporate defaulters failed to meet the standards. It cannot be applied to all cases of stressed exposure. It can be applied only to operational projects and not to under construction projects.
- The recapitalisation amount has fallen short of the amount needed by banking sector.
- The bank officers are too cautious with debt restructuring due to the fear of anti-graft charges.
- The time bound manner in which Insolvency and Bankruptcy code aims to resolve cases have been lauded by the experts. However, the long term effects are yet to be seen.

Several experts point towards further increase in NPAs in Indian banking sector. To address this problem, the government and banking sector together should consistently work on remedial measures like the BAD Bank and other structural reforms. The Government is also bringing Financial Resolution and Deposit Insurance Bill for the insolvency of financial firms including banks.

6. Even though the Pradhan Mantri Jan-Dhan Yojana is an accelerated effort towards financial inclusion, mere opening of bank accounts will not transform into financial inclusion in India. Analyse.

Approach:

- Briefly explain the objectives of Prime Minister's Jan Dhan Yojana towards financial inclusion.
- Explain the issues to be dealt in addition to opening of bank accounts in order to achieve financial inclusion in India.
- Conclude positively with a way forward.

Answer:

Financial inclusion denotes delivery of various financial services at an affordable cost to the vast sections of the disadvantaged and low-income groups. The objective of financial inclusion is to extend the scope of activities of the organized financial system to include within its ambit people with low incomes.

The Pradhan Mantri Jan-Dhan Yojana (JDY) was launched in August 2014 as an ambitious financial inclusion scheme. The yojana envisages universal access to banking facilities with at least one basic banking account for every household, access to credit, insurance and pension facility.

It is estimated that nearly 14.7 crore accounts were opened till 31 March 2015. Even though the programme is an accelerated effort towards financial inclusion in India, mere opening of bank accounts will not transform into financial inclusion.

In addition to opening of bank accounts, there is a need to address various other issues in order to achieve financial inclusion:

- According to the World Bank's Global Financial Development Report (2014) only 11% of those who had a bank account had savings and only 8% took loans. Equally alarming are the number of bank accounts that are opened and lie dormant.
- As per the RBI data almost 75% of savings accounts lie dormant. These figures get more dismal if we look at the accounts opened by business correspondents (BCs).
- While it is true that bank accounts can be used to link different wage employment schemes such as MgNREGA, it does not ensure affordable credit from formal sources for the rural poor who continue to rely on informal sources of finance at high interest rates for their credit needs.
- The poorer and more disadvantaged group of households in agriculture and allied activities form just a mere 1% of the savings in formal institutions.
- The banks are faced with high operating cost in extending the financial services to the remote areas. High maintenance cost of these accounts as well as small ticket size of the transactions is also adding to the problem.
- The current service delivery model of using BCs and mobile money to increase outreach faces a formidable trust barrier. The Inter Media India FII Tracker Survey (2013) report suggest that just 3% of households fully trust BCs with their financial transactions and only 1% of households trust the use of mobile money. This defeat the very purpose of making financial services more accessible and affordable for the poor.
- There is a need for banks to mitigate the supply side processes that prevent poor and disadvantaged social groups from gaining access to the financial system. Despite the risk, financing of first time entrepreneurs is a must for financial inclusion and growth.
- Low level of financial literacy is another major issue. Reaching out to the illiterate people or people who can handle only the regional languages is also difficult without developing a suitable communication mode.

There is a need to compute a more multidimensional index of financial inclusion to include both financial deepening indicators such as the number of bank accounts as well as financial habit indicators such as the number of bank accounts that are actually used.

Both access and use will be necessary to smooth consumption and reduce risks for the poor. The mere chasing of numerical targets of financial access becomes meaningless unless deeper issues that address financial capability and trust in service delivery are tackled simultaneously.

7. *MUDRA bank has been termed as a game changer for micro finance sector in the country. What are the objectives of MUDRA Bank? Is there a need of such an institution when there already are multiple schemes and institutions operating for the same purpose?*

Approach:

- Describe the MUDRA Yojna briefly.
- Bring out the argument whether such a scheme is needed or not.
- Mention past and present schemes for the sector and their impact.
- Give relevant facts/examples to support your view point.

Answer:

With an initial corpus of Rs 20000 crores and a credit guarantee corpus of Rs 3000 crores Government recently launched MUDRA (Micro Units Development Refinance Agency) to infuse finance into MSME sector of the country. Formal sector generates about 29.6 million while 57.8 million small and micro enterprises provide 128 million jobs. Almost 2/3rd of them belong to the SCs, STs and OBCs. More than half of them operate from rural areas, where financial outreach of formal channels is limited and delivering economic growth difficult. A focused approach of finance availability through MUDRA has immense potential in development of MSME sector that will bring inclusive growth.

Following are the objectives of the MUDRA:

- Almost 90% of MSMEs depend upon the informal sector for financing where money lenders charge very high interest. Even the MFIs lend at a rate of about 25% to these enterprises because banks lend them at around 14%. MUDRA will partner state and regional level coordinators to enable them to provide refinance to last mile financiers of micro businesses and cut borrowing costs for the cash-starved domestic small businesses.
- It will create a framework that regulates and provides refinancing capital flows to micro-finance institutions that are in turn in the business of lending to micro/small business entities engaged in manufacturing, trading and services activities.
- MFIs do not meet the funding requirements of small entrepreneurs who want more than Rs.50,000 and up to a few lakhs. Commercial banks, too, are reluctant to give them loans. This lacuna will be addressed by the MUDRA bank.
- It will help in bringing transparency, accountability and technology to the sector.
- NABARD and SIDBI also refinance MSMEs. However, MUDRA will have sole focus on the Micro and Small businesses.

However, the following issues should be addressed to make MUDRA a success:

- There already exist financing schemes like Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE), Portfolio Risk Fund (PRF) etc and many others apart from the technical and managerial support. Hence, it is not only lack of finance but also the multiplicity of schemes, poor implementation, problems like corruption and complex processes and lack of awareness which is impeding the growth of sector.
- A redrawing of the functions of NABARD and SIDBI, which have not performed up to the mark, in the light of creation of MUDRA should be done.
- Regulatory and credit functions of the MUDRA should be separated to avoid conflict of interest.

- Small banks also have immense potential for the sector and can be used to supplement MUDRA.
- Introduction of electronic transfer facility for the sector.

While the global trend is discourage shadow banking and use the main-line banking system to meet the financing needs of all segments we are creating one more refinancing agency. Hence, a thorough redress of these issues should be done to ensure credit flow to SMEs also called as 'missing middle' and prevent MUDRA from being another lost opportunity.

4. Previous Years UPSC Mains Questions

1. Describe the organisation and the functions of Regional Rural banks, Review their achievements. Is there any conflicting jurisdiction between these rural banks and cooperative credit societies?
2. What are the main components of money supply in India?
3. It is being suggested that the commercial banks in India should reduce their holdings of non-performing assets. Does it mean that the former should abandon social priorities? (About 250 words)
4. What has been the rationale for deregulating commercial bank's lending rates as a policy strategy?

CENTRAL BANK AND MONETARY POLICY

Contents

1. Central Bank

A central bank is the apex institution in the banking and financial structure of the country. It plays a leading role in organizing, running, supervising, regulating and developing the banking and financial structure of the economy. Its activities are very essential for the proper functioning of the economy. Almost all the countries in the world have a central bank. India's central bank is known as the Reserve Bank of India.

Reserve Bank of India
The Reserve Bank of India is the central bank of the country. It is the apex monetary and banking authority in India. The RBI was established on April 1, 1935 under the provisions of RBI Act, 1934 initially as a private shareholders' bank. It was nationalized on January 1, 1949 and given wide powers. The executive head of the RBI is called the Governor. Its headquarters is in Mumbai. **RBI has seven major functions** • Print Notes: RBI has the sole autonomy to print notes. GoI has the sole authority to mint coins and one rupee notes. • Banker to the Government: It manages government's deposit accounts. It also represents government as a member of the IMF and World Bank. • Custodian of Commercial Bank Deposits and Regulation and supervision of the banking and non-banking financial institutions, including credit information companies. • Custodian to Country's Foreign Currency Reserves and management of Current and Capital accounts. • Lender of Last Resort: Commercial banks come to RBI for their monetary needs in case of emergency. • Central Clearance and Accounts Settlement: As RBI keeps cash reserves from commercial banks therefore it rediscounts their bills of exchange easily. • Credit Control: It controls supply of money in the economy through its monetary policy.

1.1. Functions of a Central Bank

A central bank performs a number of important functions in every country. The major functions are as follows:

1. **Bank of Issue:** Central bank is the bank of issue. It enjoys the monopoly of note issue. In most of the countries the central bank is required to keep a certain amount of gold and foreign securities against the issue of notes.

   Concentration of exclusive power of note issue with the central bank has a number of advantages:

   - It brings uniformity in note issue as a result of which these notes are widely accepted as a medium of exchange.
   - It imparts the notes a distinctive prestige as a result of which people develop faith in the currency.
   - It enables the central bank to have an effective control on the bank money created by commercial banks.
   - It enables the government to have supervision and control over the supply of money in the economy.

2. **Banker, Fiscal Agent and Adviser to the Government:** Central banks in all countries act as banker, fiscal agent and adviser to the government. As the banker to the government, the central bank performs the same functions as are performed by commercial banks for their customers. The central bank receives the deposits of cash, cheques, drafts etc. from the government. It provides cash to the government for paying salaries and wages and other cash disbursements. It makes payments on behalf of the government. It gives short-period loans to the government. It buys and sells foreign currencies on behalf of the government.

   As fiscal agent, it manages public debt. It issues new loans on behalf of the government, receives subscriptions to these loans, pays interest on them, and finally repays these loans. It also acts as the government's agent in enforcing foreign exchange control.

   The central bank acts as the financial adviser to the government. It advises the government on all financial and monetary matters and in the formulation of economic policies, such as those for the control of inflation or deflation, devaluation or revaluation of the currency, use of deficit financing, foreign trade policy, budgetary policy etc.

3. **Banker to the Banks:** Central bank has the same relationship with the commercial banks as the latter has with the general public. As the bankers' bank, the central bank performs several functions. It acts as the custodian of cash reserves of commercial and other banks. Commercial banks are under statutory obligation to keep a part of their deposits as reserves with the central bank. The central bank provides credit, mainly short-term credit, to the commercial banks. It provides them guidance and direction and regulates their activities. Commercial banks are required to shape their policy in accordance with these directions and guidance of the central bank.

   The centralization of cash reserves has many advantages, like:

   - It is on the basis of these reserves that payment by one bank to another is done to facilitate the clearing of cheques.
   - It is a source of great strength to the banking system of the country.
   - Centralized cash reserve serves as the basis of a large and more elastic credit structure.
   - The central bank can control the credit creation by the commercial banks by changing these cash reserves.
   - Centralized cash reserve can be used effectively during the period of seasonal strains and in financial crisis or emergencies.

4. **Custodian of Nation's Foreign Exchange Reserves:** As the custodian of foreign exchange reserves, the central bank performs several functions:
   - All the foreign exchange transactions of a country are routed through the central bank. The central bank controls both the receipts and payments of foreign exchange.
   - It tries to maintain stability of the exchange rate. For this purpose, it buys or sells foreign currencies in the market to minimize fluctuations in the foreign exchange rates.
   - It enforces exchange control regulations prescribed by the government from time to time.

5. **Lender of Last Resort:** When commercial banks have exhausted their resources and are in need of funds they approach the central banks to tide over the financial crises. In its capacity as the lender of the last resort, the central bank provides, directly or indirectly, all reasonable financial assistance to commercial banks, discount houses, bill brokers and other financial institutions. The central bank assists such institutions in times of financial stresses through discounting of approved securities and collateral loans and advances.

6. **Clearing House for Transfer and Settlement of Mutual Claims of Commercial Banks:** Every day the customers of different banks issue cheques drawn on their banks. This creates the need of settling claims of the commercial banks on each other. Since the commercial banks keep their cash reserves with the central bank, it is easier and convenient to clear and settle claims on each other by making transfer entries in their accounts maintained with the central bank. For transfer and settlement of mutual claims of the banks, the central bank provides 'clearing house' facility in big cities and trade centres. It is a simple, convenient, time-saving and economical device for settling of commercial banks on each other.

7. **Controller of Credit:** The most important function of the central bank is to control credit creation by the commercial banks. Since 'credit money' or 'bank money' is the dominant form of money presently, it is essential that the supply of credit must be regulated so as to ensure the smooth functioning of the economy. For this purpose, the central bank adopts quantitative and qualitative methods of credit control. Quantitative methods aim at controlling the cost and availability of credit, while the qualitative methods influence the use and direction of credit.

8. **Promotional and Developmental Functions:** In a developing country, the central bank not only performs the so called traditional functions, but in addition it performs various promotional and developmental functions, among which the more important ones are:
    - Central bank is entrusted with the responsibility of developing and promoting a strong banking system. For this purpose, it provides liberal and cheap rediscounting facilities to commercial banks and gives various types of concessions.
    - It assists in the development of financial institutions like 'developmental banks' to provide investable funds for the development of agriculture, industry and other sectors of the economy. It helps in the development of money and capital market in the country. It also pursues appropriate monetary policy to promote economic development.
    - Create awareness about financial products and services, good financial practices, going digital and consumer protection.

9. **Publication of Economic and Statistical Information:** The central bank collects periodical economic and statistical information relating to different aspects of the economy and publishes periodical reports. This provides valuable information regarding the functioning of the economy. This also enables the government to formulate appropriate economic policies to promote economic development.

2. Monetary Policy

2.1. Definition of Monetary Policy

Monetary Policy refers to the policy measures undertaken by the government or the central bank to influence the availability, determine the size and rate of growth of the money supply in the economy.

Alternatively, some economists define monetary policy as a process of managing a nation's money supply to achieve specific goals such as constraining the inflation, achieving higher growth rates, achieving full employment etc. Generally, all across the globe, monetary policy is announced by the central banking body of the country, for example the RBI announces it in India. The RBI has the duty to see that legitimate credit requirements are met and at the same credit is not used for unproductive and speculative purposes

2.2. Types of Monetary Policy

Broadly, monetary policy can be of two kinds **Expansionary Monetary Policy** and **Contractionary Monetary Policy**. Alternatively, they are also called as Cheap Money policy or Dear money policy respectively.

Expansionary monetary policy increases the supply of money in an economy by making credit supply easily available. Money produced through such a policy is called as cheap money.

An expansionary monetary policy is utilized when an economy goes through a phase of recession accompanied by lower levels of growth and high levels of unemployment. For example in 2008-09 the entire world including India adopted an expansionary monetary policy to counter slowdown/recession.

But expansionary monetary policy comes with its own risks, such as inflation. Also, there is a time lag between the time when policy is announced and when it takes effect in the economy, thus at times the expansionary monetary policy may not have desired impact on the economy in terms of growth.

Contractionary monetary policy on the other hand, decreases the supply of money in the economy. Contractionary monetary is used to tackle the menace of inflation in the economy by raising the interest rates.

2.3. Objectives

Traditionally, there have been varying objectives of monetary policy in different countries in different times and in different economic conditions. The proper objective of the monetary policy is to be selected by the monetary authority keeping in view the specific conditions and requirements of the economy. For developing countries like India its objective may be the maintenance of monetary stability and helping in the process of economic development. In developed countries its objective may be to achieve full employment, without inflation.

Some of the objectives of monetary policy are listed as below:

a) **Economic growth:** The monetary policy can influence economic growth by controlling real interest rates and its resultant impact on the investment. If the RBI opts for a cheap credit policy by reducing interest rates, the investment level in the economy can be encouraged. This increased investment can speed up economic growth.

b) **Price Stability:** In current regime of Monetary Policy Committee, it is the primary objective of monetary policy in India. Price stability is defined as a low and stable order of inflation. Thus, the monetary policy having an objective of price stability tries to keep the value of money stable. For developed countries, such an inflation threshold is considered to be around 2 percent which could be higher for developing countries depending on their stage of economic development. A number of prominent central banks including the European Central Bank, Bank of England and Bank of Japan have adopted price stability as the single objective of monetary policy. When the economy suffers from recession the monetary policy should be an 'easy money policy' but when there is inflationary situation there should be a 'dear money policy'.

c) **Exchange Rate Stability:** If exchange rate of an economy is stable it shows that economic condition of the country is stable. Monetary policy aims at maintaining the relative stability in the exchange rate. The RBI by altering the foreign exchange reserves tries to influence the demand for foreign exchange and tries to maintain the exchange rate stability.

d) **Generating Employment:** Monetary policy can be used for generating employment. If the monetary policy is expansionary then credit supply can be encouraged. It would thus help in creating more jobs in different sector of the economy.

e) **Equal income distribution:** Earlier, many economists used to justify the role of the fiscal policy in maintaining economic equality. However, in recent years economists have given the opinion that the monetary policy can play a supplementary role in attainting economic equality. Monetary policy can make special provisions for sectors such as agriculture, small-scale industries, village industries, etc. and provide them with cheaper credit for longer term. This can prove fruitful for these sectors to come up. Additionally, the monetary authority can help in establishment and expansion of banks and institutions in rural and backward areas of the country. Thus in recent times, the role of monetary policy in reducing economic inequalities has been greatly enhanced.

In India, as defined by former RBI governor C. Rangarajan, broad objectives of monetary policy are:

a) To regulate monetary expansion so as to maintain a reasonable degree of price stability; and
b) To ensure adequate expansion in credit to assist economic growth.

2.4. Tools to Regulate Monetary Policy

There are many tools by which a Central Bank regulates the monetary policy. They can be classified into two categories:

2.4.1. Quantitative Credit Control Methods

These methods are designed to control the overall volume of credit created in an economy. A number of them exist of date such as CRR, SLR, Bank Rate, Repo rate, Reverse Repo rate, interest changes for the instruments of the Money Market, etc.

Statutory Liquidity Ratio: The statutory liquidity ratio refers to that proportion of total deposits which the commercial banks are required to keep with themselves in a liquid form. The commercial banks generally make use of this money to purchase the government securities. Thus, the statutory liquidity ratio, on the one hand, is used to siphon off the excess liquidity of the banking system, and on the other, it is used to mobilize revenue for the government. The Reserve Bank of India is empowered to raise this ratio upto 40 per cent of aggregate deposits of commercial banks. ***At present it is 19.5 per cent (August 2018)***. It used to be as high as 38.5 percent at one point of time.

Cash Reserve Ratio: The cash reserve ratio (CRR) is the ratio (fixed by the RBI) of the total deposits of a bank in India, which is kept with the RBI in cash form. CRR deposits do not earn any interest for banks. Initially, limits of 3% (lower) and 20% (upper) were set for CRR, but respective amendments removed these limits, thereby providing RBI with much needed operational flexibility. If CRR is high, less money is available for lending by the banks to players in the economy. RBI increases CRR to tighten credit and lowers CRR to expand credit in the economy. CRR as a tool of monetary policy is used when there is a relatively serious need to manage credit and inflation. Otherwise, RBI relies on signaling its intent through the policy rates of repo and reverse repo. ***At present CRR is 4 percent (August 2018).***

Bank Rate: In basic terms, bank rate is the interest rate at which RBI provides **long term credit facility** to commercial banks. A change in bank rate affects other market rates of interest. An increase in bank rate leads to an increase in other rates of interest, and conversely, a decrease in bank rate results in a fall in other rates of interest. Bank rate is also referred to as the discount rate. A deliberate manipulation of the bank rate by the Reserve Bank to influence the flow of credit created by the commercial banks is known as **bank rate policy**.

An increase in bank rate results in an increase in the cost of credit or cost of borrowing. This in turn leads to a contraction in demand for credit. A contraction in demand for credit restricts the total availability of money in the economy, and hence results as an anti-inflationary measure of control.

Penal rates are linked with Bank Rates. For instance if a bank does not maintain the required levels of CRR and SLR, then RBI can impose penalty on such banks.

Nowadays, bank rate is not used a tool to control money supply, rather LAF (Repo Rate) is used to control the money supply in economy.

Repo Rate: Repo rate is the rate at which banks borrow funds from the RBI to meet the gap between the demands they are facing for money (loans) and how much they have on hand to lend. In simple words, Repo Rate is the interest rate charged by the Central Bank from other banks for **short-term borrowings.**

If the RBI wants to make it more expensive for the banks to borrow money, it increases the repo rate; similarly, if it wants to make it cheaper for banks to borrow money, it reduces the repo rate. ***As of August 2018 repo rate stood at 6.25%.***

Reverse Repo Rate: Reverse Repo is the rate at which the Central Bank (RBI) borrows from the market. This is called as reverse repo as it the reverse of repo operation.

Repo and Reverse Repo Rates are also referred to as the **Policy rates** and are often used by the Central Bank (RBI) to send single to the financial system to adjust their lending and borrowing operations.

Repo rates and reverse repo rates form a part of the ***liquid adjustment facility*** **(LAF).**

Open Market Operations (OMOs): It refers to buying and selling of government securities in open market in order to expand or contract the amount of money in the banking system. Purchases inject money into the banking system while sale of securities do the opposite. It is a common misconception that OMOs change the total stock of government securities, but in reality they only change the proportion of Government Securities held by the RBI, commercial and co-operative banks. The Reserve Bank of India has frequently resorted to the sale of government securities to which the commercial banks have been generously contributing. Thus, open market operations in India have served, on the one hand as an instrument to make available more budgetary resources and on the other as an instrument to siphon off the excess liquidity in the system.

2.4.2. Qualitative Credit Control Methods

These are those tools through which the central bank not only controls the value of loans but also the purpose for which these loans are assigned by the commercial banks. Some of these are:

1. **Moral Suasion:** Moral suasion means persuasion and request. To arrest inflationary situation central bank persuades and requests the commercial banks to refrain from giving loans for speculative and non-essential purposes. On the other hand, to counter deflation central bank persuades the commercial banks to extend credit for different purposes. Under Moral Suasion, RBI issues periodical letters to bank to exercise control over credit in general or advances against particular commodities. Periodic discussions are held with authorities of commercial banks in this respect. In India, from 1949 onwards the Reserve Bank has been successful in using the method of moral suasion to bring the commercial banks to fall in line with its policies regarding credit.
2. **Rationing of credit**: Rationing of credit is a method by which the Reserve Bank seeks to limit the maximum amount of loans and advances, and also in certain cases, fix ceiling for specific categories of loans and advances. RBI also makes credit flow to certain priority or weaker sectors by charging concessional rates of interest. This is at times also referred to as Priority Sector Lending.

3. **Regulation of Consumer Credit**: Now-a-days, most of the consumer durables like Cars, Televisions, and Laptops etc. are available on installment basis financed through bank credit. Such credit made available by commercial banks for the purchase of consumer durables is known as consumer credit.

   If there is excess demand for certain consumer durables leading to their high prices, central bank can reduce consumer credit by (a) increasing down payment, and (b) reducing the number of installments of repayment of such credit.

   On the other hand, if there is deficient demand for certain specific commodities causing deflationary situation, central bank can increase consumer credit by (a) reducing down payment and (b) increasing the number of installments of repayment of such credit.

4. **Direct action:** This method is adopted when a commercial bank does not co-operate with the central bank in achieving its desirable objectives. Direct action may be any many forms:

   Central banks may charge a penal rate of interest over and above the bank rate upon the defaulting banks; Central bank may refuse to rediscount the bills of those banks which are not following its directives; Central bank may refuse to grant further accommodation to those banks whose borrowings are in excess of their capital and reserves.

5. **Margin Requirements:** Generally, commercial banks give loan against 'stocks or 'securities'. While giving loans against stocks or securities they keep margin. Margin is the difference between the market value of a security and its maximum loan value. Let us assume, a commercial bank grants a loan of Rs. 8000 against a security worth Rs. 10,000. Here, margin is Rs. 2000 or 20%.

If central bank feels that prices of some goods are rising due to the speculative activities of businessmen and traders of such goods, it wants to discourage the flow of credit to such speculative activities. Therefore, it increases the margin requirement in case of borrowing for speculative business and thereby discourages borrowing. This leads to reduction in money supply for undertaking speculative activities and thus inflationary situation is arrested.

On other contrary, central bank can encourage borrowing from the commercial banks by reducing the margin requirement. When there is a greater flow of credit to different business activities, investment is increased. Income of the people rises. Demand for goods expands and deflationary situation is controlled.

Thus, margin requirement is a significant tool in the hands of central bank to counter-act inflation and deflation.

2.5. Limitations of Monetary Policy

a) **Limited Role in Controlling Prices:** As per the critics, the monetary policy of Reserve bank has played only a limited role in controlling the inflationary pressure. It has not succeeded in achieving the objective of growth with stability. The role of monetary policy in combating inflation is strictly limited and monetary policy can be effective only if it is a part of an overall framework of policy, which includes not only fiscal and foreign exchange policy but also structural changes in the economy. For example, a bad monsoon in India may lead to inflation of food products. Monetary policy will not be very effective in controlling food prices in such a situation rather a mix of structural reforms (maintaining buffer stocks, reducing wastage etc) and fiscal policy (ex. Import of food grains) is desirable.
b) **Existence of Black money:** The existence of black money in the economy limits the working of the monetary policy. Black money is not recorded since the borrowers and lenders keep their transactions secret. Consequently, the supply and demand of money also not remains as desired by the monetary policy.

c) **Large non-monetized sector:** There is a large non-monetized sector which hinders the success of monetary policy in such countries. People mostly live in rural areas where barter is practiced. Consequently, monetary policy fails to influence this large segment of the economy.
d) **Large number of Non- Banking Financial Intermediaries:** Non-bank financial intermediaries like the indigenous bankers operate on a large scale in countries like India but they are not under the control of the monetary authority. The factor limits the effectiveness of monetary policy in such countries
e) **Conflicting Objectives:** An important limitation of monetary policy arises from its conflicting objectives. To achieve the objective of economic development the monetary policy is to be expansionary but contrary to it to achieve the objective of price stability a curb on inflation can be realised by contracting the money supply. The monetary policy generally fails to achieve a proper coordination between these two objectives.
f) **Underdeveloped Money Market:** Another limitation of monetary policy in India is underdeveloped money market. The weak money market limits the coverage, as also the efficient working of the monetary policy.
g) **Influence of non-monetary factors:** An important limitation of monetary policy is its ignorance of non-monetary factors. The monetary policy can never be the primary factor in controlling inflation originating in real factors, deficit financing and foreign exchange resources. The Reserve Bank has no control over deficit financing. It cannot regulate the deficit financing, which affects money supply considerably.
h) **Ineffective implementation of Monetary Policy:** Successful application of monetary policy is not merely a question of availability of instruments of credit control. It is also a question of judgment with regard to timing and the degree of restraint employed or relaxation allowed. However, past experience shows that Reserve Bank's credit restrictions have always fallen short of the required extent of restraint. The Bank has adopted a hesitant attitude in the field of monetary control. In short, the monetary policy of the Reserve Bank suffers from many limitations. It requires improvements in many directions.

2.6. Revision of Monetary Policy in India

Historically, in India the monetary policy was announced twice a year, namely a slack season policy (April to September) and a busy season policy (October to March). But, in the wake of pressures of globalization and growing importance of monetary policy, RBI has become more proactive in altering the monetary policy from time to time depending upon the state of economy. Also, the RBI has moved in for a single monetary policy every year in April end although the review of monetary policy takes place every quarter.

Presently, Monetary Policy in India is managed by **Monetary Policy Committee**, thus the Governor of RBI is no longer the sole authority to decide on the Monetary Policy.

2.7. Monetary Policy Committee (MPC)

MPC was set up consequent to the agreement reached between Government and RBI to task RBI with the responsibility for price stability and inflation targeting. The Reserve Bank of India and Government of India signed the Monetary Policy Framework Agreement on 20 February 2015.

The MPC replaced the erstwhile system where the RBI governor, with the aid and advice of his internal team and a technical advisory committee, has complete control over monetary policy decisions.

Pursuant to this, it was written into the preamble of the RBI Act that the **primary objective of the monetary policy is to maintain price stability, while keeping in mind the objective of**

growth, and to meet the challenge of an increasingly complex economy, RBI would operate a Monetary Policy Framework.

Recommendations to constitute MPC:

Many committees have suggested setting up of MPC. For example, in 2002 the Y. V. Reddy Committee recommended for a MPC to decide policy actions. Subsequently, suggestions were made to set up a MPC in 2006 by the Tarapore Committee, in 2007 by the Percy Mistry Committee, in 2009 by the Raghuram Rajan Committee and then in 2013, both in the report of the Financial Sector Legislative Reforms Commission (FSLRC) and the Dr. Urjit R. Patel (URP) Committee.

Advantages of Targeting Inflation

- **Lowers the interest rates**- lower interest rate increases borrowings, boosts investment and thereby activity in the economy.
- **Helps in long term planning** for public and private entities and in policy formulation
- **Redistributes income and wealth** between different groups in society. High inflation benefits some groups at the expense of others.
- **Provides a climate of certainty** and thus boosts lender confidence. High inflation implicitly penalizes the lender.

Composition of MPC

- MPC consists of six members - the RBI Governor (Chairperson), the RBI Deputy Governor in charge of monetary policy, one official nominated by the RBI Board and the remaining three members nominated by the Government of India.
- The Government nominees are appointed based on the recommendations of a search cum selection committee consisting of the cabinet secretary (Chairperson), the RBI Governor, the secretary of the Department of Economic Affairs, Ministry of Finance, and three experts in the field of economics or banking as nominated by the central government. The nominee will hold office for a period of four years and will not be eligible for re-appointment.
- The RBI act lays down the required qualification and eligibility for Members of MPC.

Functions of MPC

- RBI will be responsible for containing inflation targets at 4% (with a standard deviation of 2%) in the medium term.
- Central Government determines the inflation target in terms of the Consumer Price Index, once in every five years in consultation with the RBI.
- RBI would have to give an explanation in the form of a report to the Central Government, if it failed to reach the specified inflation targets. The report will give reasons for failure, remedial actions as well as estimated time within which the inflation target shall be achieved.
- RBI is mandated to publish a Monetary Policy Report every six months, explaining the sources of inflation and the forecasts of inflation for the coming period of six to eighteen months.
- RBI has to organize at least four meetings of the MPC in a year.
- The MPC takes decisions based on majority vote (by those who are present and voting). In case of a tie, the RBI governor will have the *second* or casting vote. The decision of the Committee would be binding on the RBI.

2.8. Latest Developments

Urjit Patel Committee

In January 2014, RBI appointed an expert committee headed by Urjit Patel, the current Governor of RBI to examine the existing monetary policy framework. The committee made several far reaching recommendations, some of which have been discussed below.

- The most important recommendation of the committee was that the RBI should focus on controlling inflation in the economy or in other words inflation should be the nominal anchor to frame monetary policy.
- The nominal anchor or the target for inflation should be set at 4 per cent with a band of +/- 2 per cent around it.
- The nominal anchor should be defined in terms of headline CPI inflation, which closely reflects the cost of living and influences inflation expectations relative to other available metrics. Historically, Indian policymakers have relied on the wholesale price index
- It recommended a 12-month target of 8 per cent and 24-month target of 6 per cent, before the inflation target is formally adopted.
- The committee asked the Central Government to ensure that the fiscal deficit as a ratio to GDP (gross domestic product) is brought down to 3.0 per cent by 2016-17.
- The Patel panel felt that the monetary policy decision-making should be vested with a **monetary policy committee** (MPC).
- It went on to recommend that the Governor of the RBI should be the Chairman of the MPC. It felt that the Deputy Governor in-charge of monetary policy could be the Vice-Chairman. The Executive Director in charge of monetary policy could be its member. It could have two external members.
- The term of office of the MPC could be three years, without prospect of renewal.
- Minutes of the proceedings of the MPC to be released with a lag of two weeks from the date of the meeting.
- Currently, the RBI governor is the sole decision maker on monetary policy, though he is advised by his four deputy governors and a technical advisory committee.

Concerns regarding Urjit Patel Committee Recommendations

- In a developing country, the Central Bank cannot escape from the difficult challenge of weighing the growth-inflation trade off in determining its monetary policy stance.
- Experts feel that it is premature to use the Consumer Price Index (CPI) as anchor since the data had imperfections.
- Monetary policy is not the only variable affecting inflation especially in India where inflationary pressures emerge from supply side constraints. According to former RBI Governor D Subbarao, 50 per cent of inflation is beyond the control of monetary policy.
- A necessary condition for inflation targeting to work is efficient monetary transmission. In India there are several factors inhibiting the monetary transmission process such as an asymmetric relationship between depositors and banks, administered interest rates on postal savings that are not adjusted in line with prevailing interest rate trends and rigidities in the financial markets.
- Recommendations do not talk about exogenous shocks which may spike inflation(e.g. Oil price hike)
- Monetary policy is ill-equipped to accurately forecast future inflation trends

However some experts also believe that the panel recommendation for adopting monetary policy, which is centered on inflation, will be a shift from traditional policymaking, and will also bring RBI policy calibration closer to the international practices.

2.9. Miscellaneous

2.9.1. Monetary Policy vs. Fiscal Policy, Monetary-Fiscal Policy Mix

In recent times, monetary policy has been gaining a lot of importance in management of economies. There has therefore been a constant debate on whether fiscal policy or monetary policy is more effective in making the desired impact on an economy. Some of the propositions have been discussed below:

Political compulsions and objectives: The experience of the 1960s, 1970s, and 1980s suggests that democratically elected governments have more trouble using fiscal policy to fight inflation. Fighting inflation requires government to take unpopular actions like reducing spending or raising taxes. Political realities, in short, may favor a bigger role for monetary policy during times of inflation.

On the other hand, fiscal policy is more suited to combat unemployment in the economy as the government can increase spending to create public infrastructure and process jobs.

Problem of Liquidity Trap: The monetary policy remedy to economic decline is to increase the amount of money in circulation, thereby cutting interest rates. But once interest rates reach zero, the Central Bank can do no more. Such a situation is referred to by the economists as the **"liquidity trap".** The problems experienced by the Japanese in the 1990's in trying to stimulate their economy through a zero-interest rate policy might be mentioned here.

With its economy stagnant and interest rates zero, many economists contended that the Japanese Government had to resort to more aggressive fiscal policy. In such a case monetary policy proved to be of no value at all.

But some economists disagree on this too. They argue that short term changes in monetary policy do impact quite quickly and strongly on consumer and business behavior. For example, the domestic demand in both the United States and the UK responded positively to the interest rate cuts introduced in the wake of the terror attacks on the USA in 2001.

Difference in Lags of Monetary and Fiscal Policies

Monetary and fiscal policies differ in the speed with which each takes effect as the time lags are variable in each case. Monetary policy is extremely flexible and emergency rate changes can be made in quick time, whereas changes in taxation take longer to organize and implement.

Because capital investment requires planning for the future, it may take some time before decreases in interest rates are translated into increased investment spending. Typically it takes six months – twelve months or more before the effects of changes in monetary policy are felt.

The impact of increased government spending is felt as soon as the spending takes place and cuts in direct and indirect taxation feed through into the economy pretty quickly. However, considerable time may pass between the decision to adopt a government spending programme and its implementation.

Therefore, even on this front it is very difficult to choose between the one of two.

As stated by many experts, the need of today is not just the pumping of liquidity in to the Indian economy (i.e. use of monetary policy) but also additional injection of demand. This can occur only through direct fiscal action by government. In India, larger government expenditure has to be oriented towards agriculture, rural development, health, human resources and infrastructure to make inclusive and balanced growth.

In conclusion, the goal of the monetary policy and fiscal policy are the same, which is to promote stable and growing economic conditions in an economy, but the instruments used to carry these out and the bodies that carry these out are different. They should be in sync to work well and such that actions of one don't affect the actions of another and they succeed in their goals of maintaining a reasonable level of inflation and steady economic growth.

2.9.2. Inflation vs. Growth Tradeoff in Monetary Policy

RBI has increased its repo rate several times (since January 2011) to combat inflationary trends in the economy. But such attempts of RBI have been unsuccessful. Critics have questioned this policy/method of increasing interest rates to combat inflation.

Views against increasing interest rates

Critics feel that overemphasis on combating inflation sometimes comes at the cost of economic growth. They also argue that increasing interest rates without any thought in the monetary policy does not help. High interest rates have been identified, by many, as a major barrier to boosting growth. Many times entrepreneurs hold on to their investment plans pending any relaxation in monetary policy by the RBI. Industry representatives on the other hand feel that industrial growth is severely impacted by high cost of funds and other structural rigidities in the economic system like poor infrastructure and high transaction costs

Rationale given by RBI for hiking interest rates

- Tighter policy action aimed at puncturing the inflation balloon will help revive growth, although industry has been pushing for the opposite.
- There is enough liquidity in the system, so there will be no immediate increase in deposit and lending rates.
- Banks have seen huge inflows in the form of FCNR deposits and they are looking at opportunities at deploying those funds.
- There was also a warning that If RBI wants to knock out core inflation, the policy rate would have to be hiked further.
- It is noted that bringing down inflation to a low and stable level that monetary policy can contribute to reviving consumption and investment in a sustainable way.

Can monetary policy alone control inflation in the economy?

Inflation is a much debated subject in India in recent times and is the apparent cancer of Indian Economic Growth. RBI's Monetary Policy is seen as a panacea, by the State and the laymen, for arresting this cancer's mushrooming growth in the financial sector. But, this is a wrong approach as RBI also has its limitations. The State cannot delegate the duty of maintaining the financial health of the country in the tied-down hands of RBI. RBI has its hands tied-down because monetary policy plays a limited role. In contrast, Fiscal Policy plays a huge role in this financial equation. The absence of harmony between the objectives and aims of the monetary and financial policies also seems apparent.

Supply Side Inflation: There is a need therefore for looking more into the supply-side responses. Monetary and Fiscal Policies should not only concentrate on demand push inflation, but also on cost push inflation. In Indian realm, unfortunately, Inflation is misunderstood as just as Demand push inflation only.

Structural Reforms: There is need for structural reforms to take place on the fiscal front. The food inflation occurs especially due the systemic flaws (for e.g. large dependency of Indian Agriculture on Monsoon, lack of agricultural infrastructure etc.). There is need for work at this end.

Import Inflation: There is a need for dealing with the issues of Import Inflation. The dependence on imported goods for which highly valued foreign currency has to be paid also has been underplayed time and again.

Inflation Indexing: Need for a core inflation sector index to be adopted by the RBI, as one of the parameter, for deciding its monetary policy which excludes those sectors over which RBI's policies don't have much control. E.g. In USA, a core inflation index excludes food and oil from the basket because prices of these commodities do not respond to Federal Reserve policy. The excluded items differ from country to country depending on their volatility. This will make RBI's aims more realistic.

From above discussions one can infer that a simplistic inflation-targeting approach i.e. Fighting inflation first through stabilization and worrying about growth later is an IMF approach that has not worked well elsewhere in the world and will not work in India. We need a more comprehensive approach that will revive growth and lower inflation simultaneously. The interactions between monetary, fiscal and supply-side policies will need to be taken into consideration to get out of our current stagflationary predicament.

2.9.3. Some Recent Terms

Quantitative Easing: This term is used to describe a situation or a form of monetary policy used to simulate an economy when the interest rates are very low or zero. It is an occasionally used monetary policy, which is adopted by the government to increase money supply in the economy in order to further increase lending by commercial banks and spending by consumers. The central bank infuses a pre-determined quantity of money into the economy by buying financial assets from commercial banks and private entities. This leads to an increase in banks' reserves.

Usually, central banks try to raise the amount of lending and activity in the economy indirectly, by cutting interest rates. Lower interest rates encourage people to spend, not save. But when interest rates can go no lower, a central bank's only option is to pump money into the economy directly. That is quantitative easing (QE).

Quantitative easing comes with its own **risks** such as **Inflation and depreciation of currency** (Note: Quantitative easing is considered when short-term interest rates are at or approaching zero, and does not involve the printing of new banknotes).

Inflation occurs because with more money in economy, the cost of goods tends to rise. Depreciation can occur because with more currency in supply, one can buy less foreign bonds thus reducing the value of domestic currency.

It was first tried by the central bank of Japan to get it out of a period of deflation following its asset bubble collapse in the 1990s. The US government has done this three times so far. QE1 (November 2008 to March of 2010), QE2 (November to June 2011) and QE3 (September 2012 - October 2014). The US QE programme eventually saw a reduction (tapering) during QE3 and purchases of bonds were halted in October 2014. Federal Reserve Chairwoman Janet Yellen in 2017 has remarked that QE was a very unusual intervention which will not be frequently relied on in future as it causes fluctuations in the balance sheet of the central bank. Former RBI governor Raghuram Rajan has also questioned the use QE by developed countries to spur growth at home due to its implications on developing economies.

Marginal Standing Facility: Marginal Standing Facility (MSF) rate refers to the rate at which the scheduled banks can **borrow funds overnight** from RBI against government securities. MSF is a **very short term borrowing scheme** for scheduled commercial banks. Banks may borrow funds through MSF during severe cash shortage or acute shortage of liquidity.

Banks often face liquidity shortfalls due to mismatch in their deposit and loan portfolios. These are usually very short term and banks can borrow from RBI for one-day period by offering dated government securities.

The MSF is the last resort for banks once they exhaust all borrowing options including the liquidity adjustment facility by pledging through government securities, which has lower rate (i.e. repo rate) of interest in comparison with the MSF. The MSF would be a penal rate for banks and the banks can borrow funds by pledging government securities within the limits of the statutory liquidity ratio. The scheme has been introduced by RBI with the main aim of reducing volatility in the overnight lending rates in the inter-bank market and to enable smooth monetary transmission in the financial system. MSF rate automatically adjusts to 1 per cent above the repo rate.

Base Rate: Base Rate is the interest rate below which Scheduled Commercial Banks (SCBs) cannot lend to their customers. This rate was introduced in 2010 based on the recommendation of Deepak Mohanty Committee.

It was brought in to ensure that corporate houses are not lent money at low rates and Small and Medium business are not discriminated against with higher loan rates. In past banks used to compensate for lower rates for corporates by charging exorbitantly higher rates from Small and Medium Businesses (SMBs).

One another benefit of Base Rate is that it helps in monetary transmission, i.e. rate reductions undertaken by RBI passes through to all the sections of the society. In absence of such a regime corporate houses get the reduction and SMBs continue to pay higher rates.

This system has replaced the much abused **Benchmark Prime Lending Rate (BPLR)**. The BPLR system, introduced in 2003, fell short of its original objective of bringing transparency to lending rates.

Base rate is determined on the basis of a bank's costs of funds which include costs of deposits, profit margins, operating expenses, administrative expenses and statutory expenses.

Now, all categories of loans are priced with reference to the Base Rate only, except:

a) Differential rate of Interest (DRI) loans
b) Loans to banks' own employees, and
c) Loans to banks' depositors against their own deposits.

Since the Base Rate will be the minimum rate for all loans banks are not permitted to resort to any lending below this rate- accordingly, the provision of lending below the BPLR to a customer by banks if the loan amount is not less than Rs. 2 lakh has been withdrawn.

2.9.4. Marginal Cost of Funds Based Lending Rate (MCLR)

The marginal cost of funds based lending rate (MCLR) refers to the minimum interest rate of a bank below which it cannot lend, except in some cases allowed by the RBI. It is an internal benchmark or reference rate for the bank. MCLR actually describes the method by which the minimum interest rate for loans is determined by a bank - on the basis of marginal cost or the additional or incremental cost of arranging one more rupee to the prospective borrower. The MCLR is a tenor linked benchmark (tenor means the amount of time left for the repayment of a loan).

The MCLR methodology for fixing interest rates for advances was introduced by the Reserve Bank of India with effect from April 1, 2016. This new methodology replaces the base rate system introduced in July 2010.

Reasons for introducing MCLR

- rates based on marginal cost of funds are more sensitive to changes in the policy rates
- Prior to MCLR system, different banks were following different methodology for calculation of base rate /minimum rate – that is either on the basis of average cost of funds or marginal cost of funds or blended cost of funds.

MCLR aims to:

- Improve the transmission of policy rates into the lending rates of banks.
- Bring transparency in the methodology followed by banks for determining interest rates on advances.
- Ensure availability of bank credit at interest rates which are fair to borrowers as well as banks.
- Enable banks to become more competitive and enhance their long run value and contribution to economic growth.

3. Vision IAS GS Mains Test Series Questions

1. In the context of Indian Economy, it is said that there are three macro-economic challenges -- managing growth inflation, mitigating vulnerability of the external factors and managing the political economy of fiscal consolidation. Discuss.

Approach:

This question has following key terms: 'growth–inflation conundrum', external factors mainly foreign capital inflow and fiscal consolidation mainly about fiscal deficit.

Answer:

- India's average growth during pre-crisis period was 8.7 per cent and it started fraying beginning with the global financial crisis. In the current macro-economic situation, the growth had significantly influenced by inflation. The balance of payments is under stress and investments have decelerated.
- First challenge before Indian economy is managing the 'growth–inflation conundrum'. Inflation is driven by food inflation (both cyclical and structural), global commodity and fuel prices, and depreciation of currency and demand pressures. commodity prices, and depreciation and demand pressures. The growth-inflation dynamics of pre-crisis growth is quite different from post-crisis as the issue of inflation has become more rigorous and harsh, particularly to the lower strata of the bottom of pyramid.
- Hight growth needs easy money supply in the market, which results in more production and hence more employment which implies more demand. However the growth is limited by the resource availability. So if there is too much easy money in the market, it will lead to high inflation. This is what Indian economy faced after the fiscal stimulus given in wake of global financial crisis of 2008-09. Since then RBI has tried to put control on higher inflation by increasing the interest rates, which resulted in less money supply in the market and hence lower growth. While inflation pressure has still not come down to a comfortable level. So this is one of the main challenge where RBI needs to take a calibrated approach to maintain a balance between growth momentum and inflationary pressure.
- Second challenge before Indian economy is that it is no longer decoupled from external shocks. It is intricately linked to the world economy, international capital flows and to energy and fuel prices. Impact of European economic crisis, slow down of USA economy is noticeable on Indian economy. The slowing down of demand of

exports in foreign markets, less capital inflow in form of FDI/FII etc have started showing their effect in form of increasing current account deficit. This also resulted in devaluation of Indian rupee, creating further problems in managing the foreign-exchange reserves.

- Thirdly, the policy measures taken by the govt. for fiscal consolidation have defaulted. Over the past 15 years, India's fiscal deficits have exceeded 5 percent in every year except in 2007. The deficit again widened during the global financial crisis due to fiscal stimulus and some political announcements like loan waivers etc. Also the fuel subsidies are putting extra pressure on government's exchequer. Govt has made structural changes in economic policy by incorporating acts such as FRBM for fiscal consolidation and is trying to bring reforms in taxation like GST bill and DTC bill. However, achieving long-run fiscal consolidation still remains a challenging task to the policy makers.
- The govt. needs to find a holistic solution to these problems avoiding compartmentalized approach by individual ministries and centralized planning. There is a need of second round of economic reforms afresh.

2. *What do you understand by Monetary Policy Trilemma? How can it be resolved in Indian context?*

Approach:

- Explain the trilemma – describe all the three dimensions of it.
- Explain why it's difficult to able to meet all the three dimensions.
- Finally give your recommendations as to what we should do.

Answer:

- Monetary Policy Trilemma also known as 'impossible trilemma' refers to the incompatibility of retaining monetary policy sovereignty in the face of a convertible capital account and flexible exchange rate. In other words we cannot have all of the three together –
  - A fixed exchange rate
  - Free capital movement (absence of capital controls)
  - An independent monetary policy
- An economy open to free movement of capital can keep a fixed exchange rate, for example, only by subjugating monetary-policy independence —by raising interest rates sharply, say, when capital outflows put downward pressure on the currency. Yet the trilemma also implies that an economy can enjoy both free capital flows and an independent monetary policy, so long as it gives up worrying about its exchange rate.
- Therefore instead of sweating over keeping the exchange rate under check, India must work towards the underlying reasons
  - India is a country which has a perennially high CAD problem which make its currency vulnerable to external pressures, which get accentuated at times when something like tapering is announced
  - Hence the way forward is to-
    - increase our exports by diversification of products and markets,
    - curb the unproductive imports by rationalization of petroleum subsidies, and
    - also make India more attractive a destination for long term capital in form of FDI instead of hot money (Portfolio investment) by improving upon the

'Ease of Doing Business Index' parameters, better regulatory mechanisms etc.

- A positive CAD or a negative CAD that can be financed by FDI inflows will shield Indian rupee as well as independence of our monetary policy from external shocks.

3. *Monetary policy transmission in India has largely remained ineffective. What are the reasons behind this? Explain what marginal cost-based lending rate (MCLR) is and how it can affect monetary policy transmission in India.*

Approach:

- List out the major reasons behind poor monetary policy transmission.
- Define the marginal cost-based lending rate and how it affects monetary policy transmission.

Answer:

Generally, the effect of a policy rate change would be passed on to a large share of the population. But in India, when the RBI changes the policy rate, the impact is felt by only a small fraction of the population and it has not led to any major changes in interest rates charged by the banks.

The changes in policy rate would affect the entire economy through **banking system, bond market and exchange rate system**. But in India, none of these channels are working effectively in monetary policy transmission.

- First**, Indian economy is dominated by public sector banks** and the private banks and foreign banks face lot of entry barriers. Therefore, the small number of banks thwarts competition among the existing banking system, which does not feel the necessity to pass on the policy rate changes to the final consumers.
- Second, in India **we do not have fully developed bond market**, as it is in advanced economies. In the absence of large and liquid bond market, the burden of monetary policy transmission falls on the banking system.
- Third, in an open economy with flexible exchange rate and monetary independence, the policy rate changes have impact on capital flows and exchange rate. But in India, the **capital market is burdened with several restrictions;** therefore the change in policy rate does not necessarily result in concomitant changes in capital flows.
- **High CRR and SLR**-Cutting down on statutory liquidity ratio (SLR) currently pegged at 21.5% will theoretically allow banks to use more money to give loans to borrowers instead of investing in government bonds. Similarly, banks' cash reserve ratio (CRR), or the deposits that commercial banks are required to keep with RBI (on which they do not earn any interest), can also be cut.

The **marginal cost-based lending rate (MCLR)** refers to an internal benchmark rate for the bank below which bank cannot lend, except in some cases allowed by the RBI. It describes the method by which the minimum interest rate for loans is determined by a bank - on the basis of marginal cost or the additional cost. This new methodology replaces the base rate system. **Under the base rate system, the repo rate is not included to determine the base interest rate; however, under the marginal cost-based lending rate system, it is mandatory for banks to consider the repo rate while calculating the marginal cost-based lending rate.** This improves the transmission of policy rates into the lending rates of banks.

Other benefits of MCLR include:

- Brings transparency in the methodology followed by banks for determining interest rates on advances.
- Ensures availability of bank credit at interest rates which are fair to borrowers as well as banks.
- Enable banks to become more competitive and enhance their long run value and contribution to economic growth.

However, certain loans like fixed rate loans of tenor above three years, special loan schemes formulated by Government of India, Advances to banks' depositors against their own deposits, Advances to banks' own employees etc. are not linked to MCLR.

4. Examine the causes of rupee depreciation and its impact on the Indian economy. Also discuss the steps taken by the Government and RBI to stem its slide.

Approach:

- Write the major causes of rupee depreciation
- Then, list out the impacts on different areas due to the depreciation
- Finally, discuss the steps by govt. and RBI

Answer:

[Student Note: The answer has been kept long to discuss all points of the issue in detail at one place. Write down a summary within word limit for your answer]

Causes of Rupee Depreciation:

- **Appreciation in the US dollar:** Since the United States Federal Reserve hinted at exiting from Quantitative Easing (QE) in May 2013, the currencies of several emerging markets have been affected. Since then, the Indian Rupee has depreciated 22% against the US dollar. The easy money ensured that US funds moved to emerging markets like India in search of high yields. So, as the Fed tapers off its bond-purchasing program, and with US interest rates rising, the belief is that fund inflows to countries like India will also slow down.
- **Large Current Account deficit:** Depreciation is also a highly visible symptom of a much deeper economic malaise represented by the burgeoning current account deficit (CAD), which, at over $90 billion, threatens macroeconomic stability.
- **Weakening capital inflows:** Capital inflows have reduced due to the improving economic situation in the US and other developed countries. The prospect of the Federal Reserve's ultra-soft monetary policy ending has already raised bond yields there. As in other countries, the Indian bond market has also seen withdrawals by foreign institutional investors (FIIs) in the past few weeks. With a risk-off environment setting in globally, there have been redemptions from global exchange-traded funds (ETFs). This has led to selling by FIIs in the Indian equity market, compounding the rupee's woes.
- **Inflation:** Part of the depreciation is attributable to the adjustment of the rupee exchange rate to the inflation differential, i.e. India's relatively high rate of inflation versus other economies.

Impact of rupee depreciation:

- **RBI's monetary policy:** If the depreciation in rupee continues, it will further increase inflation. In such a situation RBI will have very less room to cut policy rates. No cut in policy rate will add to the borrower's woes, which are eagerly waiting to get rid of the high loan regime.

- **Fuel price:** A weak rupee will increase the burden of Oil Marketing Companies (OMCs) and this will be passed on to the consumers. If the OMCs increase fuel prices, there will be a substantial increase in overall cost of transportation, which will stoke up inflation.
- **Country's fiscal health:** A frail rupee will add fuel to the rising import bill of the country and thereby increasing its current account deficit (CAD). A widening CAD is bound to pose a threat to the growth of overall economy.
- **Importers/Exporters:** Importers will strongly feel the pinch of falling rupee as they will be forced to pay more rupees on importing products. Conversely, a feeble rupee will bring delight to the exporters, as goods exported abroad will fetch dollars, which in return will translate into more rupees. Also, a weak rupee will make Indian produce more competitive in global markets, which will be fruitful for India's exports.

Steps taken up by RBI and Government:

The RBI and the government have taken the following steps to stabilize the currency markets, reduce the current account deficit and enhance capital inflows:

- **Capital Outflow:** The RBI reduced the limit for outbound investment and remittances from India.
- **Encouraging Capital Inflows:** RBI has removed administrative restrictions on investment schemes offered by banks to non-resident Indians, and removed ceiling on interest rates on deposit accounts held by NRIs. The government has liberalized the FDI limits for 12 sectors, including oil and gas. A Bill is pending in the Parliament to revise the FDI limit to 49% in the insurance sector. RBI increased the current overseas borrowing limit for banks from 50% to 100%, and allowed it to be converted into rupees and hedged with the RBI at concessional rate. RBI also allowed banks to swap fresh NRI dollar deposits with a minimum duration of 3 years with the RBI. Specific public sector undertakings are being permitted to issue quasi-sovereign bonds to mop up funds for the infrastructure sector. The norms for external commercial borrowings (ECBs) are also being eased to enable the oil PSUs to garner dollars for financing their import requirements.

In short, the strategy is to stimulate dollar inflows by further liberalizing external commercial borrowings (ECBs), freeing interest rates on non-resident Indian deposits, liberalizing FDI norms and directing a few public sector finance companies to mop up dollars by issuing quasi-sovereign bonds.

- **Limiting Imports and encouraging exports:** The Finance Ministry increased the customs duty on importing precious metals including gold and platinum. The strategy seeks to address supply-side issues, curbing the import of gold, silver and a few "non-essential" items. 20% of every lot of import of gold must be exclusively made available for the purpose of export.
- **Oil Import Needs:** RBI decided to provide dollar liquidity to three public sector oil-marketing companies (IOC, HPCL and BPCL) to help them meet their entire daily dollar requirements. RBI will provide dollars to oil importers through a special forex-swap window wherein oil companies will buy dollars from the central bank and, simultaneously agree to sell dollars back to RBI at a future date. Government is also considering increasing its import of crude oil from Iran, and pay for it directly in Indian rupees.

- **Trade Deficit:** Ministry of Commerce has set up a Task Force to consider currency swap arrangements for trade and explore the possibility of bypassing payment in dollars for trade and paying instead in rupees or the trading country's currency. RBI allowed exporters and importers more flexibility in management of their forward currency contracts.
- **Curbing Speculative in currency:** RBI increased the short-term emergency borrowing rates for banks. It lifted the Marginal Standing Facility (MSF) and the Bank Rate by 200 basis points. The daily holding requirements under the Cash Reserve Ratio for banks have been modified.

5. RBI has recently classified some banks as 'Domestic Systemically Important Banks' (D-SIBs). What is the rationale behind this move? Examine the possible implications of this step.

Approach:

- Introduce with the concept of D-SIBs and background.
- Explain the reasons for this move in detail.
- List both positives and negatives associated with the step.
- Conclude with a balanced opinion.

Answer:

Financial Stability Board (FSB), an international body affiliated with G20 recommended identification of systematically important banks (SIB), which are too important to fail as their failure would have cascading impact on the entire financial system.

RBI issued guidelines and listed two banks – SBI and ICICI as part of an annual process to declare such banks as Domestic Systemically Important Banks. These banks would have to set aside 0.2 per cent to 0.8 per cent extra capital, based on the category under which they fall.

However, it might not be easy for banks to arrange these additional funds. SBI has already stated the need for government help in this regard. RBI has kept the requirements already lower than other countries in face of the capital stress that banks in India are currently experiencing. For most global banks it ranges from 1 to 2.5 per cent. This could threaten the stability and dilute the original objective of the provision.

Also, the list included only two names instead of 6 originally considered. This can prove to be dangerous as these banks are big and systemically important with deep and wide exposures across the market.

The biggest benefit would be in increasing stability. Even in case of a financial crisis, these banks will find it easier to run their operations. Also, it reduces government bailout chances as well as quantum.

RBI's implementation of its domestic SIB framework is less stringent than that of other countries, as it has considered the fact that Indian banks are very small considered to global banks with lower assets as well as assets to GDP ratio. Also, global banks are exposed to riskier inter-connected and complex financial products which Indian banks have negligible.

The Reserve Bank of India has taken a well-balanced step as it followed the broad principles laid down by the Basel Committee for making such a selection, which would protect it from failure of financial system. At the same time, the decision has been made with an eye on local conditions.

4. Previous Years UPSC GS Mains Questions

1. What is Bank Rate? What is the Bank Rate in India at present?
2. What are the main components of money supply in India?
3. What is Cash Reserve Ratio?
4. What does "Priority sector lending" mean?
5. What is cheap Money?
6. What is Repo market?

FISCAL POLICY

Contents

1. Introduction and Definition

Fiscal policy is the policy under which the government uses the instruments of **taxation, public spending and public borrowing** to achieve various objectives of economic policy. It is concerned with effects of these on income, production and employment.

While **fiscal policy deals with the taxation and expenditure decisions of the government**, monetary policy deals with the supply of money in the economy and the rate of interest. In most modern economies, **the government deals with fiscal policy while the central bank is responsible for monetary policy.**

2. Instruments of Fiscal Policy

Fiscal policy is carried out by the legislative and/or the executive branches of government. The two main **instruments** of fiscal policy are **government taxes and expenditure.** The government collects taxes in order to finance expenditures on a number of **public goods** and **services**. The effect of government expenditures, taxation, and debt on the aggregate economy is of immense importance.

Objectives of Fiscal Policy at a Glance

1. Maintaining Economic Stability
2. Attainment of Full Employment
3. To Accelerate Economic Growth
4. Reduction in Inequalities in Income and Wealth
5. Price Stability
6. Attaining External Equilibrium

Three distinct functions that operate through the fiscal policy of the government are:

1. Certain goods, referred to as **public goods** (such as national defence, roads, government administration), as distinct from **private goods** (like clothes, cars, food items), cannot be provided through the market mechanism, i.e. by transactions between individual consumers and producers and must be provided by the government. This is the **allocation function**.
2. Second, through its tax and expenditure policy, the government attempts to bring about a distribution of income that is considered 'fair' by society. The government affects the personal disposable income of households by making transfer payments and collecting taxes and, therefore, can alter the income distribution. This is the **distribution function**.
3. Third, the economy tends to be subject to substantial fluctuations and may suffer from prolonged periods of unemployment or inflation. There may be times when extra government expenditure is needed to raise aggregate demand. There may be times when expenditures exceed the available output under conditions of high employment and thus may cause inflation. In such situations, restrictive conditions are needed to reduce demand. These constitute the ***stabilisation*** requirements of the domestic economy.

Note: Public provision of goods is not the same as public production. **Public provision** means that they are financed through the budget and made available free of any direct payment. These goods may be produced directly under government management or by the private sector.

2.1. Government or Public Expenditure

Public expenditure refers to expenses incurred by public authorities – central government, state government and local authorities – for their own maintenance and also for the satisfaction of collective needs of the citizens and/or for promoting their economic and social welfare. For e.g. expenditure incurred by public authorities in running the government in the form of expenditure on administration and maintenance of law and order, as also on education, health, transportation, defence, social security etc.

Government expenditure can be classified under the following heads:

2.1.1. Capital and Revenue Expenditure

Capital Expenditures of the government are those expenditures which result in creation of physical or financial assets or reduction in financial liabilities. These include:

- Expenditure on the acquisition of land, building, machinery, equipment, investment in shares; and
- Loans and advances by the central government to state and union territory governments, PSUs and other parties.

Revenue Expenditure is expenditure incurred for purposes other than the creation of physical or financial assets of the central government. It relates to:

- expenses incurred for the normal functioning of the government departments and various services,
- interest payments on debt incurred by the government; and
- grants given to state governments and other parties

2.1.2. Development and Non-Development Expenditure

Development Expenditure - All expenditures that promote economic growth and social development are termed as development expenditure. These are the same as productive expenditure. Example – education, public health, employment, transport, communication etc.

Non-Development Expenditure - Unproductive expenditures are termed as non-development expenditures. Example – administrative services like police, administration of justice, defence or interest payments, grants to states etc.

2.1.3. Direct Expenditure and Transfer Expenditure

Direct Expenditure - The direct or non-transfer expenditure relates to expenditure which results in creation of income or output. Basically it is an expenditure by government on the purchase of goods and services and on current services of factors of production.

The non-transfer expenditure includes development as well as non-development expenditure that results in creation of output directly or indirectly. Economic infrastructure such as power, transport, irrigation, etc.; Social infrastructure such as education, health and family welfare; Internal law and order and defence; Public administration, etc.

By incurring such expenditure, the government creates a healthy conditions or environment for economic activities. Due to economic growth, the government may be able to generate income in form of duties and taxes.

Transfer Expenditure - Transfer expenditure relates to the expenditure in the form of payments against which there is no corresponding return. Such expenditure includes public expenditure on - National Old Age Pension Schemes, Interest payments, Subsidies, Unemployment allowances, Welfare benefits to weaker sections, etc.

By incurring such expenditure, the government does not get anything in return, but it adds to the welfare of the people, especially those belonging to the weaker sections of the society. Such expenditure basically results in redistribution of money incomes within the society.

2.1.4. Productive and Unproductive Expenditure

Productive Expenditure - Expenditure on infrastructure development, public enterprises or development of agriculture increase productive capacity in the economy and bring income to the government. Thus they are classified as productive expenditure. Example – expenditure on physical assets like machineries etc. or expenditure on human capital – training etc.

Unproductive Expenditure - Expenditures in the nature of consumption such as defence, interest payments, expenditure on law and order, public administration, do not create any productive asset which can bring income or returns to the government. Such expenses are classified as unproductive expenditures. Example – maintenance of law and order, defence etc.

2.2. Government or Public Revenue

Public revenue refers to the income of the government from all its sources. It includes: receipts from tax revenue and those from non-tax revenue. These are revenue sources of the government i.e. they are sources of the government's income, which are not subject to repayment by the government. It is different from public receipts in that public receipts refer to all incomes of the government including public borrowing and issue of new currency.

Public Receipts = Public Revenue Receipts + Income from other sources like Public Borrowing and Printing of Currency

Government revenue or receipts can be classified into revenue and capital receipts.

2.2.1. Revenue Receipts

Revenue receipts are receipts of the government which are non-redeemable, that is, they cannot be reclaimed from the government. They are divided into tax and non-tax revenues.

2.2.1.1. Tax Revenue

Tax Revenues consist of the proceeds of taxes and other duties levied by the central government. Tax revenues are an important component of revenue receipts and comprise of following taxes:

1. **Personal income tax**: Taxes on individual salaries and income
2. **Corporation tax**: Taxes on firms and corporations
3. **Excise duties:** Duties levied on goods produced within the country
4. **Customs duties:** Duties imposed on goods imported into and exported out of India
5. **Service tax**: Tax levied by the government on service providers on certain service transactions.
6. **Wealth tax**: Charged on the net wealth of the assesse. It is a tax on the benefits derived from ownership of property.
7. **Gift tax:** Tax on the transfer of property by one individual to another while receiving nothing, or less than full value, in return. The tax applies whether the donor intends the transfer to be a gift or not.

Taxes like wealth tax, gift tax and estate duty (now abolished) have never been of much significance in terms of revenue yield and have thus been referred to as **paper taxes**.

2.2.1.2. Meaning of Taxes

Taxes can be defined as a "*compulsory contribution from a person to the government to defray the expenses incurred in the common interest of all, without reference to special benefits conferred*".

The nature of taxes can be explained in terms of the following four characteristics

- **Compulsory contribution** – No one can refuse to pay taxes as refusal attracts legal action and punishment
- **Personal obligation** – It imposes an obligation to pay taxes
- **General benefit** – Taxes are used for the general benefits and welfare of the people
- **No quid pro quo** – A tax payer does not receive a definite, direct and proportional benefit from the government.

2.2.1.3. Types of Taxes

Direct and Indirect Taxes

Taxes are also classified as **Direct and Indirect taxes**. A **direct tax** is one that the taxpayer pays directly to the government. These taxes cannot be shifted to others. A homeowner pays personal property taxes directly to the government. A family pays its own income taxes.

Merits of Direct Taxes

The following are the merits of direct taxes:

- **Economical** – in terms of cost of collecting as they are usually collected at source
- **Certainty** – for the government knows fairly definitely how much they are going to receive as the taxpayers know how much and on what basis they have to pay
- **Equity & reducing inequalities** – By making tax rates progressive, burden can be put ore on rich than poor
- **Elastic** – revenue can be increased by raising tax rates in times of crisis
- **Civic consciousness** – Since the taxpayers provide the funds to government, they become more aware and conscious of how government is spending it.
- **Simplicity** – easy and simple to understand

Direct Tax	
Merits	Demerits
1. Economical	1. Unpopular
2. Certainty	2. Tax Evasion
3. Equity	3. Inconvenient
4. Reducing inequalities	4. Adverse effect on will to work and save
5. Elastic	5. Arbitrariness
6. Civic consciousness	6. Narrow in scope
7. Simplicity	

Demerits of Direct Taxes

The major drawbacks with the direct taxes are as follows:

- Unpopular – tax payers feel the pinch directly as they can't be shifted.
- Possibility of tax evasion as people can conceal their income or adopt some fraudulent practices to pay less taxes
- Inconvenient – maintenance of elaborate accounts and need to observe various formalities make the process inconvenient
- Adverse effect on the will to work and save – For example if property and inheritance are taxed, it will discourage the people to save
- Arbitrariness – the rates are arbitrarily fixed by the government
- Narrow in scope – because imposed on certain groups of people not all the groups.

An **indirect tax** is tax that can be passed on to another person or group. A business may recover the cost of the taxes it pays by charging higher prices to customers. A **tax shift** occurs when the business shifts its taxes to others.

Excise Duties and Custom Duties are examples of indirect taxes while rest of the above mentioned taxes are direct taxes.

INDIRECT TAXES	
Merits	***Demerits***
1. Convenience	1. Regressive and Unjust
2. Elastic	2. Inflationary impact
3. Less of Tax Evasion	3. Uneconomical
4. Equitable	4. Uncertainty
5. Increase in Social welfare	5. Lack of Civic Consciousness
6.Promote Production and Investment	

Specific and Advalorem Taxes

Another classification of taxes is done as **Specific Taxes and Advalorem Taxes.** When any good is taxed on the basis of its measure, size and weight such tax is known as **specific tax**. For example, if excise duty is imposed on sugar with respect to its weight; or excise duty is imposed on cloth on the basis of meters or yards, it will be a specific tax. The specific tax is advantageous because it can easily be imposed and charged. When any commodity is taxed on the basis of value of sales, it is known as **advalorem tax**. In such case, the tax is imposed on the basis of value of the product whatsoever be the weight or size of the product. Advalorem tax is beneficial in the sense that its burden lies with the rich. Hence, it is in accordance with the canon of equity. *But the complication with this tax is that it is difficult to find the exact value of goods.*

The government has abolished all centre and state level indirect taxes and replaced them with single indirect tax named Goods and Services Tax (GST) effective from 1st July, 2017.

Note: **Tobin Tax** was put forward in 1972 by the Nobel-prize winning American economist James Tobin. Originally, he suggested a tax on all payments from one currency to another. His aim was to curb massive and destabilising movements of funds between foreign currency exchanges. He proposed that the cash raised should be used as aid for developing countries. The idea has since been extended to cover a tax on all share, bond and currency transactions.

The advantage of the tax is that it could be a huge money-raiser for governments. It is only fair that banks and other financial firms pay an additional tax to help tackle government debt levels that they helped increase, as a result of the bailout schemes, which many of them required during the financial crisis. Those in favour of the tax also argue that it helps to increase stability. They say that in the 1990s, it could have prevented countries such as Russia, Mexico and those in South East Asia having to raise their interest rates to very high levels, as their currencies came under threat from speculators.

Critics argue that the tax will result in fewer financial transactions being made, resulting in job losses in financial centres. Others warn that the tax will mean pension funds and savers get less returns, as banks will simply pass the cost of the tax onto their customers.

2.2.1.4. Non Tax Revenue

Non-tax revenue mainly consists of:

- Interest receipts on account of loans by the central government,
- Dividends and profits on investments made by the government,
- Fees and other receipts for services rendered by the government.
- Cash grants-in-aid from foreign countries and international organisations.

2.2.1.5. Characteristics of Good Taxation Systems

A good tax system should meet five basic conditions: fairness, adequacy, simplicity, transparency, and administrative ease.

Fairness, or equity, means that everybody should pay a fair share of taxes. There are two important concepts of equity: *horizontal equity* and *vertical equity*.

Horizontal equity means that taxpayers in similar financial condition should pay similar amounts in taxes.

Vertical equity is just as important, however. Vertical equity means that taxpayers who are better off should pay at least the same proportion of income in taxes as those who are less well off. Vertical equity involves classifying taxes as *regressive*, *proportional*, or *progressive.*

Taxes can also be categorized as either **regressive, proportional, or progressive**, and the distinction has to do with the *behaviour of the tax as the taxable base (such as a household's income or a business' profit) changes.(see graph below)*

- **Progressive tax**—A tax that takes a larger percentage of income from high-income groups than from low-income groups.
- **Proportional tax**—A tax that takes the same percentage of income from all income groups.
- **Regressive tax**—A tax that takes a larger percentage of income from low-income groups than from high-income groups.
- **Degressive tax** – The rate of progression in taxation does not increase in the same proportion as the increase in income.

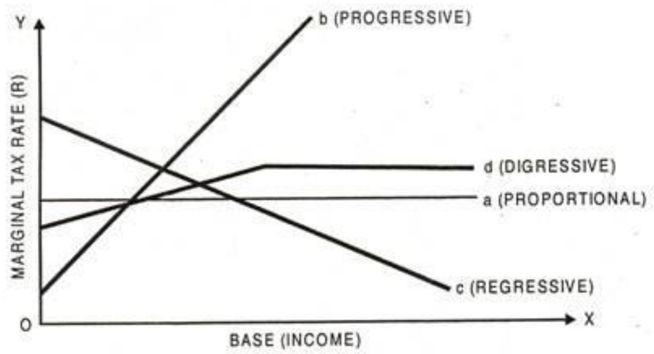


Fig. 1. Different Tax Rates.

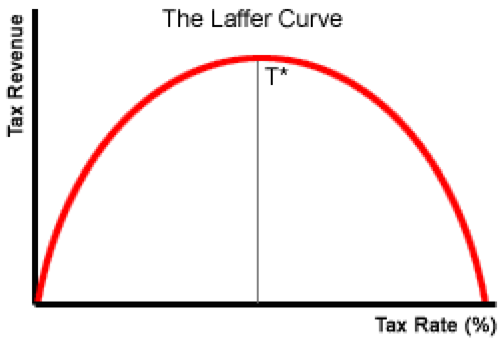
Progressive taxation is the most popular owing to the following reasons:

- It leads to **equitable** and just distribution of burden of taxes as it imposes higher tax burden on the rich
- It helps in **reducing inequalities** of income and wealth
- These are **elastic** as revenue of government increases substantially with the increase in tax rate
- It is **productive** because increase in income automatically brings in more revenue
- These are **economical** as the cost of tax collection does not increase with the increase in tax rates

Adequacy means that taxes must provide enough revenue to meet the basic needs of society. A tax system meets the test of adequacy if it provides enough revenue to meet the demand for public services.

Transparency means that taxpayers and leaders can easily find information about the tax system and how tax money is used. With a transparent tax system, we know who is being taxed, how much they are paying, and what is being done with the money. We also can find out who (in broad terms) pays the tax and who benefits from tax exemptions, deductions, and credits.

Administrative ease means that the tax system is not too complicated or costly for either taxpayers or tax collectors. Rules are well known and fairly simple, forms are not too complicated, it is easy to comply voluntarily, the state can tell if taxes are paid on time and correctly, and the state can conduct audits in a fair and efficient manner. The cost of collecting a tax should be very small in relation to the amount collected.



Note: The **Laffer Curve** shows the relationship between tax rates and tax revenue.

This graph shows that as the tax rate increases from zero, the amount of tax revenue collected will increase. At point T*, however, increases in the tax rate lead to decreases in the tax revenue collected. Governments would like to be at point T*, because it is the point at which the government collects maximum amount of tax revenue while people continue to work hard. This would theoretically be the point at which potential GDP is maximized.

2.2.1.6. Taxation Systems in Developing Economies

Tax is more than just a source of revenue and growth. It also plays a key role in building up institutions, markets and democracy through making the state accountable to its taxpayers. Rich and poor country governments have agreed on the importance of tax for development for years. The 2002 Monterrey Consensus, which launched a new focus on development recognised the key role of taxation in mobilising domestic resources-90% of domestic revenue is usually derived from tax.

Setting up an efficient and fair tax system is, however, far from simple, particularly for developing countries that want to become integrated in the international economy. The ideal tax system in these countries should raise essential revenue without excessive government borrowing, and should do so without discouraging economic activity and without deviating too much from tax systems in other countries. Major problems associated with taxation in developing countries are:

- First, most workers in these countries are typically employed in agriculture or in small, informal enterprises. As they are seldom paid a regular, fixed wage, their earnings fluctuate, and many are paid in cash, "off the books." The base for an income tax is therefore hard to calculate. Nor do workers in these countries typically spend their earnings in large stores that keep accurate records of sales and inventories. As a result, modern means of raising revenue, such as income taxes and consumer taxes, play a diminished role in these economies, and the possibility that the government will achieve high tax levels is virtually excluded.
- Second, it is difficult to create an efficient tax administration without a well-educated and well-trained staff, when money is lacking to pay good wages to tax officials and to computerize the operation (or even to provide efficient telephone and mail services), and when taxpayers have limited ability to keep accounts. As a result, governments often take the path of least resistance, developing tax systems that allow them to exploit whatever options are available rather than establishing rational, modern, and efficient tax systems.
- Third, because of the informal structure of the economy in many developing countries and because of financial limitations, statistical and tax offices have difficulty in generating reliable statistics. This lack of data prevents policymakers from assessing the potential impact of major changes to the tax system. As a result, marginal changes are often preferred over major structural changes, even when the latter are clearly preferable. This perpetuates inefficient tax structures.
- Fourth, income tends to be unevenly distributed within developing countries. Although raising high tax revenues in this situation ideally calls for the rich to be taxed more heavily than the poor, the economic and political power of rich taxpayers often allows them to prevent fiscal reforms that would increase their tax burdens. This explains in part why many developing countries have not fully exploited personal income and property taxes and why their tax systems rarely achieve satisfactory progressivity.

In conclusion, in developing countries, tax policy is often the art of the possible rather than the pursuit of the optimal. It is therefore not surprising that economic theory and especially optimal taxation literature have had relatively little impact on the design of tax systems in these countries.

2.2.1.7. Characteristics of a Good Taxation System for Developing Countries

In developing countries where market forces are increasingly important in allocating resources, the design of the tax system should be as neutral as possible so as to minimize interference in the allocation process. Different taxes and their necessary characteristics can be discussed as under:

Personal Income Tax

This tax has yielded relatively little revenue in most of the developing countries and the number of individuals subject to this tax (especially at the highest marginal rate) is small. Countries frequently attach great importance to maintaining some degree of nominal progressivity in this tax by applying many rate brackets, and they are reluctant to adopt reforms that will reduce the number of these brackets. Effective rate progressivity could be improved by *reducing* the degree of nominal rate progressivity and the number of brackets *and* reducing exemptions and deductions. Indeed, any reasonable equity objective would require no more than a few nominal rate brackets in the personal income tax structure.

Corporate Income Tax

Developing countries are more prone to having multiple rates along sectoral lines (including the complete exemption from tax of certain sectors, especially the parastatal sector) than industrial countries, possibly as a legacy of past economic regimes that emphasized the state's role in resource allocation. Allowable depreciation of physical assets for tax purposes is an important structural element in determining the cost of capital and the profitability of investment. Rectifying these shortcomings should also receive a high priority in tax policy deliberations in these countries.

Value-Added Tax, Excises, and Import Tariffs

While *VAT* has been adopted in most developing countries, it frequently suffers from being incomplete in one aspect or another. Many important sectors, most notably services and the wholesale and retail sector, are left out of the VAT net, or the credit mechanism is excessively restrictive (that is, there are denials or delays in providing proper credits for VAT on inputs), especially when it comes to capital goods. As these features allow a substantial degree of cascading (increasing the tax burden for the final user), they reduce the benefits from introducing the VAT in the first place. Rectifying such limitations in the VAT design and administration should be given priority in developing countries.

The most notable shortcoming of the *excise systems* found in many developing countries is their inappropriately broad coverage of products—often for revenue reasons. A good excise system is invariably one that generates revenue (as a by-product) from a narrow base and with relatively low administrative costs. Reducing *import tariffs* as part of an overall program of trade liberalization is a major policy challenge currently facing many developing countries.

Tax Incentives

Tax incentives can be justified if they address some form of market failure, most notably those involving externalities (economic consequences beyond the specific beneficiary of the tax incentive). For example, incentives targeted to promote high-technology industries that promise to confer significant positive externalities on the rest of the economy are usually legitimate. By far, the most compelling case for granting targeted incentives is for meeting regional development needs of these countries. Nevertheless, not all incentives are equally suited for achieving such objectives and some are less cost-effective than others. Unfortunately, the most prevalent forms of incentives found in developing countries tend to be the least meritorious.

2.2.2. Capital Receipts

All those receipts of the government which create liability or reduce financial assets are termed as capital receipts. The main items of capital receipts are:

- loans raised by the government from the public which are called market borrowings,
- borrowing by the government from the Reserve Bank and commercial banks and other financial institutions through the sale of treasury bills,
- loans received from foreign governments and international organisations,
- recoveries of loans granted by the central government,
- small savings (Post-Office Savings Accounts, National Savings Certificates, etc),
- provident funds, and
- net receipts obtained from the sale of shares in Public Sector Undertakings.

3. Cascading Effects of Taxation: MODVAT and CENVAT

Taxation of inputs, like raw materials, components and other intermediaries had a number of limitations. In production process, raw material passes through various processes stages till a final product emerges. Thus, output of the first manufacturer becomes input for second manufacturer and so on. When the inputs are used in the manufacture of product `A', the cost of the final product increases not only on account of the cost of the inputs, but also on account of the duty paid on such inputs. As the duty on the final product is on ad valorem basis and the final cost of product `A' includes the cost of inputs, inclusive of the duty paid, duty charged on product `A' meant doubly taxing raw materials. In other words, the tax burden goes on increasing as raw material and final product passes from one stage to other because, each subsequent purchaser has to pay tax again and again on the material which has already suffered tax. **This is called cascading effect or double taxation.**

This very often distorted the production structure and did not allow the correct assessment of the tax incidence. Therefore, the Government tried to remove these defects of the Central Excise System by progressively relieving inputs from excise and countervailing duties. An ideal system to realize this objective would have been to adopt value added taxation (VAT). However, on account of some practical difficulties it was not possible to fully adopt the value added taxation.

Hence, Government evolved a new scheme, **MODVAT (Modified Value Added Tax)**. MODVAT Scheme which essentially follows VAT Scheme of taxation. i.e. if a manufacturer A purchases certain components(raw materials) from another manufacturer B for use in its product. B would have paid excise duty on components manufactured by it and would have recovered that excise duty in its sales price from A. Now, A has to pay excise duty on product manufactured by it as well as bear the excise duty paid by the supplier of raw material B. Under the MODVAT scheme, a manufacturer can take credit of excise duty paid on raw materials and components used by him in his manufacture. It amounts to excise duty only on additions in value by each manufacturer at each stage.

MODVAT Scheme ensures the revenue of the same order and at same time the price of the final product could be lower. Apart from reducing the costs through elimination of cascade effect, and bringing in greater rationalization in tax structure and also bringing in certainty in the amount of tax leviable on the final product, this scheme will help the consumer to understand precisely the impact of taxation on the cost of any product and will, therefore, enable consumer resistance to unethical attempts on the part of manufacturers to raise prices of final products, attributing the same to higher taxes.

Subsequently, MODVAT scheme was restructured into **CENVAT (Central Value Added Tax)** scheme. Whatever restrictions were there in MODVAT Scheme were put to an end. Under the CENVAT Scheme, a manufacturer of final product or provider of taxable service shall be allowed to take credit of duty of excise as well as of service tax paid on any input received in the factory or any input service received by manufacturer of final product.

4. Budgetary Deficits

When government expenditures *exceed* government tax revenues in a given year, the government is running a **budget deficit** for that year. When government expenditures are *less* than tax revenues in a given year, the government is running a **budget surplus** for that year. The budget surplus is the difference between tax revenues and government expenditures. In the case where government expenditures are exactly equal to tax revenues in a given year, the government is running a **balanced budget** for that year.

Various measures that capture government deficit and their implications for the economy are discussed below:

4.1. Revenue Deficit

The revenue deficit refers to the excess of government's revenue expenditure over revenue receipts

Revenue Deficit = Revenue Expenditure – Revenue Receipts

The revenue deficit includes only such transactions that affect the current income and expenditure of the government. **When the government incurs a revenue deficit, it implies that the government is dissaving and is using up the savings of the other sectors of the economy to finance a part of its consumption expenditure.** This situation means that the government will have to borrow not only to finance its investment but also its consumption requirements. This will lead to a build-up of stock of debt and interest liabilities and force the government, eventually, to cut expenditure. **Since a major part of revenue expenditure is committed expenditure, it cannot be reduced. Often the government reduces productive capital expenditure or welfare expenditure**. This would mean lower growth and adverse welfare implications.

4.2. Fiscal Deficit

Fiscal deficit is the difference between the government's total expenditure and its total receipts excluding borrowing

Gross fiscal deficit = Total expenditure – (Revenue receipts + Non-debt creating capital receipts)

Non-debt creating capital receipts are those receipts which are not borrowings and, therefore, do not give rise to debt. Examples are recovery of loans and the proceeds from the sale of PSUs.

The fiscal deficit will have to be financed through borrowing. Thus, it indicates the total borrowing requirements of the government from all sources. From the financing side

Gross fiscal deficit = Net borrowing at home + Borrowing from RBI + Borrowing from abroad

Net borrowing at home includes that directly borrowed from the public through debt instruments (for example, the various small savings schemes) and indirectly from commercial banks through Statutory Liquidity Ratio (SLR).

The gross fiscal deficit is a key variable in judging the financial health of the public sector and the stability of the economy. From the way gross fiscal deficit is measured it can be seen that revenue deficit is a part of fiscal deficit

Fiscal Deficit = Revenue Deficit + Capital Expenditure - non-debt creating capital receipts

A large share of revenue deficit in fiscal deficit indicated that a large part of borrowing is being used to meet its consumption expenditure needs rather than investment.

4.3. Primary Deficit

Borrowing requirements of the government includes interest obligations on accumulated debt. **The goal of measuring primary deficit is to focus on present fiscal imbalances**. Primary deficit is used to obtain an estimate of borrowing on account of current expenditures exceeding revenues. It is simply the fiscal deficit minus the interest payments.

Gross primary deficit = Gross fiscal deficit – Net interest liabilities

Net interest liabilities consist of interest payments minus interest receipts by the government on net domestic lending.

4.4. Deficit Financing

Budgetary deficits must be financed by either taxation or borrowing or printing money. Governments have mostly relied on borrowing, giving rise to what is called government debt. The concepts of deficits and debt are closely related. Deficits can be thought of as a *flow* which adds to the *stock* of debt. **If the government continues to borrow year after year, it leads to the accumulation of debt and the government has to pay more and more by way of interest. These interest payments themselves contribute to the debt.**

4.4.1. Whether Government Debt is Good or Bad?

By borrowing, the government transfers the burden of reduced consumption on future generations. This is because it borrows by issuing bonds to the people living at present but may decide to pay off the bonds some twenty years later by raising taxes. These may be levied on the young population that have just entered the work force, whose disposable income will go down and hence consumption. Thus, national savings, it was argued, would fall. Also, **government borrowing from the people reduces the savings available to the private sector. To the extent that this reduces capital formation and growth, debt acts as a 'burden' on future generations**.

4.4.2. Ricardian Equivalence

It has been argued that when a government cuts taxes and runs a budget deficit, consumers respond to their after-tax income by spending more. It is possible that these people are short-sighted and do not understand the implications of budget deficits. They may not realise that at some point in the future, the government will have to raise taxes to pay off the debt and accumulated interest. Even if they comprehend this, they may expect the future taxes to fall not on them but on future generations.

A counter argument is that consumers are forward-looking and will base their spending not only on their current income but also on their expected future income. They will understand that borrowing today means higher taxes in the future. They would increase savings now, which will fully offset the increased government dissaving.

This view is called **Ricardian equivalence** after one of the greatest nineteenth century economists, David Ricardo, who first argued that in the face of high deficits, people save more. It is called 'equivalence' because it argues that taxation and borrowing are equivalent means of financing expenditure. When the government increases spending by borrowing today, which will be repaid by taxes in the future, it will have the same impact on the economy as an increase in government expenditure that is financed by a tax increase today.

4.4.3. Debt vs Inflation

One of the main criticisms of deficits is that they are inflationary. This is because when government increases spending or cuts taxes, aggregate demand increases. Firms may not be able to produce higher quantities that are being demanded at the on-going prices. Prices will, therefore, have to rise. **However, if there are unutilised resources, output is held back by lack of demand. If a high fiscal deficit is accompanied by higher demand and greater output it need not be inflationary.**

It has been argued that there is a decrease in investment due to a reduction in the amount of savings available to the private sector. This is because if the government decides to borrow from private citizens by issuing bonds to finance its deficits, these bonds will compete with corporate bonds and other financial instruments for the available supply of funds. If some private savers decide to buy bonds, the funds remaining to be invested in private hands will be smaller. Thus, some private borrowers will get **crowded out** of the financial markets as the government claims an increasing share of the economy's total savings. **However the economy's flow of savings is not really fixed unless it is assumed that income cannot be augmented. If government deficits succeed in their goal of raising production, there will be more income and, therefore, more saving. In this case, both government and industry can borrow more.**

If the government invests in infrastructure, future generations may be better off, provided the return on such investments is greater than the rate of interest. The actual debt could be paid off by the growth in output. The debt should not then be considered burdensome. **The growth in debt will have to be judged by the growth of the economy as a whole**.

Redemption of Public Debt at a Glance

1. Repudiation of Debt
2. Refunding
3. Debt Conversion
4. Budgetary Surplus
5. Terminal Annuities
6. Sinking Fund
7. Statutory Reduction in Interest Rate
8. Capital Levy
9. Exports Surplus

Note: Larger deficits do not always signify a more expansionary fiscal policy. The same fiscal measures can give rise to a large or small deficit, depending on the state of the economy. For example, if an economy experiences a recession and GDP falls, tax revenues fall because firms and households pay lower taxes when they earn less. This means that the deficit increases in a recession and falls in a boom, even with no change in fiscal policy.

4.5. Deficit Reduction

Government deficit can be reduced by an increase in taxes or reduction in expenditure. In India, the government has been trying to increase tax revenue with greater reliance on direct taxes (indirect taxes are regressive in nature – they impact all income groups equally). There has also been an attempt to raise receipts through the sale of shares in PSUs.

However, the major thrust has been towards reduction in government expenditure. This could be achieved through making government activities more efficient through better planning of programmes and better administration. A study by the Planning Commission had estimated that to transfer Re 1 to the poor, government spends Rs 3.65 in the form of food subsidy, showing that cash transfers would lead to increase in welfare. The other way is to change the scope of the government by withdrawing from some of the areas where it operated before.

Cutting back government programmes in vital areas like agriculture, education, health, poverty alleviation, etc. would adversely affect the economy. Governments in many countries run huge deficits forcing them to eventually put in place self-imposed constraints of not increasing expenditure over pre-determined levels. In India, we also adopted FRBM Act explained in the next section.

Larger deficits do not always signify a more expansionary fiscal policy. The same fiscal measures can give rise to a large or small deficit, depending on the state of the economy. For example, if an economy experiences a recession and GDP falls, tax revenues fall because firms and households pay lower taxes when they earn less. This means that the deficit increases in a recession and falls in a boom, even with no change in fiscal policy

4.5.1. Fiscal Responsibility and Budget Management Act, 2003 (FRBMA)

In a multi-party parliamentary system, electoral concerns play an important role in determining expenditure policies. A legislative provision, it is argued, that is applicable to all governments – present and future – is likely to be effective in keeping deficits under control. The enactment of the FRBMA, in August 2003, marked a turning point in fiscal reforms, binding the government through an institutional framework to pursue a prudent fiscal policy.

Main Features

1. The Act mandates the central government to take appropriate measures to reduce fiscal deficit to not more than 3 per cent of GDP and to eliminate the revenue deficit by March 31, 2009 and thereafter build up adequate revenue surplus (amended later).
2. It requires the reduction in fiscal deficit by 0.3 per cent of GDP each year and the revenue deficit by 0.5 per cent. If this is not achieved through tax revenues, the necessary adjustment has to come from a reduction in expenditure.
3. The actual deficits may exceed the targets specified only on grounds of national security or natural calamity or such other exceptional grounds as the central government may specify.
4. The central government shall not borrow from the Reserve Bank of India except by way of advances to meet temporary excess of cash disbursements over cash receipts.
5. Measures should be taken to ensure greater transparency in fiscal operations.
6. The central government to lay before both Houses of Parliament three statements – Medium-term Fiscal Policy Statement, The Fiscal Policy Strategy Statement, The Macroeconomic Framework Statement along with the Annual Financial Statement.
7. Quarterly review of the trends in receipts and expenditure in relation to the budget be placed before both Houses of Parliament.

The Act applies to the central government. However, the states have already enacted fiscal responsibility legislations which have made the rule based fiscal reform programme of the government more broad based.

4.5.1.1. Amendments to the FRBM Act

- The central government shall reduce the fiscal deficit by an amount equivalent to 0.1 percent or more of the gross domestic product at the end of each financial year **beginning with the financial year 2018-19**, so that **fiscal deficit** is brought down to **not more than 3 percent of the GDP by 31st day of March, 2021.**
- **Budget 2018** has proposed **to stop setting targets on Revenue Deficit** reduction from next year year through amendment in the FRBMA**.**

While FRBM Act has improved the level of disclosures that government has to make about its finances, its main target of reducing the actual size of deficit remains elusive. It is because government budgets in a democracy are not just economics and are deeply political. So, merely setting a number may not help.

4.5.1.2. Lacunae in FRBM Act

A notable lacuna in the FRBM regime has been that there are often deviations from the fiscal rules. FRBM Act explicitly provides for breach of targets in the case of national security need, national calamities and other exceptional circumstances. This leaves a lot of leeway in interpretation. The amendment to the FRBM Act in 2012-13 has re-established the regime of fiscal rules, and introduced a medium-term expenditure framework. Going forward, there is a need to remove a large part of ambiguity about any exceptions to be made, by adding expenditure rules to deficit rules and by adopting broader definition of deficit to cover quasi-fiscal activities.

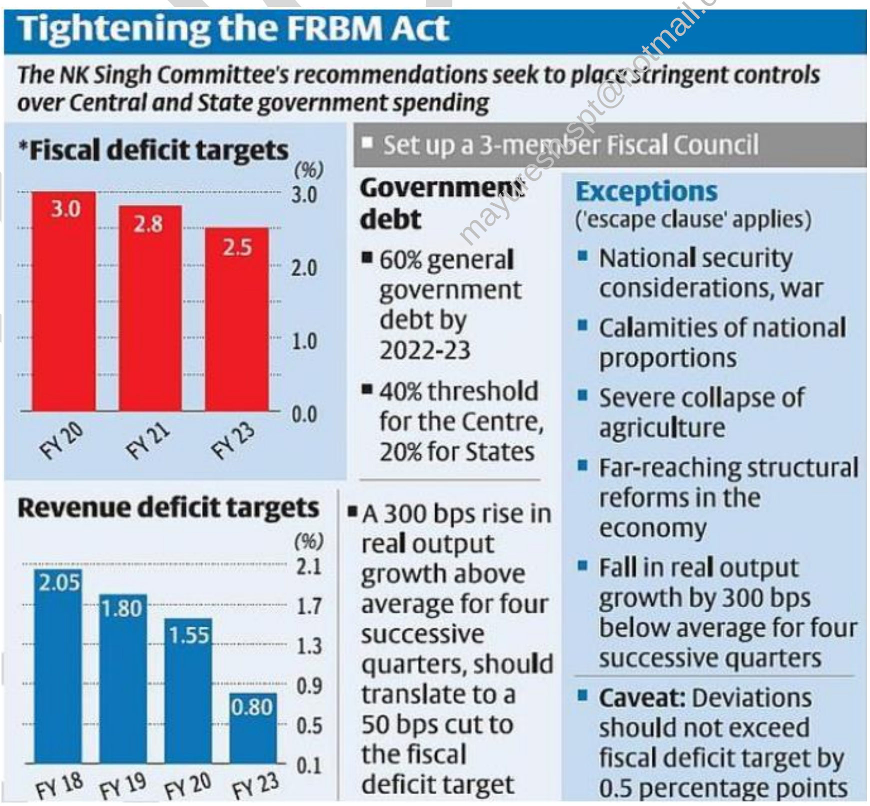
The existing FRBM Act prescribes a target fiscal deficit of 3% of GDP for the centre but with no explicit justification for the number. Since there is also a separate limit for the states (although not specified in the Act), the combined fiscal deficit (general government deficit in International Monetary Fund terminology) is much larger. The Fourteenth Finance Commission (chaired by Y.V. Reddy), for example, has explicitly recommended a 3% fiscal deficit for the centre and another 3% for the states, yielding a combined limit of 6% per year for the period 2015-16 to 2019-20.

Both the Thirteenth Finance Commission and the Fourteenth Finance Commission recommended the establishment of an autonomous body to review fiscal performance under the FRBM Act. This could evolve into a statutory Fiscal Council, reporting to Parliament through the finance ministry. Such institutions have been set up in several countries, with somewhat varying mandates.

A Fiscal Council, with technical expertise, would help generate better understanding of the consistency of fiscal stance of each budget with the longer-term fiscal trajectory envisaged under the FRBM Act. It would certainly improve the quality of Parliamentary oversight and also contribute to a more informed public debate. The Council would actually strengthen the hands of the finance ministry, which is otherwise the lone guardian of fiscal prudence, battling other ministries typically keen on expanding expenditure.

The Government had constituted a Committee in May 2016 to review the Fiscal Responsibility and Budget Management (FRBM) Act. This Fiscal Responsibility and Budget Management (FRBM) Committee, headed by Shri N.K. Singh, has submitted the report and the Government will take appropriate action.

Major Recommendations of the NK Singh (FRBM Review) Committee



- Public debt to GDP ratio should be considered as a medium-term anchor for fiscal policy in India. The combined debt-to-GDP ratio of the centre and states should be brought down to 60% by 2023 (comprising of 40% for the Centre & 20% for states) as against the existing 49.4%, and 21% respectively.
- It advocated fiscal deficit as the operating target to bring down public debt. For fiscal consolidation, the centre should reduce its fiscal deficit from the current 3.5% (2017) to 2.5% by 2023. The Committee set 0.5% as escape clause for fiscal deficit target to adjust with cyclical fluctuations
- The central government should reduce its revenue deficit steadily by 0.25 percentage (of GDP) points each year, to reach 0.8% by 2023, from a projected value of 2.3% in 2017.
- It suggested the setting up of a 'fiscal council', an independent body which will be tasked with monitoring the government's fiscal announcements for any given year. It will provide its own forecasts and analysis for the same as well as advise the finance ministry on triggering the escape clauses.

5. Fiscal Policy in Action

5.1. Expansionary and Contractionary Fiscal Policy

Expansionary fiscal policy is defined as an *increase* in government expenditures and/or a *decrease* in taxes that causes the government's budget deficit to increase or its budget surplus to decrease. **Contractionary** fiscal policy is defined as a *decrease* in government expenditures and/or an *increase* in taxes that causes the government's budget deficit to decrease or its budget surplus to increase.

In case of Expansionary fiscal policy, government needs to borrow from domestic or foreign sources, draw upon its foreign exchange reserves or print an equivalent amount of money. On a broad generalisation, *excessive printing of money leads to inflation*. If the government borrows too much from abroad it leads to a *debt crisis*. If it draws down on its foreign exchange reserves, *a balance of payments crisis may arise*. *Excessive domestic borrowing by the government may lead to higher real interest rates and the domestic private sector being unable to access funds resulting in the **crowding out** of private investment*. Sometimes a combination of these can occur. In any case, **the impact of a large deficit on long run growth and economic well-being is negative**. Therefore, it is not prudent for a government to run an unduly large deficit.

However, in case of developing countries, where the need for infrastructure and social investments may be substantial, running surpluses at the cost of long-term growth might also not be wise. *The challenge then for most developing country governments is to meet infrastructure and social needs while managing the government's finances in a way that the deficit or the accumulating debt burden is not too great.*

5.2. Classical and Keynesian views of Fiscal Policy

The **classical view** of expansionary or contractionary fiscal policies is that such policies are unnecessary because there are market mechanisms—for example, the flexible adjustment of prices and wages—which serve to keep the economy at or near the natural level of real GDP at all times. Accordingly, classical economists believe **that the government should run a balanced budget each and every year.**

The belief that expansionary and contractionary fiscal policies can be used to influence macroeconomic performance is most closely associated with Keynes and his followers. Keynesian theories of output and employment were developed in the midst of the Great Depression of the 1930s, when unemployment rates in the U.S. and Europe exceeded 25% and the growth rate of real GDP declined steadily for most of the decade. Keynes and his followers believed that **the way to combat the prevailing recessionary climate was not to wait for prices and wages to adjust but to engage in expansionary fiscal policy instead.**

Note: **Classical view of Fiscal Policy is also referred to as Active Fiscal Policy. Keynesian view of Fiscal Policy is also referred to as Passive Fiscal Policy.**

5.3. Discretionary and Automatic Fiscal Policy

Discretionary Fiscal policy is the change(s) in the level of active government taxation, and spending due to changes in the economy. These are changes that are often initiated in an attempt to meet some/all of the goals of economies such as full employment and stable prices. Some examples can be increasing spending on infrastructure to stimulate the economy and increase aggregate demand as well as the number of employed.

Automatic Fiscal policy are changes that are a result of past government regulations and tax laws, which are still in effect and adjust/stabilize spending in the economy without direct government intervention, through both the expansionary and recessionary periods of the business cycle. These include things such as progressive taxation, governmental assistance to agriculture and employment insurance.

Discretionary fiscal policy is made more difficult due to lags in recognizing the need for changed fiscal policy and the lags that occur with enacting the changed fiscal policy. Implementing the modified fiscal policy usually requires legislative action, which takes a long time to implement. One difficulty with proper timing is that forecasting economic activity is not an exact science. There is usually a lag between the time fiscal policy changes are needed and the instance that the need to act is widely recognized. Poorly timed fiscal policy could actually increase inflation and accelerate declines in the economy when the economy has already started to slow down.

Fiscal policy does have an advantage over monetary policy in the sense that increased government spending leads to an immediate increase in aggregate demand.

5.4. Fiscal or Economic Stimulus

Fiscal or Economic Stimulus refers to attempts by government to financially stimulate an economy. An economic stimulus is the use of monetary or fiscal policy changes to kick start a lagging or struggling economy. **Governments can use tactics such as lowering interest rates, increasing government spending and quantitative easing, to name a few, to accomplish this.**

The term economic stimulus became an everyday economic term following the recession created by the 2008-2009 Credit Crisis, which caused most, if not all, of the world's nations to slowdown, with many entering recessions and some depressions. Governments in many cases took unprecedented measures to stimulate lame economies through numerous economic measures.

5.5. Effects of Fiscal Policy on Macro Economy

Fiscal policy affects aggregate demand, the distribution of wealth, and the economy's capacity to produce goods and services. In the short run, changes in spending or taxation can alter both the magnitude and the pattern of demand for goods and services. With time, this aggregate demand affects the allocation of resources and the productive capacity of an economy through its influence on the returns to factors of production, the development of human capital, the allocation of capital spending, and investment in technological innovations.

Tax rates, through their effects on the net returns to labour, saving, and investment, also influence both the magnitude and the allocation of productive capacity. Fiscal policy also feeds into economic trends and influences monetary policy.

5.6. Effects of Fiscal Policy on Consumer Spending

Lower taxes, everything else being constant, increase households' disposable income, allowing consumers to increase their spending. The consequences of the cut — how much is spent or saved, and the response of economic activity — depend on the way households make their decisions and on prevailing macroeconomic conditions.

Whether the tax cut is perceived to be temporary or permanent will influence how much consumers save. A temporary cut will alter households' disposable income relatively little, and so might have little effect on consumption. If the cut is, instead, perceived to be permanent, then households will perceive a larger increase in their disposable income and so will likely increase their desired consumption by much more than they would if they thought the cut were temporary.

There is a potential conflict between the use of fiscal policy to stimulate aggregate demand when the economy is operating below potential in the short run and the use of policy to promote longer-run goals for national saving and capital formation to improve future living standards. When there are underutilized economic resources, fiscal stimulus can increase investment. But when the economy is operating near potential, an increase in the public debt might eventually depress private investment, unless the fiscal stimulus is reversed as the economy approaches full employment and utilisation.

Note: **Fiscal drag** is a concept where inflation and earnings growth may push more tax payers into higher tax brackets. **Therefore fiscal drag has the effect of raising government tax revenue without explicitly raising tax rates**.

This fiscal drag has the effect of reducing Aggregate Demand and becomes an example of deflationary fiscal policy. It could also be viewed as an automatic fiscal stabiliser because higher earnings growth will lead to higher tax and therefore moderate inflationary pressure in the economy.

6. Drawbacks and Limitations of Fiscal Policy

1. Time lags are significant
    - Recognition lag: time it takes government to recognize there is a problem
    - Decision lag: time required for government to determine most appropriate policy
    - Implementation lag: time it takes to figure out how to implement new directives
    - Impact lag: time it takes to be felt through multiplier effect
2. Difficulties in changing spending and taxation policies
    - It is far easier to increase spending and decrease taxes then to increase taxes and decrease spending
3. Conflict between levels of government over appropriate policies
    - Federal, provincial and city governments may differ on what needs to be done.
    - Regional variations
4. Crowding out of private investment
    - Increases interest rates
    - Reduces amount of funding for private investment
5. Deficits impose net burden on future generations
6. Foreign-owned debt removes capital from economy

7. Fiscal Federalism and Centre State Transfers

In India, resources can be transferred from the centre to states in many ways. **The Finance Commission** is responsible for centre-state financial relations.

7.1. The Finance Commission

Article 280 of the Constitution provides for a FC as a quasi-judicial body. It is constituted by the President every 5th year or at such earlier time as he considers necessary. The FC makes recommendations to the President on following matters:

- The distribution of the net proceeds of taxes between the centre and the states, and the allocation between the states of the respective shares of such proceeds.
- The principle that should govern the grants-in-aid to the states by the centre (out of the Consolidated Fund of India).
- The measures to augment the Consolidated Fund of a state to supplement the resources of local governments on the basis of recommendations made by the state finance commission.
- Any other matter referred to it by the President.
- Recommendations made by the FC are only advisory in nature.
- The Constitution empowers the FC to go beyond the core issues of how to divide taxes vertically between centre and the states on the one hand and horizontally between states on the other.
- It also allows FC to make broader recommendations in the interests of sound finance

7.2. Changes in Indian Taxation System

Developing countries have embarked on tax reforms in recent years. **Such reforms were motivated both by local factors as well as by rapid internationalization of economic activities**. The need to correct fiscal imbalances and the transition from a centralized plan to a market economy were the important local factors hastening tax reforms. Difficulties in compressing expenditures necessitated that tax system reform take an important role in fiscal adjustment strategy.

The transition from plan to market required the substitution of administered prices with market determined prices, the replacement of physical controls with financial controls, and the substitution of public enterprise profits with tax revenues. Likewise, tax reforms become imperative in a globalizing environment. Enhancing competitiveness and attracting foreign investment require minimizing both efficiency and compliance costs of the tax system. Globalization also involves loss of revenue from customs, which needs to be replaced with domestic taxes.

The Indian tax system too had to be reformed in response to changes in development strategy. In the initial years, tax policy was used as an instrument to achieve a variety of diverse goals which included increasing the level of saving and correcting for inequalities arising from **a market structure created by a centralized planning regime, including a licensing system, exchange control, and administered prices.**

The evolution of tax policy within the framework of planned development strategy had important implications for India:

1. Tax policy was directed to raise resources for the public sector without regard to efficiency implications.
2. The objective of achieving a socialistic pattern of society on the one hand and the attempt to tax large oligopolistic rents generated by the system of licenses, quotas, and restrictions on the other, called for a steeply progressive tax structure.
3. Pursuit of a multiplicity of objectives complicated the tax system with adverse effects on both efficiency and horizontal equity. This also opened up large avenues for evasion and avoidance of taxes.

4. The above considerations complicated the tax system, and selectivity and discretion became a legitimate part of the tax policy and administration.
5. The influence of special interest groups, changing priorities, and lack of information system and scientific analysis led to ad hoc and often inconsistent calibration of policies.

While India has had a history of periodically assessing the tax structure, through the constitution of tax reform committees (India 1971, 1977), actual reform attempts were largely ad hoc. It required a crisis of some severity before systematic tax reforms were implemented. Fiscal and balance of payments crises of 1991 warranted systematic reform not only to improve the revenue productivity of the tax system to phase out fiscal imbalance, but also to reorient the tax system to the requirements of a market economy.

The Tax Reforms Committee (India 1991) laid out a framework and a roadmap for the reform of direct and indirect taxes as a part of the structural reform process. The important proposals put forward by the TRC included:

1. Reduction in the rates of all major taxes, i.e., customs, individual, and corporate income and excise taxes to reasonable levels, maintain progressivity but not such as to induce evasion.
2. A number of measures to broaden the base of all the taxes by minimizing exemptions and concessions, drastic simplification of laws and procedures, building a proper information system and computerization of tax returns, and revamping and modernization of administrative and enforcement machinery.
3. It also recommended that the taxes on domestic production should be fully converted into a value added tax, and it should be extended to the wholesale level, in agreement with the States, with additional revenues beyond post-manufacturing stage passed on to the State governments.

8. Recent Developments in Taxation System

8.1. Goods and Services Tax (GST)

GST has been implemented from 1st July, 2017 following 101st Constitutional Amendment Act. GST is a single tax on the supply of goods and services, right from the manufacturer to the consumer. It is essentially a tax only on value addition at each stage as input taxes credit paid at each stage will be available in the next stage of value addition. In this taxation system, the final consumer will bear only the GST charged by the last dealer in the supply chain, thus eliminating the cascading effects present in earlier tax regime.

GST is an indirect tax for the whole nation subsuming all other indirect taxes and making India **'One Country, One Tax, One Unified Common Market'.** Currently, GST has a **four-slab structure**:

- 5% (on basic necessities), 12%, 18%; and
- 28% (on luxury goods)

Taxes subsumed under GST

At the ***Central level***, the following taxes have been subsumed:

- Central Excise Duty
- Additional Excise Duty
- Service Tax
- Additional Customs Duty commonly known as Countervailing Duty; and
- Special Additional Duty of Customs.

At the ***State level***, the following taxes have been subsumed:

- State Value Added Tax/Sales Tax
- Entertainment Tax (other than the tax levied by the local bodies)
- Central Sales Tax (levied by the Centre and collected by the States)
- Octroi and Entry tax
- Purchase Tax
- Luxury tax; and
- Taxes on lottery, betting and gambling.

GST Administration

- Keeping in mind the federal structure of India, there are two components of GST – **Central GST (CGST)** and **State GST (SGST).**
- Both Centre and States simultaneously levy GST across the value chain. The Tax is levied on every supply of goods and services.
- Centre levies and collect Central Goods and Services Tax (CGST), and States levy and collect the State Goods and Services Tax (SGST) on all transactions within a State.
- The input tax credit of CGST is available for discharging the CGST liability on the output at each stage. Similarly, the credit of SGST paid on inputs is allowed for paying the SGST on output.
- No cross utilization of credit is permitted.
- In addition to this, the Centre levies and collects the **Integrated Goods and Services Tax (IGST)** on all inter-State supplies of goods and services under Article 269A (1) of the Constitution in case of inter-State transactions.

GST Council

As per newly inserted Article 279A of the Constitution, the GST Council is a joint forum of the Centre and the States. This Council consists of the following members namely:
1. Union Finance Minister (Chairperson)
2. The Union Minister of State, in-charge of Revenue of finance
3. The Minister In-charge of finance or taxation or any other Minister nominated by each State Government

As per Article 279A (4), the Council will make recommendations to the Union and the States on important issues related to GST, like the goods and services that may be subjected or exempted from GST, model GST Laws, principles that govern place of supply, threshold limits, GST rates including the floor rates with bands, special rates for raising additional resources during natural calamities/disasters, special provisions for certain States, etc.

IT Infrastructure for GST implementation

- **Goods and Services Tax Network (GSTN)**: For the implementation of GST in the country, the Central and State Governments have jointly registered GSTN as a not-for-profit, non-Government Company to provide shared IT infrastructure and services to Central and State Governments, tax payers and other stakeholders. The known authorized capital of GSTN is Rs. 10 crore (US$1.6 million) in which Central Government holds **24.5 percent** of shares while the state government holds **24.5 percent** and rest with private banking firms.
- The key objectives of GSTN are to provide a standard and uniform interface to the taxpayers, and shared infrastructure and services to Central and State/UT governments. GSTN is working on developing a state-of-the-art comprehensive IT infrastructure including the common GST portal providing frontend services of registration, returns and payments to all taxpayers, as well as the backend IT modules for certain States that include processing of returns, registrations, audits, assessments, appeals, etc.

- **Project Saksham**: It is a New Indirect Tax Network (Systems Integration) of the Central Board of Excise and Customs (CBEC). It will help in implementation of Goods and Services Tax (GST) by integrating CBEC's IT system with GSTN. It will also help in extension of Indian Customs' Single Window Interface for Facilitating Trade (SWIFT).
- All States, accounting authorities, RBI and banks, are also preparing their IT infrastructure for the administration of GST.
- There would no manual filing of returns. All taxes can be paid online. All mis-matched returns would be auto-generated, and there would be no need for manual interventions. Most returns would be self-assessed.

Benefits of GST

The benefits of GST can be summarized as under:

For business and industry

- **Easy compliance**: Under a robust and comprehensive IT system, all tax payer services such as registrations, returns, payments, etc. would be available to the taxpayers online, which would make compliance easy and transparent.
- **Uniformity of tax rates and structures**: GST will ensure that indirect tax rates and structures are common across the country, thereby increasing certainty and ease of doing business. In other words, GST would make doing business in the country tax neutral, irrespective of the choice of place of doing business.
- **Removal of cascading effect**: A system of seamless tax-credits throughout the value-chain, and across boundaries of States, would ensure that there is minimal cascading of taxes. This would reduce hidden costs of doing business.
- **Improved competitiveness**: The subsuming of major Central and State taxes in GST, complete and comprehensive set-off of input goods and services and phasing out of Central Sales Tax (CST) would reduce the cost of locally manufactured goods and services. This will increase the competitiveness of Indian goods and services industry.
- **Gain to manufacturers and exporters**: The increased competitiveness of Indian industry in the international market will give boost to Indian exports. GST is estimated to increase the GDP growth by 1.5 to 2%.

For Central and State Governments

- **Simple and easy to administer**: Multiple indirect taxes at the Central and State levels are being replaced by GST. Backed with a robust end-to-end IT system, GST would be simpler and easier to administer than all other indirect taxes of the Centre and State levied so far.
- **Better controls on leakage**: GST will result in better tax compliance due to a robust IT infrastructure. Due to the seamless transfer of input tax credit from one stage to another in the chain of value addition, there is an in-built mechanism in the design of GST that would incentivize tax compliance by traders.
- **Higher revenue efficiency**: GST is expected to decrease the cost of collection of tax revenues of the Government, and will therefore, lead to higher revenue efficiency.
- It would **lower tax evasion by the self-policing feature** of tax being levied on the value added to a good or service. Also with dual administrative control – Centre and States – the tax evasion may minimize.

For the consumer

- **Single and transparent tax proportionate to the value of goods and services**: Due to multiple indirect taxes being levied by the Centre and State, with incomplete or no input tax credits available at progressive stages of value addition, the cost of most goods and services in the country today are laden with many hidden taxes. Under GST, there would be only one tax from the manufacturer to the consumer, leading to transparency of taxes paid to the final consumer.

- **Relief in overall tax burden**: Because of efficiency gains and prevention of leakages, the overall tax burden on most commodities will come down, which will benefit consumers.

Significance

- It would mitigate the ill effects of cascading along with removing multiplicity of taxes thus **lowering costs, improving competitiveness and improving liquidity of the businesses**.
- It would **improve revenue buoyancy by widening the tax base** and improving the taxpayer compliance.
- GST is largely technology driven and therefore will **reduce the human interface leading to speedy decisions**.

8.2. The Direct Taxes Code Bill, 2010

Though, the Direct Taxes Code Bill, 2000 has lapsed in the Parliament, such a legislation is desirable. Presently, the taxation of the income of individuals, companies and other entities is governed by the Income Tax Act, 1961. The Act specifies the entities to be taxed, the kinds of incomes subject to tax (or exempt from tax), and the tax rates to be imposed on them. It lays out a system by which taxes are to be assessed and collected and specifies a procedure by which disputes with tax authorities are to be addressed. The process of taxing the wealth of individuals and other entities is governed by the Wealth Tax Act, 1957. Changes to income and wealth tax (including tax rates) are introduced in Parliament in the form of an annual Finance Bill which amends the Income Tax Act and the Wealth Tax Act.

The Direct Taxes Code Bill seeks to consolidate and simplify the language and structure of the direct tax laws. The Bill will replace the Income Tax Act, 1961 and the Wealth Tax Act, 1957. The Draft Code proposes a number of changes in the way income is taxed under the Income Tax Act. The Discussion Paper released with the Draft Code states the following reasons for introducing the Draft Code:

1. Widening of the tax base by (a) removing exemptions, (b) reducing ambiguities in the law, and (c) preventing tax evasion which leads to erosion of the tax base;
2. Remove deductions and exemptions as these reduce efficiency and distort economic behaviour.

To implement these principles, a number of changes were made to the existing tax rates, available deductions and exemptions, and tax administration in the Draft Code. Key features of the bill are:

Tax on Individuals

The Bill retains the rates of income tax at 10%, 20% and 30%. It widens the slabs:

- income up to Rs 2 lakh will be tax exempt;
- income between Rs 2 lakh and Rs 5 lakh will be taxed at 10%; and
- income between Rs 5 lakh and Rs 10 lakh will be taxed at 20% and income above Rs 10 lakh will be taxed at 30%.

Senior citizens will be exempt from tax for income up to Rs 2.5 lakh. Most existing exemptions and deductions for individuals have been retained. The Bill specifically taxes any income from a "controlled foreign company" set up by Indian residents in a foreign country with the purpose of paying lower taxes.

Tax on Businesses

- Most tax deductions, such as those offered on export profits, will be removed. In some cases, existing units can continue to avail of incentives currently offered for the period that was originally specified (i.e. grandfathered). New units however, will be offered only incentives available in the Code.

- The Bill does away with a number of tax incentives in the Act and introduces investment linked incentives for sectors such as SEZ development, power, oil and natural gas exploration and cold chains. That is, cumulative profits up to the amount of capital investment will be eligible for exemption. Certain incentives existing under the Act will be grandfathered.
- The Bill states that income from separate businesses shall be computed differently. A business shall be distinct if there is no connection or interdependence between the businesses, or if they are at different locations.
- The Act also prevented business losses to be carried forward for more than eight years. The Bill allows losses to be carried forward indefinitely.
- In the Act, Indian companies are treated as residents. Non-Indian companies are resident if control or management is wholly in India. According to the Bill any non-Indian company is treated as resident if its place of effective management is in India.

The Bill removes a number of deductions and exemptions which could lead to a rise in revenue. At the same time income tax slabs have been widened, which could lead to a decrease in tax collections. There is no information available in the public domain which shows the net impact on revenue of these proposals. Therefore, it is not possible to estimate whether there will be an increase or decrease in the government's revenue collection under the Bill.

9. Miscellaneous

9.1. Tax Terrorism

In any taxation system, the government's intent is to maximize revenue, whereas taxpayers look for low tax rates and rules that are easy to comply. However, when government puts illegal and extra-legal pressure on taxpayers to extract more tax from honest taxpayer, this enthusiasm of government is referred to as tax terrorism.

Examples of tax terrorism:

- Enforcing the tax law on the general public in a harsh manner with taxman perceiving every transaction with suspicion.
- Retrospectively amending the Income-tax Act, 1961 affecting business confidence in the country.
- Imposition of Tax targets on Tax Inspectors
- Denying refunds or passing adverse adjudication orders in the name of realizing target of revenue.
- General Anti Avoidance Rule (GAAR)

9.2. Tax Evasion and Tax Avoidance

Tax evasion is the illegal practice of not paying taxes, by not reporting income, reporting expenses not legally allowed, or by not paying taxes owed. It is considered tax evasion if you knowingly fail to report income.

Tax avoidance is the legitimate minimizing of taxes, using methods approved by the government. Businesses avoid taxes by taking all legitimate deductions and by sheltering income from taxes through better tax planning. It involves making use of the loopholes in tax laws to one's own advantages to reduce the tax burden. Unlike Tax evasion, tax avoidance is legal practice. However, it is unadvisable as the taxpayer has defeated the intention of law maker and used this to his own advantage.

9.3. Tax Havens

A tax haven is a country that offers foreign individuals and businesses low or zero tax rate, politically and economically stable environment, and with little or no financial information sharing with foreign tax authorities. Such countries include Andorra, Cayman Islands, British Virgin Island, etc.

Tax havens do not require individuals to reside in or businesses to operate out of their countries. Due to the globalization of business operations, an increasing number of Multi-National Companies (MNCs), are keeping cash in offshore tax havens to minimize corporate taxes.

10. Vision IAS GS Mains Test Series Questions

1. ***It is important for India to return to the path of fiscal consolidation while also increasing public investment. Explain why achieving both these objectives are important to revive the present economic environment in the country.***

Approach:

- Defining fiscal consolidation, discuss its significance for economic stability.
- Discuss the significance of public investment.
- Discuss the underlying challenges in balancing the two and suggest measures for the same.

Answer:

Fiscal consolidation (FC) means reducing fiscal deficit (FD) by reducing public expenditure and/or increasing the revenue. The aim is to discipline the public finances and is enjoined by the FRBM Act, 2003 (which intends to cap the Fiscal deficit to 3% of GDP). Public investment means committing public money to various socio-economic objectives. It is often seen that public investment is curtailed to cater the needs of fiscal consolidation. Both these objectives have been contested, with arguments on both the sides.

Fiscal Consolidation (FC)

A. Significance

- Large FD means government as the major borrower leaving private sector short of credit for investment.
- High FD adds to interest burden on the government, thereby diverting the money from productive sectors. At present, interest payments at the Union level, account for almost 50% of their net tax revenues.
- High FD increases the interest rates in the economy, thereby fuels inflation.

Therefore, the importance of FC can't be overstated. Hence, the credit rating agencies consider FD as an important variable to assess the credit worthiness of an economy.

B. Argument against

During economic slowdown, the government has to incur deficit to boost the economy. When the aggregate demand is already low, adhering to the path of FC is counter-productive. For example, during 2008 crisis we have to abandon the targets under FRBM Act. To look into this issue further, NK Singh Committee has been set up by Finance Ministry.

Public Investment

A. Significance

- Public investment in productive sectors acts as the stimulator, fueling demand and hence growth in the economy. It is particularly important in current scenario of sluggish growth.
- At present, capital expenditures is merely 1.7% of GDP which means lesser future growth. Public investment in infrastructure would boost future growth and consumption in the present.
- It has domino effect as it crowds in the private investment, which, at present, is significantly depressed.
- Private investment is volatile and it being majorly in form of FDI and FII is prone to global risks and hence more volatile.
- Private investment in India has been in capital intensive sectors like services. Hence, to boost employment growth public investment is needed.
- Public investment is necessary to bridge the sectoral and regional inequalities.

B. Challenges

- Increased public investment may crowd out private investment.
- It is difficult to mobilize resources for investment in current slowdown.

Way forward

We have to find balance between these apparently conflicting objectives as under:

- Reprioritize expenditure, with greater focus on the productive capital expenditure and reducing revenue expenditure.
- Rationalize subsidies to increase fiscal space.
- Divest government's stakes held in specified PSUs and utilize these resources for capital investment.
- In line with Vijay Kelkar Committee's report on PPP, we should resolve the stuck investment projects and revive the PPPs.
- As suggested by FFC, there should be an independent Fiscal Council to monitor the implementation of fiscal rules by the government.
- The implementation of a well-designed Goods and Services Tax (GST) and other tax reforms would also play the crucial role in enhancing revenues.
- Exploring feasibility of having a 'fiscal deficit range' as the target in place of the existing fixed numbers(percentage of GDP) as fiscal deficit target.

2. It is argued that India's fiscal centre of gravity has rapidly shifted from the Centre to the States. Analyse the statement in context of the debate on fiscal discipline. Also, enumerate the key recommendations of the N.K. Singh panel on Fiscal Responsibilty and Budget Management Act.

Approach:

- Explain how India's fiscal centre of gravity has rapidly shifted from the Centre to the States.
- Mention the status of fiscal discipline of the states and the reasons behind it.
- Enumerate recommendations of the N. K. Singh panel.

Answer:

Centre's fiscal discipline is often subjected to intense public scrutiny. This belies the fact that India's fiscal centre of gravity has rapidly shifted from the Centre to the States, as at present, the State Governments account for about 60% of total government expenditure.

The Fiscal Responsibility and Budget Management (FRBM) Rules in the last decade helped State Governments improve their fiscal performance significantly. According to the Fourteenth Finance Commission (FFC), the Gross Fiscal Deficit of the States came down from the level of 3.3% of GDP in 2004-05 to 2.4% of GDP in 2014-15. During the same period, the Centre was unable to meet its fiscal targets. However, the situation seems to have reversed with Centre showing more fiscal discipline and States showing less fiscal prudence due to:

- **Rise in expenditure**: States' fiscal deficit is rising because of a rise in current expenditure. This trend is expected to continue due to implementation of the 7th Pay Commission Report, under-provisioning of interest payment for schemes such as Ujwal DISCOM Assurance Yojna (UDAY).
- **Lack of capacity:** States need to build their administrative capacity to check wastage and pilferage at the implementation level.
- **Populist measures** such as Farm-loan waivers undertaken in different states. **Increasing states' borrowings**: if the current trend continues, by Financial Year 19, states' market borrowings would exceed that of the Centre's borrowings.

Ideally, fiscal condition of the States should have improved due to increased States' share in union taxes from 32% to 42% in line with the Finance Commission recommendations. However, this is not the case.

In this light, the key recommendations of the N.K. Singh panel on Fiscal Responsibility and Budget Management Act are:

- **Debt Management and Fiscal Responsibility Bill, 2017** to replace the Fiscal Responsibility and Budget Management Act, 2003 (FRBM Act).
- **Debt to GDP ratio**: It suggested using debt as the primary target for fiscal policy instead of fiscal deficit. A debt to GDP ratio of 60% should be targeted & achieved by 2023.
- **Fiscal Council**: It proposed to create an autonomous Fiscal Council with a role of preparing multi-year fiscal forecasts, improving quality of fiscal data, advising the government if conditions exist to deviate from the fiscal target, and advising the government to take corrective action in case of non-compliance.
- **Deviations**: It suggested that grounds on which the government can deviate from the targets should be clearly specified with no scope of adding further exceptions.
- **Debt trajectory for individual states**: 15th Finance Commission should be asked to recommend the debt trajectory for individual states.
- **Borrowings from the RBI** by the government should be done only under certain circumstances. Fiscal indiscipline causes crowding out of private investment due to increase in cost of borrowings and diminishes chances of credit-ratings upgrade. Thus, the issue of state governments managing their finances deserves very serious attention and priority action.

3. Successive Finance Commissions have tried to balance the twin issues of fiscal discipline and regional disparities. Yet, they have been criticized by both the rich and poor states for neglecting their needs. Discuss. How far has the 14th Finance Commission been able to address this issue?

Approach:

- Briefly discuss the methodology of vertical and horizontal resource allocation used by Finance Commissions.
- Bring out the criticism by the states of the resource allocation.
- Mention the recommendations of the 14^{th} Finance Commission in this regard.
- Discuss to what extent FC has been successful in addressing this issue.

Answer:

Finance Commission is the balancing wheel of the fiscal federalism in India. Most commissions have allocated the resources between the states on more or less the following criteria: Population, Area, Fiscal Capacity Distance (Difference in the per capita income etc.), Fiscal Discipline and Tax Effort. The first three can be categorized as equity criteria (82.5 percent weight) while the last two as efficiency criteria (17.5 percent weight).

States performing well feel that they are being punished for showing higher growth and fiscal discipline and their revenue is being diverted to poorer states lacking fiscal discipline and policy vision for development. While poorer states demand more as they are not able to get private sector investment because of backwardness and are stuck in a vicious. States also complain about lesser share to states from the central tax pool and devolution of funds by states to local bodies.

14^{th} FC has recommended some major changes having centre-state and interstate fiscal ramifications, which have been accepted by the government. Prominent amongst them are:

- Change in the criteria for horizontal resource allocation. 7.5%: Forest cover, 17.5%: Population, 15%: Area, 10%: Demographic change, 50%: Income distance. Thus, financial efficiency has been omitted. Because of forest cover criteria poor states in plains having minimal forest cover are going to lose their percent share. Meanwhile, 19 states stand to gain from the new arrangement, which include north-eastern states and tribal states. Thus, it has positively benefited underdeveloped hilly and tribal states but negatively impacted poor states in the plains.
- 42% share to states in the divisible tax pool. With greater devolution all the states will have greater fiscal resources at their disposal that can be used in their development programme. Moreover, it will ease the implementation of tax reform of GST Bill where the states fear a loss of revenue.
- The Commission has recommended devolution of higher resources to the local bodies directly by the center. Separate allocation of funds to local bodies will unburden state governments which can use its resources elsewhere.
- It has identified 30 centrally sponsored schemes (CCS) for transfer to the states. However, due to importance of the schemes and legal obligations, only 8 CCS would be delinked from support from the centre. With CSS being transferred to the states, states will have greater flexibility in operating these schemes and grudge of states regarding unilateral action by centre is going to be resolved.

These recommendations have lot of positives regarding hilly and tribal states, local bodies and autonomy of states. However, the developmental disparity and fiscal discipline issues still remain unresolved. With greater dependence on central taxes, fluctuation in tax revenue of centre will impact the fiscal health of states. With fiscal discipline becoming unimportant in funds allocation, the better performing states will tend to lose while poor performers will not be penalized. The criterion of forest cover should be implemented with greater flexibility for populous and poor states of the plains have little chance to improve upon these criteria and will continue to lose. Such improvisation needs to be made in the implementation of recommendations to create a balance between the fiscal discipline and developmental disparity.

4. *What are the objectives of public debt management in India? Examine the rationale for setting up an independent agency to manage government debt. Also highlight the issues that need to be addressed to ensure successful debt management by an agency other than the RBI.*

Approach:

- Introduction should briefly define the concept of public debt management.
- Further, delineate the objectives of public debt management in India.
- Next part of the answer should examine the reasons for setting up of an independent agency to manage government debt.
- Finally, bring out issues that need to be addressed for success of independent authority for debt management.

Answer:

Public debt management is the process of establishing and executing a strategy for managing the government's debt in order to raise the required amount of funding, achieve its risk and cost objectives. Policy paper of the Ministry of Finance in 2010 stated that the overall objective of the Central Government's debt management policy is to:

- meet Government's financing needs at the lowest possible long term borrowing costs and
- to keep the total debt within sustainable levels.
- support development of a well-functioning and vibrant domestic bond market.

Recently Government has planned to relieve RBI of Public Debt Management role and is planning to bring in Public Debt Management Agency (PDMA) in two years' time. The rationale behind such a move can be understood as following:

- Bringing together all government borrowings under one roof is propagated as a key reason for the creation of an independent PDMA. At present, the RBI is responsible for all internal debt management functions, while external debt falls under the purview of the Department of Economic Affairs under the Ministry of Finance (MoF).
- A separate agency, which assigns specific responsibilities and is accountable on its own, will lead to a more transparent and efficient system. This is seen as a necessary step towards deepening of the bond market.
- It would resolve the conflict of interest that arises when the RBI manages the government's debt, as it leads to a conflict of interest with its role as monetary authority working to contain inflation and ensure financial stability.

- Separation of debt management will allow the central bank to focus on monetary policy of setting short terms interest rates. It would relieve the RBI of the burden of contending with twin incentives pulling in opposite directions in scenarios such as when rising inflation demands an increase in policy rates but the government wants takers for its debt offered at lower rate.

Countries like US and UK have an independent debt management office.

Though it is a welcome move, there are certain challenges that need to be addressed to ensure successful debt management by an agency other than RBI-

- A full fledge PDMA will require amendments to the RBI Act, and that might delay the procedure.
- Fears of market volatility caused by the shifting of responsibility to a new agency needs to be addressed.
- Government debt although largely domestically held, is one of the highest among the Emerging Markets and with nominal growth rate not keeping pace with nominal interest rates, debt-GDP ratio will rise.
- With new investments conspicuous by their absence and the export outlook unexciting, the government understandably wants to lend recovery a helping hand. But if higher public spending is not accompanied by higher revenues, fiscal and primary deficits will increase, stoking government debt.
- Chance of demand supply mismatch in government bond and higher government borrowing may crowd out private investment. Hence, the challenge of remaining independent and coordinating with RBI needs to be resolved for the success of the new agency.

11. Previous Years UPSC Mains questions

1. Discuss the rationale for introducing Goods and Services Tax (GST) in India. Bring out critically the reasons for the delay in roll out for its regime.
2. What were the reasons for the introduction of Fiscal Responsibility and Budget Management (FRBM) Act, 2003? Discuss critically its salient features and their effectiveness.
3. What is meaning of the term tax-expenditure? Taking housing sector as an example, discuss how it influences budgetary policies of the government.
4. What is Laffer Curve?
5. What is twin deficit?
6. What are the hurdles faced by the Finance Ministers of India in keeping the fiscal deficit below 3-4 per cent of the GDP? Suggest steps to lower the fiscal deficit.
7. Does reduction in fiscal deficit necessarily assure reduction in inflation?
8. In a developing country like ours what according to you, should be the basis of taxation- income or consumption? Spell out your arguments clearly.
9. What is fiscal drag? What is its effect?

GOVERNMENT BUDGETING

Contents

1. Budgeting: Meaning and Importance

Budget is a statement of estimated receipts and expenditures of the government in respect of every financial year. Budgeting is the process of estimating the availability of resources and then allocating them to various activities of an organization according to a pre-determined priority. It is an attempt to balance scarce means with public needs and ends.

Budgets are beyond money; they also represent choices, policies and philosophies. It is about allocating resources to competing priorities and issues of fairness or social justice come into it. They indicate the direction in which a country is headed and the path it has chosen to achieve its objectives.

Apart from its financial roles, the other functions performed by or through budgets are:

- Budgets act as instruments of control. They act as a benchmark to evaluate the progress of various departments. If a department is off-target, w.r.t. its budgetary proposals, it can be informed and corrective actions could be taken.
- Budgetary process involves all the departments of the government. Conflicts among various departments have to be resolved. So, budgetary planning and implementation helps in bringing various departments together and hence achieve co-ordination among them.
- Budgets can also be used as tools of punitive action by reducing the allocation of under-performing departments. So, they are also helpful in maintaining efficiency in working of various departments.
- Budgets can also be helpful in bringing about and institutionalising a change that an administrator wants. For example, if the government wants to improve the productivity of its employees, it can introduce incentives like performance related bonus through budgets.
- Budget also provides a platform for redistribution of resources. This redistribution might be from rich to poor or between regions, between generations, between workers and non-workers.
- It serves the purpose of public accountability of funds.

In sum, it is a planned approach towards increasing government activities that calls for mobilisation of large resources. The criticality of budgets to governance can be well understood by the changes in budgetary process in response to changing public opinion about the functions of government over the years.

Business and government budgeting are more different than alike. The differences between the two is tabulated below:

Government Budgeting	Business Budgeting
It is legally required for almost all government entities	It is not legally required
It has to stay within the amounts appropriated and any changes need formal approval and difficult to get through the system	It can implement budget as it pleases and may even abandon its budget in midstream
It is formulated with welfare motive	It is mostly profit oriented

2. The Union of India's Budget

Article 112 of the Indian constitution refers to budget as the 'annual financial statement.' The union budget has two purposes:

1. To finance the activities of the union government.
2. To achieve macroeconomic objectives such as employment, sustained economic growth, and price level stability, which forms a part of fiscal policy.

Considering limited resources at its disposal to fulfill multivariate responsibilities, financial planning, and the democratic maxim of 'no taxation without representation', the government has to bring financial statement annually before the Parliament. The Government is not free to tax, borrow and spend money the way it likes. Every item of expenditure has to be well thought out and the total outlay worked out for a specific period. Also, there must be the sanction of the people behind all these financial proposals, expressed clearly through their chosen representatives.

It is in this context that the Budget of the Government of India is presented before both the Houses of Parliament every year. The Budget contains the **financial statements** of the government embodying the **estimated receipts and expenditure** for one financial year, which at present commences on the 1st of April every year. In other words, it is a proposal of how much money is to be spent on what and how much of it will be contributed by whom or raised from where during the coming year.

The Budget gives estimates for the ensuing year and offers an opportunity to the government to review and explain its financial and economic policy and programmes besides enabling the Parliament to discuss and criticize it. Its importance is not limited to finances only as it also reflects government's vision and signals the policies to come in future.

The essential features of the financial procedure followed in India are laid down in the Constitution, which ensures the supremacy of the Lok Sabha, at the Union, and that of Legislative Assembly at state level, in the financial matters. The Constitution provides that no tax shall be levied or collected except by authority of Parliament (Article 265) and that the President shall, in respect of every financial year, cause to be laid before both Houses, the **Annual Financial Statement (Article 112)**.

Article 112 (in case of central government) and Article 202 (in case of state government) of the constitution requires the annual financial statement to be laid before the respective legislatures.

Since 1921, the **union government** has had two budgets – Railway budget and General budget. This separation has been done away with in 2017-2018 budget and the two have been merged into a single document, presented by the Union Finance Minister.

Any budget has the following three types of information:

- Actual figures of receipts and expenditure of the previous year
- Budget and revised figure for the current year
- Budget estimate for the upcoming year

For example, this year our finance minister presented the budget for the year 2018-19. Then previous year is 2016-17 and current year is 2017-18 at the end of which budget is presented and the coming year is 2018-19.

The receipts and disbursements are shown under the three parts, in which Government Accounts are kept viz. (i) Consolidated Fund (ii) Contingency Fund and (iii) Public Account. The estimated receipts and expenditures are essentially made into and out of these three funds.

(i) Consolidated fund - It is a fund to which all receipts are credited and all payments are debited, that is,

- All revenues received by the Government of India.
- All loans raised by the Government by the issue of treasury bills, loans or ways and means of advances.
- All money received by the government in repayment of loans forms the Consolidated Fund of India.

All the legally authorized payments on behalf of the Government of India are made out of this fund. For example - repayment of debt, giving loans to the state governments etc. No money out of this fund can be appropriated (issued or drawn) except in accordance with a parliamentary law. Money can be withdrawn only under appropriation made by law. Due to constitutional provisions, the expenditures are embodied in the Budget as:

- The sums required to meet the items of expenditure described by the Constitution as those charged on the Consolidated Fund of India.
- The sums required to meet other expenditures proposed to be made from the Consolidated Fund of India.

Expenditures contained in the first category can be discussed in both the Houses but are not submitted to vote of either House. In other words, they constitute the non-votable part of the Budget. The expenditures charged on the Consolidated Fund of India include:

- The emoluments and allowances of the President
- The salaries and allowances of the Chairman, Deputy Chairman of the Rajya Sabha and the Speaker and the Deputy Speaker of the Lok Sabha
- The salary and other allowances payable to the judges of the Supreme Court
- Pensions of the judges of high courts.
- Salary, allowances and pension of the Comptroller and Auditor General of India.
- Salaries, allowances and pension of the chairman and members of the Union Public Service Commission.
- Administrative expenses of the Supreme Court, the office of the Comptroller and Auditor General of India and the Union Public Service Commission including the salaries, allowances and pensions of the persons serving in these offices.
- The debt charges for which the Government of India is liable, including interest, sinking fund charges and redemption charges and other expenditure relating to the raising of loans and the service and redemption of debt.
- Any sum required to satisfy any judgement, decree or award of any court or arbitral tribunal.
- Any other expenditure declared by the Constitution or by Parliament by law to be so charged

The expenditure falling in the second category is presented in the form of Demands for Grants to the Lok Sabha and is voted upon by this House. The Lok Sabha has the right to assent or to refuse any such demand or reduce the demand specified therein. No such demand shall be made except on the recommendation of the President. Since these demands are meant to fulfill the programmes and policies of the government, if any demand as a whole is voted down, it tantamounts to a defeat of the government.

(ii) Public accounts of India - All other public money (other than those which are credited to the Consolidated Fund of India) received by or on behalf of the Government of India shall be credited to the Public Account of India.

- This includes Moneys held by Government in Trust as in the case of Provident Funds, Small Savings collections, income of Government set apart for expenditure on specific objects like road development, primary education, Reserve/Special Funds etc.
- This account is operated by **executive action**, that is, the payments from this account can be made without parliamentary appropriation.
- Public Account funds do not belong to Government and have to be finally paid back to the persons and authorities that deposited them. Parliamentary authorization for such payments is, therefore, not required, except where amounts are withdrawn from the

Consolidated Fund with the approval of Parliament and kept in the Public Account for expenditure on specific objects, in which case, the actual expenditure on the specific object is again submitted for vote of Parliament for withdrawal from the Public Account for incurring expenditure on the specific object.

(iii) Contingency fund of India – Article 267 of The Constitution authorizes the **Parliament to establish** a 'Contingency Fund of India', into which amounts determined by law are paid from time to time. Accordingly, the Parliament enacted the Contingency Fund of India Act in 1950.

- This fund is placed at the disposal of the President, so that he can make advances out of it to meet unforeseen expenditure pending its authorization by the Parliament. The fund is held by the finance secretary on behalf of the president.
- Like the public account of India, it is also operated by executive action.
- Parliamentary approval for such unforeseen expenditure is obtained, post-facto, and an equivalent amount is drawn from the Consolidated Fund to recoup the Contingency Fund. The corpus of the Contingency Fund as authorized by Parliament presently stands at 500 crore and may be enhanced by the Parliament. Finance Ministry operates this fund on the behalf of the President.

Under the Constitution, Annual Financial Statement distinguishes expenditure on revenue account from other expenditure. Government Budget, therefore, comprises Revenue Budget and Capital Budget. The estimates of receipts and expenditure included in the Annual Financial Statement are for the expenditure net of refunds and recoveries, as will be reflected in the accounts.

2.1. Components of the Government Budget

The Constitution of the country demands that the budget shall distinguish expenditure on revenue account from other expenditure. Therefore, the Budget comprises of the Revenue Budget and the Capital Budget.

2.1.1. Revenue Account

Revenue Account consists of the revenue receipts of Government and the expenditure met from these revenues.

Revenue receipts – These are the receipts which need not to be paid back to the payee by the government, that is, it is non-redeemable. It cannot be reclaimed by the government. Therefore they are one way transaction. It does not create liability for the government. They are divided into tax revenues and non-tax revenues.

- **Tax revenues** – It is the revenue generated by levy and collection of taxes by the central government. It comprises of direct taxes and indirect taxes.
    - **Direct taxes** – These are the taxes which falls directly on individuals and firms like Income tax (tax on personal income of an individual), corporate tax (tax on a firm), securities transaction tax, commodities transaction tax etc.

      Other direct taxes such as wealth tax (abolished in 2015-16 budget), gift tax and estate duty (now abolished) have never been of much significance in terms of revenue yield and therefore these are known as paper taxes.
    - **Indirect taxes** – These are the taxes which may be levied on one person but ultimately paid by others. For example – excise duty is levied on producer but ultimately is paid by consumer along with the price.

      It includes excise taxes (duties levied on goods produced within the country), customs duties (taxes imposed on goods imported into and exported out of India), sales tax/VAT (tax on sales of goods levied by state government), central sales tax (tax on sales of goods in inter-state trade levied by central government but collected and retained by state) and service tax (tax imposed on services).

- Non-Tax revenues – It mainly consists of
  - **Interest receipts** – It is the interest income from the loan given by the central government to state government and other government bodies. This constitutes the single largest item of non-tax revenue
  - **Dividends and profits** on the investment made by the government. Dividends are income from the shares held by government in private enterprises and semi government enterprises. Profits are dividend income from the fully government owned enterprises
  - **Fees and other receipts** for the services rendered by the government
  - **Cash grants-in-aid** from foreign countries and international organizations.

The estimates of revenue receipts shown in the Annual Financial Statement take into account the effect of various taxation proposals made in the Finance Bill.)

Revenue expenditure – It consists of all those expenditures of the government, which do not result in creation of physical or financial assets. It relates to those expenses incurred for the normal functioning of the government departments and various services, i.e., day to day and regular needs expenditure that will not yield any revenue in future. It is a one way payment which mean if government spends money it cannot recover it. Till 2017-2018 budget, it included two components:

- **Plan Revenue expenditure** – It used to be related to Central Plans (the Five-Year Plans) and central assistance for State and Union Territory Plans.
- **Non-plan revenue expenditure** – It included:
  - **Interest payments** on debt incurred by the government through market loans or external loans or from various other reserve funds
  - **Grants** given to state governments and other parties (even though some of the grants may be meant for creation of assets).
  - **Others -** defense services, subsidies, salaries and pensions and various social services (non-capital expenditure towards health, education etc.).

This categorization stands abolished by the 2017-2018 budget, based on the recommendation of Rangarajan Committee. This would be further discussed later in this document.

2.1.2. Capital Account

Capital Account is an account of the assets as well as liabilities of the central government, which takes into consideration changes in capital. It consists of the capital receipts and capital expenditure of the government

Capital receipts - All those receipts of the government which create liability or reduce financial assets are termed as capital receipts. It can be classified into two categories –

- **Debt capital receipts** – It mainly includes borrowings and other liabilities.
  - **Borrowings or public debt** – Money raised on the security of consolidated fund of India and repayable out of it. It includes:
    - ✓ Borrowing within the country, that is, loans raised from the public (market borrowings), borrowings from RBI and other financial institutions through sale of treasury bills.
    - ✓ Borrowing outside the country , that is loans received from foreign governments and international organisations

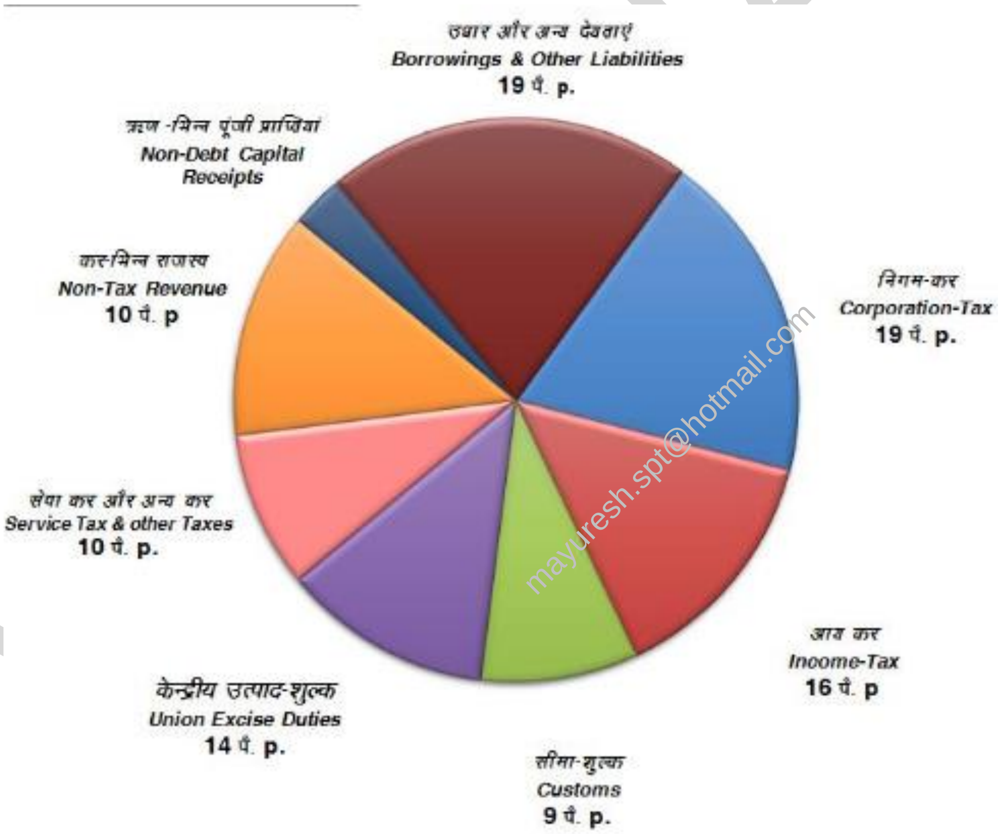
- **Other liabilities** – These are money not directly borrowed from people but is available for the government's expenditure purpose which government is liable to pay back. It includes money kept in public account of India which includes small savings (Post-Office Savings Accounts, National Savings Certificates, etc), provident funds.

- **Non-debt capital receipts** – It includes recoveries of loans granted by the central government and net receipts obtained from the sale of shares in Public Sector Undertakings (PSUs) (This is referred to as PSU disinvestment).

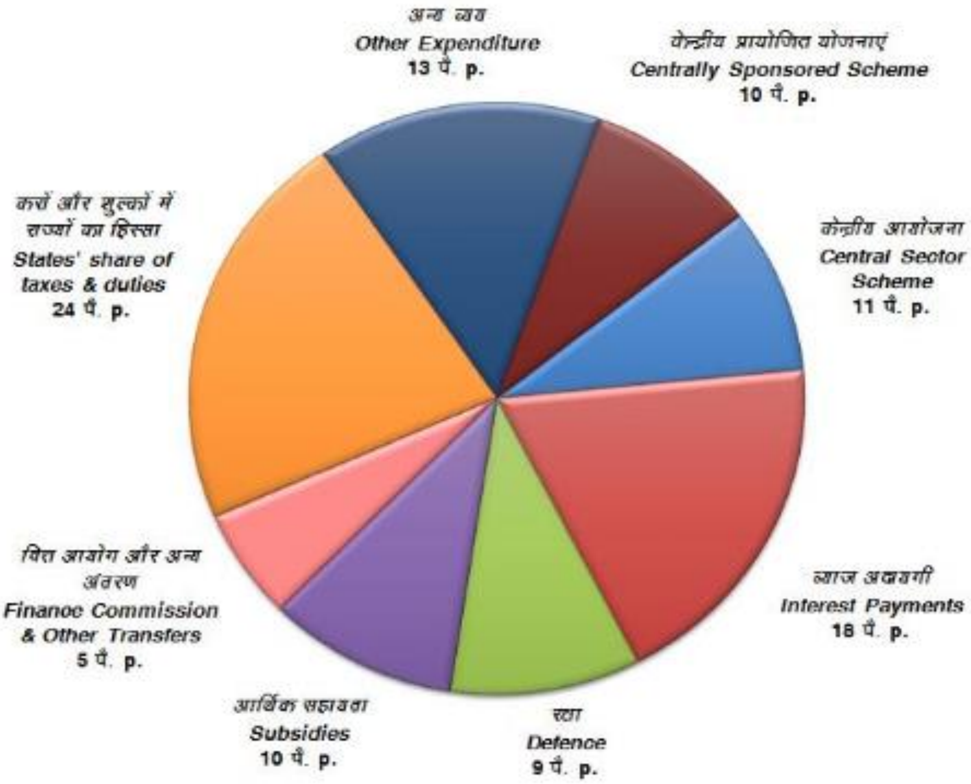
Capital Expenditure: It includes expenditures that create permanent assets and yield periodical income. This includes expenditure on the acquisition of land, building, machinery, equipment, investment in shares, and loans and advances by the central government to State and Union Territory governments, PSUs and other parties. Capital expenditure was also categorised as plan and non-plan in the budget documents. Plan capital expenditure, like its revenue counterpart related to central plan and central assistance for state and union territory plans. Non-plan capital expenditure covered various general, social and economic services provided by the government.

2.1.3. Statistics as Given by the Union Budget 2017-18

Below is where the money comes from



Below is how the money is spent

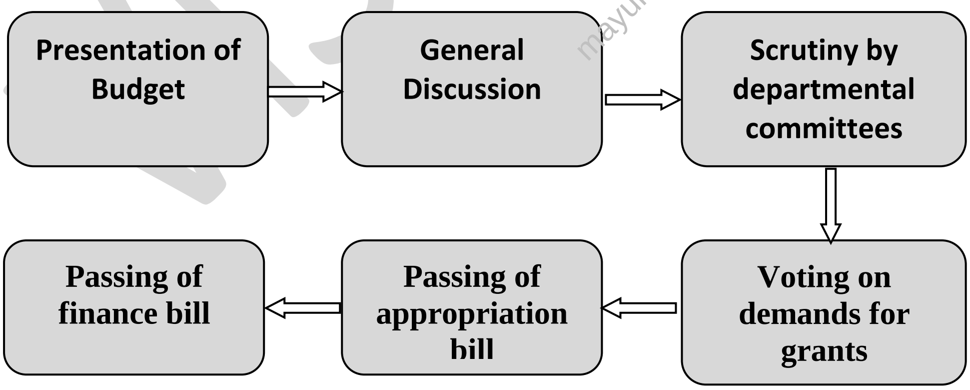


Points to be noted from above:

- Corporate tax contributes the largest share in all tax revenues
- Excise duty contributes the largest share in all indirect tax revenues
- Of all the tax revenues, direct taxes contribute 52.4 percent

2.2. Stages in Enactment

The procedure adopted in the Parliament while dealing with financial matters, specifically the Budget, involves many stages (refer diagram below):



2.2.1. Presentation of Budget

From fiscal year 2017-2018, the consolidated budget would be presented whereby the hitherto existing Railway Budget would be merged in the General Budget. This consolidated budget would be presented by the Union Finance Minister. The rationale behind this move would be discussed later in this document.

The Budget is presented with a 'Budget Speech', which is in two parts: Part A contains 'a general economic survey' of the country and Part B 'the taxation proposals' for the ensuing financial year.

The Rules of Procedure and Conduct of Business in the **Lok Sabha** for Financial Legislation are as follows:

- The **Annual Financial Statement** or the **Statement of the Estimated Receipts and Expenditure** of the Government of India in respect of each financial year (also called **'the Budget'**) is presented to the House on such day as the President may direct.
- The Budget is presented to the House in such form as the Finance Minister may, after considering the suggestions, if any, of the Estimates Committee, settle.
- There shall be no discussion of the Budget on the day on which it is presented to the House.

2.2.2. General Discussion on Budget

- Subsequently, on a day appointed by the Speaker, the House is at liberty to discuss the **Budget as a whole** or any **question of principle** involved therein, but no cut motion is moved nor is the Budget submitted to the vote of the House.
- It takes place in both the Houses of Parliament and lasts usually for three to four days.
- The Finance Minister has a general right of reply at the end of the discussion.
- The Speaker may, if he thinks fit, prescribe a time limit for speeches.

2.2.3. Scrutiny by Departmental Committees

After the general discussion on the budget is over, the Houses are adjourned for about three to four weeks. During this gap period, the 24 departmental standing committees of Parliament examine and discuss in detail the demands for grants of the concerned ministries and prepare reports on them. These reports are submitted to both the Houses of Parliament for consideration. The standing committee system established in 1993 (and expanded in 2004) makes parliamentary financial control over ministries much more detailed, close, in-depth and comprehensive.

2.2.4. Demand for Grants

Demand for grants is a statement of estimated expenditure to be made out of consolidated fund of India**. Article 113** of the Constitution mandates that the estimates of expenditure from the Consolidated Fund of India included in the Annual Financial Statement and **required to be voted by the Lok Sabha** are submitted in the form of Demands for Grants. The Demands for Grants are presented to the Lok Sabha along with the Annual Financial Statement.

- Generally, **separate demands** are made for the grants proposed for each Ministry.
- Each demand contains first a statement of the **total grant proposed** and then a statement of the **detailed estimate** under each grant divided into items. A demand becomes a grant after it has been duly voted.
- Two points should be noted in this context.
    - **One**, the voting of demands for grants is the exclusive privilege of the Lok Sabha, that is, the Rajya Sabha has no power of voting the demands.
    - **Second**, the voting is confined to the votable part of the budget—the expenditure charged on the Consolidated Fund of India is not submitted to the vote (it can only be discussed).
- Demands are required to be made in the form of a **motion** but in practice, they are assumed to have been moved and are proposed by the Chair to save the time of the House.
- During this stage, the members of Parliament can discuss the details of the budget. They can also move motions to reduce any demand for grant. Such motions are called as 'cut motion'

A motion may be moved to reduce the amount of a demand in any of the following ways:

- **'that the amount of the demand be reduced to Re.1/-'** representing disapproval of the policy underlying the demand. Such a motion shall be known as **'Disapproval of Policy Cut'**. A member giving notice of such a motion has to indicate in precise terms the particulars of the policy which he proposes to discuss. The discussion is confined to the specific point or points mentioned in the notice and it is open to members to advocate an alternative policy;
- **'that the amount of the demand be reduced by a specified amount**' representing the economy that can be effected. Such specified amount may be either a lump sum reduction in the demand or omission or reduction of an item in the demand. The motion shall be known as **'Economy Cut'**. The notice has to indicate briefly and precisely the particular matter on which discussion is sought to be raised and speeches shall be confined to the discussion as to how economy can be effected;
- **'that the amount of the demand be reduced by Rs.100/-'** in order to ventilate a specific grievance which is within the sphere of the responsibility of the Government of India. Such a motion shall be known as **'Token Cut'** and the discussion thereon is confined to the particular grievance specified in the motion.

For the sake of convenience, usually the main motion for demand and the Cut Motion relating to it are put and discussed together in the House. Cut Motion, thus is a device to initiate the discussion on demand for grants and to uphold the principle of responsible government by probing the activities of the government. After discussion, first the cut motions are disposed off and thereafter, the demands for grants are put to vote of the House. Cut Motions are generally moved by members from the opposition, and if carried, amount to a vote of censure against the government.

In total, 26 days are allotted for the voting of demands. On the last day the Speaker puts all the remaining demands to vote and disposes them whether they have been discussed by the members or not. This is known as 'guillotine'.

Other grants - In addition to the budget that contains the ordinary estimates of income and expenditure for one financial year, various other grants are made by the Parliament under extraordinary or special circumstances:

- **Vote on Account-** Only after enactment of Appropriation Act after it is assented to by the President, the payments can be made from the Consolidated Fund of India. Before 2017-18, this used to go on till the end of April. But the government needed money to carry on its normal activities after 31 March (the end of the financial year). To overcome this functional difficulty, the Constitution has authorized the Lok Sabha to make any grant in advance in respect to the estimated expenditure for a part of the financial year, pending the completion of the voting of the demands for grants and the enactment of the appropriation bill. This provision is known as the 'vote on account'.
- **Supplementary grants, Votes of Credit etc.**
    - Supplementary, additional, excess and exceptional grants and votes of credit are regulated by the same procedure as is applicable in the case of demands for grants.
    - Supplementary grant is granted when the amount authorized by the Parliament through the appropriation act for a particular service for the current financial year is found to be insufficient for that year.
    - Additional Grant is granted when a need has arisen during the current financial year for additional expenditure upon some new service not contemplated in the budget for that year.
    - Excess Grant is granted when money has been spent on any service during a financial year in excess of the amount granted for that service in the budget for that year. It is voted by the Lok Sabha after the financial year.

- Vote of Credit is granted for meeting an unexpected demand upon the resources of India, when on account of the magnitude or the indefinite character of the service, the demand cannot be stated with the details ordinarily given in a budget. Hence, it is like a blank cheque given to the Executive by the Lok Sabha.
- Exceptional Grant is granted for a special purpose and forms no part of the current service of any financial year.

- **Token grant**
  - When funds to meet proposed expenditure on a new service can be made available by reappropriation, a demand for the grant of a token sum may be submitted to the vote of the House. If the House assents to the demand, funds may be made available.

2.2.5. Appropriation Bill

Under the Constitution, no money can be withdrawn from the Consolidated Fund of India without enactment of law by the Parliament. In pursuance of this, a Bill incorporating all the demands for Grants voted by the Lok Sabha, along with the expenditure charged on the Consolidated Fund, is introduced in the Lok Sabha. This Bill is known as the Appropriation Bill. The Bill, as the name suggests, intends to give legal authority to the government to appropriate the expenditure from and out of the Consolidated Fund.

Procedure regarding Appropriation Bill

- The procedure in regard to the passage of an Appropriation Bill is the same as for any other Bill, generally with only those modifications that the Speaker may consider necessary.
- The debate on an Appropriation Bill, however, is restricted to those matters, which have not already been raised while the relevant demands for grants were under consideration.
- No amendments can be proposed.

After the Bill is passed by the Lok Sabha, the Speaker certifies it as a Money Bill and transmits it to the Rajya Sabha. The latter House has no power to amend or reject the Bill, but has to give its concurrence, and if Rajya Sabha doesn't take any action on it within 14 days even then it is considered as passed by the Rajya Sabha. The bill, thereafter, is presented to the President for his assent.

2.2.6. Finance Bill

At the time of presentation of the Annual Financial Statement before Parliament, a Finance Bill is also presented in fulfillment of the requirement of Article 110 (1)(a) of the Constitution, detailing the imposition, abolition, remission, alteration or regulation of taxes proposed in the Budget. A Finance Bill is a Money Bill as defined in Article 110 of the Constitution. It is accompanied by a Memorandum explaining the provisions included in it.

3. Weaknesses in the Budgetary Process

3.1. Weaknesses in Resource Allocation and Use

Many of the weaknesses in budgeting reflect the failure to address linkages between the various functions of budgeting. The following factors contribute to budget systems and processes that create a disabling environment for performance in the public sector, both by commission and by omission:

- Almost exclusive focus on inputs, with performance judged largely in terms of spending no more, or less, than appropriated in the budget;
- Input focus takes a short-term approach to budget decision making; failure to adequately take account of longer-term costs (potential and real), and biases in the choice of policy instruments (e.g., between capital and current spending and between spending, doing, and regulation) because of the short-term horizon;

- A bottom-up approach to budgeting that means that even if the ultimate stance of fiscal policy was appropriate (and increasingly after 1973 it was not) game playing by both line and central agencies led to high transaction costs to squeeze the bottom-up bids into the appropriate fiscal policy box;
- A tendency to budget in real terms, leading either to pressure on aggregate spending where inflation is significant (which was often validated through supplementary appropriations) or arbitrary cuts during budget execution with adverse consequences at the agency level;
- Cabinet decision making focused on distributing the gains from fiscal drag across new spending proposals;
- Cabinet and/or central agencies extensively involved in micro-decision making on all aspects of funding for ongoing policy;
- Weak decision making and last-minute cuts cause unpredictability of funding for existing government policy; this is highlighted to the centre by central budget agencies on the alert to identify and rake back "fortuitous savings;"
- Strong incentives to spend everything in the budget early in the year and as quickly as possible, since the current year's spending is the starting point for the annual budget haggle and the fear of across-the-board cuts during execution;
- Existing policy itself (as opposed to its funding) subject to very little scrutiny from one year to the next. (This and previous point epitomize the worst dimension of incremental budgeting);
- Poor linkages between policy and resources at the centre, between the center and line agencies, and within line agencies because of incremental budgeting;
- A lack of clarity as to purpose and task and therefore poor information on the performance of policies, programmes and services, and their cost because of poor linkages;
- The linking together (in association with the point above) within government departments of policy advising, regulation, service delivery and funding and an aversion to user charging; and
- Overall, few incentives to improve the performance of resources provided.
- Weak parliamentary control over finances, as the accountability is number driven. Therefore, the ruling party, having the majority in Lok Sabha, has its say in budget making.
- The goals in the budget are very difficult to quantify and measure. As a result the accountability of the executive to the legislature remains weak.

3.2. Weaknesses in the Indian Budgetary System and Implementation

- Unrealistic budget estimates
- Delay in implementation of projects
- Skewed expenditure pattern with a major portion getting spent in the last quarter of the financial year, especially in the last month.
- Inadequate adherence to the multi-year perspective and missing 'line of sight' between plan and budget
- No correlation between expenditure and actual implementation
- Ad hoc project announcements
- Emphasis on compliance with procedures rather than on outcomes.

4. Budgetary Reforms

Attempts are continuously being made to overcome as many of the shortcomings as possible. A good example is the trend in OECD countries. The common elements of the budgetary reforms in OECD member countries are:

4.1. Medium Term Budget Frameworks

Medium-term budget frameworks form the basis for achieving fiscal consolidation. They need to clearly state the government's medium term fiscal objectives in terms of high-level targets such as the level of aggregate revenue, expenditure, deficit/surplus, and debt. They then need to operationalize these high-level targets by establishing hard budget constraints for individual ministries and programmes over a number of years.

4.2. Prudent Economic Assumptions

Deviations from the forecast of the key economic assumption underlying the budget are the government's key fiscal risk. There is no single factor more responsible for "derailing" fiscal consolidation programmes than the use of incorrect economic assumptions. Great care must be taken in making them and all key economic assumptions should be disclosed explicitly. The establishment of an independent body to recommend the economic assumptions to be used in the budget may be considered as well. All this serves to place safeguards against the use of unrealistic, or "optimistic," economic assumptions.

4.3. Top-Down Budgeting Techniques

Budgeting has traditionally operated on a bottom-up principle. This means that all agencies and all ministries send requests for funding to the finance ministry. These requests greatly exceed what they realistically believe they will get. Budgeting then consists of the Finance Ministry negotiating with these ministries and agencies until some common point is found. This bottom-up system has several disadvantages to it.

First, it is very time consuming and it is essentially a game; all participants know that the initial requests are not realistic. Second, this process has an inherent bias for increasing expenditures; all new programmes, or expansion of existing programs, are financed by new requests; there was no system for reallocation within spending ministries and there were no pre-set spending limits. Third, it was difficult to reflect political priorities in this system as it was a bottom-up exercise with the budget "emerging" at the end of this process. This manner of budgeting is now being abandoned and replaced with a new top-down approach to budget formulation. This has been of great assistance in achieving fiscal consolidation.

The starting point for the new system is for the government to make a binding political decision as to the total level of expenditures and to divide them among individual spending ministries. This decision is made possible by the medium-term expenditure frameworks which contain baseline expenditure information, i.e. what the budget would look like if no new policy decisions were made. The political decision is whether to increase expenditures for a high-priority area, for example education, and to reduce expenditures, for example defence programs. Only the largest and most significant programmes reach this level of political reallocation. The key point is that each ministry has a pre-set limit on how much it can spend.

4.4. Relaxing Central Input Controls

This is based on the simple premise that the heads of individual agencies are in the best position to choose the most efficient mix of inputs to carry out the agency's activities. The end-result is that an agency can produce the same services at less cost, or more services at the same cost. This greatly facilitates fiscal consolidation strategies by mitigating their effects on services.

Relaxing central input controls operates at three levels. First, the consolidation of various budget lines into a single appropriation for all operating costs (salaries, travel, supplies, etc.). Second, the decentralization of the personnel management function. Third, the decentralization of other common service provisions, notably accommodations (buildings). This can be seen as the public sector's version of "deregulation."

4.5. An Increased Focus on Results

An increased focus on results is a direct quid pro quo for relaxing input controls as described above. Accountability in the public sector has traditionally been based on compliance with rules and procedures. It didn't matter what you did as long as you observed the rules. Now, when the public sector is deregulated, a new results-based system is needed to hold managers accountable. This is a fundamental change: holding managers accountable for what they do, not how they do it.

4.6. Budget Transparency

The budget is the principal policy document of government, where the government's policy objectives are reconciled and implemented in concrete terms. Budget transparency – openness about policy intentions, formulation and implementation – is therefore at the core of good governance agenda. The extent to which budget achieves any or all of its purposes is dependent on its transparency. If we take a look at fiscal transparency in concrete terms, we can say that it has three essential elements:

- The first is the release of budget data. The systematic and timely release of all relevant fiscal information provided for analysis and conclusions by decision makers is what we typically associate with budget transparency. It is an absolute pre-requisite, but it is not enough.
- The second element is an effective role for the legislature. It must be able to scrutinize the budget reports and independently review them. It must be able to debate and influence budget policy and be in a position to effectively hold the government to account. This is both in terms of the constitutional role of the legislature and the level of resources that the legislature has at its disposal.
- The third element is an effective role for civil society, through the media and nongovernmental organisations. Citizens, directly or through these vehicles, must be in a position to influence budget policy and must be in a position to hold the government to account. In many ways, it is a similar role to that of the legislature albeit only indirectly.

4.7. Modern Financial Management Practices

The modernisation of financial management within governments made great advances during the past ten years. The sheer scale of government means that such improvements had a material effect on fiscal outcomes. These include the introduction of accruals, capital charges, carry-overs of unused appropriations, and interest-bearing accounts.

Fiscal Responsibility and Budget Management Act (FRBMA) The Fiscal Responsibility and Budget Management Act (FRBMA) 2003 has been enacted by the Parliament to institutionalize **fiscal discipline** at both the centre and state level by setting targets including reduction of fiscal deficits and elimination of revenue deficit. It is a legal step to ensure fiscal discipline and fiscal consolidation in India.

(Kindly refer the document of Fiscal Policy for more details on FRBMA.)

5. Recent Changes in Union Budgeting

5.1. Budget 2016-17

5.1.1. Rationalization of Centrally Sponsored Schemes (CSS) and expenditure Thereon

Budget 2016-17 introduced a new classification system for the Centre's spending, based on the categorization of CSS, pruning the existing 66 CSSs to 28, and then further divided them into three categories—six 'core of the core' schemes, 20 core schemes, and two optional schemes. The classification is discussed as under:

1. ***Core of the Core:*** Those schemes which are for social protection and social inclusion should form the core of core and be the first charge on available funds for the National Development Agenda. Under the new classification, six schemes are classified as Core of the Core, including MGNREGA and all the umbrella schemes for the upliftment of minorities, Scheduled Castes, and Scheduled Tribes.

   As per the new system, the Core of the Core schemes are of highest priority, and thereby will retain their expenditure allocation framework. For example, MGNREGA had 75 per cent of the material expenditure from the Centre and 25 per cent from the states.

2. ***Core:*** Focus of CSSs should be on schemes that comprise the National Development Agenda where the Centre and States will work together in the spirit of Team India. The Core schemes, 20 in number, include schemes as far-ranging as the Krishi Unnati Yojana, the Smart Cities programme, and the modernisation of the police force. These are second in priority and will have a 60:40 formula of expenditure.

3. ***Optional Schemes:*** It includes all those schemes, presently two in number, which a particular state feels necessary considering its level of socio-economic development. These will have a 50:50 formula, with the states having the flexibility to decide whether to invest in these or not.

This system was put in place on the recommendations of a sub-committee of Chief Ministers formed by Niti Aayog for the rationalisation of the CSS.

5.2. Budget 2017-18

With the Budget 2017-18, the government brought in three kinds of changes in budgeting process. These are discussed as under.

5.2.1. Scrapping of Plan and Non-Plan classification

The previously exiting Plan and non-plan classification of expenditure has been done away with from FY 2017-2018 and their place has been now taken by capital and revenue spending classifications. In 2011, an experts' committee headed by C. Rangarajan had proposed that this distinction should be abolished.

Under the previous classification, all expenditures which were done in the name of planning were called plan expenditures while all other expenditures were placed under non-plan expenditures. Further, generally (not always), the plan expenditure produced some tangible assets related to economic development. This was the reason that plan expenditures were also called "development expenditures".

Rationale behind this move

1. This move is in line with the scrapping of Planning Commission and thereby development based on hitherto existing planning.
2. This classification has led to an increasing tendency to start new schemes/projects neglecting maintenance of existing capacity and service levels.
3. It has also led to the misperception that non-plan expenditure is inherently wasteful, adversely affecting resource allocation to social sectors like education and health where salary comprises an important element.
4. It prevented any meaningful 'outcome based budgeting' because only plan expenditure is considered for looking at outcomes while practice should be to look at total expenditure.
5. Growing complexity in nature of government and expenditure on varied heads ensure that

segregating a head under plan or non-plan items is not done on rational grounds and hence the distinction is not logical.

6. The distinction meant that infrastructure like schools come under planned expenditure while expenditure on teachers come under non-planned expenditure likewise hospitals under planned and salaries etc. of doctors under non-planned. This mismatch leads to mismanagement and ineffective resource utilization.

5.2.2. Merging of Railway and General Budget

The 92 years old practice of presenting separate budgets- Railway Budget and General Budget has been abolished. It was recommended by Bibek Debroy Committee on restructuring and reforming railways. This move is being lauded for it will be beneficial for the economy at large and there will be positive influence in the development in railways.

Rationale for introducing separate budgets in 1921

The separation was introduced in 1921 based on the recommendation of Acworth Committee report. The reason was that a larger part of the country's GDP depended on railway revenue, therefore, railway demanded separate budgetary focus. Independent India also continued this practice and over the period of time it became accepted practice with following advantages:

1. ***Accountability:*** Separate budget used to give sufficient media attention to the budgetary proposals, thereby enforcing accountability of the government.
2. ***Public transport:*** Railways has been the public transportation system, therefore it was desirable that railways should be given special attention by separate budget.
3. ***Autonomy:*** It was expected that separate budgetary process would ensure requisite autonomy to the railways to function as independent commercial entity.

However, over a period of time, the railway budget became a tool for populism and led to populist waste and inefficiency. Hence, there was a strong demand for corporatization of the Railways. Not having a separate budget for it prepares the ground for such a change.

Rationale for Merger

1. During the British rule Railways took up to 85% of the yearly budget while now it has gone down to about 15% only.
2. Now that the Railway Budget will be introduced along with the Union Budget, there will be less wastage of time when a new policy is to be initiated and implemented.
3. Separate Railway Budget became a tool for corruption, inefficiency, and populist measures. As a result, the successive Railway Minister used to find it hard to increase fairs in line with the increasing operational costs. This was the primary reason for cross subsidization (where the passenger traffic is subsidized by the freight traffic).
4. The Railways would not need to pay Rs 10,000 crore annual dividend to the union government. This annual dividend can now be used for development of Indian Railways.
5. Synergetic transportation policies would henceforth be possible because the Finance Ministry would be responsible for allocation of resources to all kinds of transportation system.

Apprehensions against this move

1. The resource allocation to Railways would henceforth be dependent on Finance Ministry. Therefore, there may be rise or fall in resource allocation to Railways depending on the size of the budget. This may hamper the independent development of Railways.
2. Merger may result in reduced accountability, as the media attention given to separate budget would no longer be there. This would make easy for the government to sweep the losses in railways under the carpet.

3. Some experts feel that merger would throw railways open to privatization and crony capitalism.

There have been mismanagement of the highest order in Indian railways and if there are chances of seeing it improve, merging it with the Union budget is just the solution that could help. The falling revenue and more projects for new trains and stoppages have been a difficult project for the railway ministry which took the right step by merging the two budgets.

5.2.3. Budget Advancement

The Budget was present 27 days before the earlier practice of presenting the budget on last day of February. The objective behind this move is to have the Budget constitutionally approved by Parliament and assented to by the President, and all allocations at different tiers disseminated to budget-holders, before the financial year begins on April 1.

Rationale of this move

1. The Finance Bill, incorporating the budget proposals, could be passed well before the starting of fiscal year. Therefore, the government departments, agencies would know their allocation right from April 1, the onset of financial year.
2. It would also help the private sector to anticipate government procurement trends and evolve their business plans.
3. In the earlier scheme of things, the Lok Sabha passed Vote on Account for April-June quarter, under which departments are provided with a sixth of their total allocation for the year. Advancing the budget enables the government to do away with this practice.
4. The investment in infrastructural projects largely takes place in later part of the year, because budget gets passed only by June, but by then monsoon sets in making it difficult to start infrastructural project. As a result, the effective investment period is quite short, thereby ending in 'March Rush'. This causes inefficiency in resource utilization and delays in project implementation.

Apprehensions against this move

1. One big disadvantage of advancing the Budget was lack of comprehensive revenue and expenditure data. Previously, work on the Budget began in earnest by December. By the time it was finalized in mid-February, data on revenue collections and expenditure trends was available for the first nine months of the financial year, i.e. April-December, based on which, projections for the full year would be made.
2. Advancing the Budget dates is fraught with practical difficulties. Effective Budget planning also depends on the monsoon forecasts for the coming year, making advancing the whole exercise even more difficult.

Despite the apprehensions, all the above discussed budget reforms are a welcome move, but these reforms have to go further, as has been suggested by C. Rangarajan Committee in 2011.

6. Evolution of Budgeting

When governments had to prove to their tax-payers that they could be trusted with their money, the budget emphasized controlling costs, accounting for finances, and improving efficiency. Later, during the depression, people wanted the government to proactively solve problems for which the private sector was largely blamed, the effectiveness of public programs came into greater budgetary focus. In recent years, both of these missions have been reflected in the budgets.

6.1. The Line Item Budget

- In the early nineteenth century, government budgeting in most countries was characterized by weak accounting procedures, adhocism, little central control and poor monitoring and evaluation.
- In the late nineteenth century, line-item budgeting was introduced in some countries. The line item budget is defined as *"the budget in which the individual financial statement items are grouped by cost centers or departments .It shows the comparison between the financial data for the past accounting or budgeting periods and estimated figures for the current or a future period"*
- In a line-item system, expenditures for the budgeted period are listed according to objects of expenditure, or "line-items." These line items include detailed ceilings on the amount a unit would spend on salaries, travelling allowances, office expenses, etc. The focus is on ensuring that the agencies or units do not exceed the ceilings prescribed which is monitored by a central authority or the Ministry of Finance

Advantages

- The line item budget approach is easy to understand and implement.
- It also facilitates centralized control and fixing of authority and responsibility of the spending units.

Disadvantages

- Its major disadvantage is that it does not provide enough information to the top levels about the activities and achievements of individual units.
- The weaknesses of the line item budgeting were sought to be remedied by introducing certain reforms. Performance budgeting was the first such reform.

6.2. Performance Budgeting

Unlike the traditional line item budget, a performance budget reflects the goal/objectives of the organization and spells out performance targets. These targets are sought to be achieved through a strategy. Unit costs are associated with the strategy and allocations are accordingly made for achievement of the objectives. A Performance Budget gives an indication of how the funds spent are expected to give outputs. However, performance budgeting has a limitation - it is not easy to arrive at standard unit costs especially in social programmes, which require a multi-pronged approach.

6.3. Outcome budgeting

It is the compilation of anticipated and intended outcomes of various ministries. Outcome is not just the physical output of financial input. Outcome means the benefits arising out of the physical output from respective financial input.

For example – allocating money for constructing building, buying table chairs etc. is the input for which construction of school is the output. Here outcome will be the number of students finally getting educated.

6.4. Zero-based Budgeting

The concept of zero-based budgeting (ZBB) was introduced in the 1970s. As the name suggests, every budgeting cycle starts from scratch. Unlike the earlier systems where only incremental changes were made in the allocation, under zero-based budgeting every activity is evaluated each time a budget is made and only if it is established that the activity is necessary, are funds allocated to it. The basic purpose of ZBB is phasing out of programmes/activities, which do not have relevance anymore. However, because of the efforts involved in preparing a zero-based budget and institutional resistance related to personnel issues, no government ever implemented a full zero-based budget, but in modified forms the basic principles of ZBB are often used.

6.5. Gender Budgeting

Gender budgeting is a strategy for ensuring gender sensitive resource allocation and a tool for engendering macro economic policy, not a separate budget for women.

The 2005-06 Indian Budget introduced a statement highlighting the gender sensitivities of the budgetary allocations. Gender budgeting is an exercise to translate the stated gender commitments of the government into budgetary commitments, involving special initiatives for empowering women and examination of the utilisation of resources allocated for women and the impact of public expenditure and policies of the government on women. The 2006-07 budget enlarged the earlier statement.

Need of Gender Budgeting

- To ensure men's and women's needs and priorities are considered equally.
- To encourage the incorporation of gender analysis in preparation, implementation, audit and evaluation of government budgets at all the levels and evaluating the impact of the budget on the gender equality objective.
- To enhance the linkages between economic and social policy outcomes.

The Framework adopted for gender analysis of expenditures is often broken down in three categories:

- **Gender-specific allocations** are allocations specifically targeting women and girls or men and boys. For example, school bursaries for girls or domestic violence counselling for men. Many governments have allocated special funds for women's programmes and it is important to analyse their impact on women's lives and ensure that such programmes give value for money.
- **Mainstream allocations** need to be examined for their gendered impacts. Most expenditures fall in this category and the real challenge of gender analysis of budgets is to examine whether such allocations address the needs of women and men, girls and boys of different social and economic backgrounds equitably.
- **Equal opportunity employment allocations** are allocations intended to promote gender equality in the public service. For example, day-care facilities for employees' children, paid parental leave, or special training for women middle-level managers.

Challenges and Limiting factors in Gender Budgeting

Various challenges remain in implementing gender budgeting and accepting the analysis generated by these processes:

- **Collection of sex-disaggregated data:** There is some sex-disaggregated data available but there is a need to generate more information in order to shed more light on the differences between women and men, girls and boys, particularly in access to resources, opportunities and security without which it is not possible to integrate a gender perspective in the budget process.
- **Limited evidence connecting analysis with policy & budget changes** as most of the gender budgeting initiatives worldwide are at the stage of analysis.
- **Limitation of parliamentary intervention:** Legislatures, in partnership with gender experts and civil society groups, have sometimes played an important advocacy role in various countries but the role of legislatures in the budget process is often confined to budgetary approval and oversight and not involved in formulation and execution

- **Political will to institutionalise gender budgeting:** Gender budgeting requires political will, adequate resources and capacity to support a process of transforming the traditional budget-making and policy processes by removing long-standing, in-built biases which disadvantage women and girls.

6.6. E-Budgeting

E-budgeting may be defined as electronic or enterprise-wide budgeting. It presents a strategic advantage with help of the capability of internet to let various establishments execute an enterprise wide budgeting system, which can be reached from any location.

Advantages

- Extremely efficient as it brings efficiency with supervision and control and elimination of cumbersome accounting tasks
- convenient and adaptable as the technology is being used for anywhere and anytime budgeting.
- enables planning to keep pace with e-business
- ability to collaborate with managers, administrators, ministers in the same platform
- worldwide communication and collaboration
- easy assessment through automatization of calculations and other processes

E-budgeting is rapidly becoming the norm all over the world due to its ability to allocate resources efficiently and assisting governments in competing successfully in an ever changing economic environment

7. Vision IAS GS Mains Test Series Questions

1. What do you mean by gender budgeting? Examine the rationale and achievements of gender budgeting in India.

Approach:

- First of all briefly explain gender budgeting.
- Then bring out the rationale as to why there is need of Gender Budgeting.
- Finally elaborate the achievements of Gender Budgeting in India.

Answer:

Gender Budgeting is a tool for achieving gender mainstreaming so as to ensure that benefits and development reach women as much as men. It is not an accounting exercise but an ongoing process of keeping a gender perspective in policy and program formulation, its implementation and review. Gender Budgeting entails dissection of the Government budgets to establish its differential impact on women and to ensure that gender commitments are translated into budgetary commitments.

The rationale for gender budgeting arises from recognition of the fact that budget impacts men and women differentially. Women, who constitute 48% of India's population, lag behind men on many social indicators like health, education, economic opportunities etc., and therefore warrant special attention.

Also, gender inequality poses a significant development challenge in India. The Global Gender Gap Index 2014 ranked India at 114 out of 142 countries. The ranking is based on a country's ability to reduce gender disparities in four areas: economic participation and opportunity, education, political empowerment, and health and survival. Violence against women and girls persists, both in private and in public spaces. As a response to these challenges, India adopted 'gender-responsive budgeting' (GRB) in 2005, which is a method of planning, programming and budgeting that helps advance gender equality and women's rights.

Examination of steps taken for GB:

- Gender Budgeting cells (GBCs) have been setup in various ministries and departments as focal points for coordinating GRB. Many state governments have also adopted it.
- Pre-budgeting consultations are organized every year before the budget.
- The quantum allocation for women as proportion of total budget has remained almost constant for the past 10 years.
- Budget for MoCWD has improved although most of it is allocated for ICDS scheme, leaving only a little for schemes exclusively meant for women.
- New schemes such as Beti Bachao Beti Padhao and Sukanya Samriddhi Yojana are examples of explicit targets in order to improve socio-economic conditions of women.

The stand-alone goal on gender equality and women's empowerment in the Sustainable Development Goals will remain elusive if not backed by adequate investments. As such GB is essential to achieve these targets.

2. What are the reasons behind a low tax base in India? Discuss the issues associated with it and the steps required to widen the tax base.

Approach:

- Explain why taxes are required and the reasons for low tax base.
- Explain what are the problems due to this.
- End with positive note like what needs to be done.

Answer:

Tax collection form the backbone of an economy as taxes fund an effective state that protects national security, administers justice, builds infrastructure and funds a social security net. However, India's economic development lags behind its political development, as the tax collection is very low- only 3-4% registered voters pay income taxes in India.

Reasons:

- Ineffective tax administration: Therefore, we do not have data on potential tax payers.
- Frequent raising of tax exemption threshold- Faster than the rise in income levels.
- High rate of poverty.
- Tax evasion due to corruption, black money, low number of income tax official, high rate of tax due to multiplicity of tax and various tax exemptions.
- Non taxation of agriculture sector.
- 90% of workforce is in informal sector, which is poorly regulated and majorly out of tax net.
- Prevalence of cash transactions, avenues for parallel economy like Hawala transactions etc.

A low tax collection adversely affects the economy in several ways :

- Regressive tax structure: Low direct tax means increasing share of indirect taxes in total revenue which affect poor.

- Reduced legitimacy of the state.
- Generation of black money which directly affects the expenditure on capital formation and social security.
- Taxation evasion also results in rise of organised crime.
- Limits government's ability to fund social security and developmental schemes.
- Less number of tax payers pose limitations to accountability and transparency mechanisms and implicitly penalises the honest tax payers.

Way forward

- Reduce corruption in tax administration to increase legitimacy of the state. This would motivate people to pay their dues.
- Improve tax administration to make tax compliance easier.
- Need for widening the tax base.
- Explore the possibility of taxing the property tax in urban areas which has not been explored fully till now.
- Do not raise tax exemption limits so frequently.
- Swift implementation of big tax reforms like GST, GAAR etc.
- Promoting cashless and digital transactions.
- Creating awareness among consumers and establishments regarding tax discipline.

The Indian state is fiscally constrained thanks to inadequate direct tax collections. The solution is neither a sharp increase in tax rates nor a carefree disregard for fiscal imbalances. The way ahead has to be based on further tax reforms combined with better tax administration, so that more Indians pay income tax.

3. The "Outcome Budget" reflects the endeavour of the Government to convert "Outlays" into "Outcomes". Explain. Also, discuss why the potential of outcome budgeting remains untapped in the Indian context.

Approach:

- Explain Outcome budgeting in the context of changing outlays to outcomes.
- Highlight its benefits.
- Discuss challenges faced by India while using the practice of outcome budgeting

Answer:

Budgeting is an annual government exercise of estimating receipts and expenditures for the coming year. Accordingly, outlays are assigned to various ministries and government schemes on the basis of estimated output or outcome.

Under 'Outcome-based Budgeting', outcomes of each programme or scheme designed by the government is estimated. These Outcomes are the end results or impact of initiatives and interventions. Here Output must be differentiated from Outcome, as the former deals with quantitative result while the latter also includes qualitative aspect.

For instance, if outlay of 100 Crore is assigned for construction of hospital, then the 'output' would be measured in terms of physical infrastructure, whereas 'outcome' will also include the impact of the initiative, like percentage reduction in death rate, maternal mortality rate in that area among other parameters.

Benefits of Outcome based Budgeting

- Outcome Budgeting shifts the perspective from "doing the job" to "doing it well".

- It leads to efficient service delivery, transparency, and accountability.
- The outcome budget indicates actual performance which helps people scrutinising the government and educates them about policies.

Outcome Budgeting in India:

The Outcome Budget was first introduced in India in 2005-06, with an understanding that "the people of the country are concerned with outcomes, not outlays". However, limited progress has been made in this front, primarily due to three key reasons:

- Much of the development interventions are routed through the state governments. Only a few states have adopted planning outcome budgeting.
- Limited understanding exists on the linkage between specific Government interventions and their outcomes. Ministries face difficulties in spelling out the outcomes on ex-ante basis.
- The principles and intent of outcome budgeting are often overlooked. There is lack of programme formulation, programme implementation and programme monitoring capabilities in the ministries.

Way Forward

- Appropriate Centre-State institutional framework should be created to standardize set of output indicators and processes for collecting and collating outcome related information.
- Effective feedback system such as social audit is required in implementation of every programme.
- The country needs to evolve ways and means to strengthen its institutions, without undermining them. Following steps have to be undertaken in this regard:
  - strengthening the Public Accounts Committee
  - professionalising the internal audit and vigilance organisation in the ministries
  - building capacities for risk management techniques in the programme divisions
  - making budget division and budget formulation activities independent of the executive to improve the outcome of programmes.
  - as the outcome may not be co-terminus with the period of the budget. There needs to be defined intermediate outcomes as well.

4. *"Good economics and bad politics cannot coexist in a sound budgetary process" Discuss.*

Approach:

The question needs to cover the following issues:

- The importance of a sound budgetary process in a developing country like India
- First define briefly what you mean by 'Good Economics' and 'bad politics'
  - Does demand politics play a role in the government budgeting process?
- Conclusion, on a positive note, with suggestions for reforms

Answer:

The government budgeting process, in most countries of the world, is influenced by the exigencies of popular politics. However, the extent to which political exigencies and economic decision-making are interlinked differ from one country to another. In a country like ours, where the Indian State is envisaged as a developmentalist State, politics and economics are intricately intertwined. Our demand politics is oriented towards short term goals, competitive processes for determining policies, public interest and the provision of private goods. It is constrained and directed by the imperatives of electoral victory and pluralist and class bargaining. This is essentially 'bad politics'.

A sound budgetary process, on the other hand, requires resources allocation, efficiency, achieving macroeconomic objectives like employment, sustained economic growth, and price level stability, capital formation, controlling deficits, curtailing wasteful expenditure, efficient management of BoP etc. This is essentially 'Good Economics'.

A necessary condition to achieve these economic goals is the state's ability to free itself through leadership or repression from the constraints of societal demand. It requires sacrificing short run for long run benefits, while demand politics do the reverse. The preference of political leaders and bureaucrats largely determine budgetary decisions and policy choice in our country. They favour, repress, license, or co-opt economic classes, organized interests, and elites. Thus we can say, in Indian scenario, that 'good economics' and 'bad politics' are not compatible in a sound budgetary process. For instance, 'good economics' says that fuel subsidies should be removed as they are harmful for financial health of nation. But due to 'bad politics' these subsidies are still continuing to some extent.

However seeing 'bad politics' as populist measures – they need not be always incompatible with the 'good economics'. Adopting budgetary reforms like adopting medium-term budget frameworks, prudent economic assumptions, top-down budgeting techniques, relaxing central input controls, focussing on results, budget transparency and modern financial management practices, along with performance budgeting, outcome budgeting and zero budgeting can bring an end to the contradiction between bad politics and good economics.

5. ***"Unspent provisions in a grant or appropriation indicate either poor budgeting or shortfall in performance or both". Elaborate this statement in the context of budgeting in India. Also suggest few remedies to overcome it.***

Approach:

The lack of efficiency in programme management at the departmental level in an annual budget cycle should be stressed.

Answer:

Despite having an elaborate and time consuming system of making budgetary estimates, large amounts of unspent money is surrendered every year at the lapse of the financial year. Large-scale unspent provisions are indicative of lack of efficiency in programme management at the departmental level in an annual budget cycle and undermine efficient use of public money which is one of the major objectives of any budgeting system. Excessive provision under various sub-heads during the budget preparation stage due to lack of a realistic assessment of departmental requirements is the major reason for this. It also shows that proper forecasting methods are not used to estimate expenditure on account of various items.

Following steps can be taken to solve this problem.

- Ministry of Finance advised the Ministries/Departments to gear up the 'existing mechanism of review, monitoring and control' as to make a careful formulation of plan/schemes having regard to 'ground realities and achievable targets' and also to make 'realistic assessment of funds.'

- The assumptions made while formulating estimates must be realistic. At the end of each year the reasons for the gap between the 'estimates' and 'actuals' must be ascertained and efforts made to minimize them. These assumptions should also be subject to audit.
- The method of formulation of the annual budget by getting details from different organizations/ units/ agencies and fitting them into a predetermined aggregate amount leads to unrealistic budget estimates. This method should be given up along with the method of budgeting on the basis of 'analysis of trends'. This should be replaced by a 'top-down' method by indicating aggregate limits to expenditure to each organization/agency.
- Internal capacity for making realistic estimates needs to be developed.

8. Previous Years UPSC Mains Questions

1. One of the intended objectives of Union Budget 2017-18 is to 'transform, energize and clean India'. Analyse the measures proposed in the Budget 2017-18 to achieve the objective.
2. Women empowerment in India needs gender budgeting. What are the requirements and status of gender budgeting in the Indian context?
3. In what way could replacement of price subsidy with Direct Benefit Transfer (DBT) change the scenario of subsidies in India? Discuss.
4. What are the reasons for introduction of Fiscal responsibility and Budget Management (FRBM) act, 2003? Discuss critically its salient features and their effectiveness.
5. What is meaning of the term tax-expenditure? Taking housing sector as an example, discuss how it influences budgetary policies of the government.
6. Discussion the rationale for introducing Good and services tax in India. Bring out critically the reasons for delay in roll out for its regime.

INFLATION

Contents

1. Definition of Inflation

Inflation refers to a sustained rise in the general price level in the economy and a fall in purchasing power of money over a period of time. In simple words, inflation refers to rise in average price level of most of goods and service in an economy.

2. Types of Inflation (on the basis of rate of inflation)

Creeping Inflation occurs when the inflation rate is in the range of 1% to 5%. Such inflation erodes the purchasing power of money, but is referred to as manageable and sometimes inevitable in a growing economy.

Trotting Inflation on the other hand lies in the range of 5% to 10%, which if not controlled properly may lead to *"galloping inflation"* at a rate of 10% to 20% annually. This galloping inflation may worsen into *"runaway inflation"* too.

Hyper Inflation: This form of inflation is out of control, which might have the annual rate in million or even trillion. In such inflation not only the range of increase is very large, but the increase takes place in a very short span of time, prices shoot up overnight. It rapidly reduces the value of currency to the extent that government thinks to adopt a new currency. One of the most famous examples of hyperinflation occurred in Germany between January 1922 and November 1923. Among the recent examples, the one experienced in Zimbabwe in 2008 is a prominent one.

3. Types of Inflation (based on causes)

Demand Pull Inflation: This type of inflation is caused by increase in demand and when the demand in the economy outgrows the supply in the economy. This kind of inflation can be described by "too much money chasing too few goods". One of the reasons for demand pull inflation can be the increase in money supply, by way of increased salary, increased government expenditure etc.

Cost-push inflation: It is also referred to as supply shock inflation. Such inflation occurs due to reduced supplies because of increased prices of inputs. For example, an increase in price of international crude oil adversely affects the inputs of almost all the items in a country like India, which neither has alternatives to oil for energy needs nor has significant amount of domestic oil production.

Structural Inflation: This type of inflation is also called as bottleneck inflation. Such an inflation is built into the economic system due to government policies. Such inflation occurs from time to time because of weather and seasonal conditions or due to supply side constraints, leading to shortage of supply in goods and services. Inflation in India is largely due to structural factors. For example, large number of intermediaries between farmer and final consumer in India; changing dietary patterns without commensurate increase in the supply of demanded goods.

4. Associated Terms

Stagflation: Stagflation refers to a situation in an economy when inflation and unemployment both are at high levels i.e. a combination of high inflation and low growth. Such a situation occurs when the inflation may have gone on for a long period and resultantly affected the input prices as well as the demand for goods and services in the economy.

Deflation: This is nothing but the completely opposite of inflation as there is a fall in the general price levels in the economy over a period of time. Deflation occurs when the inflation rate falls below 0% (where inflation is in negative territory). This should not be confused with *disinflation*, which implies slow-down in the inflation rate only (where inflation is in declining trajectory but remains positive). Following the Asian financial crisis in late 1997, Hong Kong experienced a long period of deflation which did not end until the end of 2004.

Recession: It is a situation which is characterized by negative growth rate of GDP in two successive quarters. Some of the indicators of a recession include slowdown in the economy, fall in investments, fall in the output of the economy etc.

Depression: It is an extreme form of recession and characterizes a situation in which the recession may have gone on for too long resulting in depression in the economy. ***A common rule of thumb for recession is two quarters of negative GDP growth. The corresponding rule of thumb for a depression is a 10 percent decline in gross domestic product (GDP).*** Some of the indicators of a depression are huge fall in demand and consumption of goods and services, shattering of business confidence, a sharp decline in the output of the economy and investments. One of the examples of depression is the great depression of 1930s.

Inflation Spiral: An inflationary situation in an economy, which results out of a process of wage and price interaction 'when wages press prices up and prices pull wages up', is known as the inflationary spiral. It is also known as the wage-price spiral. This wage-price interaction was seen as a plausible cause of inflation in the year 1935 in the US economy, for the first time.

Reflation: Reflation is a situation often deliberately brought by the government to reduce unemployment and increase demand by going for higher levels of economic growth. Governments go for higher public expenditures, tax cuts, interest rate cuts, etc. Fiscal deficit rises, extra money is generally printed at higher level of growth, wages increase and there is almost no improvement in unemployment. Reflation can also be understood from a different angle—when the economy is crossing a cycle of recession (low inflation, high unemployment, low demand, etc.) and government takes some economic policy decisions to revive the economy from recession, certain goods see sudden and temporary increase in their prices, such price rise is also known as reflation.

5. Causes of Inflation

Inflation primarily occurs due to two sets of factors, the demand-pull factors and the cost-push factors. Both of them have been explained below in detail:

a) **Demand Pull factors:** These are those set of factors due to which there may be an increase in the demand of goods and services in the economy.
   Some of them are:
   (i) **Increase in government expenditure:** Increased government expenditure results in increased demand for goods and services and consequent increase in prices. This is because increased government expenditure results in putting large money in the hands of public, thereby putting to effect too much money chasing too few goods. And if the production capacity is not able to meet the increasing demand it results in inflation. The Government may also print new money to meet its expenditure, which has the highest effect on inflation of all the factors. This was the reason it was banned post the FRBMA Act 2003.
   (ii) **Rising population:** Increasing population also acts as an important factor in pushing up prices because of increased demand especially when the supply is unable to meet the demand.
   (iii) **Black Money:** A large part of the black money is used in buying and selling of real estate in urban areas, extensive hoarding and black marketing in essential wage goods, such as cereals, pulses, etc. Black money, therefore, fuels demands and leads to rise in prices.

(iv) **Changing consumption patterns:** One theory that was put forward by senior officials at the Reserve Bank of India (RBI) is that the inflation problem in India has its roots in a sharp increase in demand for certain food items that people eat more frequently as income rises. One example is protein-rich food. Increased consumption of pulses, eggs, fish and poultry were apparently driving up their prices in the economy.

(v) **Increased wages:** When the general wages increase, they have the effect of increasing demand in the economy because of increased money supply.

b) **Cost- Push Factors:**

(i) **Rise in wages:** At times rise in wages, if greater than rise in productivity, increases the costs therefore increasing the prices too.

(ii) **Increase in indirect taxes** also leads to cost side inflation. Taxes such as custom and excise duty raise the cost of production as these taxes are levied on commodities.

(iii) **Increase in administered prices** such as the MSP (Minimum Support Price) for the food grains, petroleum products etc. also leads to inflation as they have a huge share in budget of common citizens.

(iv) **Infrastructural bottlenecks:** Infrastructural bottlenecks such as the lack of proper roads, electricity, water etc. raise per unit cost of production. This is one of the prime reasons for inflation in the context of Indian economy.

(v) **Fluctuation due to seasonal and cyclical reasons:** Owing to events such as failed monsoons there is a drop in agricultural productivity, which inevitably results in inflation at times.

c) **Miscellaneous Factors:**

Apart from the above, there are several other factors that lead to inflation in the economy. Some of them have been listed below.

(i) Rise in price of international commodities such as edible oil, crude oil etc.

(ii) Huge number of middlemen and large amounts of money siphoned off as profits by them.

(iii) Cartelization practices as adopted by some of the traders in the Indian economy thereby harming the interests of the consumers.

(iv) Huge dependence on import of crude oil for meeting the energy demands of the economy.

(v) Prolonged industrial unrest, which results in reduction of production capacity.

6. Impact of Inflation

Inflation impacts economy in many ways, some of them have been listed below:

1. **Recession in some of the sectors:** Because of the increase in prices of certain goods, their demand goes down and results in recession in some of the sectors of the economy.
2. **Adversely impacts the wage earners:** Inflation adversely impacts the wage earners as their purchasing power goes down but wages remain constant. On the other hand, it helps the businessmen, as their profits tend to go up because of rise in prices.
3. **Creates distortions in production patterns:** Because of inflation, capital resources get diverted from long term to short term uses and production shifts from essential to non-essential goods in the economy.
4. **Impact growth and availability of credit for industry:** More often than not, the interest rates are raised to curb the inflation in the economy. This results in credit crunch for the industry thereby impacting the growth of the economy. The recent spell of inflation in India in last few years has witnessed this trend.
5. **Impacts exports:** Inflation discourages exports because the foreign importers find manufactured goods costlier; and domestic sales are attractive for the manufactures. All

this adversely affects the Balance of Payments. For example, recently Indian economy witnessed one of the highest Current Account Deficit, accompanied by high inflation.

6. **Impacts imports:** Inflation in domestic economy increases imports as the imported goods may be cheaper than the domestically produced. This has the potential to increase the Current Account Deficit.
7. **Adverse effect on Foreign Exchange:** With low exports and increased imports due to inflation, the demand of foreign currency increases. This has the effect of depreciation of domestic economy. For example, Indian Rupee saw the largest depreciation in recent times, accompanied by high inflation.
8. **Discourage savings:** Because of decreasing value of money and uncertainty in the long run, higher inflation depletes the saving rate in an economy.
9. **Creates unequal distribution of incomes:** Inflation increases the nominal (face) value of the wages while their real value falls. That is why there is a negative impact of inflation on the purchasing power and living standard of the wage employees. Thus making the poor poorer. During inflationary times, the speculators and the black marketers earn income by hoarding the stocks etc. and because of the artificial scarcity, people have to pay more to get the goods and consequently the distribution of income becomes imbalanced and the money goes to traders.
10. **Breeds corruption**: Inflation mars incentive for hard and honest work, since a common man cannot meet rising expenses with a constant income. It also encourages practices such black marketeering, hoarding etc.
11. **Increased Fiscal Deficit:** Inflation can also make borrowings by the government costlier thereby raising the fiscal deficit.

7. Measures to Curb Inflation and their Limitations

Monetary, fiscal and administrative measures are taken to control inflation to an optimal level in the economy.

a) Monetary Measures

This type of measures are taken by the Central Bank of the country (RBI in case of India) through Monetary Policy. The principal tool under this method is regulating the interest rate in the economy. Since it has the effect of regulating the liquidity in the economy therefore it can be used only to control the demand-pull inflation. It is discussed as under:

(i) The RBI may take recourse to tighter monetary policy to cool down the demand-pull. For example, the RBI may increase the bank rates/repo rates etc. to curb the supply of money in the market.

(ii) RBI may also use qualitative control methods, such as raising margin on loans for commodities for which traders have a tendency to speculate and hoard.

(iii) Reserve Bank may also resort to other operations such as the Open Market Operations to mop out the liquidity from the market by selling government securities and bonds.

Limitations of Monetary Measures in curbing inflation:

(i) It is not much successful if the inflation is caused due to cost-push factor.

(ii) Another issue, which is important in a country like India, is the large presence of unorganized banking. Because of this RBI is not able to control a large part of the banking sector in the economy.

(iii) High interest rate to curb inflation has the effect of throttling the flow of credit to the productive sectors of the economy. As a result, the economic growth may have to be compromised. This has been the persistent problem in Indian economy in the last few years.

b) Fiscal Measures

These measures are implemented by way of Fiscal Policy, popularly called annual Budget. The government can take two routes to bring down the prices under this method:

(a) It can **cut down its own spending** on various schemes, projects etc.

(b) It can **increase the taxes** (either direct or indirect).

As far as the first option is concerned most of the governments across the world do not employ this method for two simple reasons, first they cannot suddenly reduce the money, which is being spent on several critical projects pertaining to infrastructure etc. as it would not only bring down the image of the country but also create a negative market sentiment. Secondly, if they cut down spending on several important welfare schemes etc. then it may politically harm them in the next elections. So cutting down government expenditure is not considered feasible.

The second method is raising the taxes to discourage spending. The government may increase the private direct taxes to reduce the incomes and thereby decreasing the consumption tendencies among the public. It may also increase the indirect taxes on commodities, raising their prices and thereby discouraging spending on them by the public.

But the limitation of this move is that it takes some time to give effect, because the fiscal policy is implemented on annual basis.

c) Administrative Measures:

These measures are implemented by the administrative agencies. Since, both monetary policy and fiscal policy have their inherent limitations and operate with a lag, therefore, it is important for the government to take certain administrative measures to curb down inflation. Some of administrative measures are discussed below:

(i) Banning of exports of certain items such as edible oils, onions and pulses.

(ii) Imposing a temporary ban on trading on futures in some of the essential commodities.

(iii) The government can also work towards strengthening of the PDS to reduce leakages, the Chhattisgarh PDS model is a perfect example of how government can reform the PDS and significantly affect the price levels in the market and at fair price shops

(iv) Government also needs to ensure raiding of the warehouse of essential commodities to dig out the hoarded stocks with the hoarders.

These measures also have their own limitations in that they can curb inflation only on short term basis. They do not have significant effect on checking the demand-pull or cost-push inflation. These steps are taken to provide immediate respite to the people.

Therefore, for effective control a combination of these measures is adopted. One of which is the policy of **Inflation Targeting,** which would be discussed later in this document.

8. Measures of Inflation

Changes in the price of goods and services in the economy are calculated by using various price indices in India such as the WPI, CPI etc. One feature common to all the price indices is the use of "base year", which is a particular year used as a reference to calculate the price rise in a particular year. For example, the base year for All-India Wholesale Price index (WPI) has been revised from 2004-05 to 2011-12 recently.

8.1. Inflation measurement based on period

- ***Annual Average Inflation Rate***: It is the average of inflation rate in the last 52 weeks.
- ***Point to Point Inflation Rate***: It reflects the changes in the inflation rate between a particular week of the last year and the same week of the current year. For example, the changes in inflation rate in 36th week of current year and the same week last year.

8.2. GDP Deflator

This is the ratio between GDP at Current Prices and GDP at Constant Prices. If GDP at Current Prices is equal to the GDP at Constant Prices, GDP deflator will be 1, implying no change in price level. If GDP deflator is found to be 2, it implies rise in price level by a factor of 2, and if GDP deflator is found to be 4, it implies a rise in price level by a factor of 4. GDP deflator is acclaimed as a better measure of price behavior because it covers all goods and services produced in the country.

8.3. Wholesale Price Index (WPI)

Inflation calculated on the basis of Wholesale Price Index is also called as the **"headline inflation"**. Headline inflation in India is measured in terms of Wholesale Price Index (WPI) and the Office of the Economic Adviser, Department of Industrial Policy & Promotion is entrusted with the task of releasing this index. WPI is an important statistical indicator, as various policy decisions of the Government, like inflation management, monitoring of prices of essential commodities etc., are based on it. Even though WPI was prepared on a weekly basis for a number of decades, India shifted to monthly calculation of the WPI in 2009.

The Government periodically reviews and revises the base year of the macroeconomic indicators as a regular exercise to capture structural changes in the economy and improve the quality, coverage and representativeness of the indices. In this direction, the base year of All-India WPI has been revised from 2004-05 to 2011-12 by the Office of Economic Advisor (OEA), Department of Industrial Policy and Promotion, Ministry of Commerce and Industry to align it with the base year of other macroeconomic indicators like the Gross Domestic Product (GDP) and Index of Industrial Production (IIP).

The Wholesale Price Index (WPI) series in India has undergone six revisions in 1952-53, 1961-62, 1970-71, 1981-82, 1993-94 and 2004-05 so far.

The current series is the seventh revision. The revision entails shifting the base year to 2011-12 from 2004-05 changing the basket of commodities and assigning new weights to the commodities. It has generally been the practice to undertake the revisions on the advice of a Working Group constituted each time. For the new series with base 2011-12=100, a Working Group was constituted on 19th March 2012 chaired by Late Dr. Saumitra Chaudhuri, Member, erstwhile Planning Commission and comprised most stakeholders.

Key Highlights

In the revised series, WPI will continue to constitute three Major Groups,namely Primary Articles, Fuel & Power and Manufactured Products.

Highlights of the changes introduced in the new series are summarized below:

- Updated item basket and weighting structure conforming to the structure of economy in 2011-12.
- Increase in number of items from 676 to 697. In all 199 new items have been added and 146 old items have been dropped.
- The new series is more representative with increase in number of quotations from 5482 to 8331, an increase by 2849 quotations (52%).

New Features

- In the new series of WPI, prices used for compilation do not include indirect taxes in order to remove impact of fiscal policy. This is in consonance with international practices and will make the new WPI conceptually closer to 'Producer Price Index'.

- A new "WPI Food Index" will be compiled to capture the rate of inflation in food items. This is being compiled combining the "Food Articles" under "Primary Articles" and "Food Products" under "Manufactured Products". Together with the Consumer Food Price Index released by Central Statistics Office, this would help monitor the price situation of food items better.
- Seasonality of fruits and vegetables has been updated to account for more months as these are now available for longer duration.
- Item level aggregates for new WPI are compiled using Geometric Mean (GM) following internationalbest practice and as is currently used for compilation of All India CPI.
- A high level Technical Review Committee has been set up for the first time to carry out dynamicreview process in order to keep pace with the changing structure of the economy.
- Under the new series of WPI, weight of manufactured items has decreased to 64.2 per cent from 64.9 per cent in old series. Similarly, the weight of fuel and power has decreased to 13.1 per cent from 14.9 per cent. On the other hand, the weight of primary items have increased to 22.6 per cent from 20.1 per cent.

Need of New Series and Analysis

This move was long overdue as it will bring all the key macroeconomic indicators—IIP, WPI, CPI (Consumer Price Index), national accounts—on a common base of 2011-12, making the comparisons easier. The old series being used has become obsolete, part of the basket is no longer in consumption, many of the contemporary products are not being covered by it and many products are under weighed. Analysts believe that the series with a new base year would be more comprehensive in nature.

However, analysts believe that though the new series will be able to capture the current state of affairs of the economy by replacing the old basket of goods with a contemporary one, but it will still not be able to reduce the volatility in the indices.

Nevertheless, it must be said that volatility in itself is mostly a real life problem and not a statistical problem. If it's a real life problem then data should capture and change in base year will not make much difference. Further, it is believed that the new basket of goods would bridge some kind of gap which persists between the WPI and CPI numbers.

Limitations of WPI

- It doesn't include services such as health, education, transport, finances etc.
- Doesn't account for the products of the unorganized sector in India, which account for more than 30 percent of the manufactured output of the Indian economy.
- Since the collection of prices is on voluntary basis, the flow of price data, especially from manufacturing units, becomes irregular leading to problems in compilation of Wholesale price index. While in case of CPI data collection is done by NSSO official surveys.
- It reflects the price movement at wholesale level, thereby not reflecting the retail prices at which price goods are bought by the final consumer.

It was for this reason, the RBI has started using CPI for "inflation targeting" as recommended by Urjit Patel Committee.

Importance of WPI

- Monitors the dynamic movement of prices.
- It helps design trade, fiscal and other economic policies.
- In the business contract it is used to calculate price escalation clauses in the supply of raw materials, machinery and construction work.

8.4. Consumer Price Index (CPI)

Apart from the WPI, inflation in India is calculated at the consumer level also by the means of CPI. Because the wide disparities in the consumption baskets for different segment of consumers, India had not been able to evolve a single and a comprehensive consumer price index for a long time. The four CPIs adopted by India are:

CPI (Industrial Workers): The Consumer Price Index for the industrial workers (CPI-IW) has 260 items (plus the services) in its basket with 2001 as the base year (the first base year was 1958–59). The data is collected at 76 centres with one month's frequency and the index has a time lag of one month. It contains 120–160 commodities in its basket. Basically, this index specifies the government employees (other than banks' and embassies' personnel). The wages/salaries of the central government employees are revised on the basis of the changes occurring in this index, the dearness allowance (DA) is announced ***twice*** a year. When the Pay Commissions recommend pay revisions, the base is the CPI (IW).

CPI (Urban Non- Manual Employees): The Consumer Price Index for the Urban Non-Manual Employees (CPI-UNME) has 1984–85 as the base year and 146–365 commodities in the basket for which data is collected monthly with two weeks' time lag.

This index depicts the changes in the level of average retail prices of goods and services consumed by the urban segment of the population. The target group of this index was urban families who derived major portion of their income from non manual occupations in the non-agricultural sector.

This price index has limited use and is basically used for determining dearness allowances (DAs) of employees of some foreign companies operating in India (i.e. airlines, communications, banking, insurance, embassies, and other financial services). It is also used under the Income Tax Act to determine ***capital gains*** and by the CSO (Central Statistical Organisation) for deflating selected service sector's contribution to the GDP at factor cost and current prices to calculate the corresponding figure at constant prices. It has been discontinued since January 2011 because of outdated base year and also CPI (Urban) is brought out.

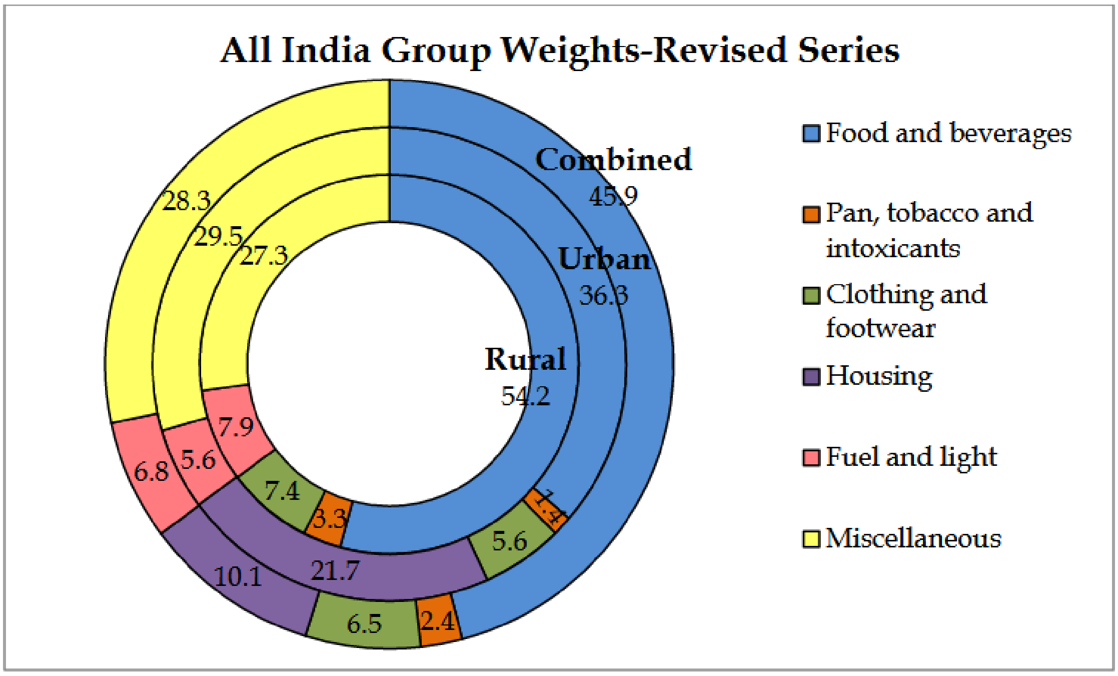
CPI (Agricultural Labor): The Consumer Price Index for Agricultural Labourers (CPI-AL) has 1986–87 as its base year with 260 commodities in its basket. The data is collected in 600 villages with a monthly frequency and has three weeks' time lag.

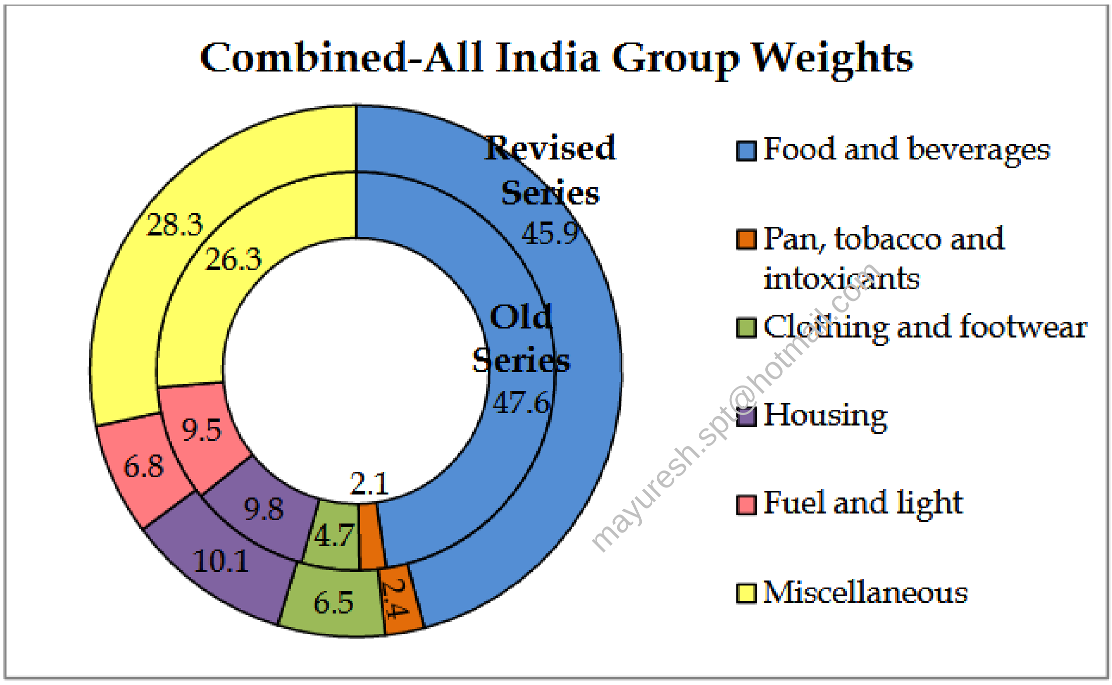
This index is used for revising minimum wages for agricultural labourers in different states.

CPI (Rural Worker): There is yet another Consumer Price Index for the Rural Labourers (CPI-RL) with 1983 as the base year, data is collected at 600 villages on monthly frequency with three weeks' time lag, and its basket contains 260 commodities.

Recent changes in CPI

In 2011 the CSO brought out a revised CPI, which was CPI (Urban), CPI (Rural) and CPI (Urban + Rural) with 2010 as the base price. CSO revised the base year of this newly set up index to 2012 in January 2015. The number of items in CPI basket include 448 in rural and 460 in urban. Thus, it makes it clear that CPI basket is broader than WPI basket. The weight of different groups in revised CPI-rural, CPI-urban, and CPI-combined is depicted below:





Salient features of new CPI index (revised in 2015)

- The number of Groups, which was five in the old series, has now been increased to six. ‘Pan, tobacco and intoxicants’, which was a Sub-group under the earlier Group ‘Food, beverages and tobacco’, has now been kept as a separate Group. Accordingly, the Group ‘Food, beverages and tobacco’ has been renamed as ‘Food and beverages’.
- Egg, which was part of the Sub-group ‘Egg, fish and meat’ in the old series, has now been kept as a separate Sub-group. Accordingly, the earlier Sub-group has been modified as ‘Meat and fish’.
- Due to change in consumption pattern, few additional items appeared in the CPI basket.
- The elementary/item indices are now being computed using Geometric Mean (GM) of the

Price Relatives of Current Prices with respect to Base Prices of different CPI : Changes in the Revised Series markets in consonance with the international practice. In the old series, Arithmetic Mean (AM) was used for that purpose. The advantage of using GM is that it moderates the volatility of the indices as GM is less affected by extreme values.

- Sample size for collection of house rent data for compilation of House Rent Index has been doubled from 6,684 rented dwellings in the old series, to 13,368 rented dwellings in the revised series.

8.5. Services Price Index (SPI)

The contribution of the tertiary sector in India's GDP has been strengthening for the past 6 to 7 years and today it stands approximately at 54 per cent. The need for a service price index (SPI) in India is warranted by the growing dominance of the sector in the economy. **There is no index, so far, to measure the price changes in the service sector.** The present inflation (at the WPI) only shows the price movements of the commodity-producing sector i.e. it includes only the primary and the secondary sectors—the tertiary sector is not represented by it.

The need for such an index was recommended by the Working Group headed by Prof. Abhijet Sen which was set up to revise the WPI (1993–94) series and was reiterated by the National Statistical Commission (headed by C. Rangarajan).

At present, efforts are being made to develop service price indices for selected services initially on an experimental basis (covering road transport, railways, airways, business, trade, port, postal telecommunications, banking and insurance services only).

Core Inflation: Core inflation calculates the price of all the goods and services in the economy excluding the energy and food items. Such a measure does not include the volatile items, which may distort the true picture of inflation in the economy. As a result, this measure reflects the change in demand in the economy.

To understand why the categories of food and energy are more sensitive to price changes, consider environmental factors that can destroy a year's crops, or fluctuations in the oil supply from the OPEC cartel. Each is an example of a supply shock that may affect the prices for that product. However, although the prices of those goods may frequently increase or decrease at rapid rates, the price disturbances may not be related to a trend change in the economy's overall price level. Instead, changes in food and energy prices often are more likely related to temporary factors that lie outside the economy and may reverse themselves later.

8.6. Likely effect of GST on inflation rates

Since the GST will be captured on the final point of sale, it will be reflected only in the CPI, because the recent changes in WPI would exclude the indirect taxes. So the GST will account for a certain degree of divergence between the new WPI data and the CPI data.

Likely effect of GST on inflation

- ***Effect on CPI***

  The multi-tiered GST may not be inflationary as far as goods are concerned as 81% of them will be taxed at 18% or less with mass-consumption items at the lower end of the bands.

  This is because, while implementing the Goods and Services Tax (GST) could produce a short-lived pass-through impact on the inflation trajectory, but creation of a unified goods and services market in the country would reduce supply chain rigidities, cut down on transportation costs and also bring down costs in general through improvements in productivity. But the long term impact would be based on standard tax rate under GST, which is at present is 18%.

However, the general consensus is that the impact on consumer price inflation is likely to be moderate if the standard GST rate is kept at 18 percent - in fact, overall price levels may go down due to more efficient allocation of factors of production.

- ***Effect on WPI***

  GST won't impact wholesale price inflation as it doesn't include indirect taxes.

9. Recent Policy Measures to control inflation

Government has institutionalized a commitment to low inflation in the new monetary policy framework agreement. As per revised monetary policy framework, the Government fixes inflation target in consultation with the Reserve Bank. Now the monetary policy is managed by the Monetary Policy Committee (MPC), headed by the RBI Governor, as provided in the amended Reserve Bank of India Act, 1934.

As per the revised monetary policy framework, the Government has fixed the inflation target of 4 per cent with tolerance level of +/- 2 per cent for the period beginning from August 5, 2016 to March 31, 2021.

The Monetary Policy Committee is entrusted with the task of fixing the benchmark policy rate (repo rate) required to contain inflation within the specified target level. Here the targeted inflation is CPI. As per the provisions of the RBI Act, out of the six Members of Monetary Policy Committee, three Members will be from the RBI and the other three Members of MPC will be appointed by the Central Government.

9.1. Advantages of Monetary Policy Committee

- ***Collective Decision:*** MPC would ensure that decision making would be collective against the earlier practice of Governor as the sole authority.
- ***Transparency in decision making:*** The MPC is required to publish its decisions along with the reasons thereof.
- ***Accountability of the monetary authority:*** MPC is answerable to the government if it fails in achieving its pre-decided target.

9.2. Apprehensions against Monetary Policy Committee

- *Undermining of RBI as monetary authority:* Now MPC would be the final authority on monetary policy and its implementation. Therefore, some argue that it would undermine the role of RBI and its governor in deciding on matters related to monetary policy.
- *Governmental interference:* Some argue that due to nominated members, MPC would function as an arm of the government, thereby would compromise on the delicate balance between the price stability and growth.
- *Unable to control supply side inflation:* Experts are of the view that since MPC would focus only on maintaining targeted inflation through monetary means. Therefore, it can't control the inflation which is due to supply side constraints.

Notwithstanding these apprehensions, this reform has long been needed in line with the international practice. The MPC has sufficient autonomy to function independently of the government, with requisite authority of the RBI in monetary matters. It is because the decision would be taken by majority vote with RBI governor having the casting vote. However, for effective check on inflation and growth stability the fiscal policy must work in tandem with the monetary policy.

10. Vision IAS GS Mains Test Series Questions

1. *What do you understand by inflation? Critically evaluate the growth-inflation trade-off.*

Approach:

- Firstly, define inflation
- Then explain that little bit of inflation is desirable in a developing economy as it encourages investment
- Explain how beyond a point excess inflation starts eating into the growth itself.
- Finally conclude that the relation between the two is not linear. Hence efforts should be made to bring down excess inflation while promoting growth.

Answer:

- Inflation refers to the persistent rate at which the general level of prices for goods and services is rising, and, subsequently, purchasing power is falling. Central banks attempt to stop severe inflation, along with severe deflation, in an attempt to keep the excessive growth of prices to a minimum.
- A little inflation is usually the sign of an economy that is growing. It encourages investors to invest and hence leads to further growth. Hence some inflation is desirable and may be inevitable in a developing economy. Thus, inflation remains favorable to growth if it is not very high. There is also evidence to show that an environment of low and stable inflation is a necessary precondition for sustainable growth
- However, beyond a point inflation begins to eat into the growth itself because –
    - It encourages spending instead of long term investing
    - It increases the cost of living so the households have less to save
    - It erodes the value of currency vis-à-vis others and thus may lead to troubles on external front
    - Morally also inflation is a regressive tax and it hurts the poor the most.
- Thus, the relation between the two is not linear. Hence efforts should be made to bring down excess inflation while promoting growth.
- In the ultimate analysis – both high inflation (which exists due to supply side constraints) and low growth can be tackled by having a stable and conducive policy environment.

2. *What is inflation targeting? Describe the major recommendations of the Urjit Patel Committee for it.*

Approach:

- Firstly define what is inflation targeting and the need for it in brief.
- Then write down the major recommendations of Urjit Patel committee.

Answer:

Inflation targeting is a practice whereby the Central bank of the country makes a commitment to keep the inflation within some desirable/reasonable limit as fixed by it. Given the double digit inflation witnessed in the country in the past few years, the RBI formulated the Urjit Patel committee to suggest measures to better manage the monetary policy of the country.

The major recommendations of the committee are as follows:

- Instead of managing inflation, growth, exchange rate etc. RBI should primarily focus on inflation. Hence the committee recommended bringing about transparency and accountability in RBI's functioning by clearly defining its role.
- There should be a monetary policy review committee (MPC) headed by the RBI governor to formulate and monitor the monetary policy. In this way the executive will also have a say in the monetary policy determination.
- Instead of WPI, CPI should be used to monitor inflation as it better represents the inflationary pressure on the common man.
- The RBI should bring down the CPI inflation to 4% (+/- 2%) in a phased manner (the nominal anchor will be CPI).
- The government was advised to help the RBI achieve its target by bringing about fiscal consolidation.
- To fight inflation it recommended that the repo rate should be higher than the CPI rate.

Given the fact that in the past few years India's inflation rate was highest among the G20 nations and the BRICS countries, the recommendations are a step in the right direction and hence will help to achieve the overall goal of inclusive socio-economic development of the nation.

11. Previous Year UPSC GS Mains Questions

1. The phenomenon of rising prices has been largely responsible for putting Indian economy and planning out of gear; it is also a source of acute hardship to the people. What are the basic reasons for continuous inflation in India and what has been the Government strategy to control it? What specific measures have recently been taken by the Government of India for controlling price level? (200 words) (81/I/12/30)
2. 'Inflation has been a major and persistent cause of poverty and inequality in India. Analyze. (83/II/5c/20)
3. Discuss the steps taken by the Government in recent years to control inflation. (97/II/5a/20)
4. Differentiate between "galloping inflation" and "run-away inflation". (01/II/6f/2)
5. Write about Cost-push inflation. (05/II/6l/2)
6. Unemployment in India is of many types and therefore a complex issue. Describe the nature of this problem and the measures adopted to deal with it particularly in rural areas. (About 150 words) (82/II/2a/30)
7. Describe the various types of unemployment in India. What are the measures devised in the Sixth Plan to deal with rural unemployment? (82/II/6c/20)
8. Discuss the problem of rural unemployment in India. What specific schemes have been launched by the Government to generate employment opportunities in rural areas? (88/II/2a/40)

EXTERNAL SECTOR AND CURRENCY EXCHANGE RATES

Contents

1. Importance of External Sector – Why Imports and Exports Matter

In the advent of globalisation, where labour and capital mobility are high, international trade requires countries to engage in trade according to the resource endowments that they possess.

This is the theory of comparative advantage, where by nations engage in trade according to their resource rich capacities. For instance, India being rich in labour intensive production must export goods that are labour intensive and import goods in which it does not have a comparative advantage, capital-intensive goods in this case.

The relative differences in resource endowments then become the basis of trade for efficient allocation and utilisation of resources resulting in economic gains for trading countries.

In order to utilise resources most efficiently, external sector of a country becomes important. For example, foreign trade influences Indian aggregate demand in two ways. First, when Indians buy foreign goods, this spending escapes as a leakage from the circular flow, decreasing aggregate demand for domestically produced goods. Second, our exports to foreigners enter as an injection into the circular flow, increasing aggregate demand for domestically produced goods.

2. Types of Economies- Closed/Inward and Open/Outward

Closed Economy: In a closed economy, no external trade takes place. This means that there are no imports or exports. It indicates a self-sufficient, self-reliant economy primarily growing via its domestic sectors. Another term for a closed economy is **Autarky.**

It is said that India had a near closed economy focusing more on self-development after 1950s, running upto 1980s, finally opening its economy after the economic crisis of 1991.

Total foreign trade (exports + imports) as a proportion of GDP is a common measure of the degree of openness of an economy.

The balance of exports and imports of goods is referred to as **the trade balance**.

Open Economy: An open economy is one that trades with other nations in goods and services and also in financial assets.

3. Balance of Payments

Balance of Payments (BoP) of a country is a systematic record of all economic transactions between the residents of one country and the rest of the world during a given period of time. It summarizes all transactions that a country's individuals, companies and government bodies complete with individuals, companies and government bodies outside the country. These transactions consist of imports and exports of goods, services and capital, as well as transfer payments such as foreign aid and remittances.

3.1. Components of Balance of Payments

There are two main accounts in the BoP – **Current Account** and **Capital Account**.

3.1.1. Balance of Current Account

- It includes the BoT (visibles), the balance of invisibles (services or transfer payments).
- It is a measure of all payments made for currently produced goods and services plus non-trade flows of funds between a country and rest of the world.
  - Non-trade flows comprise Factor Income from abroad (interest, profits, wages, etc.) and international transfer payments.
  - Invisible Balance shows the value of imports and exports of services or invisible items.

Balance of Current Account = Balance of Trade + Balance of Invisibles + Balance of Transfers

3.1.1.1. Balance of Trade (BoT)

- It shows the balance of imports and exports of visible goods.
- It refers to the merchandise portion of BoP, meaning that it is the value of exported merchandise (tangible goods) minus the value of imported merchandise.

  BoT = Export of goods – Import of goods

Current Account Deficit is the difference between the **value of all imports, including goods, services and investment incomes, and the value of all exports**. It reflects the **difference between domestic savings and domestic investment**, and tells us how much if this deficit is needed to be funded by foreign savings.

3.1.2. Balance of Capital Account

- It refers to the balance of capital transfers, borrowing and lending from abroad and sales or purchase of stocks of gold and foreign exchange from other countries.
- There are two types of capital flows in Capital Account:
  - **Autonomous Capital Flows:** These are ordinary capital flows. These take place because of normal economic considerations like earning of dividends, interests and other incomes by international investment and lending.
  - **Accommodating Flows:** These flows have to be made specifically to bring the BoP into equilibrium.
- Balance of Current Account and Balance of Capital Account are interrelated. A deficit on Current Account must be settled by a net surplus on Capital Account. The foreign currency necessary to finance the excess imports must be either borrowed from some other country or to be provided by the government out of its reserves of gold and foreign exchange. Similarly, a surplus in Current Account must be matched by a deficit in the Capital Account.

BoP being the sum total of Balance of Current Account and Balance of Capital Account is always in equilibrium.

3.1.2.1. Foreign Exchange Regulation Act 1973 and Foreign Exchange Management Act (2000)

- FERA came into force in 1974.
- FERA applied all over India to its citizens. The idea was to regulate all foreign transactions and payments. The legislation focussed on too much control and regulation, thwarting growth and development and was subsequently replaced **by Foreign Exchange Management Act (FEMA) in 1999. This was also in consonance with liberalisation policies introduced in 1991.**
- FEMA was considered to be more liberal in allowing transactions without restrictions, and facilitated international trade. It eased restrictions on cross-border capital flows especially foreign investment.
- FEMA covers three areas:
  - **Rupee Convertibility**
  - **Setting up of a separate Enforcement Directorate (ED) for trying out criminal offenses in foreign exchange**
  - **Borrowings by the corporate sector**

3.1.2.2. Capital Account Convertibility (CAC)

- Currency convertibility is the ease with which a country's currency can be converted into gold or another currency. It means freedom to convert local financial assets into foreign ones at market-determined exchange rates.

- At present, India allows full convertibility in current account but only partial convertibility in capital account.
- S. S. Tarapore Committee has recommended to move towards full CAC.
- Should **India** move towards full **Capital Account convertibility**?
  Positives:
  - RBI recently allowed Indian companies to raise rupee debt offshore.
  - Convertibility would facilitate further liberalisation and increase foreign investment.
  - Increasing openness to international trade may create opportunities for avoiding capital account restrictions.
  - It can lead to free exchange of currency at lower rates. Also, it promotes unrestricted mobility of capital – which may impact the economy in times of global recession.

  Negatives
  - It could destabilise an economy in case there are massive capital flows in and out of the country;
  - Currency appreciation/depreciation could affect the trade balance.

3.2. Balance of Payments Disequilibrium

- For a BoP Equilibrium, the current and capital accounts must sum to zero. This means that the balance of payments of a country is said to be in equilibrium when the demand for foreign exchange is equal to its supply.
- In order to understand BoP disequilibrium, one must take into account the c**urrent account balance** which is the difference **between current income and current expenditures;**
- BoP disequilibrium is financed by internal or external financing. External financing could be through **FDI inflows, portfolio inflows, increased loans from foreigners / reduced holdings of foreign currency / increased foreign holdings of domestic currency; by acquiring foreign currency from the government** (lower reserves) or lastly by hoping that the foreign government forgives the debt, if it is so, it would be a unilateral flow in capital account.

There will be a **deficit** in the **balance of payments when the demand for foreign exchange exceeds its supply**, and there is a **surplus when the supply of foreign exchange exceeds the demand;**

A number of factors affect the balance of payments as discussed below:

a. Causes of Adverse BoP
- Disequilibrium may take place either in the form of deficit or in the form of surplus
  - Political uncertainty
  - Domestic factors
  - Large scale development expenditure, leading to an increase in aggregate demand and prices resulting in excess imports. It must be noted that large scale increase in capital goods imports results in a BoP deficit
  - Events such as global recession
  - Market fluctuations
  - Disasters that may stall a country's progress

b. Measures to correct disequilibrium in the BoP
- The BoP disequilibrium is corrected via **monetary policy and fiscal policy.**
- A BoP deficit reflects increasing imports. When there is less money supply in the economy, there is reduced purchasing power, which then reduces the aggregate demand and domestic prices reducing imports.
- This **fall in the domestic prices** would encourage more exports.
- Thus, money supply falls - imports decrease and exports go up. This results in the correction of a BoP deficit situation.

- **By devaluation** - Devaluation means reduction of the official rate at which the currency is exchanged for another currency. The idea behind currency devaluation is to stimulate its exports and discourage imports to correct the disequilibrium.
- **Exchange Control:** Under exchange control, the central bank has complete control over foreign exchange reserves and earnings of the country.
- **Export Promotion:** This includes reduction and abolition of the export duties, providing export subsidy, encouraging export production and export marketing so as to increase foreign exchange reserves.
- **Import Control**: This may be done by improving or enhancing import duties, restricting imports through import quotas, licensing and even prohibiting altogether the import of certain inessential items.
- **Policies focusing on FDI increase**.
- **Gold Monetization Scheme** also aims at reducing import of gold in the long run, thus helping to curb disequilibrium in Balance of Payment.

3.3. Indian Balance of Payments Crisis (1991)

- Post 1979 oil shocks, the value of imports in India became almost double between 1978, 1981-82. By the end of the 6th plan, the Current Account Deficit rose.
- The economic crisis was primarily due to the large and growing fiscal imbalances over the 1980s. Large fiscal deficits, over time, had a spillover effect on the trade deficit culminating in an external payments crisis. By the end of 1990, India was in serious economic trouble.
- It is said that the foreign exchange reserves had dried up to the point that India could barely finance three weeks' worth of imports.
- In mid-1991, India's exchange rate was subjected to a severe adjustment.
- Apart from the external assistance, India had this huge deficit in the current account through the withdrawal of SDR from IMF.
- **Steps taken to counter the BoP crisis**: In 1991, Rupee was devalued. Due to the currency devaluation the Indian Rupee fell from 17.50 per dollar in 1991 to 45 per dollar in 1992. Industries were delicensed. Import tariffs were lowered and import restrictions were dismantled. Indian Economy was opened for foreign investments. Liberalised Exchange Rate Management System, or LERMS, was also introduced in 1992 and India moved from a fixed to a dual exchange rate system. Budget 1993-94 announced a move towards a unified exchange rate or a market-determined management system, marking the transition to convertibility on the current account soon afterward.

4. Opening of Indian Economy- Neo Liberal Economic Reforms 1991

- Until 1980s, when seeming reforms to open Indian economy had shown initial signs, the Indian economy was largely subjected to an overall protectionist regime, with a strong focus on import substitution, centralised public sector and state monitoring.
- By 1991, India had a fixed exchange rate system, where the rupee was pegged to the value of a basket of currencies of major trading partners.
- As discussed, India faced its economic crisis in 1991.
- In the wake of realising how pivotal it was to open Indian economy, the government announced trade liberalisation neo liberal economic reforms in 1991 aiming to liberalise India in the advent of globalisation.
- The **objective was to abandon the legacy of License Raj, introduce Indian economy to markets and private sector, reduce restrictions and introduce Foreign Direct Investment.**

- Following market friendly measures were undertaken to open up markets to the private and foreign players and minimise monopoly of the public sector hitherto:
  - **Reduction in import tariffs, deregulation of markets, reduction of taxes, and greater foreign investment.**
  - **These measures are also referred to as Liberalisation – Privatisation and Globalisation reforms.**
  - By opening its economy, India sent a strong message that it was interested in economic integration with the world.
- Reforms covered all key sectors such as **industries, external trade, foreign investment, exchange rate system, banking, capital market and fiscal and monetary policies**.

4.1. 25 years of Neo-Liberal Economic Reforms 1991

- The average earning of an Indian, measured as per capita income, has risen nearly 15 times since 1991 — from Rs 6,295 to Rs 1,12,835 in March, 2018. Even after adjusting for inflation, incomes have jumped five-and-a-half times, mirroring rising spending power.
- Between 2005-06 and 2010-11, the average annual growth rate was 8.8 per cent.

4.2. Criticism of Neo-Liberal Economic Reforms / Is the Neo-Liberal Policy of 1991 Sustainable?

- Low human development rankings – 131 in HDI 2016
- Rising economic inequalities
- Lagging agricultural sector, rising farmer suicides
- Rise of crony capitalism
- Increasing non-performing assets of banking sector
- Structural inequalities embedded in class, caste, gender and religion have not only grown after reforms, attempts at privatizing public services such as health and education have also led to further marginalization of the disadvantaged groups from the mainstream
- Lack of employment opportunities
- The decades prior to 1991 may have been years of slow growth, but it is equally true that state-led growth did create capacities which enabled the economic reforms to reap the benefits of liberalization.
- Globalisation has contributed to **Informalisation of Indian economy**
  - More use of external labour, such as contract workers, out-workers, agency labour, temporary workers and tele-workers.
  - Numerical decline of the organised workforce, the expansion of the informal sector and informalisation of work.
  - This 'informalization' of labor has taken place not only in the informal sectors of the economies but also in the formal sectors through out-sourcing and sub-contracting of output and jobs from formal sectors to informal sectors.
  - Impacts of informalisation:
    - Inadequacy of social security nets, weakening trade unions and growing wage inequality.
    - The incidence of poverty is much greater among informal workers.
    - Lowering down productivity of economy by overlooking training and development of informal human resource.

5. Currency Exchange Rate

- The price of one currency in terms of the other is called exchange rate. It could be defined as the amount of domestic currency required to buy one unit of foreign currency.
- Usually it is defined as the price of foreign currency in terms of domestic currency. This is called the bilateral **nominal exchange rate**.

5.1. Real Exchange Rate

- The ratio of foreign to domestic prices measured in same currency.
- If the real exchange rate is equal to **one,** currencies are at purchasing power parity, which means goods cost the same in two countries when measured in the same currency.
- The real exchange rate is taken as a measure of a country's international competitiveness.

Real Exchange Rate = ep1/p0

where

p0 is price level in home country and

p1 is price level abroad

e is the rupee price of foreign exchange (nominal exchange rate)

6. Exchange Rate System – Fixed and Flexible Exchange Rate

- **Flexible Exchange Rate:** This is also known as floating exchange rate system. The exchange rate is determined by the forces of market demand and supply. In a flexible system, the central banks do nothing to directly affect the level of the exchange rate. The central banks therefore don't intervene in the foreign exchange market (and this means there are no official reserve transactions.)
- **Fixed Exchange Rates**: Countries have had flexible exchange rate system since Bretton woods system collapsed. Previous to that, most countries had the fixed rate system or the pegged exchange rate system (called in some countries only). It must be noted that in a fixed exchange rate system such as the gold standard, adjustment to the BoP surplus or deficits can't be brought about through changes in exchange rates. Adjustment should either happen automatically or brought about by the government. In a fixed exchange regime, the government may also devalue the currency. **In a fixed exchange rate system,** the government may choose to leave the exchange rate unchanged and deal with the BoP problem by the use of monetary and fiscal policy.

In a fixed exchange-rate system, a country's central bank typically uses an open market mechanism and is committed at all times to buy and/or sell its currency at a fixed price in order to maintain its pegged ratio and, hence, the stable value of its currency in relation to the reference to which it is pegged.

- **Managed Floating**: The present day world order has moved to a managed floating exchange rate system. It is a mix of a flexible exchange rate system and a fixed rate system. This is also referred to as **Dirty Floating** – where central banks intervene to buy and sell foreign currencies in an attempt to moderate exchange rate movements whenever they feel such actions are appropriate. Official reserve transactions are not equal to zero in this case.

7. Currency Exchange Rates – Concepts

a. Depreciation, Appreciation and Devaluation of Rupee

- **Depreciation:** Currency depreciation is a decrease in the level of a currency in a floating exchange rate system due to market forces.
- **Appreciation:** An increase of value of a currency, is currency appreciation;

- **Devaluation:**
  - Devaluation means official lowering of the value of a country's currency within a **fixed exchange rate system**.
  - Devaluation of a currency happens in countries with a fixed exchange rate (or also where it is managed floating rate).
  - In a fixed-rate economy, it is the government that decides what its currency should be worth compared with that of other countries. In this case, usually the government pledges to buy and sell as much of its currency as needed to keep its exchange rate the same. The exchange rate can change only when the government decides to change it. If a government decides to make its currency less valuable, the change is called devaluation.

b. **NEER and REER**

- **Nominal Effective Exchange Rate (NEER)-** is a multilateral rate representing the price of a representative basket of foreign currencies each weighted by its importance to the domestic currency in international trade (the average of export and import shares is taken as an indicator of this)
- **Real Effective Exchange Rate (REER)-** is calculated as the weighted average of the real exchange rates of all its trade partners, the weights being the shares of the respective countries in foreign trade. It is represented as the quantity of domestic goods required to purchase one unit of a given basket of foreign

Depreciation vs Devaluation

Depreciation of the currency is a slow process and value of the currency automatically gets adjusted by the market forces.

Thus, once the currency of a country has depreciated, the investors from other countries will see an opportunity and are likely to shift from other economies. This will help in boosting the economy which may in the long run even push back the value of the currency

During **devaluation**, there is less trust in the economy and once currency is devalued, Government finds it very difficult to revalue the same by government dictate as there will be fear that such revaluation can backfire and put the economy in risk mode.

c. **Role of RBI in maintaining stability of rupee**

- The exchange rate of the Rupee is largely determined by demand and supply conditions in the foreign exchange market.
- The Reserve Bank has the role of maintaining stability in the foreign exchange market by ensuring orderly conditions without targeting a pre-specified level or band for Rupee's exchange rate.
- In recent times, Rupee saw too much of fluctuation in foreign exchange market. Then, in order to stabilize the value of rupee, RBI has taken various measures like clamping restrictions on import of gold, tightening the position limits on currency futures, prohibiting arbitrage trades between futures and OTC markets, rationalizing forex outflows by residents and encouraging capital inflows.

8. Indian External Debt

a. **External Commercial Borrowing**

- External Commercial Borrowings (ECB) refer to commercial loans availed from non-resident lenders with minimum average maturity of 3 years.
- ECB includes bank loans, buyers' credit, suppliers' credit, securitised instruments (e.g. floating rate notes and fixed rate bonds).
- ECB can be accessed under two routes, viz., Automatic Route and Approval Route
- Under approval route, the explicit permission of government is required before taking loan. It is required for specific sectors such as export and import.

- ECB is different from FDI in the sense that FDI is the foreign money invested to finance equity capital. Whereas, ECB is any kind of funding other than equity.
- ECBs have been a crucial determinant of the magnitude of India's external debt and its single largest component.

b. Sovereign Bonds

- A sovereign bond is a debt security issued by a national government.
- They can be either local-currency-denominated or denominated in a foreign currency.
- Unlike corporate bonds, the risks associated with these bonds are the exchange rate (if the bonds are priced in local currency), economic risks, and political risks that can lead to a possible default on the interest payments or principal.
- Sovereign bond defaults aren't very common and generally, they are low risk bonds and thus, provide low yield relatively.
- These bonds are rated by three most popular rating agencies - Standard & Poor's, Moody's and Fitch. They base their ratings on several factors such as
  - Per Capita Income
  - Gross Domestic Product Growth
  - Inflation
  - External Debts
  - History of Defaulting
  - Economic Development

c. India's External Debt Scenario

- India's external debt crossed the half a trillion dollars mark to touch $529 billion in March 2018 which is 2.4% higher than its level at end-March 2017.
- **Primary reasons for Rise in Debt:** increase in commercial borrowings, short-term debt and non-resident Indian (NRI) deposits.
- The increase in debt was also due to a valuation loss resulting from the depreciation of the US dollar against major currencies.
- Commercial borrowings rose the highest by 30% continued to be the largest component of external debt with a share of 38.2 per cent, followed by NRI deposits which rose 9.3 per cent and accounted for 23.8 per cent of total debt.
- Short-term trade credit rose 14 per cent and accounted for 19.0 per cent of total debt.
- There are concerns over external sector with the rupee touching a new low versus the US dollar and the current account deficit more than doubling to 1.9% of GDP in March 2018.
- Various external debt indicators are showing signs of deterioration in debt.
  - The external debt to GDP ratio stood at 20.5 per cent as at end-March 2018, higher than its level per cent at end-March 2017.
  - The ratio of foreign exchange reserves to total debt increased to 80.2% in March this year from 78.5 per cent last year.
  - Short-term debt on a residual maturity basis (i.e., debt obligations that include long-term debt by original maturity falling due over the next twelve months and short-term debt by original maturity) constituted 42.0 per cent of total external debt at end-March 2018 and stood at 52.3 per cent of foreign exchange reserves.
  - But the debt service ratio declined marginally from 8.5 per cent in March 2017 to 7.5% in March 2018.
  - With global interest rates rising following the US Fed raising its policy rates, the debt service ratio could rise by March'19.
- The external debt policy of the Government of India has resulted in external debt remaining within safe and comfortable limits and in containing its rise.

- The **external debt management policy** followed by the Government of India continues to emphasize monitoring of long- and short-term debt, raising sovereign loans on concessional terms with long-term maturities, regulating ECBs through end-use and all-in-cost restrictions and rationalizing interest rates on NRI deposits.

d. Impact of BREXIT on India's External Debt

- According to experts, the world is at the risk of a currency war after the Brexit vote, as each economy seeks to devalue its money in a bid to boost growth. The renminbi has fallen over 1 per cent after the Brexit vote as the US dollar index gained some 2 per cent in the same period.
- This rise was led largely by long-term external debt that accounted for 83 per cent of India's total external debt, while the share of short-term debt was only 17 per cent. The contribution of short-term debt has come down from 23.6 per cent in 2012-13 to 17 per cent in 2015-16.
- Our exposure to Europe is about 16.5 per cent, even if that gets impacted. In general, the direct impact on the rupee is not much. The real impact on the rupee is the spillover effect of what is happening in the rest of the world, the turmoil in the financial markets and how much that will spread.

e. India's foreign exchange reserves and comparison with other countries

- India external debt is in a more comfortable position compared to some of the other countries and the rate of growth in external debt has come down, experts point out.
- Among peers with high external debt China has $960 billion, Mexico $433 billion, Turkey $408 billion, Brazil $557 billion and Malaysia $211 billion.

9. Miscellaneous

9.1. New Model Indian Bilateral Investment Treaty

- The Law Commission of India in its 260th report on the Draft Model Indian Bilateral Treaty has tried to maintain balance between **the rights of the investors and the rights of the state;**
- The **new Indian Model BIT** will provide appropriate **protection to foreign investors in India and Indian investors in the foreign country;**
- The essential features include an **asset based definition of investment,** non-discriminatory treatment through due process, national treatment, protections against expropriation, a refined **Investor State Dispute Settlement (ISDS) provision requiring investors to exhaust local remedies before commencing international arbitration**, and limiting the power of the tribunal to awarding monetary compensation alone.
- The model **excludes** matters such as government procurement, taxation, subsidies, compulsory licenses and national security to preserve the regulatory authority for the Government.
- India has unilaterally terminated its Bilateral Investment Treaty (BIT) with Netherlands and has also served notices to 20 EU members for termination of their respective BITs.

> A BIT is a treaty between two countries that sets out to provide certain basic protections to the investors of one state investing in another. For instance, most such treaties provide investors a guarantee of "fair and equitable treatment" — the clause, to draw an analogy from constitutional law, is broadly akin to the right of equality and protection against arbitrary state action.

> A BIT increases the confidence of investors by assuring a level playing field and non-discrimination in all matters. It provides for an independent forum for dispute settlement by arbitration.
>
> In turn, BITs help project India as a preferred foreign direct investment (FDI) destination as well as protect outbound Indian FDI.

- **Rationale for a BIT**?
  - It was in 2011 that India faced its first **adverse arbitral award** arising out of a BIT in the **White Industries** case, an Australian firm that succeeded in obtaining a **foreign arbitral award against Coal India Ltd**. White Industries argued that it had been denied "effective means" of enforcing its rights in relation to its investment, a protection incorporated into the India-Australia BIT by virtue of an MFN clause it contained. Since then 17 firms including Vodafone have issued notices for arbitration against India. For instance, Vodafone's retrospective tax amendment case and Telenor, whose investment in India was in 2G licences that stood cancelled pursuant to a Supreme Court order.

Law Commission Recommendations on BIT:

- A modification from a highly narrow '**enterprise-based definition' of investment to a broader and universally accepted 'asset-based definition'**. An enterprise-based definition would mean that a foreign investor who did not set up an enterprise in India to carry on business would have absolutely no protection.
- MFN must not be incorporated since India might chose to provide differential benefits to trading partners based on the extent of incoming investment from a country.
- LCI suggests amendments to certain provisions of the dispute resolution mechanism contained in the Model Draft.
- The Model Draft contained general exceptions with a long list of permissible objectives such as public health, environment, public order, public morals, improving working conditions, ensuring the integrity and stability of the financial system, banks and financial institutions etc., and it provided that any measures which the state considered to be in furtherance of the above objectives would not be subject to scrutiny before an arbitral tribunal.

9.2. Indian Foreign Trade Policy (FTP) 2015 -2020

Primary objective was to **boost Indian exports alongside strengthening schemes like Make in India, Digital India, thereby focusing on manufacturing in India along with Ease of Doing business.**

Key Features

- To increase India's exports to US $ 900 billion by 2019-2020.
- FTP would reduce export obligations by 25% and give boost to domestic manufacturing.
- FTP benefits from both MEIS & SEIS will be extended to units located in SEZs.
- FTP 2015-20 introduced two new schemes:
  - "**Merchandise Exports from India Scheme (MEIS**)" and "Services Exports from India Scheme (SEIS)". The six different schemes of the earlier FTP (**Focus Product Scheme, Market Linked Focus Product Scheme, Focus Market Scheme, Agriculture Infrastructure Incentive Scrip, Vishesh Krishi and Gram Udyog Yojana and Incremental Export Incentive Scheme**), which had varying sector-specific or actual user only conditions attached to their use have been merged into a single scheme, namely the **Merchandise Export from India Scheme (MEIS).**
  - The **'Services Exports from India Scheme' (SEIS) is for increasing exports of notified services**. The Served from India Scheme (SFIS) has been replaced with the **Service Export from India Scheme (SEIS).** The SEIS applies to 'service providers located in India' instead of 'Indian service providers'. Thus, it provides for incentives to all service providers of notified services who are providing services from India, regardless of the constitution or profile of the service provider. The rates of incentivizing under the SEIS

are based on net foreign exchange earned. The incentive issued as duty credit scrip, will no longer carry an actual user condition and will no longer be restricted to usage for specified types of goods but be freely transferable and usable for all types of goods and service tax debits on procurement of services/goods.
  - Merchandize exports from India (MEIS) to promote specific services for specific Markets Foreign Trade Policy.
  - These schemes (MEIS and SEIS) replace multiple schemes earlier in place, each with different conditions for eligibility and usage. Incentives (MEIS & SEIS) to be available for SEZs also. e-Commerce of handicrafts, handlooms, books etc., eligible for benefits of MEIS.
- Agricultural and village industry products to be supported across the globe at rates of 3% and 5% under MEIS. Higher level of support to be provided to processed and packaged agricultural and food items under MEIS.
- Industrial products to be supported in major markets at rates ranging from 2% to 3%.
- Business services, hotel and restaurants to get rewards scrips under SEIS at 3% and other specified services at 5%.
- Duty credit scrips to be freely transferable and usable for payment of customs duty, excise duty and service tax.
- Inter-ministerial consultations to be held online for issue of various licences.
- Export obligation period for export items related to defence, military store, aerospace and nuclear energy to be 24 months instead of 18 months
- Calicut Airport, Kerala and Arakonam ICDS, Tamil Nadu notified as registered ports for import and export and Vishakhapatnam and Bhimavarm added as Towns of Export Excellence.

9.3. Relevance of WTO in Present Day Order

- With **the multilateral trade negotiations process under the WTO being a painfully slow one requiring broad-based consensus**, regional trade agreements (RTAs) have progressively assumed greater importance and a growing share in international trade.
- While RTAs are broadly compliant with WTO mandates and remain broadly supportive of the WTO process, they remain second-best solutions that are discriminatory in nature against non-members and are inefficient as low cost producing non-members lose out to members. While bilateral RTAs have no equity considerations, mega-regional trading groups may not necessarily be equitable if membership is diverse and small countries may lose out either way—if they are part of it they may not have much say and if they are not, they may stand to lose.
- India has always stood for an open, equitable, predictable, non-discriminatory and rule-based international trading system and views RTAs as building blocks in the overall objective of trade liberalization as well as complementing the multilateral trading system under the WTO.
- **Regional and thematic plurilateral agreements** are reshaping trade flows which is thwarting progress of emerging economies. Industrialised countries are increasingly becoming against WTO led trade liberalisation. These pacts have slowly reduced the importance of WTO.
- **Trans Pacific Partnership:** The Trans-Pacific Partnership (TPP) agreement is one new mega-regional block that has become a reality and has implication for India.
  - The TPP trade agreement is very comprehensive and not only encompasses the scope of tariff-eliminating mega regional trade pacts, but also aims at setting higher global standards for international trade through lower benchmarks for nontariff barriers, more stringent labour and environment regulation, higher intellectual property rights (IPR)

protection, greater transparency in government procurement and limiting advantages to state-owned enterprises (SOE) and transparency in health care technology, competitiveness and supply chains.
  - It includes new and emerging trade issues and cross-cutting concerns such as internet and digital economy.
  - In the short run, the trade impact of the TPP may not be seriously adverse but careful analysis is required for adapting and responding to the challenges in the long run.
  - Recently, United States, the leading proponent, has left the grouping. Despite that, the remaining members have decided to revive the deal without US participation.
- Agreements like **TPP focus on reducing tariffs on industrial goods to zero, and liberalising financial services and investments**;
  - **Transatlantic Trade and Investment Partnership (TTIP)** (In 2013, EU and US entered these negotiations**)**. European NGOs are against the TTIP because it may undermine social and environmental standards and consumer protection, all of which are much more effectively developed in the EU. The most controversial part of the agreement relates to investment protection. If TTIP is adopted, Mexico's textile industry, will suffer.
- Alongside these **regional mega-agreements, there are plurilateral agreements led by industrialized countries.**
  - **Trade in Services Agreement (TISA):** In 2012, 50 countries, including the US, EU and Switzerland, launched negotiations on a comprehensive services agreement.

Impact of these agreements on developing countries

- These agreements focus on **privatization, deregulation and liberalisation** of the world economy.
- These mega-agreements constitute a thinly veiled attack on **China, India and South Africa, all countries that, in the WTO framework, oppose the liberalisation of trade in industrial goods, services, government procurement and investments, and are stubbornly insisting on more just global rules in agriculture**.
- Developing nations, including India, face a double disadvantage at **WTOs Dispute Settlement Body (DSB)**. These nations are challenged not only by the lack of a sufficient pool of trade law experts to represent them effectively at the DSB but also by not including non-trade issues such as **labour and environment** – two important factors for developing countries.

In trade negotiations, including multilateral trade negotiations in the World Trade Organization (WTO), India has always taken a consistent stand to protect the interest of the country and its farmers.

The mandate of the Doha round of trade negotiations in the WTO envisaged the reductions of, with a view to phasing out, all forms of export subsidies.

The Uruguay Round WTO Agreement on Agriculture (AOA) permits use of export subsidies to the Members that used them during the base year 1986-88.

Mostly developed countries like the US, EU are entitled to provide export subsidies as per Agreement on Agriculture (AoA).

India could use only a special and differential provision of AoA that allows developing countries to use subsidies aimed at reducing the cost of marketing including internal and external transport as well as handling and processing costs.

WTO is still important

- Inspite of growing regionalism in trade liberalization**, t**he WTO is the only forum where every country can talk to each other.
- While protectionism was bound to grow globally in the face of fragmented agreements and a contracting economy, it is in such circumstances that WTO's dispute resolution (mechanism) assumes significance.

- Recently, Trade Facilitation Agreement, signed under the aegis of WTO, entered into force. The agreement seeks to ease the movement of goods across the borders.
- Further, some members of WTO, including India are proposing Trade Facilitation in Services Agreement.

Trade Facilitation Agreement

- WTO members concluded negotiations at the 2013 Bali Ministerial Conference on the landmark Trade Facilitation Agreement (TFA), which entered into force on 22 February 2017 following its ratification by two-thirds of the WTO membership.
- The agreement aims at easing the movement of goods across borders through expediting the movement, release and clearance of goods, including goods in transit.
- It seeks to simplify, modernize and harmonize export and import processes, reduce bureaucratic delays and red tapism. It also sets out measures for effective cooperation between customs and other appropriate authorities on trade facilitation and customs compliance issues. It further contains provisions for technical assistance and capacity building in this area.
- The Union Government has ratified TFA and constituted a **National Committee on Trade Facilitation** (NCTF) to develop the pan-India road map for trade facilitation.
  - The NCTF will be inter – ministerial body headed by Cabinet Secretary
  - It will have three tier structures with main national committee for monitoring implementation of TFA.

Trade Facilitation in Service (TFS)

- The proposed pact is similar to the Trade Facilitation Agreement in Goods. Here, TFS is about "making market access 'effective' and commercially meaningful. In India's proposal on TFS, it is not about new (or greater) market access.
- **Aims of TFS**
  - To ensure portability of social security contributions and crossborder insurance coverage to boost medical tourism.
  - To ease norms for movement of skilled workers across borders.
- The TFS agreement will address the key issues that are pertinent to facilitating trade in services, such as transparency, streamlining procedures, and eliminating bottlenecks.
- India had, in February 2017, submitted to the WTO a legally-vetted draft proposal for a TFS agreement.
- In draft legal text that India submitted, it covered services under Mode1 (cross-border services), Mode 2(consumption abroad) and Mode 4 (movement of short-term services providers or natural persons).
- The draft provides for special and differential treatment provisions under which developing countries are offered transition period while least-developed countries are exempted from undertaking any commitments arising out of the TFS agreement.
- However, several developing countries said that it would impose burdensome commitments on them.
- Major industrialized members such as the European Union (EU), Canada, Switzerland, Australia and New Zealand, among others, welcomed the Indian proposal.

9.4. Important International Trade Agreements and Relevant Regional Global Significant for India

- **Regional Comprehensive Economic Partnership (RCEP) Agreement among ASEAN + Six FTA Partners** (Australia, China, India, Japan, South Korea and New Zealand):
  - RCEP is proposed regional Free Trade agreement whose members combined account for 40 percent of global trade.

- The negotiations in agreement cover a number of areas like trade in goods, services, investment, intellectual property, economic and technical cooperation, competition, e-commerce and legal and institutional issues.
- It aims to achieve high levels of tariff liberalizations in trade of goods. The negotiations will cover all the service sector, and with regard to investment, they will cover all the four pillars – promotion, protection, facilitation and liberalisation.
- Significance to Indian economy
    - The RCEP agreement would complement India's existing free trade agreements with the ASEAN and some of its member countries.
    - Since India is not party to any of the APEC, TTP and TTIP, the membership of RCEP would reduce their potential negative impact on Indian economy.
    - India will get closer to ASEAN economy which will align with the objective of India's **Act East Policy.**
    - RCEP will provide access to new markets and India can leverage its capabilities in IT, Healthcare, Education and services to utilize these opportunities.
- Challenges faced by India in RCEP
    - **Tariff barriers**, which have been a matter of discontent in bilateral FTAs, particularly in the case of the ASEAN-India FTA.
    - **Non-trade issues** such as environment and labor are likely to be prickly as well and need greater attention.
    - **Strengthening MSME sector** to not only survive the free flow of trade, but also to become a set of more competitive players.
    - **China** will be a major difficulty for India while negotiating terms with it.

9.5. East Asian Crisis 1997

- Between June 1997 and January 1998 a financial crisis took place in the "tiger economies" of SE Asia. Over the previous decade the SE Asian states of Thailand, Malaysia, Singapore, Indonesia, Hong Kong, and South Korea, had seen high economic growth rates in the world.
- In 1997, this Asian miracle, however, ended when stock and currency markets in these countries crashed.
- The Asian financial crisis, also called the "**Asian Contagion**," was a series of **currency devaluations and other events that spread through many Asian markets beginning in 1997**.
- The currency markets **first failed in Thailand as the result of the government's decision to no longer peg the local currency to the U.S. dollar (USD)**.
- Almost all countries suffered from a loss of demand and confidence in the region.
- It is believed that weak **Asian financial systems caused this crisis**. The weaknesses of the financial sector were masked by rapid growth and accentuated by large capital inflows, **which were partly encouraged by pegged exchange rates.**

9.6. Recession of 2008 and India

- The Recession of 2008 was caused by the Financial Crisis of 2008.
- In Asia, ripple effects of the financial crisis were felt through transmission of stock market turbulence and domestic credit stringency.
- India was protected from financial meltdown, largely because of the still large role of the nationalised banks and other controls on domestic finance.
- The most immediate effect of that crisis on India has been an outflow of foreign institutional investment from the equity market. Foreign institutional investors, who need to retrench assets in order to cover losses in their home countries and are seeking havens of safety in an uncertain environment, became major sellers in Indian markets.
- There was rupee depreciation.

9.7. Various Duties

- **Import Duty**: Import duty is a tax that the importer has to pay to bring foreign goods into his or her country. Import duty is also known as customs duty, tariff, or import tariff. Import duty can be ad valorem, i.e. based on the value of the goods, or it can be specific, i.e. based on weight, dimensions, or other units of measure.
- **Export Duty:** Export duties consist of general or specific taxes on goods or services that become payable when the goods leave the economic territory or when the services are delivered to non-residents; profits of export monopolies and taxes resulting from multiple exchange rates are excluded**.**
- **Countervailing duties:** Tariffs levied on imported goods to offset subsidies made to producers of these goods in the exporting country. Countervailing duties (CVD) are meant to level the playing field between domestic producers of a product and foreign producers of the same product who can afford to sell it at a lower price because of the subsidy they receive from their government. If left unchecked, such subsidized imports can have a severe effect on domestic industry, forcing factory closures and causing huge job losses. As export subsidies are considered to be an unfair trade practice, the World Trade Organization (WTO) – which deals with the global rules of trade between nations – has detailed procedures in place to establish the circumstances under which countervailing duties can be imposed by an importing nation.
- **Anti-Dumping Duty:** It is a protectionist tariff that a domestic government imposes on foreign imports that it believes are priced below fair market value. If a company exports a product at a price lower than the price it normally charges on its own home market, it is said to be "dumping" the product. The WTO agreement (GATT) allows governments to act against dumping where there is genuine ("material") injury to the competing domestic industry.

9.8. Masala Bonds

- Masala bonds are **Indian rupee denominated bonds issued in offshore capital markets**.
- These are **rupee-denominated bonds issued to offshore investors** settled in dollars and, therefore, **the currency risk lies with investor and not the issuer, unlike external commercial borrowings – where Indian companies raise money in foreign currency loans.**
- **Green Masala Bond:** The masala bond meant for investing in building green infrastructure.
- **Examples:**
    - **In 2015, The International Finance Corporation (IFC), issued a ₹1,000 crore bond to fund infrastructure projects in India**. These bonds were listed on the London Stock Exchange (LSE).
    - In 2016, Mortgage lender Housing Development Finance Corp (HDFC) has raised Rs 3,000 crore by issuing masala bonds.
- **Benefits of Masala Bonds:**
    - Companies **do not have to worry about rupee depreciation.**
    - Masala bonds help protect corporate balance sheets from exchange rate risks, **however their issuance should be used in moderation.**
    - Masala bonds can **have implications for the rupee, interest rates and the economy as a whole.**

Difference between ECB and Masala Bonds

In Masala Bonds, the currency risk lies with investor and not the issuer, unlike external commercial borrowings.

While ECBs help companies take advantage of the lower interest rates in international markets, the cost of hedging the currency risk can be high.

In the case of Masala bonds, the cost of borrowing can work out much lower.

9.9. Trade Deficit in India

- India's trade deficit has increased from US $ 28 billion in 2004-05 to all time highest US $ 195 billion in 2012-13.
- Since then, the trade deficit has consistently declined (the trade deficit from April-March 2016-17 was estimated at US $ 105.72 billion) due to the decline in the value of Petroleum, Oil and Lubricants (POL) imports, caused by a fall in international oil prices.
    - Trade deficit can be decomposed into POL deficit and non-POL deficit. POL deficit (POL exports minus POL imports), the major component of trade deficit, which was hovering at around US$100 billion from 2011-12 to 2013-14, declined to US$ 81.5 billion in 2014-15 and to US$ 52.5 billion in 2015-16.
- Trade policy has focused on promoting exports and thereby moderates the levels of trade deficit. The moderation in the levels of trade deficit had a salutary effect on sustaining the moderation in the overall balance-of-payments outcome in the current fiscal.

9.10. Foreign Direct Investment, FII, FPI

9.10.1. Foreign Direct Investment

- Investment made by a company or individual in one country in business interests in another country, in the form of either establishing business operations or acquiring business assets in the other country, such as ownership or controlling interest in a foreign company.
- Foreign direct investments are distinguished from portfolio investments in which an investor merely purchases equities of foreign-based companies. The key feature of foreign direct investment is that it is an investment made that establishes either effective control of, or at least substantial influence over, the decision making of a foreign business.
- As per new definition, accepted as per recommendation of Arvind Mayaram Committee, foreign investment of **10% or more in an Indian listed company** is treated as FDI.
- In addition, foreign investment in **an unlisted company**, irrespective of the threshold limit, is treated as FDI.

9.10.2. Foreign Portfolio Investment

- Investment by **non-residents in Indian securities including shares, government bonds, corporate bonds, convertible securities, infrastructure securities** etc.
- The class of investors who make investment in these securities are known as Foreign Portfolio Investors.
- According to SEBI, any equity investment by non-residents which is less than 10% of capital in a company is portfolio investment. While above this the investment will be counted as Foreign Direct Investment (FDI).
- Foreign Portfolio Investors includes investment groups of Foreign Institutional Investors (FIIs), Qualified Foreign Investors (QFIs) (Qualified Foreign Investors) and subaccounts etc.

9.10.3. Foreign Institutional Investors

- FIIs comprise of a pension fund, a mutual fund, investment trust, insurance company or a reinsurance company.
- According to SEBI, "an FII is an institution established or incorporated outside India which proposes to make investment in India in securities".
- FII is an institution that is registered under the Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, 1995.

9.11. Gaps Between MoUs and FDI

- In recent years, foreign investors have shown a lot of interest in Indian economy owing to its large market size and have signed many MoUs with India to bring in the investment. However, many of these MoUs did not get converted into actual FDI due to plenty of drawbacks.
  - Poor ease-of-doing-business scenario in India leading to unsuitable investment climate.
  - Lack of robust physical infrastructure such as road-rail connectivity
  - Complex labour and contract enforcement laws
  - Perception of tax terrorism.
  - High Fiscal deficit and policy paralysis post 2009-10.
- Understanding the need of FDI in country, Governments at every federal level has formulated and implemented incremental reforms to attract FDI.

9.12. Reforms in FDI

- The World Bank has improved India's **ranking to 130th in the 2017 Study of Ease of Doing Business**. Data released by DIPP shows that FDI inflows into India in 2016 jumped 18% to a record $46.4 billion, at a time global FDI inflows fell
- IMF has branded India as the brightest spot in the Global Economy whereas the World Bank projects **India's growth at 7.6% for FY 2018**
- The essence of these reforms is to **ease, rationalise and simplify the process of foreign investments** in the country and to put more and **more FDI proposals on automatic route instead of Government route** so as to make the processes more efficient living upto ideals of **minimum government and maximum governance**. This is also in continuation of the liberalisation reforms started in 1991.
- Further refining of foreign investments in sectors such as Construction, manufacturing sector for wholesale, retail and e-commerce strengthening programmes like Make in India, Start up India, food processing and Digital India.
- The government has proposed in the budget about abolition of Foreign Investment Promotion Board for further liberalising FDI policy
- The measures taken by the Government are directed to **open new sectors for foreign direct investment, increase the sectoral limit of existing sectors and simplifying other conditions of the FDI policy.**

> **Automatic Route**: Under this route no Central Government permission is required.
>
> **Government Route**: Under this route applications, are considered by the Foreign Investment Promotion Board (FIPB). Approval from Cabinet Committee on Security is required for more than 49% FDI in defence. The proposals involving investments of more than INR 30 billion are considered by Cabinet committee on economic affairs.

9.13. Foreign Direct Investment Policy 2016

- The FDI policy amendments are meant to liberalise and simplify the FDI policy so as to provide ease of doing business in the country leading to larger FDI inflows contributing to growth of investment, incomes and employment.
- According to PIB, most of the sectors would be under automatic approval route, except a small negative list. **With these changes, India is now the most open economy in the world for FDI.**
- **Food products:** It has now been provided that 100% FDI under government route for trading, including through e-commerce, is permitted in respect of food products manufactured and/or produced in India.

- **Foreign Investment in Defence Sector up to 100%:**
  - **Up to 49% FDI participation** in the equity of a company is permitted under automatic route.
  - **Foreign investment beyond 49% has now been permitted through government approval route** wherever it is likely to result in access to modern technology or for other reasons to be recorded.
  - FDI limit for defence sector has also been made applicable to Manufacturing of Small Arms and Ammunitions covered under Arms Act 1959.
  - **Impact on Indian economy and its defence sector**
  - It marks a major push to defence manufacturing under the 'Make in India' initiative.
  - It will ensure availability of cutting edge technologies for the defense forces, boost local manufacturing in India
- **Pharmaceutical:** The earlier FDI policy on pharmaceutical sector provides for 100% FDI under automatic route in greenfield pharma and FDI up to 100% under government approval in brownfield pharma. With the objective of promoting the development of this sector, 74% FDI under automatic route has been permitted in brownfield pharmaceuticals. FDI beyond 74% would be permitted through Government approval route.
- **Civil Aviation Sector**
  - With a view to aid in modernization of the existing airports to establish a high standard and help ease the pressure on the existing airports, **100% FDI under automatic route has now been permitted in Brownfield Airport projects.**
- **Animal Husbandry:** As per FDI Policy 2016, FDI in Animal Husbandry (including breeding of dogs), Pisciculture, Aquaculture and Apiculture is allowed 100% under Automatic Route under controlled conditions. The requirement of 'controlled conditions' for FDI in these activities has now been done away with.
- **Other sectors:**
  - FDI up to 100% under automatic route permitted in **Telecom**
  - FDI up to 100% under **automatic route permitted in Up-linking of Non- 'News & Current Affairs' TV Channels, Down-linking of TV Channels**
  - 100% FDI under automatic route permitted in the **marketplace model of e-commerce**
  - 100% FDI under Government route for **retail trading, including through e-commerce**, has been permitted in respect of food products manufactured and/or produced in India
  - 100% FDI allowed in **Asset Reconstruction Companies** under the automatic route
  - 49% FDI under automatic route permitted in **Insurance and Pension sectors**
  - 100% FDI under automatic route allowed on White Label ATMs

9.14. FDI in Retail – Case in point

- **Single Brand Retail Trading:** Local sourcing norms have been relaxed up to three years, with prior Government approval, for entities undertaking Single Brand Retail Trading of products having 'state of art' and 'cutting edge' technology. For such entities, sourcing norms will not be applicable up to three years from commencement of the business i.e. opening of the first store for entities undertaking single brand retail trading of products having 'state-of-art' and 'cutting-edge' technology and where local sourcing is not possible. Thereafter, sourcing norms would be applicable;
- **Multi brand retail:** It has been argued that foreign direct investment (FDI) in multi-brand retail trading cannot happen before farmers and retailers are provided enough resources to face market competition. Issues such as last-mile connectivity such as lack of back-end infrastructural support, adequate credit and financial inclusion of farmers and traders remain. India's current FDI policy permits foreign players to hold 51 per cent stake in an Indian company, subject to government approval.

a. **FDI via single brand retail in e commerce (***e commerce has also been referred to as democratized commerce)*

- According to few reports**,** the share of e**-commerce in retail is expected to jump from 2% in 2014 to 11% in 2019.**
- Indian government has allowed 100% foreign direct investment (FDI) in online retail of goods and services under the so-called "**marketplace model**" through the **automatic route**, seeking to legitimize existing businesses of e-commerce companies operating in India.
- The new rules proposed by the government prohibit marketplaces from offering discounts and capping total sales originating from a group company or one vendor at 25%. This may have been done to level the playing field with offline stores, which have witnessed a slump in footfalls corresponding to the increase in e-commerce.

> Indian e-commerce companies such as **Flipkart and Snapdeal** have been following the **marketplace model**—which was not defined—and attracting large foreign investments.
>
> **Marketplaces** essentially act as a platform connecting sellers and buyers. It is an information technology platform run by an e-commerce entity on a digital and electronic network to act as a facilitator between buyer and seller.

- Till now India has allowed 100% foreign investment in business-to-business (B2B) e-commerce but none in retail e-commerce—i.e., business-to-consumer, or B2C.
- DIPP has prohibited FDI in e-commerce companies that own inventories of goods and services and sell directly to consumers using online platforms.
- The government in the budget allowed 100% FDI in marketing of food products produced and manufactured in India.

10. Previous Years Vision IAS GS Mains Questions

1. ***Examine the causes of rupee depreciation and its impact on the Indian economy. Also discuss the steps taken by the Government and RBI to stem its slide.***

Approach:

- Write the major causes of rupee depreciation
- Then, list out the impacts on different areas due to the depreciation
- Finally, discuss the steps by govt. and RBI

Answer:

[Student Note: The answer has been kept long to discuss all points of the issue in detail at one place. Write down a summary within word limit for your answer]

Causes of Rupee Depreciation:

- **Appreciation in the US dollar:** Since the United States Federal Reserve hinted at exiting from Quantitative Easing (QE) in May 2013, the currencies of several emerging markets have been affected. Since then, the Indian Rupee has depreciated 22% against the US dollar. The easy money ensured that US funds moved to emerging markets like India in search of high yields. So, as the Fed tapers off its bond-purchasing program, and with US interest rates rising, the belief is that fund inflows to countries like India will also slow down.
- **Large Current Account deficit:** Depreciation is also a highly visible symptom of a much deeper economic malaise represented by the burgeoning current account deficit (CAD), which, at over $90 billion, threatens macroeconomic stability.
- **Weakening capital inflows:** Capital inflows have reduced due to the improving economic situation in the US and other developed countries. The prospect of the Federal Reserve's ultra-soft monetary policy ending has already raised bond yields

there. As in other countries, the Indian bond market has also seen withdrawals by foreign institutional investors (FIIs) in the past few weeks. With a risk-off environment setting in globally, there have been redemptions from global exchange-traded funds (ETFs). This has led to selling by FIIs in the Indian equity market, compounding the rupee's woes.

- **Inflation:** Part of the depreciation is attributable to the adjustment of the rupee exchange rate to the inflation differential, i.e. India's relatively high rate of inflation versus other economies.

Impact of rupee depreciation:

- **RBI's monetary policy:** If the depreciation in rupee continues, it will further increase inflation. In such a situation RBI will have very less room to cut policy rates. No cut in policy rate will add to the borrower's woes, which are eagerly waiting to get rid of the high loan regime.
- **Fuel price:** A weak rupee will increase the burden of Oil Marketing Companies (OMCs) and this will be passed on to the consumers. If the OMCs increase fuel prices, there will be a substantial increase in overall cost of transportation, which will stoke up inflation.
- **Country's fiscal health:** A frail rupee will add fuel to the rising import bill of the country and thereby increasing its current account deficit (CAD). A widening CAD is bound to pose a threat to the growth of overall economy.
- **Importers/Exporters:** Importers will strongly feel the pinch of falling rupee as they will be forced to pay more rupees on importing products. Conversely, a feeble rupee will bring delight to the exporters, as goods exported abroad will fetch dollars, which in return will translate into more rupees. Also, a weak rupee will make Indian produce more competitive in global markets, which will be fruitful for India's exports.

Steps taken up by RBI and Government:

The RBI and the government have taken the following steps to stabilize the currency markets, reduce the current account deficit and enhance capital inflows:

- **Capital Outflow:** The RBI reduced the limit for outbound investment and remittances from India.
- **Encouraging Capital Inflows:** RBI has removed administrative restrictions on investment schemes offered by banks to non-resident Indians, and removed ceiling on interest rates on deposit accounts held by NRIs. The government has liberalized the FDI limits for 12 sectors, including oil and gas. A Bill is pending in the Parliament to revise the FDI limit to 49% in the insurance sector. RBI increased the current overseas borrowing limit for banks from 50% to 100%, and allowed it to be converted into rupees and hedged with the RBI at concessional rate. RBI also allowed banks to swap fresh NRI dollar deposits with a minimum duration of 3 years with the RBI. Specific public sector undertakings are being permitted to issue quasi-sovereign bonds to mop up funds for the infrastructure sector. The norms for external commercial borrowings (ECBs) are also being eased to enable the oil PSUs to garner dollars for financing their import requirements.

In short, the strategy is to stimulate dollar inflows by further liberalizing external commercial borrowings (ECBs), freeing interest rates on non-resident Indian deposits, liberalizing FDI norms and directing a few public sector finance companies to mop up dollars by issuing quasi-sovereign bonds.

- **Limiting Imports and encouraging exports:** The Finance Ministry increased the customs duty on importing precious metals including gold and platinum. The strategy seeks to address supply-side issues, curbing the import of gold, silver and a few "non-essential" items. 20% of every lot of import of gold must be exclusively made available for the purpose of export.
- **Oil Import Needs:** RBI decided to provide dollar liquidity to three public sector oil-marketing companies (IOC, HPCL and BPCL) to help them meet their entire daily dollar requirements. RBI will provide dollars to oil importers through a special forex-swap window wherein oil companies will buy dollars from the central bank and, simultaneously agree to sell dollars back to RBI at a future date. Government is also considering increasing its import of crude oil from Iran, and pay for it directly in Indian rupees.
- **Trade Deficit:** Ministry of Commerce has set up a Task Force to consider currency swap arrangements for trade and explore the possibility of bypassing payment in dollars for trade and paying instead in rupees or the trading country's currency. RBI allowed exporters and importers more flexibility in management of their forward currency contracts.
- **Curbing Speculative in currency:** RBI increased the short-term emergency borrowing rates for banks. It lifted the Marginal Standing Facility (MSF) and the Bank Rate by 200 basis points. The daily holding requirements under the Cash Reserve Ratio for banks have been modified.

2. What are the benefits of Bilateral Investment Promotion and Protection Agreements (BIPA) in a globalized economy and comment on the present status in India with respect to BIPA.

Approach

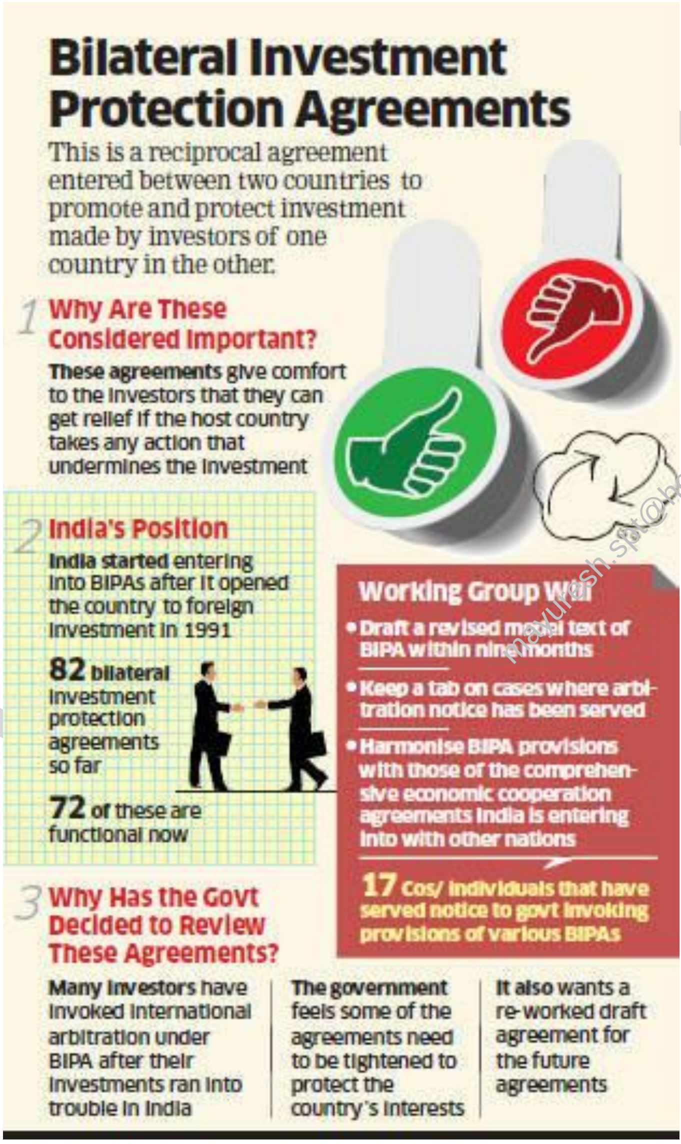
Discuss the purpose of BIPA in brief, discuss some brief features. Explain BIPA in Indian context with examples and highlight critical issues.

Answer:

- With the opening up of the economies world over, each country has been trying to attract foreign capital through liberalised investment policies. In such a scenario, all investors are seeking those investment destinations which provide most protective, hospitable and profitable climate for their investments. Many countries have entered into bilateral investment treaties or agreements which not only encourage capital flows into their own countries but also provide safe business environment for their own investors abroad.
- Bilateral Investment Promotion and Protection Agreement (BIPA) is one such bilateral treaty which is defined as an agreement between two countries for the reciprocal encouragement, promotion and protection of investments in each other's territories by the companies based in either country. Such agreements are beneficial for both the countries because they stimulate their business initiatives and thus enhance their prosperity.
- Salient features related to BIPA
  Generally, these bilateral agreements have, by and large, standard elements and provide a legal basis for enforcing the rights of the investors in the countries involved. They give assurance to the investors that their foreign investments will be guaranteed fair and equitable treatment, full and constant legal security and dispute resolution through international mechanism.

- Such Agreements increase the comfort level of the investors by assuring a minimum standard of treatment in all matters and provides for justifiability of disputes with the host country.
- **Related Issues**
  In the wake of current domestic mal practices in telecom licensing by Indian govt., corruption and other scandals, Supreme Court cancelled almost 22 licenses allotted to the telecom companies. Some of the companies such as Telenor, Systema, Kaif Investments, Capital Global and Axiata were foreign companies. For instance, Systema is a Russian company. Russian govt. invoked the cancellation of licence to Systema on the premise of BIPA which led a deterioration of bilateral relations. White Industries Australia has even got a favourable award against India's decision. India faced similar issues with key trading partners such as UAE, UK, and other European countries.

Faced with the adverse consequences for the investment climate, the government had set up a cabinet committee to review major BIPAs. The committee has suggested a detailed road map for re-negotiation of all the 82 investment protection agreements.



3. ***Even though India's export sector has had bouts of high growth at different stretches of time it is yet to take off in terms of its share in the world exports. Highlight the major issues associated with India's export sector along with measures that need to be taken to resolve them.***

Approach:

The issues mentioned should be relevant and in line with the current trends in the economy. Also the answer should emphasise on problems related to exports and not general issues associated with economy as a whole.

Answer:

India's merchandise exports share in world exports increased from 0.5 per cent in 1990 to only 1.7 per cent in 2013. As per economic survey 2013-14, India should aim to increase its share in world exports to at least 4 per cent in next five years. However, achieving this is going to be a big challenge and some of the major issues that need to be tackled are:

1. **Product Diversification:** Till now India's focus has been on exporting whatever it can. But now it needs to shift to items for which there is world demand and we have basic competence. A demand based export basket diversification with focus on three Es– Electrical, Electronic and Engineering goods is needed.
2. **Export Infrastructure:** Export infrastructure, especially port related infrastructure, needs immediate attention.
3. **Focus on useful Regional Trading Blocks:** India should ready itself to face new threats like TAFTA (Trans-Atlantic Free Trade Agreement). There is need to have some new useful RTAs/FTAs/CECAs.
4. **Inverted Duty Structure:** This refers to the situation in which import duty on finished goods is lower than import duty on raw materials imported from other countries. This may happen due to carelessness while negotiating FTAs. So, a reality check of existing FTAs, RTAs and CECAs is needed.
5. **Export Promotion Schemes:** There are multiple and overlapping export promotion schemes with many focus markets and focus products with items and markets getting added each year. There is a need to rationalise these schemes to a bare minimum which will help in reducing transaction costs and trade litigations.
6. **SEZs:** SEZ policy needs a reboot as fresh investments are slowing down and greenfield SEZs have not really taken off.
7. **Trade Facilitation:** India ranks 142 in ease of doing business and 132 in trading across borders. India needs 9 export documents as compared to 3 in Singapore. There is a need to remove the delays and costs on account of procedural and documentation factors.
8. **Inter-twining of domestic and external policy:** This is especially relevant to agricultural exports as domestic shortages or excesses result in a knee-jerk reaction for agri-export policy.

These issues, if addressed, could lead to exponential gains for India's exports.

4. *What are Offshore Rupee Bonds? Giving examples, discuss their benefits with regards to mobilisation of resources for domestic sector. Also, comment on their role in internationalisation of Indian Rupee.*

Approach:

The definition should clearly explain the meaning of all the three terms –'Offshore', 'Rupee' and 'bonds'. Giving examples of IFC (Masala bonds), or Railway finance corp. bonds, benefits such as alternate and cheaper source of finance, increasing foreign investor base, hedging, etc. can be provided. Internationalisation through greater offshore trading should be mentioned. The role of retaining investor confidence must be emphasised.

Answer:

Offshore Rupee Bonds (ORBs) are debt instruments offered in capital markets outside India and are denominated in Indian rupees (meaning that the principal amount is linked to exchange rate of rupee). They are offered and settled in dollars to raise Indian rupees from international investors. The issuer converts bond proceeds from dollars into rupees in the domestic (Indian) market and uses them to finance its requirements in India. As such, the currency risk in these bonds resides with the investor. The investor base in these bonds is much wider than the FIIs, which invest in the Indian markets.

ORBs have been issued in past by the International Finance Corporation (IFC) with a maturity upto seven years. The latest issue is called 'Masala Bonds' which have a maturity of 10 years and are the first ORBs to be listed on London Stock Exchange. They are named so because masala is a globally recognised term that invokes culture and cuisine of India. Similar bonds are proposed to be offered by Indian Railway Finance Corporation and Asian Development bank. Reserve Bank of India has also allowed Indian corporates to issue ORBs. There are several benefits of ORBs, such as –

- Bringing liquidity and depth to offshore rupee market
- Crowding in foreign investors to invest in rupee bonds and fund domestic investment
- Paving the way for an alternative source of funding for Indian Companies
- As currency risk is borne by the investor, the cost of borrowing as compared to External Commercial Borrowings (ECBs) comes down for the investor as there is no need for hedging.
- The cost of borrowing has also been lesser than government bonds in domestic markets.

It has been estimated that domestic corporates are likely to raise $30 billion in ECBs this fiscal year, while their Offshore Bond issues are likely to be $6 billion. In the next fiscal year, the bond issuances are likely to be $12 billion, but the quantum of ECBs will remain stagnant at $30 billion. However, the cost of funds for Indian companies will significantly depend on their ratings, which will be lesser than AAA rated Masala bond.

Internationalisation of the currency has two essential features:

- A state where exporters from other countries (such as Oil companies in Saudi Arabia) agree to take payments in rupees, and
- Where currency risks in international borrowings are borne by lenders rather than borrowers in India.

At the heart of internationalisation lies stability and confidence in the currency which makes it acceptable for cross-border transactions. Internationalisation is desired because countries that can borrow in their own currency are less susceptible to international crises. Please note that internationalisation is different from capital account convertibility, which means that domestic and foreign assets can be freely exchanged.

ORBs are a significant step towards internationalisation of rupee - they are international borrowings with currency risk at lenders' side. The Masala bonds were well received by foreign investors, notwithstanding the fact that rupee is still not fully convertible. ORBs are launch pad to sell strength of rupee to overseas investors as listing on foreign bourses will provide visibility and set benchmarks for yields in future issuances. Views on rupee will now be partially formed offshore, albeit in a very small way as ORBs will be subject to caps on external commercial borrowings. They could also increase demands for similar products as liquidity of these bonds rises. This also shows the confidence of international investors in Indian economy and rupee. This will require the government and the central bank to impart stability and confidence in the rupee internationally. Critical elements such as fiscal policy, current account balances and inflation have to be benchmarked to best standards to retain investor confidence in rupee. Putting these elements on a firm footing will be essential requirement for rupee internationalisation.

5. India’s export performance in the recent past has been poor in relation to the needs of the economy and in comparison with some other developing countries. Examine the reasons behind the decline in India’s exports. Highlight the measures proposed in Foreign Trade Policy 2015 to overcome this challenge.

Approach:

- Contextualise India’s export performance in the introduction.
- Delineate the reasons for the performance on this front.
- Provide a comparison with other developing countries.
- Clearly delineate the reasons behind decline in India’s exports.
- Measures proposed in Foreign trade policy 2015.

Answer:

For 12 consecutive months from January to December in 2015, India’s total exports were significantly lower than previous year. The data for the period 2010-11 to 2014-15 reveals stagnation in the dollar value of exports, around $300 billion per annum. It also shows that, on average, exports were able to finance just two-thirds of imports, leading to considerable trade deficit. India’s export performance has been poor even in comparison with some other developing countries. Between July and December of 2015, months that India's exports were slumping, Bangladesh in fact saw exports grow by eight per cent year-on-year. Vietnam saw exports grow 9.2 per cent in 2015. This is a cause of concern for India's trade policy.

Following reasons can be identified in this context:

- **Slump in the** prices of various commodities has adversely impacted the value of Indian exports.
- **Global economy slowdown**- The Great Recession that followed the financial crisis of 2008 and the Great persists even now. Recovery in output is slow, uneven and fragile. The recovery in trade is just as slow.

- **Demand constraints-** There are demand constraints also for the exports of developing countries from their markets in slowing economies.
- **Infrastructural constraints** – Deficiencies in sectors such as Power, road, rail proved to be a drag on export competitiveness
- **Non-price factors** - Like quality, delay in delivery etc. also affects the competitiveness of manufactured exports.
- **Overvaluation of the rupee** which makes exports difficult and imports attractive, contributed to the stagnant export performance.
- **Chinese economy slowdown** - Imports from China have increased markedly following the slowdown in that country's economy whereas exports, chiefly in raw materials, have declined.

The foreign trade policy 2015 offers the following measures:

- It introduces two new schemes, namely "Merchandise Exports from India Scheme (MEIS)" and "Services Exports from India Scheme (SEIS)". The 'Services Exports from India Scheme' (SEIS) is for increasing exports of notified services.
- These schemes (MEIS and SEIS) replace multiple schemes earlier in place, each with different conditions for eligibility and usage. Incentives (MEIS & SEIS) to be available for SEZs also. e-Commerce of handicrafts, handlooms, books etc., eligible for benefits of MEIS.
- Branding campaigns planned to promote exports in sectors where India has traditional Strength.
- No need to repeatedly submit physical copies of documents available on Exporter Importer Profile.
- Export obligation period for export items related to defence, military store, aerospace and nuclear energy to be 24 months instead of 18 months
- Within manufacturing exports, the government will chart out a strategy to promote the key sectors of engineering products, electronic goods and textile exports.
- Within services, a host of incentives are likely to be rolled out to sectors such as tourism, hospitality, education, etc, which might be promoted in the form of project exports from India.

6. *Tax treaties intended to avoid double taxation have in many cases become instruments for double non-taxation. Elaborate. List the major amendments in the India-Mauritius DTAA and the advantages that are expected to accrue due to it.*

Approach:

- Briefly explain what is DTAA and its relevance. Substantiate the first statement given in the question.
- Now explain the negative spill overs or loopholes in the treaty leading to double non-taxation; a loss to the government.
- In light of above consequences, list down the amendments in the tax treaty and its advantages.

***Answer*:**

A DTAA is a tax treaty signed between two countries. It is intended to make a country an attractive investment destination by providing relief on dual taxation.

However, often investors use the provisions of DTAA to route the investments through low tax regimes **to side step taxation**. This leads to loss of tax revenue for the country.

Evan a bigger issue is that of issue of double non-taxation. National tax laws have not kept pace with the globalization of corporations and the digital economy, leaving gaps that can be exploited by multi-national corporations to artificially reduce their taxes.

With a mélange of some creative accounting techniques and existing loopholes in different fiscal jurisdictions across the world, tax evasion has emerged as a global woe in the last few decades.

Thus there is a conscious attempt by many countries to tackle the reckless acts of base erosion and profit shifting (BEPS). For example: Amendment to India – Mauritius DTAA.

Major amendments of India-Mauritius DTAA:

- It will give right to india to tax capital gains arising from sale or transfer of shares of an Indian company acquired by a Mauritian tax resident provision to exempt investments made until march 31st, 2017.
- The shares acquired between april 1st 2017 to march 31st 2019 will attract capital gains tax at 50% discount on domestic tax rate.

Thus under the amended treaty, the right to tax capital gains will be available to the country where the income arose.

Benefits of the amendments:

- Will plug in **black money** in the system, **money laundering** and **tax avoidance**.
- **tackle issues of treaty abuse** and round tripping of funds attributed to the India Mauritius treaty.
- Curb non-revenue, **prevent non taxation** and streamline the flow of investment.
- **Enhanced Exchange of information** between India and Mauritius.

Discourage speculators and non-serious investors and **overall reduce market volatility.**

- The revenue generated can be used by government for **higher public spending.**

11. Previous Years UPSC Mains Questions

1. Justify the need of FDI for the development of Indian economy. Why there is gap between MOUs signed and actual FDIs? Suggest remedial steps to be taken for increasing actual FDIs in India.
2. Craze for gold in Indians has led to a surge in import of gold in recent years and put pressure on balance of payments and external value of rupee. In view of this, examine the merits of the Gold Monetization Scheme.
3. FDI in defence sector is now set to be liberalized. What influence this is expected to have on Indian defence and economy in short run and long run?
4. Discuss the impact of FDI entry into multi-trade retail sector on supply chain management in commodity trade pattern of the economy.
5. Though India allowed foreign direct investment (FDI) in what is called multi brand retail through joint venture route in September 2012, the FDI even after a year, has not picket up. Discuss the reasons.
6. Examine the impact of liberalization on companies owned by Indian. Are they competing with the MNCs satisfactorily?

ECONOMIC REFORMS

Contents

1. Introduction

The economy of contemporary India is a great paradox. It is a strange combination of outstanding achievements as well as grave failures. Since Independence, India has achieved remarkable progress in overcoming its economic backwardness. From being a very poor country in the 1950s and a 'basket case' in the mid-1960s, it has emerged as the third largest economy (in terms of **purchasing power parity**). Our economy has become one of the fastest growing economies in the world. Now the country is one of the leading players in the world knowledge economy with vast intellectual capital and booming software and information technology services. These factors together have made India one of the greatest destinations for foreign investment.

However, in spite of these historic achievements, the country has pervasive poverty, malnutrition, illiteracy, and a huge unemployment problem. Although we are the world's largest democracy, our country has an overwhelming majority of poor voters. While the country is celebrating its growth rate and technological wonders, it is witnessing social contradictions and the paradoxes and ironies of development. Thus, there is the India of burgeoning growth coexisting with the India of widespread want and misery. This gives rise to several questions: Where have we gone wrong? Was the development strategy adopted after Independence right? Were the economic reforms of 1991 done right? Could the reforms have been done better?

2. Development Planning

Economic policies adopted in India after 1947 were conditioned by the colonial legacy and the prevailing international situation. The strategic design of these policies was tremendously influenced by the dominant ideology of the Indian national movement and the ideas of nationalist leaders, especially Nehru. At the time of Independence, India was in the stranglehold of stagnating per capita national income, static and semi-feudal agriculture, poorly developed industry and inadequate infrastructure, mass poverty, extreme unemployment and underemployment, massive illiteracy, high birth and death rates and deplorable health conditions. Independent India faced the gigantic task of undoing the damage caused by British Rule. There was a need to put in huge and organized effort on a national scale to achieve substantial progress on the socio-economic front. Towards this end, planning was accepted as the key strategy of India's developmental efforts.

Planning was considered a superior way of developing the Indian economy than the market mechanism. While the market gives priority to high-profit activities, planning makes a systematic utilization of the available resources at a progressive rate to ensure quick building of the productive capacity of the country. Planning was looked upon as an instrument that could enable the state to undertake several massive development projects and unemployment and poverty alleviation programmes. Furthermore, planning was essential to deal with difficulties caused by the partition of the country in 1947, that is, huge influx of refugees from East and West Pakistan and the loss of raw material-producing areas.

Several international developments in the early decades of the 20th century revealed the limitations of market mechanism with respect to both efficiency and equity. After the 1917 revolution, the Soviet Union became the first socialist state and adopted a planned economy model. Its remarkable achievements on the socioeconomic front greatly inspired the nationalist youth in India. Around the same time, the Great Depression of 1929-33 exposed the problems of a free market economy. Keynesianism, a product of the Depression, strongly advocated the case of economic management by the state through taxation and spending policies.

In fact, the economic critique of colonialism by the national movement and its explicitly articulated set of economic objectives provided the foundation to the strategy of development planning in India after Independence. While criticizing colonial underdevelopment and the dependent character of the Indian economy, Indian nationalists put forward the idea of a self-reliant independent economic development in which state planning would play the key role. In the 1930s, ideas on development planning were crystallized due to the influence of the Russian experiment, Keynesian economic ideas and the New Deal programme in the US seeking state intervention in the economic forces. The need for planning was so strongly felt that the Indian National Congress set up the National Planning Committee (NPC) in 1938 under the chairmanship of Jawaharlal Nehru. This plan was to have great implications on the post-Independence economic strategy in India. In addition to this plan, several plan documents were prepared along different ideological lines in the 1940s: the Bombay Plan was authored by India's eight leading capitalists, the People's Plan prepared by M. N. Roy took a left position, and the Gandhian Plan formulated by Shriman Narain pleaded for a self-sufficient village economy. However, there was a broad consensus among the Gandhians, the capitalists, the socialists and the communists on the necessity of planning as well as the nature and path of development to be followed after Independence.

Jawaharlal Nehru, the chief architect of planning in India and the country's first prime minister, was greatly influenced by democratic, socialist and Gandhian values. He believed that socialism and democracy were inseparable. Hence, he described democratic socialism as the vision of independent India that would seek to make democratic social transformation an integral part of the country's economic strategy. Nehru spoke of his approach as a third way that takes the best from all existing systems—the Russian, the American and others—and seeks to create something suited to one's own history and philosophy. He thought that planning introduced in a democratic manner could become the instrument for growth and reduction of inequalities while ensuring individual freedom and avoiding the violence of revolutionary change. He hoped for a society organized on a planned basis for raising humankind to higher material and cultural levels, to cultivation of values, of cooperation and ultimately a world order. He also considered planning a positive instrument for resolving conflict in a large and heterogeneous country.

2.1. Nature and Objectives of Planning

After Independence, India adopted a democratic ideology—representative form of government based on universal adult suffrage with rights and liberties for the masses. Democracy became central to the Indian model of development. There was unanimity among the leaders on the unique approach of India to planning within a democratic and civil-libertarian framework. It was believed that planning would create a democratic economy in the country by bringing the economy under public control. At the same time, in India's development strategy market and economic planning were regarded as complementary to each other. Development plans were to be formulated and carried out within the framework of a mixed economy that included the merits of both socialism and capitalism. A mixed economy was marked by the coexistence of private and public sectors, the latter remaining confined to infrastructure and basic and heavy industries.

The basic objectives of planning were derived from the Directive Principles of State Policy enshrined in the Constitution. These basic objectives provided the guiding principles of planning in India. These spelt out as: (i) economic growth— accelerating the growth to achieve higher level of national and per capita income; (ii) modernization—implementing structural and institutional changes to make the economy progressive and independent; (iii) self-reliance—eliminating dependence on foreign aid and India's vulnerability to external pressures and disturbances; and (iv) social justice—improving the living standards of the masses, especially the underprivileged through deduction in income inequalities, removal of unemployment, elimination of poverty, land reforms and social programmes on health and education. Overall, growth and social justice formed the economic and social framework of planning. With this perspective, the Planning Commission was set up in 1950 by a government resolution to formulate a plan for economic and social development and to act as an advisory body to the Union government in its behalf. The National Development Council was formed later as an adjunct to the Planning Commission to associate the states in the formulation of plans.

2.2. The Nehru-Mahalanobis Development Strategy

The era of planned development was ushered in with the launch of the First Five-Year Plan in April 1951 (the Harrod-Domar model with some modifications was the underlying model for the First Plan). It addressed the problems arising from massive influx of refugees, acute food shortage and mounting inflation. The highest priority was given to overcoming the food crisis by raising foodgrain output, curbing inflation and the development of infrastructure.

The Second Five-Year Plan is regarded as the milestone in the trajectory of planning since it was based on the Nehru-Mahalanobis strategy of development, which guided the planning practice for more than three decades until the end of the Seventh Five-Year Plan. The draft outline of this plan was framed by P C. Mahalanobis. This development strategy was based on several assumptions regarding the causes of structural backwardness of the Indian economy. First, severe deficiency of material capital was seen as the basic constraint of development since it prevented the introduction of more productive technologies. Second, the low capacity to save was considered as the limitation on the speed of capital formation. Third, it was believed that through industrialization the surplus labour underemployed in agriculture could be productively employed in industries. Fourth, it was presumed that if the market mechanism were given primacy, this would lead to excessive consumption by higher-income groups, along with relative underinvestment in the sectors essential to the accelerated development of the economy.

Given these assumptions, the basic questions before the planners were: How to increase capital stock rapidly? How to invest wisely? How to increase savings? How to regulate the market? The Nehru-Mahalanobis development strategy found the answer to these questions in rapid capital formation through the development of capital goods industries with direct intervention of the state in the economy. As such, it was based on the principle—higher the allocation of investments to the heavy or capital goods industries, lower will be the rate of growth of income in the short run, but higher will it be in the end. Thus, industrialization with preference to capital goods industries over consumer goods industries became the core of this development strategy. The basic elements of this strategy can be summed up as:

- Raising the rate of investment since the rate of development is dependent on the rate of investment. It involved stepping up domestic and foreign savings also.
- Rapid growth of the productive capacity of the economy by directing public investment towards development of industries, especially capital goods industries. Simultaneously, promotion of labour-intensive small and cottage industries for the production of consumer goods and expansion of employment opportunities.
- Import substitution for self-reliance and reduction of external dependence.
- Setting up of an elaborate system of controls and industrial licensing to allocate resources among industries as per the Plan requirements and distribute consumption goods equitably among the consumers. This was done through the Industries Development and Regulation Act (IDRA) of 1951.
- Enhancing the scope and importance of the public sector so that this sector comes to predominate capital goods industries, and controls the commanding height of Indian economy.

In this way, the Second Five-Year Plan sought to promote a pattern of development that would ultimately lead to the establishment of a socialistic pattern of society in India. The development strategy of the Third Plan was basically the same as that of the Second Plan but the highest priority in this Plan was accorded to agriculture.

2.3. Agrarian Reconstruction

While formulating national plans and policies, the planners also tried to address the fundamental social and economic problems of the agrarian structure. The Gandhian idea of gram swaraj was a great influence in this regard. Two significant steps were taken in the 1950s to bring about major changes in the agrarian structure. These were the Community Development Programme and land reforms.

2.4. Role of the State

Given the nature of problems in India at the time of Independence, development became the core of the state's agenda. Development was comprehensively defined to encompass not only an industrial economy, but also simultaneously a programme of social transformation and political democratization. The state tried to achieve economic development as well as an egalitarian social order within the confines of democracy. The Constitution in 1950, having universal adult franchise and an extensive list of Fundamental Rights, officially declared India a democracy. The Directive Principles of the Constitution with the goals of social justice and preventing concentration of wealth shaped the scope and nature of state intervention.

For the attainment of economic as well as social transformation in the society, the Indian state took up the role of a developmental state. It became the central instrument in the development course through the process of planning, which involved state control over the production, distribution and exchange of goods and services. The state itself entered the fields of production and distribution to meet the developmental objectives. The Nehru-Mahalanobis strategy found the state as the most suitable agency to achieve its objectives. The state was required to intervene in the economy, promote public sector in heavy industries and guide the growth of the economy. The state launched big dams, large industrial and mining projects and institutions of higher learning as 'temples of modern India' for infrastructure development. To improve village life, the state undertook institutional reforms or land reforms. It took the primary responsibility for providing elementary education, basic healthcare, safe drinking water and employment programmes. Such a large expansion of the economic and social responsibilities of the state was consistent with the objective of the socialist pattern of society. However, this did not mean complete elimination of private enterprise. In fact, the state was pledged to maintain a mixed economy in the society based on its commitment to democracy and socialism.

2.5. Analysis

The Nehru-Mahalanobis strategy of development faced considerable criticism from several quarters. Since it put greater emphasis on industrialization compared to agriculture, the latter suffered. The allocation of higher priority to heavy industries compared to labour-intensive industries resulted in heavy concentration of wealth and large-scale unemployment. The IDRA (Industrial Development Regulation Act) of 1951 did not serve its purpose fully. It created a *license raj* in the country favouring the large industrial houses, which became an impediment to industrial development. Land reforms could not be implemented properly owing to the defects in legislations, lack of political will and bureaucratic apathy. Because of the same reasons, the CDP (Community Development Programme) did not achieve considerable success.

Nevertheless, the first phase of the development effort witnessed several significant achievements. This phase created the basic physical and human infrastructure for comprehensive development in the society. The overall economic performance was far better compared to the colonial period. The rate of growth was quite impressive. Both the savings and investment rates rose substantially. Growth in agricultural production occurred because of land reforms, CDP and large investment in irrigation, power and agricultural research. Industry grew more rapidly than agriculture. The country developed a heavy industry complex with considerable diversification within the industrial structure. Furthermore, progress was made in the sphere of human capital due to the setting up of institutions of higher learning, especially in the scientific field.

3. Economic Crisis – 1960s

Despite these significant achievements, India faced a **macroeconomic** crisis in the mid-1960s, due to the slow growth of agriculture and exports, two successive droughts of 1965 and 1966 and the Indo-Pak War of 1965, followed by a suspension of US aid. This situation delayed the Fourth Plan and three annual plans were adopted between 1966 and 1969. The response of the state to the crisis included:

- The adoption of restrictive **fiscal policies** by cutting down on expenditure
- The devaluation of the rupee; and
- Launching of the Green Revolution

3.1. Shifts from Early Development Strategy

The Nehru-Mahalanobis strategy of development came under severe attack due to the poor performance of the economy and the economic crisis of the mid-1960. Although the basic framework of the Mahalanobis strategy was retained until the end of the Seventh Plan, shifts from this strategy became visible from the Fourth Plan onwards. In the Fourth Plan, the objective of self-reliance was not discarded, but the main emphasis was shifted to rapid economic growth. Consequently, preference was given to quick-yielding projects as well as to light industry at the expense of heavy industry. The state went for an elaborate system of controls in the economy such as nationalization of banks in 1969, the Monopolies and Restrictive Trade Practices (MRTP) Act in 1969, nationalization of the insurance sector in 1972 and the coal industry in 1973, and the Foreign Exchange Regulation Act (FERA) in 1973.

A major criticism of the Mahalanobis development strategy came from the World Bank economists in the early 1970s. Challenging this growth-oriented strategy, they argued that the objective of removal of poverty could not be achieved by growth itself. Several studies concluded that the benefit of growth had failed to reach the poor. Hence, the Fifth Plan allocated highest priority to the elimination of poverty and it adopted various area development programmes. The Sixth Five-Year Plan adopted various redistributive measures such as the Integrated Rural Development Programme (IRDP). The Seventh Plan adopted a new long-term development strategy focusing on growth in foodgrain production, employment opportunities and productivity.

4. Economic Crisis – Early 1990s

India faced a full-scale macroeconomic crisis in the early 1990s that reached its climax in 1991. The crisis was marked by high inflation, rising food prices, large current account deficit, huge domestic and foreign debt, a sharp fall in the foreign exchange reserves, a steep decline in India's credit rating, and a cut off of commercial loans accompanied by a net outflow of NRI (Non-Resident Indian) deposits.

The long-term constraints of the preceding decades, especially the 1980s, combined with certain immediate factors gave rise to this economic crisis. The Nehru-Mahalanobis strategy of import substitution-industrialization made the Indian industry inefficient and technologically backward due to the absence of competition. Due to the discouragement of foreign capital, India could not get the benefits of technology and competition. Heavy regulation of private sector through the system of licenses and permits caused a great damage to entrepreneurship and innovation. The public sector that dominated this strategy became highly inefficient and even sick due to excessive political interference. The preoccupation of the strategy with self-sufficiency caused export pessimism. This heavy industry strategy required huge imports of capital goods. Due to large imports of capital goods and foodgrain combined with little exports, the trade deficit increased. Instead of making necessary modifications according to the changing world situation, the government itself caused fiscal deterioration in the 1980s through: (a) populist policies, (b) rapid growth of state controls over the economy, and (c) reservation of certain areas for small-scale industries. The Gulf Crisis of 1990 came as an external shock to the Indian economy, which was in a highly vulnerable state.

5. Need for Economic Reforms

In this context, there arose a need for economic reforms arose due to the following underlying factors.

5.1. Weaknesses of the Pre-1991 Policies

One of the important factors which led to economic reforms was the weakness of pre-1991 economic policies such as low rate of economic growth, rising unemployment, stagnation in the rate of domestic savings and investment, poor performance of the public sector industries, inadequate infrastructural facilities, industrial licensing policy, growth of monopolies, etc.

Apart from these, there also prevailed other crisis-like conditions in 1990 and 1991, which pushed India towards liberalisation and globalisation.

5.2. Major Foreign Exchange Crisis

In the year 1991, Indian economy faced an acute shortage of foreign exchange. Several factors were responsible for this crisis.

First, the immediate cause for the foreign exchange crisis was the war between the Gulf countries of Iraq and Kuwait. This pushed oil prices and the oil import bill went up substantially.

Second, India's external debt had increased over time. The burden of interest and repayment of old debts was very large. Fresh debts were being denied by the international institutions such as International Monetary Fund (IMF) and the World Bank as well as other commercial lenders.

Third, foreign exchange in the form of NRI deposits was being withdrawn very rapidly because of the political instability and uncertainty at home.

Finally, the growth in imports had always been far more than the growth in exports. India had to, therefore, depend on foreign loans. Hence, foreign debt was always on the rise. Very soon, the foreign exchange crisis took a serious turn. Between January 1991 and June 1991, India faced a situation in which it had foreign exchange just enough to meet the import needs of only about three weeks. India was almost on the edge of defaulting on its foreign lenders' claims. As a result, the foreign exchange reserves with the Reserve Bank of India almost dried up.

5.3. Conditionalities Imposed by IMF and World Bank

In view of the foreign exchange crisis, the Government of India was pushed to the wall. Therefore, it had to approach the IMF and the World Bank to tide over the crisis. These institutes provided the much-needed foreign exchange, but on their own terms and conditions.

As a part of these conditions, India was required to cut down fiscal deficit and the rate of growth of money supply so as to liberalise the domestic economy and to relax restrictions on international flow of goods, services, capital and technology. Therefore, under pressure from the IMF-World Bank, the Indian policy-makers were almost pressurised to make several changes in the policy before they could obtain fresh credit from the IMF and the World Bank to tide over the crisis.

5.4. Fall of USSR (Union of Soviet Socialist Republics)

The USSR and the East European countries had over time become the major markets for Indian consumer goods exports. At the end of 1990, political system of these countries collapsed. Most of these countries became market economies. India had to open up trade with these countries on the basis of its ability to compete. It had to compete in the global market to retain its share of exports. India had, therefore, to reorganise its own policies to find a share in the world market.

6. Economic Reforms

In response to the internal economic crisis of 1990-91 and the changing international situation, the Narasimha Rao government decided to introduce economic reforms or the New Economic Policy (NEP). The NEP clearly reflected certain global trends, namely, the collapse of the socialist economy and growing acceptance of economic globalization across the world.

Although the reforms as a part of the process of liberalization and globalization were revolutionary in nature, these were launced within the democratic framework of the country. They marked a shift from the Nehruvian consensus of the 1950s to a new consensus around reforms. While the national goals set out at Independence remained unaltered, the change came only in the strategy to achieve these goals – from Nehru-Mahalanobis development strategy to the new development strategy of liberalization and economic reforms.

a) Macroeconomic stabilization measures

Macroeconomic stabilization was a short-term programme adopted to overcome the macroeconomic crisis by regulating the total demand in the economy

To correct the ***twin deficit*** i.e. the BOP problem & fiscal deficit, the reform package was announced in 1991 as a ***short term measure***, which had the following three components:

- **Fiscal stabilization measures**: To check the growing fiscal deficit, it proposed to step up the investment by the State in areas of social sector (school, hospitals etc) & infrastructure (roads, power etc) without creating inflationary pressures on the economy to generate demand.
- **Internal sector Liberalization**: Selectively control & permit the private sector to make their production and investment decisions as per the market conditions of demand & supply & allow them to invest liberally.
- **External sector Liberalization:** Integration of Indian economy with the Global economy to benefit from the resource inflows & competition, by removing controls on foreign trade & exchange rates & a policy to attract FDI etc.

It was believed that these measures would generate investment & high productivity in the economy, creating more employment opportunities & boost **demand**. This demand would lead the economy to a high growth path. This was however a **short-term** strategy, a package that was intended to correct the economic lapses in the system that existed that time.

The result was that India was able to pay its dues to IMF in time. Not only this, the Indian economy was back on track & achieved an average annual growth rate of 6.5% against a targeted 5.6% during 8th FYP. But India launched another set of medium to long term measures as well, termed as Structural reforms.

b) Structural Reform Measures

It was strongly believed that the stabilization that will be achieved by the package in the short term will not be sustainable if India's economy doesn't undergo structural reforms. Structural reform was a medium- and long-term programme, which dealt with sectoral adjustments and the problems on the supply side of the economy by bringing in dynamism and competitiveness to the economy. These included liberalized trade and investment policies with emphasis on exports, industrial deregulation, disinvestment and public sector reforms, and reform of the capital markets and the financial sector.

Crisis management measures included use of gold to acquire foreign currency to meet payment obligations, devaluation of the rupee, compression of imports and seeking finances from multilateral financial institutions and bilateral donors. In this way, an attempt was made to achieve a progressive economy by removing the internal controls and further to equip it to take advantage of the opportunities provided by the worldwide globalization process. Accordingly, a new trade policy and a new industrial policy were introduced. In the face of these changes, the Eighth, Ninth and Tenth Plans were launched.

6.1. Redefining the Role of the State

The adoption of the NEP based on liberalization and privatization has given rise to a debate on the nature of the link between state and market. The NEP does not imply a retreat of the state. It is based on a few propositions.

First, the state and the market are not substitutes for one another but they complement each other. Second, these two actors provide mutual checks and balances in such a way that one can correct the failures of the other. Third, through proper intervention the state has to make the market people-friendly because governments are accountable to people, while markets are not. It calls for a reorientation in the role of the state that tended to take too many responsibilities in the past. It underlines a change in the nature of the state from a producer, investor and regulator to a facilitating agency.

The state has to maintain general law and order and provide an appropriate policy framework in the areas where the private sector can play a large role. The state needs to formulate policies to bring about improved transparency and greater accountability, which form the basic pillars of good governance.

The new development strategy urges the state to play an important role in creating economic and social infrastructure that is unlikely to attract private investment, such as rural infrastructure and the development of roads and railways. It also justifies state intervention in those areas where the markets either do not exist or where market activity can lead to undesirable outcomes – providing public goods such as healthcare, education, and safe drinking water, and generating measures for eradication of poverty, creation of employment opportunities, empowerment of the disadvantaged and elimination of regional imbalances.

7. Liberalisation, Privatisation and Globalisation

The New Economic Policy was based on three major policy measures, namely, (a) liberalisation, (b) privatisation, and (c) globalisation. Liberalisation policy was characterised by liberalisation of the Indian economy from various types of controls, licensing and permits, which regulated the non-agricultural sector before 1991. The policy of privatisation basically implied expansion of the private sector and limiting the role of the public sector. Globalisation was the policy of opening up the Indian economy to other economies of the world.

Now, let us look at the economic reforms in detail under each of these three heads.

7.1. Policy of Liberalisation of Indian Economy

The policy of liberalisation forms an important part of the economic reforms characterising the new economic policy.

7.1.1. Meaning of Liberalisation

Economic liberalisation is the policy of deregulation of different segments of economy. It is the policy of doing away or reducing the government's controls over industry and other activites, which existed before 1991. The objective of introducing the liberalisation policy in 1991 was to move from a regulated system to a new system where regulations were to be reduced and ultimately minimised. Different sectors of the economy were to be made free from controls, licenses and permits. The Indian policy-makers were not thinking of a policy of *laissez-faire*, i.e. completely unregulated economy, but of reduced regulation.

7.1.2. Features of Liberalisation Policy

The main features of the policy of liberalisation are as follows:

Delicensing: Before 1991, there existed a regulatory system of licensing and controls. Industries which were covered under this system were required to be registered and were granted licenses by the government. The regulatory system of licensing and controls became a hurdle in the industrial growth. It caused delays and was breeding corrupt practices. The industrial licensing policy led to unnecessary government interferences, delays in investment decisions, bureaucratic red-tapism, etc. The regulatory measures also created an inefficient, high-cost and weak industrial sector. Therefore, there was a need to review these measures.

The thrust of the policy of liberalisation was on abolishing the requirement of licensing of industries. In most cases, the industrial policy of 1991 has made the licensing policy very liberal. The requirement of licensing has been abolished for most of the industries. Entrepreneurs are now free to enter any industry, trade or business.

Relaxation in Controlling Monopolies: Under the Monopolies and Restrictive Trade Practices (MRTP) Act, all the firms with assets above a certain amount (Rs. 100 crore since 1985) were permitted to enter select industries only, and they were required to take the approval of the government for any investment proposals. In order to make deregulation more effective, restrictions on functioning of monopolies have been relaxed. Monopoly houses are no longer required to seek prior government approval for expansion and establishment of new industries. The emphasis has shifted now to controlling and regulating the monopolistic and restrictive unfair trade practices by taking action against the offenders so as to safeguard the interest of consumers.

Industrial Location Policy Liberalised: In a departure from the earlier industrial location policy, freedom has been given to industries to be located at any location, with some exceptions. Also there is no need for obtaining the approval of the government, except for industries subject to compulsory licensing.

Removal of Restrictions: Restrictions on mergers, takeovers, separation of industrial units etc. have been largely removed.

Liberalisation of Capital Markets: Capital market has been made free. A new company can be floated now with the issuance of new shares and debentures without seeking the permission of the government. However, Securities and Exchange Board of India (SEBI) has been set up as a watchdog for regulating the functioning of the capital market.

Foreign Exchange Market: Reforms have been introduced in the foreign exchange market. Flexible exchange rate is introduced under which exchange rate is determined by market forces. In 1993-94, the rupee was made fully convertible on trade account in terms of the foreign currency. Exporters can now convert the foreign currency earned by them into Indian rupees at the prevailing market rate. Similarly, importers can now buy the foreign currency from the market at the market rate. The Reserve Bank of India (RBI) helps only to ensure that there are no extreme fluctuations in the exchange rate.

Development of Infrastructure: Private sector has been allowed to enter and develop the infrastructure such as power, roadways, communications, shipping, civil aviation, banking etc.

7.1.3. Significance of Liberalisation Policy

The policy of liberalisation has tried to overcome the problems of '*control raj*', such as problems of uncalled delays, corruption etc. It has also injected a spirit of competition in the economic system and has encouraged the entrepreneurs to undertake investment. This has increased the efficiency in the economy.

7.2. The Policy of Privatisation

The public sector enterprises were established in many countries primarily for pragmatic reasons but partly for ideological reasons. In recent years, however, with the emergence of a new philosophy of economic liberalisation, the private sector and the market forces have acquired prominence.

In the past, the policy-makers in India traditionally held the view that the public sector was the prime mover for economic development. The Industrial Policy Resolution of 1956 assigned a strategic role to the public sector in India. Accordingly, massive investment was undertaken during the Five-Year Plans to build the public sector. There is no doubt that the public sector in India was able to establish the industrial base in the country by developing heavy and basic industries and by providing the requisite infrastructure.

However, for quite some time now, there has been a change in the perception about the role of the public sector in the process of economic development and their role is being reappraised. An important development that has been witnessed, at the same time, is the process of privatisation.

7.2.1. Meaning and Rationale of Privatisation

Privatisation basically implies the process which leads to transfer of ownership of public sector enterprises from the government to the private sector. However, taken in a wider sense, privatisation also implies the process of granting autonomy to the public sector enterprises in decision-making and infusing the spirit of commercialisation in them.

The supporters of privatisation put forward the following arguments in support of it:

a) **Ideological Grounds**: Privatisation in the advanced countries is favoured on ideological grounds. The central idea of this argument is that public sector enterprises should be confined to essential activities, which the private sector cannot or will not perform. All other activities should be performed by the private sector enterprises as they are more efficient.

b) **Improvement in Managerial Efficiency**: Privatisation is supported as a means of improving managerial efficiency. Privatisation through disinvestment (i.e. policy of sale of equities held by the government to private investors) will establish a direct relationship between the shareholders and the management. The private shareholders would have direct interest in increasing the efficiency of these enterprises. The management would not be subjected to unnecessary political pressure and interference. This would remove the managerial inefficiency of public sector enterprises that arises due to political intervention. Management would be guided by economic and commercial considerations. It will help in improving the quality of decision-making.

c) **Creation of Competitive Environment**: Transfer of the ownership of the public sector enterprises to the private sector would abolish monopoly position. These enterprises will have to compete with other similar enterprises. So a competitive environment can be created. Such an environment would help in improving the competitive strength and efficiency of these enterprises. It would infuse commercial spirit in the enterprises. These enterprises would be under pressure to increase production efficiency by using modern and improved technologies.

d) **Profit-oriented Decisions**: Privatisation policy will help in infusing the commercial spirit in the functioning of enterprises. The private sector will introduce 'profit- oriented' decision-making process in the working of enterprises. This will lead to an improvement in the efficiency and performance of the enterprises.

e) **Greater Flexibility in Decision-making**: The public sector enterprises normally do not enjoy sufficient functional autonomy. This often leads to delay in decision-making. In fact, delayed decision-making is often equivalent to making no decision at all. The policy of privatisation will be helpful in imparting greater flexibility in the decision-making process. Management would be free from any government intervention. It would not have to consult anyone for any decision. It would be possible to take quick and timely decisions, which is the hallmark of efficiency. Timely and prudent decisions will improve the efficiency of business operation.

f) **Reduction in Burden on Public Exchequer**: Operation of the public sector enterprises has been putting a large burden on public exchequer because of huge losses incurred by a number of enterprises and growing amount of subsidy payments. Privatisation would be helpful in reducing this financial burden on the government. Government would not be under obligation of providing subsidy and making up for the losses.

g) **Greater Attention to Consumers' Satisfaction**: It is often argued that the public sector enterprises many a time do not get personally involved with the needs of the consumers. However, the very survival of private enterprises depends on the satisfaction of the consumers. Privatisation will lead to the consumers being taken care of because of the need for creating and sustaining market. Hence, quality of service will improve.

h) **Greater Investment and Employment Opportunities**: Privatisation will lead to opening up of new areas to the private sector enterprises, hitherto reserved for the public sector. This will lead to the increase in investment by the private sector. Higher investment would mean creation of larger employment and income-earning opportunities in the economy.

i) **Revival of Sick Units**: A number of public sector enterprises have been incurring losses for a long time. They have become, more or less, sick units. Privatisation may help in reviving sick units, which have become a liability on the government.

j) **Increase in Accountability**: Personnels in the public sector enterprises are not accountable for any lapse. There is always the scope of responsibility being shifted to others. However, the areas of responsibility in the private sector are clearly defined. Thus, privatisation will lead to an increase in accountability of the personnel managing these enterprises.

k) **Increase in Financial Discipline**: The public sector enterprises can get budgetary support irrespective of their performance. But the private sector enterprises will be able to raise funds in the capital market only if they are performing well. Therefore, privatisation will put pressure on the enterprises to perform well in order to raise funds in the capital market. This will improve their financial discipline.

7.2.2. Arguments Against Privatisation

A number of arguments have been advanced against the policy of privatisation:

a) **Privatisation Not Always Desirable**: As explained already, in many cases, public sector enterprises have been set up because the private sector either does not possess the requisite resources or simply is not interested because of long gestation period and low profitability. Many public sector enterprises are set up to achieve social welfare. Privatisation of such public sector enterprises may not be possible because private sector may not be forthcoming to acquire such public sector units.

b) **Social Welfare Neglected:** Privatisation policy may sometimes neglect the consumers' interest. Private sector enterprises operate mainly with the objective of profit maximisation. For example, private operators usually do not like to provide goods at subsidised prices to the poor consumers to promote social welfare and thus do not uphold the principles of social justice and public welfare.

c) **Possibility of Unemployment**: One of the genuine fears is that privatisation will lead to unemployment. There is always the fear of retrenchment and consequent unemployment when the public enterprises are taken over by the private sector. The experience of privatisation in many countries is testimony to the fact that this indeed has happened.

d) **Growth of Private Monopoly**: Another genuine apprehension is that the sale of a public sector undertaking to a private company may only result in the substitution of a public monopoly by a private monopoly. This may lead to monopolistic exploitation by efficient private owners replacing the inefficient public ownership.

e) **Possibility of Corrupt Practices**: The implementation of the policy of privatisation may open the door to corruption. There is the possibility of undervaluation of assets of the public sector units to favour the private sector. There may be complicity between politicians, bureaucrats, and particular business groups.

f) **Lopsided Industrial Development**: Privatisation may result in lopsided development of industries in the country. Private enterprises will not be interested in projects which are risky and have long gestation period with lower profitability. It may retard the growth of basic and heavy industries and infrastructure in the country.

7.2.3. Features of the Policy of Privatisation in India

The New Economic Policy centred around six major measures to reform the public sector enterprises:

Policy of Dereservation: The Industrial Policy Resolution of 1956 had reserved 17 industries for the public sector. The Industrial Policy of 1991 reduced the number of such industries to eight. Subsequently, the number of industries reserved for the public sector stood, as in 2016 were:

- Atomic Energy (Production, Separation or enrichment of special fissionable materials and substances and operation of the facilities)
- Railway Operations other than construction, operation and maintenance of items specified by DIPP.

Policy Towards Sick Public Sector Undertakings: In pursuance of the new industrial policy, sick public sector enterprises have been brought within the jurisdiction of the Board for Industrial and Financial Reconstruction (BIFR) for their revival/rehabilitation with effect from 1992. Prior to 1992, this scheme was used only in the case of sick private sector enterprises. The BIFR was set up in 1987 to look into the revival of sick industrial units residing with private companies.

Policy for Navaratnas and Miniratnas: The government has granted enhanced powers to the Board of Directors of various profit-making CPSEs known as *Maharatna, Navaratna,* and *Miniratna.* The *Navaratnas* originated as a part of the programme of the government in 1996 to identify high-performing and profit-making public sector enterprises. These enterprises were to be provided financial and managerial autonomy to become global giants. Initially, nine such enterprises (and hence nicknamed as *Navaratnas)* were identified. During 2010-11, the government introduced the *Maharatnas* scheme under which mega *Navaratna* public sector enterprises have been empowered to expand their operations, both in the domestic as well as foreign market. In 2016, there were *7 Maharatnas (BHEL, GAIL (India), NTPC, SAIL, CIL, IOCL, ONGC)* and *17 Navaratnas*. The *Miniratna* companies followed *Navaratnas* in 1997. These were consistently profit-making companies and are divided in two categories. These *Maharatna/Navaratna/Miniratna* companies have been given additional power and freedom to incur capital expenditure, raise debt, enter into joint ventures, restructure their board of directors, and work out their own manpower and resource management policies.

Memorandum of Understanding (MOU): The government has entered into MOUs with the public sector enterprises with the purpose of improving their performance. The main objective of MOUs is to grant autonomy to the public sector enterprises by reducing the quantity of control and increasing the quality of accountability. It aims at bringing a balance between autonomy and accountability. This is sought to be done by specifying in clear-cut terms the measurable goals and giving each enterprise greater autonomy to achieve these goals in a competitive environment. The purpose of MOU is to ensure a level playing field for the public sector vis-a-vis the private corporate sector. The government evaluates the performance of the public sector enterprises through performance evaluation based on a comparison between the actual achievements and the annual targets set by the government. The public sector enterprises entering into MOU with the government are given rating as per their performance. Ratings on a 5 point scale — excellent, good, very good, fair and poor — are given to the public sector enterprises as an incentive to improve their efficiency.

Voluntary Retirement Scheme (VRS): Many of the public sector undertakings have been facing the problem of overstaffing. The Government has initiated a voluntary retirement scheme in the public sector enterprises to reduce the number of excess workers. Under this scheme, workers seeking voluntary retirement are given financial compensation. As a result of this scheme, the government has succeeded in reducing the excess number of employees working with the public sector enterprises.

Disinvestment Policy: The major plank of the privatisation programme under the Industrial Policy of 1991 is the disinvestment policy. Disinvestment means selling of investment. In the context of public enterprises**, *the policy of disinvestment refers to selling of government's equity in the public sector units in the market*.** Under this policy, a part of the government shareholding in the selected public sector undertakings would be offered to private investors, financial institutions, mutual funds, workers, and the public at large. Disinvestment of shares of a select number of profit-making public sector enterprises is done in order to raise resources with the objective of reducing public debt burden to provide funds for giving assistance to public sector undertakings or their modernisation and to encourage wider participation of general public and workers in the ownership of the public sector enterprises.

Thus, the New Economic Policy of 1991 has attempted to bring privatisation with the objective of reforming the public sector enterprises. However, it should be noted that privatisation, in itself, is not likely to remove all the shortcomings of public sector. If competitive environment does not exist in a country, transferring ownership to the private sector is unlikely to achieve much. Moreover, transferring ownership through privatisation may create private monopolies. Creation of private monopolies goes against the basic social and national interest. The policy of privatisation would fail to deliver goods unless it improves the performance of these enterprises.

7.3. Policy of Globalisation

Third feature of the new economic policy is globalisation. It is the policy of opening up the Indian economy to the world economy.

7.3.1. Meaning of Globalisation

Globalisation is a process of integrating the economy of the country with other economies of the world through trade, capital flow, and technology. It means opening up the economy to the other economies of the world. The main channels through which globalisation takes place are as follows:

a) The first channel of globalisation is opening up of the world trade. This requires liberalisation in trade of goods and services. In order to expand the world trade, there is a need for introducing import liberalisation programmes, removing the quantitative restrictions, and reducing the import duties. Globalisation implies removal of the barriers to international trade so as to allow free flow of goods and services between countries.
b) Globalisation also requires the removal of barriers to international investment. Liberalisation of foreign investment would lead to a large increase in international investment. It is particularly important to open up the economy to foreign direct investment (FDI). Foreign companies, including multinational corporations (MNCs), need to be encouraged to undertake investment in the country. Facilities should be provided to the foreign companies and restrictions on the entry of MNCs should be removed in order to encourage international investment.
c) Globalisation can effectively take place through free flow of technology between countries. Transfer of technology from advanced countries is needed to promote economic development of developing countries such as India.

7.3.2. Effects of Globalisation

Globalisation has several advantages on economic, technological and other fronts:

a) Globalisation has led to increase in free flow of goods between countries. As a result, world trade has increased in recent years.
b) Globalisation has increased international flow of capital. Investment opportunities for the developed countries have increased. MNCs from the developed countries have started undertaking investment in the developing countries. This has led to the emergence of worldwide financial market.
c) The interdependence between different nation states has increased. Globalisation has increased interdependence between different countries of the world. This is reflected in the interdependence with regard to trading in goods and services and in the movement of capital.
d) Globalisation has brought in new opportunities for the developing countries. They have now got greater access to the advanced technologies. The technology transfer from the developed countries has led to increased productivity and higher living standard in the developing countries.
e) There has emerged worldwide product market. This has increased the range of goods available to producers and consumers.

f) The communication between people of different countries has increased as a result of revolution in the global mass media. This has made the world appear smaller. Information flow between different countries has increased.
g) Globalisation has increased economic prosperity and opportunity in the developing world.
h) Globalisation has brought people of different cultures together. It has reduced the cultural barriers. Increase in the crosscultural contacts has made the dream of global village more realistic.

However, the developments due to globalisation have by no means been an unmixed blessing:

a) One of the consequences of globalisation has been that all countries of the world have become vulnerable to the developments outside their own borders. Thus, the decade of 1990s was marked by a large number of currency crises, and large fluctuations in exchange rates and stock prices. Likewise, the recessionary conditions due to the 2008 financial crisis in USA were transmitted to the rest of the World. The same threat was faced in 2012 because of the Euro crisis.
b) Globalisation has also thrown up new challenges like growing inequality across the nations, volatility in financial market, and environmental degradation.

7.3.3. Globalisation of Indian Economy

India embarked on the programme of globalisation in 1991. However, the seeds of globalisation were sown in the early 1980s itself with liberalisation of imports, provision of some concessions to foreign capital, and permitting MNCs to enter in some areas of the Indian economy. But globalisation of Indian economy started in full earnest after July, 1991 as an essential part of the policy of economic reforms.

7.3.4. Features of the Globalisation Policy

As part of implementation of the agenda of globalisation, the Government of India has undertaken the following policy measures since 1991:

a) **Exchange Rate Reforms:** The most important measure for integrating Indian economy with the global economy was to change over from the fixed exchange rate to market-determined exchange rate. This policy of allowing the exchange rate to be determined in the international market without official intervention is known as convertibility of the currency. The full convertibility of Indian rupee on trade account was achieved in August 1994. Along with this, various types of exchange control measures were removed in a phased manner. As a result, restrictions on the transfer of foreign exchange have been considerably relaxed over the years.
b) **Import Liberalisation:** India is committed to reducing trade barriers as a member of the World Trade Organization (WTO). The government has also taken a number of steps in the direction of import liberalisation.
    - The system of import licensing has been dismantled.
    - Quantitative restrictions on imports have been almost totally abolished under agreement with the WTO.
    - Duties on imports and exports have been reduced to make the trade between nations freer than before.
c) **Foreign Investment**: FDI is expected to add to the domestic investment, and thereby, contribute to industrial and economic development of the country. It leads to higher efficiency and productivity by increasing competition and by bringing new technology into the country. In the changing global scenario of industrial and economic cooperation, promotion of FDI is important. In a bid to attract foreign capital and to integrate Indian economy with the global economy, the Government of India has thrown open its doors to

foreign investors. The government is committed to encourage flow of FDI for better technology, modernisation and for providing goods and services of international standard. In order to invite foreign investment in high priority industries requiring large investments and advanced technology, the government decided in 1991 to grant approval for FDI up to 51 per cent foreign equity. This limit was raised from 51 per cent to 74 per cent and subsequently to 100 per cent for many of these industries. The policy of the government is also aimed at encouraging foreign investment in the core infrastructure sectors like road development, airports, airlines, real estate, banks, power generation, oil exploration, etc. Moreover, foreign institutional investors have been allowed to invest in the Indian capital market subject to certain regulations.

d) **Foreign Technology**: With a view to encourage technological development in Indian industries, free flow of technology is allowed by the government. Government provides automatic approval for technological agreements in case of high priority industries. Similar facilities are provided for other industries as well, provided such agreements do not require foreign exchange. Foreign technology induction is facilitated both through FDI and through foreign technology agreements.

7.3.5. Effects of Globalisation on Indian Industry

Globalisation has had many positive effects on Indian industries:

a) Globalisation has attracted a number of MNCs to Indian industries. These MNCs have brought in huge amount of foreign investment into the Indian industries, especially in pharmaceutical, petroleum, chemical, textile, and cement manufacturing industries. A huge amount of FDI coming to the Indian industries has boosted the Indian economy.
b) One of the major benefits of globalisation has been the emergence of information technology (IT) sector and business process outsourcing (BPO) sector. The IT and BPO sectors are providing outsourcing to the customers in other countries, particularly the USA and Europe. The opening of the call centres, outsourcing of IT and BPO services, and MNCs have also created tremendous job opportunities in the country. The last few years have seen an increase in the number of skilled professionals in India being employed in these sectors. A new middle class has emerged around the wealth that the IT and BPO industries have brought.
c) Another benefit for the Indian industries is that the MNCs have brought in highly advanced technology with them. This has helped to make Indian industry technologically advanced.
d) SEZs have been set up to attract foreign companies. Creation of SEZs has enhanced the growth of industrialisation. They have helped in generating employment opportunities, creating world class infrastructure and investment, including foreign investment.
e) Some of the leading Indian industries such as the Tata, Reliance etc., have gone global by undertaking investment abroad and by acquiring some of the leading foreign companies. From steel to textiles, from cars to IT, Indian companies have themselves emerged as the new major players in globalisation.

However, the process of globalisation in India has generated some negative effects as well.

a) One of the adverse effects of globalisation on Indian industry is that it has increased competition in the Indian market between foreign companies and domestic companies. In many cases, it has led to unequal competition between the giant cash-rich MNCs and Indian companies.
b) Another negative effect is that due to the in-coming advanced foreign technology, the requirement of labour has decreased. This has resulted in many people losing their jobs.
c) Much of FDI has gone into takeovers of the existing enterprises and towards speculative investment in Indian stock market.

Thus, despite positive effects of globalisation on Indian economy, there have been some negative effects as well. Therefore, there is a need for evolving an appropriate policy to minimise the harmful effects of globalisation.

8. Effect of Reforms on Indian Economy

The new economic policy comprising liberalisation, globalisation, and privatisation has brought about many changes in the Indian economy. Economic reforms, initiated since 1991, have resulted in improving the performance of various sectors of the economy. Some of the major achievements of the new economic policy are as follows:

Higher Growth Rates: The new economic policy has played an important role in stepping up the growth rate of the Indian economy in recent years. The growth rate of national income picked up from 5 per cent in 1990-1991 to about 9.3 per cent in 2007-08.

Performance of the Industrial Sector: The performance of the industrial sector during the post-reform period is much higher than during the pre-reform period. The period immediately following the economic reforms was marked by a low growth rate of industrial output. However, the slowdown in the industrial output was a transitional phenomenon. Industrial production in India averaged 6.59 per cent from 1994 until 2017, reaching an all time high of 20 per cent in November of 2006. It experienced a growth rate of 9.2 per cent during the Tenth Plan, and a growth rate of around 7.7 per cent during the Eleventh Plan. This allays all fears that once the economy opens up, the industrial sector will not be able to withstand the competition from other countries.

Changes in the Composition of National Income: The post-reform period has been characterised by significant changes in the composition of national income. The share of the agriculture and allied sector in national income has decreased from 29 per cent in 1991-92 to about 17 percent in 2016-17. The share of the industrial sector, on the other hand, showed a steady increase from 24 per cent in 1991-92 to about 29 per cent in 2016-17. Importantly, the share of the tertiary or service sector has increased significantly from 44 per cent in 1991-92 to about 54 per cent in 2016-17. Thus, the service sector has registered a large and consistent growth in the post-reform period. This reflects the structural transformation of the Indian economy.

Savings and Investment Performance: Post-reform period showed a remarkable increase in savings and investment. Gross domestic savings increased from about 23 per cent in 1990-91 to 31 per cent in 2015-16, rate of investment (rate of gross domestic capital formation as per cent of GDP) has increased from 26 per cent in 1990-91 to about 31 per cent in 2015-16. Private sector has been assigned a major role under the new economic policy. As a consequence, rates of Private Final Consumption Expenditure (PFCE) at current and constant (2011-12) prices during 2016-17 are estimated at 58.8 percent and 55.8percent, respectively, as against the corresponding rates of 58.0 percent and 55.0 percent, respectively in 2015-16.

Foreign Trade: Post 1991, the gradual liberalization of the Indian economy, characterized by policy reforms, created a conducive environment for India’s exports to flourish and evolve into an engine of social and economic growth. Since then India has transformed from a closed economy to a considerable player in the global market. Over time, the export sector has grown to be a significant earner of foreign exchange and a major contributor to India’s national income.

Foreign Exchange Reserves: Indian economy faced a serious foreign exchange crisis during 1990–91 because of adverse balance of payments. But the balance of payments has shown significant improvement after economic reforms. As a result, India's foreign exchange reserves have increased rapidly. The reserves stood at US $405 billion in July 2018 as against only $1.1 billion in June, 1991.

Foreign Direct Investment: FDI in India has increased significantly since 1991. It has increased from US $1.3 billion in 1990-91 to US $60.08 billion in 2016-17. This is a reflection of liberalised policy changes as well as an improved investment climate. In the three years since 2014, the government has eased 87 FDI rules across 21 sectors to accelerate economic growth and boost jobs. Over time, FDI rules have been radically overhauled across sectors such as broadcasting, retail, trading and air transport. The present government has amended legislation to hike the foreign investment cap to 49% in insurance and pension from the earlier 26%.For retail trading of food products, the government has permitted 100% FDI with unqualified condition that such food products have to be manufactured or produced in India.

Overseas Investment by Indian Companies: Outbound investments from India have undergone a considerable change not only in terms of magnitude but also in terms of geographical spread and sectoral composition with Indian companies also undertaking overseas investment. In a significant development, UK announced that India has become the third largest source of FDI for them as investments increased by 65 per cent in 2015 leading to over 9,000 new and safeguarded jobs.

Reforms in any sector cannot be seen in isolation. There is a huge degree of complementarity among different kinds of reforms. If there is delicensing of the export of a particular item/good but production of that good remains controlled, then the benefit of the reform will be limited. Instead, if the industrial policy deregulates production of goods, then the benefit will be much greater. Similarly, external-sector reforms will reach its potential if sufficient reforms are introduced in the financial, fiscal, industrial and agricultural sectors.

9. Assessment of Reforms

Although there is a broad consensus among most of the political parties on the desirability of reforms, considerable debate has emerged on the contents of the reform programme, their sequencing and pace as well as their implementation and impact.

The balance sheet of the Indian economy in the post-reform period is mixed. The overall post-reform growth rate has been higher than the average rate achieved during the pre-reform period, largely because of the services sector. The fiscal balance and inflationary tendency have been controlled. India is emerging as an important player in fields such as manufacturing and medical services. Robust export growth especially software exports, and rising remittances by Indian workers abroad have created a new confidence in the Indian economy. It has led to phenomenal growth in foreign exchange reserves. The growth competitiveness and the business competitiveness of the country are increasing. India is emerging as a stable growth engine and as a Big Emerging Market (BEM) in the world due to robust economic performance supported by a vibrant democracy, increasing young population, expanding middle class and domestic market and well-developed private sector.

However, this growth is not inclusive. First, the growth is skewed within the economy. For example, there is a great divide separating industry and agriculture, and the infrastructure, especially the rural infrastructure, is in an appalling state. Second, the reforms are just confined to the economy and they are not spreading to the social sector. The social sector including healthcare, education, social security, gender equity and environmental protection has suffered a setback owing to the decline of the public investment in this crucial area. Low spending by the government has led to growing inequity in education and a decline in the quality of education. Indian society is marked by four great divides: rural-urban, rich-poor, and along gender and caste lines – which pervade every aspect of life, including social services. In each category, there is the existence of a disadvantaged section that finds it extremely difficult to get access to social services and thus gets left out.

Though there has been immense improvement since Independence, we do not yet have a system in place that is capable of providing access to public goods. As a result of liberalization, the state is increasingly transferring its constitutional responsibility of providing public goods to market forces. Hence, the state is failing to build human capability and to ensure dignity of life for every citizen of the country. Since the market operates on the basis of economic power, it excludes the common people and the marginalized sections that do not have economic power from its benefits. Free market, coupled with the lack of necessary state support in the social sector, has led to huge interpersonal and inter-regional inequalities. These inequalities have caused social instability manifested by increasing protests and farmers' suicides.

Globalization, as shaped by the new development paradigm has given rise to large-scale human displacement and the consequent disappearance of many communities and cultures, and massive protests. The continuing paradox of India and Bharat – a fast-growing economy supported by a well-developed private sector and yet with persistent mass deprivation and no effective freedom – within the democratic framework in the country has given rise to the question of whether democracy and market are incompatible. While the market excludes common people from its outcome, democracy based on universal adult franchise includes all in economic benefits.

Nevertheless, the inherent exclusionary tendencies of the market can be limited only by the State through providing public goods and services to the marginalized and the excluded sections of the population and regions of the country. This can be done most effectively in India's highly pluralist and participative democracy with a very competitive print and electronic media, since they put pressure on governments to focus on the deprived sections of the society. To foster a more inclusive growth, we need to create new employment opportunities in rural areas, improve the quality of infrastructure (both the so-called 'soft infrastructure' – political and economic policies and institutions; and 'hard infrastructure' – roads, railways and ports) and improve human capabilities by prioritizing health and education.

Keeping these concerns in view, the government decided to introduce the second-generation reforms while continuing the beneficial measures of the first-generation reforms, or the reforms initiated in the early 1990s. The second-generation reforms focus on the predominant issues of contemporary India. These include: (a) extending reforms to the states; (b) creating infrastructure through public-private partnerships; (c) reforming the labour market, agriculture, intellectual property rights regime and the telecom sector; (d) improving governance through legal and political reforms; (e) empowering the underprivileged; (f) expanding primary education and improving quality of higher education; (g) improving human-development sector through intensive engagement with civil-society actors; and (h) achieving environmental sustainability.

The aim of these reforms is not only to help turn India into a fast-growing economy, but also a knowledge economy by strengthening the knowledge sector; a strong democracy by building *social capital*; and finally a humane society with the highest levels of sustainable human development. In light of this, the government has introduced various reports, schemes and programmes which aim to eradicate poverty and unemployment and fulfill that long-awaited promise that Jawaharlal Nehru so eloquently described as our 'tryst with destiny' at Independence.

10. Previous Years Vision IAS GS Mains Questions

1. ***"Public debates in India often reflect either an uncritical faith in market (market mania) or a blind opposition to it (market phobia). However, there is a deep complementarity between market efficiency and state action." Comment on the***

applicability of this statement with respect to the current state of the Indian economy.

Approach:

The answer should systematically highlight the role that the state and market should play in Indian economy. In the post liberalization phase, the role of state has changed to that of a regulator for the private sector and as an accountable basic service provider in the field of health, education and justice delivery system to increase the ease of doing business on the one hand and to ensure that the fruits of economic growth are distributed equitably among one and all.

Answer:

In the post liberalization phase, there has been an overarching concern with sustaining high growth rates in the Indian economy. However, while on one hand, the 11th and 12th plan recognised the need of introducing market reforms like- time bound and single window clearance facilities for opening new businesses, labour reforms, providing quality physical infrastructure to the private sector etc. and on the other, it has reinstated the fact that the role of the state needs to take a new avatar where it should become an efficient and transparent regulator to provide a levelled playing field to the players in the market and to reduce the scope of "crony capitalism".

Moreover, learning from the failure of the trickle down approach in the past two decades, the planning commission and developmental economists like Amartya Sen have argued for pursuing a more socially and economically inclusive growth model. Thus contrary to a reduced role for the state, there is a need to reinvent its role where it morphs itself to become a strong basic service provider in the primary education and health sector thus ensuring that growth becomes more inclusive on one hand (or to ensure that the fruits of growth are distributed more equitably), while becoming a transparent and efficient regulator in sectors that are thrown open to the private sector.

There is an urgent need to eschew any simplistic market vs state debate and recognise the deep complementarities that exist between the two- a strong but redefined role of state would improve India's standing on the ease of doing business index (India has a dismal ranking of 134 out of 189 countries on the ease of doing business index of World Bank) thus reinforcing the faith of the private sector, while its role as an efficient, basic service provider would ensure that India performs a course correction from becoming a "country which has islands of California in a sea of Sub- Saharan Africa" and this would restore the credibility of both, a market oriented strategy and the practice of democracy in public eye both of which have increasingly come under closer public scrutiny in the recent past.

2. How has the process of liberalization, which has otherwise led to high economic growth, affected the employment rate and the nature of employment in India?

Approach:

- Briefly describe how the liberalisation has led to high economic growth in India.

- Analyse the effect of liberalisation on the employment rate and the nature of employment in India both in organised and unorganised sectors.
- Bring out both positive and negative effects.

Answer:

The process of liberalization, which began in 1990s is seen as a milestone in the economic history of India. Since the liberalization, the economic condition gradually started improving and today India is one of the fastest growing economies in the world with an average yearly growth rate of around 6-7 per cent.

Theoretically, acceleration in GDP growth of a labour-abundant country characterised by the market regime should push employment growth rate as well. However the impact of liberalisation on growth of employment in India is not as per the expectations.

A comparative analysis of GDP growth rate and employment growth rate is given below:

Period	GDP growth (%)	Employment growth (%)	Productivity growth (%)	Elasticity of employment with respect to GDP
1972-1973 to 1983	4.66	2.44	2.22	0.52
1983 to 1993-1994	4.98	2.02	2.96	0.41
1993-1994 to 2004-2005	6.27	1.84	4.43	0.29
1999-2000 to 2009-2010	7.52	1.50	6.02	0.20
2004-2005 to 2009-2010	9.08	0.22	8.86	0.02

- It is clear from the above table that even though the liberalisation process has resulted in higher economic growth, the growth in employment rate has declined.
- Even during the high economic growth phase of 2005-12, employment growth rate was just 0.4% with the addition of just 13 million jobs. There has been continuous decline in employment elasticity as well. It declined sharply from 0.3 during 2000-05 to 0.05 during 2005-12.
- Most of the new jobs were located in the informal sector with low earnings and no social protection resulting in casualization of jobs.
- In the economy as a whole, the worker-population ratio declined in the 1990s for men and women in rural and urban areas in most age groups in the range 5-59.
- Amongst the young school participation has increased as child and youth labour have declined.
- There is an across the-board improvement in the growth rate of labour productivity and wages and it is estimated that average per capita earnings per annum increased.

- However the liberalization process has mainly benefited the top 10 per cent of wage earners who now make 12 times more than the bottom 10 per cent, up from a ratio of six in the 1990s.
- As per the NSSO data, only 18% of working people have regular wage salary employment. Roughly 30% are casual labourers, dependent on daily or periodic renewal of job opportunities. The remaining 52% are self-employed. Most of them are in agriculture, working as helpers in family owned businesses without salary.
- Employment share of public sector has gradually reduced as the public sector withdrew from many areas. A healthy growth rate in employment has been registered in the private sector.
- The liberalisation and globalisation process brought in more technological upgrades in manufacturing sector which increased the mechanisation and reduced the employment.
- In case of service sector, the employment growth has not matched the growth in GDP contribution. The sector presently contributes nearly 55% of total GDP but has employed a mere 27%. The problem of skill development enabling labour migration to services remains inadequately addressed.
- The conditions of employment in unorganised sector have not improved. The middlemen and employer continue to enjoy the benefits derived from their labour.
- In the Index of Economic Freedom World Rankings for 2013, India was ranked 119th among 177 countries, putting India in the category of 'mostly unfree' countries. The report clearly states that although there is improvement in labour freedom, it is offset by declining scores in other areas. Further, the report states that corruption is endemic throughout the economy and is becoming more serious.

3. Dismantling of administered price mechanism for fuels is being deemed as a significant piece of economic reform. Analyse. Also, discuss how the recently introduced dynamic fuel pricing can prove to be beneficial for both the OMCs as well as consumers.

Approach:

- Begin with a brief introduction about administered price mechanism.
- Then, write about the benefits of the initiative (dismantling of APM) for Indian economy as a whole.
- Then explain recently introduced dynamic fuel pricing.
- Further give arguments for the benefits of dynamic price mechanism to OMCs and consumers.

Answer:

Administered Price Mechanism (APM) for fuels denotes that the price of fuel was set by the dictates of government rather than the market forces, that is, the prices were either administered or subsidized.

Dismantling of APM is deemed to be beneficial for Indian economy because:

- It will lead to efficient allocation of a scarce resource which was being over-used by the consumers due to lower prices.
- The burden on the state fiscal accounts will also be reduced as higher imports of crude oil at higher prices due to increased demand need not be subsidised by state.
- The idea of providing returns on cost-plus formula to OMCs was not encouraging to encourage efficiency in production because it was not at all profit motivated.

Under APM, state-run fuel retailers used to revise rates on the 1st and 16th of every month, based on average international price in the preceding fortnight and the currency exchange rate. In dynamic fuel pricing, retail selling prices of petrol and diesel will be revised daily. It would link daily sales at all their petrol pumps with the international prices of crude oil.

Its benefits for OMCs

- Oil companies would be free to take independent decisions based on import parity and market forces in pricing of petroleum products rather than being governed by the dictates of the Government.
- Due to the reining in of speculative market forces, the impact of increasing/decreasing prices on the working capital of companies and dealers would be minimised.
- It ensures that OMCs do not lose out for an entire fortnight in the event of a sharp rise in crude prices as they will be able to immediately pass on the price hike to the customers.

Its benefits for consumers

- The move will take the economy towards greater transparency in fuel pricing and free pricing of petrol and diesel.
- It will ensure that the benefit of even the smallest change in international oil prices can be passed down the line to the dealers and the consumers.
- Besides the move will remove big leaps in rates that need to be effected at the end of the fortnight.
- Consumers will be more aligned to market dynamics as India will be following the practice of the most advanced markets.
- This will also lead to public sector OMCs offering competitive prices. Not only, it will improve the competitiveness of the economy overall, but also it would incentivise investments in the oil sector.

The introduction of dynamic pricing will definitely bring consumers on a better footing as it will make the demand elasticity of the consumers reflected well in the markets. This will be possible as the price and sales data will be available in public for the market participants to reflect the same. However, there are certain obstacles to be overcome like updating of prices in unautomated petrol pumps and staying the course on hardening of oil prices.

4. ***While India has taken a number of steps in order to substantially improve its ranking in the World Bank's 'Ease of Doing Business' Index, it needs to take further action in this regard. Elaborate. Also analyse the utility of these rankings vis-a-vis India's objective of facilitating a sound entrepreneurial environment.***

Approach:

- The answer can be developed under three sub-parts, in the following order:
  - Steps taken by India to improve its ranking
  - Areas/scope for further improvement
  - Role of ranking in facilitating entrepreneurship
- Discuss all parts in detail along with relevant data.

Answer:

World Bank's Ease of Doing Business (EODB) Index presents quantitative indicators on business regulations and the protection of property rights based on 10 parameters that can be compared across 190 economies.

India saw a rise of one position, to 130 in 2017, from 131 in 2016. However, if compared to 2015, the improvement is significant.

Steps taken by India to improve its EODB Index ranking on the 10 parameters:

- **Speeding up process**: such as company's registration within 1-2 working days, issuing of PAN in a day, providing electricity connections in 15 days with online application etc.
- **Digitisation**: It makes various processes easier for businesses and their employees such as digitization of property records and land records, ShramSuvidha Portal for filling returns for ESIC and EPFO etc.
- **Facilitating trade across borders**: through 'Indian Customs Single Window Project' as well as reducing the number of mandatory documents required by customs.
- **Enacting or amending laws & rules**: such as Enactment of the Commercial Courts, Commercial Division and Commercial Appellate Division of High Courts Act, 2015,the Insolvency and Bankruptcy Code, 2016 for speeding the exit procedure etc.
- **Protecting minority investors** through the Companies (Amendment) Act, 2015.

Though India has performed well on parameters like getting electricity, getting credit and protecting minority investors, on some other parameters like construction permits, resolving insolvency, paying taxes, enforcing contracts etc. it has performed poorly.

With the government plotting an eight-point strategy and firming up a 295-point reform agenda for states to improve India's ranking, the following steps may be taken if India wants to reach the 90th rank in 2017-18 and 30th by 2020:

- As labor market regulation will be included in coming reports, simplification and rationalization of labour laws is inherent to improve the ranking.
- Setting up fast track commercial courts and redressing cases related to contracts in a time-bound manner.
- Reducing complexity and crackdown on corruption in allowing construction permits.
- Online registration of properties within a time bound manner.
- Reducing documents along with doing away with complexities in paying taxes.
- Further rationalization of import-export permits by removing bureaucratic delays.

Utility of EODB ranking and entrepreneurial environment in India

- EODB Index rankings facilitate the cause of entrepreneurship by creating awareness about the opportunities available in India.
- The central government's push has led to competitive federalism among States, smoothening out their regulatory procedures.
- As good rankings create an atmosphere for favourable investments, it may also help in spurring economic activities and generation of employment.

In this regard the collaboration between World Bank and the Central government to rank states on EODB is a step in the right direction to promote entrepreneurial environment in India. However, overemphasis on these ranking should be avoided due to the following reasons:

- It covers only two cities of New Delhi and Mumbai and do not take in to account the reforms undertaken by States.

- Also, performance in just one area may bring down the overall ranking substantially.
- As other countries also increase their efforts, jumping up in the ranking gets tougher.

Therefore, for domestic assessment of progress, internal State-based rankings will serve the cause of entrepreneurship better.

11. Previous Years UPSC Mains Questions

1. Has the Indian governmental system responded adequately to the demands of Liberalization, Privatization and Globalization started in 1991? What can the government do to be responsive to this important change?
2. Liberalisation of the Indian economy since 1991 has led to excessive consumerism and over-production of 'white goods'. Elucidate.
3. "The lesson of the current global financial crisis is that India should halt and may be even reverse financial liberalisation."
4. State the comprehensive structural reforms undertaken to improve the Indian economy since 1991.
5. "Industrial growth rate has lagged behind in the overall growth of Gross-Domestic-Product (GDP) in the post-reform period" Give reasons. How far the recent changes in Industrial Policy are capable of increasing the industrial growth rate?
6. How globalization has led to the reduction of employment in the formal sector of the Indian economy? Is increased informalization detrimental to the development of the country?
7. Normally countries shift from agriculture to industry and then later to services, but India shifted directly from agriculture to services. What are the reasons for the huge growth of services vis-a-vis industry in the country? Can India become a developed country without a strong industrial base?
8. Foreign direct investment in the defence sector is now said to be liberalised. What influence this is expected to have on Indian defence and economy in the short and long run?
9. Examine the impact of liberalization on companies owned by Indian. Are the competing with the MNCs satisfactorily?
10. Discuss the impact of FDI entry into multi-trade retail sector on supply chain management in commodity trade pattern of the economy.
11. Though India allowed foreign direct investment (FDI) in what is called multi brand retail through joint venture route in September 2012, the FDI even after a year, has not picket up. Discuss the reasons.

INDUSTRIAL POLICY: CHANGES AND THEIR EFFECTS ON INDUSTRIAL GROWTH

Contents

1. Introduction

The landscape of the global economy is undergoing rapid change. Developing countries are outpacing developed countries in terms of growth and diversity. Globally, the composition of the industrial sector is changing. Aspects such as technology, efficiency, environment, and competitiveness are emerging as key determinants of growth and performance. The changing patterns of economic growth are giving way to new segments and sectors. The ranking of countries in the top league of industrial growth, performance, and competitiveness have also undergone rapid change.

In this context, the Government of India has also been undertaking several policy measures and incentives, from time to time, in order to promote rapid industrialization in the country. Rapid industrialization is aimed at achieving various socio-economic objectives, including but not limited to, generating employment, economic growth, reducing debt burden, promoting foreign direct investment (FDI) inflow, enhancing self-reliant production and distribution, reducing regional disparity as well as diversifying and modernising the existing economic set up.

2. Evolution of Indian Industry

Industry accounts for about 29 per cent of GDP in the Indian economy (29.02% GVA at current prices in 2016-17 and 31.12% at 2011-12 prices). This is smaller than the average share of 35 per cent for developing countries as a whole.

Indian industry experienced slow and poor productivity performance during the period from 1950 to 1980. The policy regime had strong preference for the public sector, extensive controls over private investment, a highly protective trade policy, and inflexible labour laws (especially after the mid-1970s). Promotion of the small-scale sector and regional balance were additional objectives of the industrial policy regime. Up to the mid-1960s, policy instruments were aimed at purposive diversification within the industrial sector and increased public investment. The period after the mid-1960s witnessed a marked deepening of the import-substitution regime and strengthening of domestic regulatory structures. This period witnessed a significant deceleration in growth to 4 per cent per annum compared to 6.1 per cent in the period from 1950 to 1965.

The decade of the 1980s witnessed some experimentation with domestic deregulation that yielded handsome dividends in productivity gains and acceleration in growth to 7 percent per annum. In 1991, in response to a major balance-of-payments crisis, India made a radical shift away from its long-standing policy of inward orientation, and the subsequent reforms have moved the policy regime significantly towards market orientation, deregulation, and liberalization. Indian industry has responded to the increased competition – domestic as well as foreign – with significant restructuring although the constraints arising from poor infrastructure, largely unreformed public sector, slowly reforming banking sector, inflexible labour laws, and other barriers to exit stand in the way of faster adjustment to the new and emerging policy regime which is inspired by market orientation.

2.1. The Pre-Reform Regime

The pre-reform industrial policy regime relied heavily on the development of a public sector to cater to the infrastructure needs of development and to provide direction to the process of industrial development within a mixed economy framework. Besides 'reserving' certain strategic areas of industrial production, for example, iron and steel, coal, transport, power, mineral oils, atomic energy, arms and ammunition, and allied items of defence equipment, in the public sector, the state also acted as the leading entrepreneur in machine tools, non-ferrous metals, fertilizers, etc. Nevertheless, the private sector was expected to play a major role, especially in the provision of consumer goods and building up the small-scale sector.

Industrial licensing was a major instrument of control of the private sector under which permission of central government was needed for both investment in new units and for substantial expansion of capacity in existing units. Licensing also controlled technology, output mix, capacity location, and import content. Large industrial houses needed separate permission for investment or expansion under the Monopolies and Restrictive Trade Practices (MRTP) Act so as to prevent the concentration of economic power. There were price and distribution controls in industries such as fertilizers, cement, aluminium, petroleum, and pharmaceuticals. Almost 800 items were reserved for production by small-scale units as a way of protecting the small-scale sector from competition from large-scale units. There were also barriers to industrial restructuring and exit of firms.

India's import tariffs were among the highest in the world, with duty rates above 200 percent being fairly common and tariff rates being highly dispersed. Imports of manufactured consumer goods were completely banned. For the rest, only some goods were freely importable, and for most items where domestic substitutes were being produced, imports were only possible with import licences. The criteria for issuing these licences were non-transparent, delays were endemic, and corruption unavoidable. Policies towards foreign investment were quite restrictive, reflecting the general protectionist thrust of industrial policy.

The period from 1950 to 1980 experienced stagnant industrial growth at the rate of 5.5 per cent per annum. However, significant diversification of the industrial structure was achieved. But total factor productivity (a measure of the efficiency with which labour and capital are used in generating value added in the manufacturing sector) is estimated to have stagnated/declined during the period from 1960 to 1980. The high-cost industrial structure resulting from the heavily protectionist policy regime created an anti-export bias in the industrial sector. The erosion of competitiveness could be seen in the secular decline of India's share in global exports of manufactured goods from 1 per cent in 1950 to 0.4 per cent in 1980.

2.1.1. Industrial Policy Regime in the Pre-Reform Period

Industrial development in India was governed by licensing policies that came into being in 1948. The first comprehensive Industrial Policy Resolution of 1956 classified industries into three categories with the state being given the primary role of industrial development and the private sector expected to supplement the efforts of the state. Industrial Policy Resolution of 1970 classified industries into four categories: core sector, heavy investment sector, the middle sector, and the de-licensed sector with the first three categories confined to large business houses and foreign companies.

The Industrial Policy Statement of 1973 gave preference and thrust to the growth of small and medium enterprises (SMEs) while that of 1977 further promoted decentralization with an increased role for small-scale, tiny, and cottage industries.

However, the Industrial Policy Statement of 1980 placed greater thrust on promotion of competition in the domestic market, technological upgradation, and modernization of industries.

2.1.1.1. Industrial Policy, 1948

The first important industrial policy statement was made in the Industrial Policy Resolution (IPR), 1948. The main thrust of IPR, 1948 was to lay down the foundation of mixed economy whereby the private and public sector were accepted as important components in the development of industrial economy of India. The policy divided the industries into four broad categories:

- **Industries with exclusive state monopoly**: It included industries engaged in the activity of atomic energy, railways and arms and ammunition.

- **Industries with government control**: It included the industries of national importance and so needed to be registered. 18 such industries were put under this category; for e.g. fertilizers, heavy chemical, heavy machinery etc.
- **Industries in the mixed sector**: It included the industries where private and public sector were allowed to operate. Government was allowed to review the situation to acquire any existing private undertaking.
- **Industries under private sector**: Industries not covered under any of the above categories fell in this category.

IPR, 1948 gave public sector a vast area to operate. The Government took the role of catalytic agent of industrial development. The resolution assigned complementary role to small-scale and cottage industries.

2.1.1.2. Industries (Development and Regulation) Act (IDRA), 1951

IDRA, 1951 is the key legislation in the industrial regulatory framework. It gave powers to the government to regulate the industry in a number of ways. The main instruments were the regulation of capacity (and hence output) and power to control prices. It specified a schedule of industries that were subject to licensing. Even the expansion of these industries required prior permission of the government, which meant that the output capacity was highly regulated. The Government was also empowered to control the distribution and prices of output produced by industries listed in the schedule. The IDR Act gave very wide powers to the Government. This resulted in more or less complete control of the industrial development of the country by the bureaucracy.

The main provisions of the IDRA, 1951 were:

- All existing undertakings at the commencement of the Act, except those owned by the Central Government were compulsorily required to register with the designated authority.
- No one except the central Government would be permitted to set up any new industrial undertaking "except under and in accordance with a licence issued in that behalf by the Central Government."
- Such a license or permission prescribed a variety of conditions, such as, location, minimum standards in respect of size and techniques to be used, which the Central Government may approve.
- Such licenses and clearances were also required in cases of 'substantial expansion' of an existing industrial undertaking.

2.1.1.3. Industrial Policy Resolution, 1956

Since the adoption of 1948 Resolution, significant development took place in India. Economic planning had preceded on an organised basis and the First Five-Year Plan had been completed. Parliament had accepted the 'socialist pattern of society' as the basic aim of social and economic policy. These important developments necessitated a fresh statement of industrial policy. A second Industrial Policy Resolution was adopted in April, 1956, replacing the Resolution of 1948. Important provisions of the 1956 Resolution were:

1. **New classification of Industries**: IPR, 1956 divided the industries into the following three categories:
    a) Schedule A industries: The industries that were the monopoly of state or Government. It included 17 industries. The private sector was allowed to operate in these industries if national interest so required.
    b) Schedule B industries: In this category of industries, the state was allowed to establish new units but the private sector was not denied to set up or expand existing units e.g. chemical industries, fertilizer, synthetic, rubber, aluminum etc.

c) Schedule C industries: The industries not mentioned in the above category formed part of Schedule C. Thus the IPR, 1956 emphasized the mutual existence of public and private sector industries.

2. **Encouragement to small-scale and cottage industries**: In order to strengthen the small-scale sector, supportive measures were suggested in terms of cheap credit, subsidies, reservation etc.
3. **Emphasis on reduction of regional disparities**: Fiscal concessions were granted to open industries in backward regions. Public sector enterprises were given greater role to develop these areas.

The basic rationale of IPR, 1956 was that the state had to be given primary role for industrial development as capital was scarce and entrepreneurship was not strong. The public sector was enlarged dramatically so as to allow it to hold commanding heights of the economy.

2.1.1.4. Monopolies Commission

In April 1964, the Government of India appointed a Monopolies Inquiry Commission "to inquire into the existence and effect of concentration of economic power in private hands." The Commission looked at concentration of economic power in the area of industry. On the basis of recommendation of the commission, Monopolies and Restrictive Trade Practices Act (MRTP Act), 1969 was enacted. The act sought to control the establishment and expansion of all industrial units that have asset size over a particular limit.

2.1.1.5. Industrial Policy Statement, 1973

The Policy Statement of 1973 drew up a list of industries to be started by large business houses so that the competitive effort of small industries was not affected. The entry of competent small and medium entrepreneurs was encouraged in all industries. Large industries were permitted to start operations in rural and backward areas with a view to developing those areas and enabling the growth of small industries around.

2.1.1.6. Industrial Policy Statement, 1977

The main elements of this policy were:

1. **Development of Small-Scale Sector**: The main thrust of the new industrial policy was an effective promotion of cottage and small industries. The Government initiated wide-spread promotional and supportive measures to encourage the small-scale sector. The small-scale sector was classified into 3 categories viz. Cottage and household industries which provide self-employment; tiny sector and small-scale industries. The purpose of the classification was to specifically design policy measures for each category. The policy statement considerably expanded the list of reserved items for exclusive manufacture in the small-scale sector.
2. **Restrictive approach towards large business houses**: The large scale sector was allowed in basic, capital goods and high-tech industries. The policy emphasized that the funds from financial institutions should be made available largely for the development of small sector. The large sector should generate internal finance for financing new projects or expansion of existing business.
3. **Expanding role of public sector**: The industrial policy stated that the public sector would be used not only in the strategic areas but also as a stabilizing force for maintaining essential supplier for the consumer.

Further, the policy statement reiterated restrictive policy towards foreign capital whereby the majority interest in ownership and effective control should rest in Indian hands.

2.1.1.7. Industrial Policy, 1980

The industrial policy 1980 emphasized that the public sector is the pillar of economic infrastructure for reasons of its greater reliability, for the large investments required and the longer gestation periods of the projects crucial for economic development. The IPR1956 forms the basis of this statement. The important features of the policy were:

1. **Effective management of public sector**: The policy emphasized the revival of efficiency of public sector undertaking.
2. **Liberalization of industrial licensing**: The policy statement provided liberalized measures in the licensing in terms of automatic approval to increase capacity of existing units under MRTP and FERA. The asset limit under MRTP was increased. The relaxation from licensing was provided for large number of industries. The broad-banding concept was introduced so that flexibility is granted to the industries to decide the product mix without applying for a new license.
3. **Redefining small-scale industries**: The investment limit to define SSI was increased to boost the development of this sector. In case of tiny sector the investment limit was raised to Rs.1 lakh; for small scale unit the investment limit was raised from Rs.10 lakh to Rs.20 lakh and for ancillaries from Rs.15 lakh to Rs. 25 lakh.

Industrial policy, 1980 focused attention on the need for promoting competition in the domestic market, technological upgradation and modernization. The policy laid the foundation for an increasingly competitive export based industries and for encouraging foreign investment in high-technology areas.

2.1.2. Major Features of Pre-1991 Industrial Policy

a) **Protection to Indian Industries**: Local industries were given shelter from international competition by introducing partial physical ban on the imports of products and high imports tariffs. Protection from imports encouraged Indian industry to undertake the manufacture of a variety of products. There was a ready market for all these products.
b) **Import-Substitution Policy**: Government used its import policy for the healthy development of local industries. Barring the first few years after Independence, the country was facing a shortage of foreign exchange, and so to save the scarce foreign exchange, imports-substitution policy was initiated i.e. the Government encouraged the production of imported goods indigenously.
c) **Financial Infrastructure**: In order to provide the financial infrastructure necessary for industry, the Government set up a number of development banks. The principal function of a development bank is to provide medium and long-term investments. They have to also play a major role in promoting the growth of enterprise. With this objective, Government established the Industrial Finance Corporation of India (IFCI) (1948), Industrial Credit and Investment Corporation of India (ICICI) (1955), Industrial Development Bank of India (IDBI) (1964), Industrial Reconstruction Corporation of India (1971), Unit Trust of India (UTI) (1963), and the Life Insurance Corporation of India (LIC).
d) **Control over Indian Industries**: Indian industries were highly regulated through legislations such as Industrial licensing, MRTP Act, 1969 etc. These legislations restricted the production, expansion and pricing of output of almost all kinds of industries in the country.
e) **Regulations on Foreign Capital under the Foreign Exchange and Regulation Act (FERA)**: FERA restricted foreign investment in a company to 40 percent. This ensured that the control in companies with foreign collaboration remained in the hands of Indians. The restrictions were also imposed on technical collaborations and repatriations of foreign exchange by foreign investors.

f) **Encouragement to Small Industries**: Government encouraged small-scale industries (SSIs) by providing a number of support measures for its growth. Policy measures addressed the basic requirements of the SSI like credit, marketing, technology, entrepreneurship development, and fiscal, financial and infrastructural support.
g) **Emphasis on Public Sector**: The Government made huge investments in providing infrastructure and basic facilities to industries. This was achieved by establishing public sector enterprises in the key sectors such as power generation, capital goods, heavy machineries, banking, tele- communication, etc.

2.1.3. Assessment of Pre-1991 Industrial Policy

The pre-1991 industrial policies created a climate for rapid industrial growth in the country. It helped to create broad-based infrastructure and basic industries. A diverse industrial structure with self-reliance on a large number of items had been achieved. At the time of independence the consumer goods industry accounted for almost half of the industrial production. In 1991 such industries accounted for only about 20 percent. In contrast capital goods production was less than 4 percent of the total industrial production. In 1991 it had gone up to 24 percent.

Industrial investment took place in a large variety of new industries. Modern management techniques were introduced. An entirely new class of entrepreneurs came up with the support system from the Government, and a large number of new industrial centers were developed in most parts of the country. Over the years, the Government built the infrastructure required by the industry and made massive investments to provide the much-needed facilities of power, communications, roads etc. A good number of institutions were promoted to help entrepreneurship development, provide finance for industry and to facilitate development of a variety of skills required by the industry.

However, the implementation of industrial policy suffered from shortcomings. It is argued that the industrial licensing system promoted inefficiency and resulted in the high-cost economy. Licensing was supposed to ensure creation of capacities according to plan priorities and targets. However, due to considerable discretionary powers vested in the licensing authorities the system tended to promote corruption and rent-seeking. It resulted into pre-emption of entry of new enterprises and adversely affected the competition. The system, opposite to its rationale, favored large enterprises and discriminated against backward regions. The Government announced a number of liberalization measures in the industrial policy of 1970, 1973 and 1980. However, dramatic liberalization efforts were made in the industrial policy, 1991.

2.2. Beginning of Reforms in the 1980s

A central focus of the reforms was the improvement of industrial productivity. Some important features included selective removal of industrial licensing, import liberalization for exports, partial liberalization of trade policies and procedures, and changes in the foreign direct investment (FDI) regime for capital goods. However, the reservation of production for the small-scale sector continued even while it constituted an important hurdle in the way of developing export capability in labour-intensive sectors such as garments, leather products, and sports goods, where India has comparative advantage. Industrial policy in the 1980s also paid little attention to facilitating the restructuring of the industrial sector by removing the numerous barriers to exit.

Trade policies during the 1980s were consciously designed to improve efficiency and promote exports. The driving force for the reform was easier access to imported intermediate inputs to facilitate capacity utilization and modern capital goods for technological upgradation. Export subsidies were provided in order to offset the anti-export bias resulting from the protectionist regime.

The limited domestic deregulation and trade policy reforms were successful in creating conditions in which productivity in the Indian manufacturing sector grew at 27 per cent per annum in the 1980s compared to a growth rate of –0.5 per cent per annum in the earlier two decades. The industrial growth rate also accelerated to over 7 per cent per annum in the 1980s. Exports of manufactured goods grew at about 11 per cent per annum during the decade. A 45 percent depreciation in the real effective exchange rate in the second half of the 1980s was one of the factors responsible for a significant acceleration in the growth of these exports from 45 percent per annum in the first half of the 1980s to 21.7 per cent per annum in the second half.

The sustainability of the better growth and productivity performance of the industrial sector, however, was being put to test by a deteriorating macroeconomic environment, largely on account of the growing fiscal profligacy of the Government of India during the 1980s. The Gulf War of 1990 and the political instability at the turn of the decade further contributed towards a collapse of international confidence in the Indian economy. The result was the balance-of-payments crisis of 1991.

2.3. New Industrial Policy, 1991

India's New Industrial Policy (NIP) announced in July 1991 was radical compared to its earlier industrial policies in terms of objectives and major features. It emphasized on the need to promote further industrial development based on consolidating the gains already made and correct the distortion or weaknesses that might have crept in, and attain international competitiveness. The liberalized Industrial Policy aimed at rapid and substantial economic growth, and integration with the global economy in a harmonized manner.

It stated that 'the government will continue to pursue a sound policy framework encompassing encouragement of entrepreneurship, development of indigenous technology through investment in research and development, bringing in new technology, dismantling of the regulatory system, development of the capital markets, and increased competitiveness for the benefit of common man'.

Distinctive Objectives of New Industrial Policy (NIP), 1991

NIP had two distinctive objectives compared to the earlier industrial policies:

- **Redefinition of the concept of self-reliance**: NIP redefined the concept of economic self-reliance. From 1956 till 1991, India had always emphasized on Import Substitution Industrialization (ISI) strategy to achieve economic-self reliance. Economic self-reliance meant indigenous development of production capabilities and producing indigenously all industrial goods, which the country would demand rather than importing from outside. The goal of economic self-reliance necessitated the promotion of ISI strategy. It helped to build up the vast base of capital goods, intermediate goods and basic goods industries over a period of time. NIP redefined economic self-reliance to mean the ability to pay for imports through foreign exchange earnings through exports and not necessarily depending upon the domestic industries.
- **International competitiveness**: NIP emphasized the need to develop indigenous capabilities in technology and manufacturing to world standards. None of the earlier industrial policies, either explicitly or implicitly, had made reference to international technology and manufacturing capabilities in the context of domestic industrial development. For the first time, NIP explicitly underlined the need for domestic industry to achieve international competitiveness.

To achieve these objectives, among others, NIP initiated changes in India's industrial policy environment, which gained momentum gradually over the decade. The important elements of NIP can be classified as follows:

1. **Public Sector De-Reservation and Privatization through Dis-Investment**:

   Till 1991, Public Sector was assigned a pre-eminent position in Indian Industry to enable it to achieve "commanding heights of the economy" under the Industrial Policy Resolution (IPR), 1956. Accordingly, areas of strategic importance and core sectors were exclusively reserved for public sector enterprises. Public enterprises were accorded preference even in areas where private investments were possible.

   Since 1991, the public sector policy consists of:

   - Reduction in the number of industries reserved for public sector: Now only two industries (atomic energy and railway operations) are reserved for the Public Sector. The essence of government's Public Sector Undertakings (PSUs) policy since 1991 has been that government should not operate any commercial enterprises. The policy emphasized to bring down government equity in all non-strategic PSUs to 26 percent or lower, restructure or revive potentially viable PSUs, close down PSUs which cannot be revived and fully protect the interests of workers. Government's withdrawal from non-core sectors is indicated on considerations of long-term efficient use of capital, growing financial un-viability and the compulsions for these PSUs to operate in an increasingly competitive and market oriented environment.
   - Implementation of Memorandum of Understanding (MOU): As a part of the measures to improve the performance of public enterprises, more and more of public sector units have been brought under the purview of Memorandum of Understanding (MoU) system. A memorandum of understanding is a performance contract, a freely negotiated document between the Government and a specific public enterprise.
   - Referral to BIFR: Many sick public sector units have been referred to the Board for Industrial and Financial Reconstruction (BIFR) for rehabilitation or, where necessary, for winding up.
   - Manpower Rationalization: In order to achieve manpower rationalization, Voluntary Retirement Scheme (VRS) has been introduced in a number of PSUs to shed the surplus manpower.
   - Private Equity Participation: PSUs have been allowed to raise equity finance from the capital market. This has put market pressure on PSUs to improve their performance.
   - Disinvestment and Privatization: Disinvestment and privatization of existing PSUs has been adopted to improve corporate efficiency, financial performance and competition amongst PSUs. It involves transfer of Government holding in PSUs to the private shareholders.

2. **Industrial Delicensing**

   The removal of licensing requirements for industries, domestic as well as foreign, commonly known as "de-licensing of industries" was another important feature of NIP. Till the 1990s, licensing was compulsory for almost every industry, which was not reserved for the public sector. This licensing system was applicable to all industrial enterprises having investment in fixed assets (which include land, buildings, plant & machinery) above a certain limit. With progressive liberalization and deregulation of the economy, industrial licenses, which are regulated under the Industries (Development and Regulation) Act 1951, are required in very few cases.

   With a few exceptions, investors are free to set up a new industrial enterprise, expand an industrial enterprise substantially, change the location of an existing industrial enterprise and manufacture a new product through an already established industrial enterprise. The objective of industrial delicencing is to enable business enterprises to respond to the fast changing external conditions. Entrepreneurs are free to make investment decisions on the basis of their own commercial judgment. This facilitates technological dynamism and international competitiveness. Further industries have the freedom to take advantage of 'economies of scale' as well as 'economies of scope' in the existing industrial policy environment.

3. **Amendment of Monopolies and Restrictive Trade Practices (MRTP) Act, 1969**

An important objective of India's earlier industrial policies was to prevent emergence of private monopolies and concentration of economic power in a few individuals. Accordingly, Monopolies and Restrictive Trade Practices (MRTP) Act, 1969 was enacted and MRTP Commission was set up as a permanent body to periodically review industrial ownership, advice the government to prevent concentration of economic power, investigate monopolistic trade practices and inquire into restrictive trade practices, which are prejudicial to public interest. An MRTP firm was mainly defined in terms of asset size. An MRTP company had to obtain prior approval of the government for setting up a new enterprise as well as for expansion. However, MRTP Act was applicable only to private sector companies.

Since 1991, the MRTP Act has been restructured and pre-entry restrictions have been removed with regard to prior approval of the government for the establishment of a new undertaking, expansion, amalgamation, merger, take over, and appointment of directors of companies. The asset restriction and market share for defining an MRTP firm has been done away with. The MRTP Act is now applicable to both private and public sector enterprises and financial institutions. Today, only restrictive trade practices of companies are monitored and controlled. The MRTP Act has been replaced by the Competition Act, 2002. This law aims at upholding competition in the Indian market. The Competition Commission has been established in 2003, which mainly controls the practices that have an adverse impact on competition.

4. **Liberalized Foreign Investment Policy**

India's earlier industrial policies welcomed FDI but emphasized that ownership and control of all enterprises involving foreign equity should be in Indian hands. The Balance of Payments (BoP) difficulties in the mid-1960s forced the country to adopt a more restrictive approach towards FDI through the setting up of a Foreign Investment Board, which classified industries into two groups: banned and favored for foreign technical collaboration and FDI. The number of industries for foreign investment was steadily narrowed down and by 1973 there were only 19 industries where FDI was permitted. The enactment of FERA, 1973 marked the beginning of the most restrictive phase of India's foreign investment policy. The NIP radically reformed foreign investment policy to attract foreign investment. The important foreign investment policy measures are as follows:

- Repeal of FERA, 1973: FERA, 1973 has been repealed and Foreign Exchange Management Act (FEMA) came into force with effect from June 2000. Investment and returns can be freely repatriated except where the approval is subject to specific conditions such as lock-in period on original investment, dividend cap, foreign exchange neutrality, etc. as specified in the sector specific policies. The condition of 'dividend balancing' was withdrawn for dividends declared. A foreign investor can freely enter, invest and operate industrial enterprises in India. The Foreign Contribution (Regulation) Act, 2010 has been enacted by the Parliament to consolidate the law to regulate the acceptance and utilization of foreign contribution.
- Dilution of restrictions on Foreign Direct Investment (FDI): FDI is allowed in all sectors including the services sector except atomic energy and railway transport.

5. **Foreign Technology Agreement**

   The automatic approvals for technology agreement are allowed to industries within specified parameters. Indian companies are free to negotiate the terms of technology transfer with their foreign counterparts according to their own commercial judgment.

6. **Dilution of protection to Small Scale Industries (SSI) and emphasis on competitiveness**

   SSIs enjoyed a unique status in Indian economy due to its diversified presence across the country and thereby utilizing resources and skills, which would have otherwise remained unutilized. Due to their potential to generate large-scale employment, produce consumer goods of mass consumption, alleviate regional disparities, etc., industrial policies protected the sector for its growth. The principal protective measures for SSI comprised:

   - Demarcating SSI from the rest of industry through a definition under the IDR Act, 1951.
   - Concessional credit from the banking system.
   - Fiscal concessions.
   - Exemption from industrial licensing and labor legislations.
   - Preferential access to scarce raw materials, both domestic and imported.
   - Market support from the government through reservation of products for government purchase and price preferences.
   - Reservation of products for exclusive manufacturing in SSIs and restrictions on the growth of output and capacity in the large-scale sector for products reserved for SSI manufacturing.

   These policy measures protected SSIs from both internal and external competition.

   However, since 1991 the protective emphasis of SSI policy has undergone dilution. In August 1991, government of India brought out an exclusive policy for SSI. The policy marked:

   - the beginning of an end to protective measures to small industry.
   - promotion of competitiveness by addressing the basic concerns of the sector namely technology, finance and marketing.

   Subsequently, the number of items reserved exclusively for small industry manufacturing was gradually brought down. The policy of reserving items had lost its relevance to a large extent because though these products could not be manufactured by large enterprises domestically, they could be imported from abroad due to the removal of quantitative and non-quantitative restrictions on most imports by the year 2001. Concession element in lending rates for small industry was largely withdrawn during the 1990s. The number of products reserved exclusively for purchase from small industry by the government has also been reduced. Measures have been adopted to improve technology and export capabilities of SSIs. Thus, the overall promotion orientation of SSI has shifted from protection towards competitiveness.

2.3.1. Assessment of New Industrial Policy (NIP)

The response to the balance-of-payments crisis was to not only put in place policies for macroeconomic stabilization but seize the opportunity to launch wide-ranging economic reforms to realize the potential of the Indian economy for higher growth. Beginning in 1991, the policymakers attempted to take significant steps towards integrating the economy with the world and improving the macroeconomic environment from the deterioration of the 1980s. The transformation in the policy regime away from extensive control and a strong inward orientation in the decade and a half since 1991 have been attained through incremental/ gradualist changes, occasional reversals, and without any big ideological U-turns. Coalitions of various political parties at the centre and different political parties ruling the states have taken turns in moving the economic reform process forward, albeit in a haphazard manner.

The period from 1991–2 to 1996–7 saw rapid and wide-ranging reforms in industrial and trade policies, tax policies, and other policies impacting on macroeconomic management. There was a distinct slowing down of reforms after 1996–7, partly because of complacency at the favourable response to the early reforms, partly because of confusion resulting from change of government at the centre, and also because by the mid-1990s, the competition had begun to pinch and Indian industry was becoming less supportive of change including external liberalization. In 2001, India regained the momentum of change towards improving the environment for private investment, opening the economy to foreign competition, and infrastructure development. However, macroeconomic management (after an excellent start when the consolidated fiscal deficit of the centre and the states was brought down from 9.6 per cent of GDP in 1990–1 to 7 per cent in 1992–3) has been an area of weakness that could undermine the achievement of sustainable growth at high rates in the future.

The industrial policy reforms during the 1990s were bold in doing away with numerous barriers to entry, for example, removal of industrial licensing for investment, opening up all but a few strategic areas to other than the public sector, and replacing the earlier MRTP Act with a new Competition Law to regulate anti-competitive behaviour. Even on the policy of reservation for the small-scale sector, a beginning was made by dereserving a number of items for manufacturing as well as purchase. However, the microeconomic reforms and judicial reforms which would make the factor markets more flexible and enable individual firms to benefit from the more competitive environment were slow to come by.

Trade policy reforms made a radical break with the past by discontinuing with the complex system of import licensing and making an open commitment to lowering the tariff rates on imports. At the outset, import licensing was dispensed with for most goods other than consumer goods, thereby removing a major source of corruption and inefficiency. In 2001, India finally began to remove the quantitative restrictions on consumer goods and agricultural products over a three-year period.

Import duties were reduced gradually if not always steadily. After a sharp decline from an average of 73 per cent in 1991–2 to around 25 per cent in 1996–7, the import-weighted import duty crept up again to 36 per cent in 2000–1 reflecting a revival of protectionist pressure from established Indian industry, Subsequently there was a reversal of this trend and the government reiterated the objective of reducing India's tariff protection rates to Association of East Asian Nations (ASEAN) levels.

In the 1990s, the FDI rules were liberalized with a view to gaining improved access to technology and world markets and also helping release the resource constraints on investment. Many industries were deregulated and opened to FDI. For others, the Foreign Investment Promotion Board was set up to expedite applications for foreign investment. In addition, the Indian stock market has been opened for investment in equity to foreign institutional investors (FIIs). These policy changes have led to a sharp increase in FDI flows from almost nothing in 1990 to considerable levels at present.

A major challenge of the reforms was how to attract private investment into sectors such as electricity, telecommunications, roads, railways, ports, and airports, in order to meet the enormous investment requirements of upgrading infrastructure. These sectors were opened up to private investment at different times in the subsequent years with varying degrees of success.

Telecommunications is the area where reforms have been most successful, helped by the fact that pricing of telecom services (unlike that of power) was not uneconomic. Access to telecom services has expanded greatly, costs have come down, and quality improved as a handful of strong private-sector telecom service suppliers are competing effectively with the public-sector companies. Private investment has also been attracted in ports and airports. In roads, new investment has been dominantly in the public sector, as is the case in most countries, but there has also been some private-sector involvement, which could increase in future.

With respect to the power sector, the expectations of attracting large investments in generation capacity were belied by continuing financial problems of the distribution segment, which remained unviable for long because of a combination of unrealistically low tariffs for some sections of consumers (households and farmers) and very large inefficiencies in collection. In recent years, attempts have been made to depoliticize the process of fixing power tariffs. The Electricity Act of 2003 lays out a broad legal framework of regulation for the sector and effectively empowers state governments to accelerate power-sector reforms through fostering greater competition, increased involvement of the private sector, and better governance.

Profit-making public-sector units (PSUs) were allowed greater autonomy and larger freedom to raise resources in the capital market, but the relatively less well-performing PSUs languished for want of public funds and political will to restructure, privatize, or close down. A Disinvestment Commission was set up in 1997, but privatization was not seriously put on the policy agenda until 2001. A few public-sector enterprises were privatized with the transfer of management control during 2001–3, the most important being BALCO (Bharat Aluminium Company Ltd), which was sold to a strategic private investor. But resistance surfaced strongly when privatization of two oil companies was attempted. Further brakes were put on privatization by the government which came to power in 2004. However, there has been a renewed focus on disinvestment off late to increase the efficiency of the public sector.

The increased market orientation of policy regime generated a favourable investment response from the private sector up to 1996–7. Indeed, the rate of private fixed investment increased from a low of 12.9 per cent in 1991–2 to 15.9 per cent in 1996–7.

The slowdown in reforms after 1996–7, together with a worsening of the external economic environment after the Asian financial crisis, resulted in slowing down of industrial growth rate. From 12.3 per cent in 1995–6, industrial growth rate dropped to 7.7 per cent in 1996–7 and 3.8 per cent in each of the successive two years. However, the subsequent period has shown industrial revival with improved growth rates. Moreover, the software boom has continued and created a new brand image for India in world markets.

There is substantial evidence to suggest that Indian industry has been restructuring and reducing costs in a slow but steady manner since the mid-1990s. The pace of adjustment and adaptation has been slow in some of the important traditional industries, for example, textiles and garments which are facing new challenges of the competitive world market scenario after the end of the Multifibre arrangement (MFA) in January 2005. On the other hand, pharmaceuticals and automotive components are examples of manufacturing industries that have successfully turned around and developed a global vision to penetrate world markets.

The Indian pharmaceutical industry, while making inroads into the fast-growing generics market worldwide, is also positioning itself under the new Intellectual Property Rights (IPR) regime through increased research and development (R&D) expenditures and strategic alliances to move up the value chain. With a more liberal foreign investment policy, multinational corporations and international generics companies have also been attracted to restructure their operations and increase their stakes in existing ventures in India and set up new ventures.

The post-reform era has also spurred the development of the biotechnology industry which is driven by new enterprise and new innovation. Skilled human resources, active government support, and increased investment–public as well as private–promises sustained growth of this industry with global orientation. India is emerging as the most favoured destination for collaborative R&D, bioinformatics, contract research and manufacturing, and clinical research as a result of growing compliance with internationally harmonized standards. Several states have taken steps to develop bio-clusters based on academic and entrepreneurial strengths.

3. Initiatives Taken by the Government for Industrial Development

3.1. Disinvestment

Owing to several shortcomings, the functioning of the public sector has often been questioned. It has been argued that the public sector works well only when it is protected by state measures. Some also argued that the public sector had entered in too many areas and, therefore, it must withdraw itself by giving entry to private players. Thus, privatization of some PSUs was advocated and disinvestment was the process through which this privatization could take place.

Various reasons given for the disinvestment were as follows:

- It will release a large amount of public resources locked up in non-strategic PSUs. Then these resources can be redeployed in areas that are much higher on social priority such as health, education, etc.
- Reduction in the public debt.
- Transferring the commercial risk to private sector where it is willing to share it.
- Releasing manpower and other intangible resources for redeployment in high priority social sectors.
- Enabling public having ownership or say in management of some PSUs.

But, the critics questioned the way in which disinvestment happened. Private sector took part in the disinvestment of only profit making PSUS. They totally neglected the loss making PSUs. Thus, the aim of sharing risk with the private sector was diluted.

The critics also questioned the disinvestment of profit making PSUs. But, the government used disinvestment as a tool to reduce fiscal deficit. In other words, to cover its inefficiency in the economic management of the country the government lost a profit making and revenue generating entity.

Proceeds of Disinvestment

The proceeds of disinvestment go into National Investment Fund (NIF), which was setup in 2005. The purpose of the fund was to receive disinvestment proceeds of central public sector enterprises and to invest the same to generate earnings without depleting the corpus. The earnings of the Fund were to be used for selected Central Social Welfare Schemes. This fund was kept outside the Consolidated Fund of India.

In 2013, NIF was restructured and it was decided that the entire disinvestment proceeds will be credited to the existing 'Public Account' under the head NIF and they would remain there until withdrawn/invested for the approved purpose. The allocations out of the NIF will be decided in the annual Government Budget.

Proceeds from NIF are utilized for following purposes:

- Subscribing to the shares being issued by the CPSE including PSBs and Public Sector Insurance Companies, on rights basis so as to ensure that 51% ownership of the Government in those CPSEs/PSBs/Insurance Companies, is not diluted.
- Preferential allotment of shares of the CPSE to promoters as per SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 so that Government shareholding does not go

down below 51% in all cases where the CPSE is going to raise fresh equity to meet its Capex programme.
- Recapitalization of public sector banks and public sector insurance companies.
- Investment by Government in RRBs/IIFCL/NABARD/Exim Bank.
- Equity infusion in various Metro projects.
- Investment in Bhartiya Nabhikiya Vidyut Nigam Limited and Uranium Corporation of India Ltd.
- Investment in Indian Railways towards capital expenditure.

There are various ways for disinvestment like Strategic Sales, warehousing, buy-back equity, private placement and other instruments of capital market etc.

Recent changes in management of Disinvestment Proceeds

The Department of Disinvestment was set up as a separate Department in 1999 and since 2004 it has been made as one of the Departments under the Ministry of Finance. The Department of Disinvestment was renamed as Department of Investment and Public Asset Management (DIPAM) in the 2016-2017 Budget and was assigned the following functions:
- It was responsible for all matters relating to management of Central Government investments in equity including disinvestment of equity in Central Public Sector Undertakings.
- All matters relating to sale of Central Government equity through offer for sale or private placement or any other mode in the erstwhile Central Public Sector Undertakings.
- Decisions on the recommendations of Administrative Ministries, NITI Aayog, etc. for disinvestment including strategic disinvestment.
- Decisions in matters relating to Central Public Sector Undertakings for purposes of Government investment in equity like capital restructuring, bonus, dividends, disinvestment of government equity and other related issues.
- Advise the Government in matters of financial restructuring of the Central Public Sector Enterprises and for attracting investment in the said Enterprises through capital market.

However, to streamline the disinvestment process, in January 2017, the government transferred the role of advising the government on how to utilize the proceeds from disinvestment from the Department of Investment and Public Asset Management (DIPAM) to the Department of Economic Affairs. The Department of Economic Affairs in the Finance Ministry will now be in charge of "financial policy in regard to the utilisation of the proceeds of disinvestment channelized into the National Investment Fund."

3.2. Ease of Doing Business in India

- The Ease of Doing Business (EoDB) is an index created by the World Bank.
- It presents quantitative indicators on business regulations and the protection of property rights based on 10 parameters that can be compared across 190 economies.
- Higher rankings indicate better, usually simpler, regulations for businesses and stronger protections of property rights.

India's rank in Doing Business Report, 2018 jumped to 100th in comparision to 130th rank in Doing Business Report, 2017.

Steps taken by India to improve its EODB Index ranking on the 10 parameters:
- **Speeding up process**: such as company's registration within 1-2 working days, issuing of PAN in a day, providing electricity connections in 15 days with online application etc.
- **Digitisation**: It makes various processes easier for businesses and their employees such as digitization of property records and land records, ShramSuvidha Portal for filling returns for ESIC and EPFO etc.

- **Facilitating trade across borders**: through 'Indian Customs Single Window Project' as well as reducing the number of mandatory documents required by customs.
- **Enacting or amending laws & rules**: such as Enactment of the Commercial Courts, Commercial Division and Commercial Appellate Division of High Courts Act, 2015,the Insolvency and Bankruptcy Code, 2016 for speeding the exit procedure etc.
- **Protecting minority investors** through the Companies (Amendment) Act, 2015.

Though India has performed well on parameters like getting electricity, getting credit and protecting minority investors, on some other parameters like construction permits, resolving insolvency, paying taxes, enforcing contracts etc. it has performed poorly. However, the government has plotted an eight-point strategy and firmed up a 295-point reform agenda for states to improve India's ranking.

3.3. E- Biz Project

- E-Biz is one of the integrated services projects and a part of the 27 Mission Mode Projects (MMPs) under the National E-Governance Plan (NEGP) of the Government of India.
- The focus of E-Biz is to improve the business environment in the country by enabling fast and efficient access to Government-to-Business (G2B) services through an online portal. This will help in reducing unnecessary delays in various regulatory processes required to start and run businesses.
- This project aims at creating an investor-friendly business environment in India by making all regulatory information – starting from the establishment of a business, through its ongoing operations, and even its possible closure - easily available to the various stakeholders concerned. In effect, it aims to develop a transparent, efficient and convenient interface, through which the government and businesses can interact in a timely and cost effective manner, in the future.
- The eBiz portal was conceptualized with support from National Institute of Smart Governance (NISG) and developed by Infosys Technologies Limited (Infosys) in a Public Private Partnership (PPP) model for a period of 10 years.

3.4. Make in India Initiative

With the objective of making India a global hub of manufacturing, design and innovation, the Make in India initiative, which is based on four pillars --new processes, new infrastructure, new sectors and new mindset-- has been taken by the government. The initiative is set to boost entrepreneurship, not only in manufacturing but in relevant infrastructure and service sectors as well.

An interactive portal http://makeinindia.com for dissemination of information and interaction with investors has been created with the objective of generating awareness about the investment opportunities and prospects of the country, to promote India as a preferred investment destination in markets overseas and to increase Indian share of global FDI. In addition, information on 25 thrust sectors, along with details of the FDI Policy, National Manufacturing Policy, Intellectual Property Rights and the proposed National Industrial Corridors including the Delhi Mumbai Industrial Corridor (DMIC), are available on the portal.

The Department of Industrial Policy and Promotion (DIPP), in consultation with various central ministries, state governments, industry leaders, and other stakeholders, has formulated a strategy for increasing the contribution of the manufacturing sector to 25 per cent of the GDP by 2020.

The Government of India has set up "Invest India" as the national investment promotion and facilitation agency. With the objective of promoting investment in the country, a full-fledged Investment Facilitation Cell has been set-up under the Make in India initiative, primarily to support all investment queries as well as to handhold and liaise with various agencies on behalf of potential investors.

3.5. National Manufacturing Policy, 2011

Rationale

- Inadequate physical infrastructure, complex regulatory environment and inadequate availability of skilled manpower have constrained the growth of manufacturing in India.
- The share of manufacturing in India's GDP has stagnated at 15-16% since 1980s which needs to be increased for increasing efficiency, productivity leading to accelerated development of the people.
- Manufacturing sector will have multiplier effect on the creation of jobs in other sectors too.
- In other Asian countries the share of manufacturing sector in the GDP is around 25-34%. This shows that we have not been fully able to leverage the opportunities provided by the globalization.
- India has favourable demographic dividend with 60% of people in the age group 15-59 years. Therefore, it becomes necessary to provide gainful employment opportunities with this section of people with varying skills.
- India has many agricultural and natural resources but the amount of value addition is very less. Growth of manufacturing sector will address this problem of value addition and reduce our dependence on imports of capital equipment.
- We also need depth in manufacturing from the point of competitiveness in strategic areas of economy such as defence and telecommunications.

Features of the Policy

- It aimed to increase manufacturing sector growth to 12-14% over the medium term to make it the engine of growth for the economy and to enable manufacturing sector to contribute at least 25% of the National GDP by 2022.
- Increase the rate of job creation in manufacturing to create 100 million additional jobs by 2022.
- Creation of appropriate skill sets among the rural migrant and urban poor to make growth inclusive.
- Increase domestic value addition and technological depth in manufacturing.
- Enhance global competitiveness of Indian manufacturing through appropriate policy support.
- Ensure sustainability of growth, particularly with regard to the environment including energy efficiency, optimal utilization of natural resources & restoration of damaged/ degraded eco-systems.

Ways to achieve this

- Foreign investments and technologies will be welcomed while leveraging the country's expanding market for manufactured goods.
- Competitiveness of enterprises in the country will be the guiding principle in the design and implementation of policies and programmes.
- Compliance burden on industry arising out of procedural and regulatory formalities will be reduced through rationalization of business regulations.
- The NMP provides for promotion of clusters and aggregation, especially through the creation of national investment and manufacturing zones (NIMZs).

Recently, the government announced that NMP is being modified to align it with initiatives like 'Make in India' and also Industrial Revolution 4.0, which refers to high end automation.

3.6. Delhi-Mumbai Industrial Corridor (DMIC)

- Delhi-Mumbai Industrial Corridor is a mega infra-structure project with financial & technical aids from Japan. It covers an overall length of 1483 km between Delhi and Mumbai.
- It will pass through six states - U.P, NCR of Delhi, Haryana, Rajasthan, Gujarat and Maharashtra, with end terminals at Dadri in the National Capital Region of Delhi and Jawaharlal Nehru Port near Mumbai.
- This Dedicated Freight Corridor envisages a high-speed connectivity for High Axle Load Wagons (25 Tonne) of Double Stacked Container Trains supported by high power locomotives. The Delhi-Mumbai leg of the Golden Quadrilateral National Highway also runs almost parallel to the Freight Corridor.
- This corridor will be equipped with an array of infrastructure facilities such as power facilities, rail connectivity to ports en route etc.

3.7. Steps Taken for Promotion and Development of MSMEs

Realizing the importance of the MSME sector, the government has undertaken a number of schemes/programmes like the Prime Minister's Employment Generation Programme (PMEGP), Credit Guarantee Trust Fund for Micro and Small Enterprises (CGTMSE), Credit Linked Capital Subsidy Scheme (CLCSS) for Technology Upgradation, Scheme of Fund for Regeneration of Traditional Industries (SFURTI), and Micro and Small Enterprises Cluster Development Programme (MSECDP) for the establishment of new enterprises and development of existing ones. Some of the new initiatives undertaken by the government for the promotion and development of MSMEs, are as follows:

- **Udyog Aadhar Memorandum (UAM)**: The UAM scheme (2015) is a pathbreaking step to promote ease of doing business for MSMEs. Under the scheme, MSME entrepreneurs just need to file an online entrepreneurs' memorandum to instantly get a unique Udyog Aadhaar Number (UAN).
- **Employment Exchange for Industries**: To facilitate match-making between prospective job seekers and employers an employment exchange for industries was launched in June 2015 in line with Digital India.
- **Framework for Revival and Rehabilitation of MSMEs**: Under this framework, banks have to constitute a Committee for Distressed MSME enterprises at zonal or district level to prepare a Corrective Action Plan (CAP) for these units.
- **A scheme for Promoting Innovation and Rural Entrepreneurs (ASPIRE):** ASPIRE was launched with the objective of setting up a network of technology centres and incubation centres to accelerate entrepreneurship and promote start-ups for innovation and entrepreneurship in rural and agricultural industry
- **The India Aspiration Fund** has also been set up under the Small Industries Development Bank of India (SIDBI) for venture capital financing of newly set-up or expanding units in the MSME sector.
- **SIDBI Make in India Loan for Small Enterprises (SMILE)** has been launched to offer quasi-equity and term-based short-term loans to Indian SMEs with less stringent rules and regulations and a special focus on 25 thrust sectors of Make in India.
- **Micro Units Development Refinance Agency (MUDRA) Bank** has been set up to provide development and refinance to commercial banks/ NBFCs/cooperative banks for loans given to micro-units. MUDRA Bank would follow a credit-plus approach while also providing financial literacy and addressing skill gaps, information gaps, etc.
- **Startup India campaign** is based on an action plan aimed at promoting bank financing for start-up ventures to boost entrepreneurship and encourage start ups with jobs creation, with focus on MSME sector.

4. Previous Years Vision IAS GS Mains Questions

1. ***Indian manufacturing is lagging in the face of stiff competition from other developing economies in Asia and elsewhere, both in domestic as well as global markets. What are the main reasons that can be attributed for this scenario? Suggest few remedies for the same.***

Approach:

- The question deals with shortcomings in the Indian manufacturing sector. The limitations and efforts undertaken to overcome those limitations should be discussed. Reference to the past efforts by government and relevant policies may be mentioned.

Answer:

- The principal question which remains unanswered is that why the speeding up of reforms after 1991 did not yield faster outputs, employment and labour intensive growth in the Indian manufacturing sector. Many experts say that the reforms have remained incomplete, with the persistence of the labour market rigidities (lack of entrepreneurial freedom to hire and fire workers at will), infrastructure bottlenecks and incomplete financial integration, including full convertibility of the currency.
- A prime reason attributed to such a scenario is that India had followed idiosyncratic policies of promoting skill intensive industries, discouraging labour intensive manufacturers- a pattern that has not changed after the reforms due to labour market rigidities. Also the average Indian firms tend to be smaller as workers cannot be fired, preventing them from reaping the advantages of the economies of scale production. Also, there need to be steps to provide more flexibility to employers to adjust employment levels along with more fairness and security to employees.
- Infrastructural bottlenecks are also throttling the industrial progress which is often blamed on lack of resources, enormous cost and time overruns in project completion and poor public management in general. Attributing these problems to public ownership, the reforms have encouraged entry of private and foreign capital in these industries. Besides, *the cost of doing business* is much higher in India than in other countries due to the plethora of forms and inspections that manufacturers have to comply with, some of them arising out of legislations long pending review, such as the Factories Act. The streamlining of these requires action by government agencies in the state and in the centre.
- Besides, the government had released its new *National Manufacturing Policy* with an aim to increase the sectoral share of manufacturing in GDP to at least 25% by 2022; to increase the rate of job creation so as to create 100 million additional jobs by 2022; and to enhance global competitiveness, domestic value addition, technological depth and environmental sustainability of growth. The policy envisages specific interventions broadly in the areas of industrial infrastructure development through the creation of National Investment and Manufacturing Zones (NIMZs); improvement of the business environment through rationalization and simplification of business regulations; development of appropriate technologies especially green technologies for sustainable development and skill development of the younger population.

2. ***"There is a myth that small firms create the most jobs in an economy. The fact is that small firms that grow big create the jobs". In context of the Indian economy what are the factors that prevent firms that start small from growing bigger. What progress has India made in this respect and what other measures are required?***

Approach:

- The answer is centered on the employment potential of small firms and the problems faced by them. Therefore, the answer should start with elaboration of the given statement.
- The next part should discuss some problems being faced by those firms.
- Finally, the answer should discuss some measures taken by the government to improve the situation.

Answer:

MSME sector employs close to 40 percent of India's workforce plays a critical role in generating millions of jobs, especially at the low-skill level. According to NSSO, there are about 57.7 million non-corporate business units outside construction sector, mostly unregistered and self-employment units. However, SMEs in India, due to their low scale and poor adoption of technology, have very poor productivity. The total employment in MSME sector is about 80.5 million (4^{th} All India Census for Small Scale Industry), which averages to less than 2 people per firm.

Although they employ 40% of India's workforce, they contribute less than that (~35%) to the GDP. Too many firms stay small, unregistered and un-incorporated in the unorganised sector so that they can avoid taxes and regulations. These firms need to expand, grow and innovate in order to continue to scale up and hire more people to run their operations.

In a journey from a small firm towards a big one, it may face following roadblocks:

- **Finance:** with most of the 57.7 million units unregistered, banks, perhaps rightly, do not finance them. Lack of institutional credit means exploitation by usurious moneylenders.
- **Regulations:** Compliance cost- money, time and labour rise drastically once a firm graduates from M to S to Medium and large. As such, about 90% of MSMEs are Micro only and remain so.
- **Marketing and Branding:** Generally, small firms have good business idea but lack marketing and branding strategy to evolve themselves as a big firm.
- **Access to technology** – partly because of limited finance and partly due to inertia. This hampers productivity and renders the enterprise uncompetitive..
- **Strict Labor Laws & Lack of skilled workforce:** Firms deliberately remain small because as they grow they come under strict labour laws.
- **Tax incentives:** SMEs have tax concessions, therefore to continue to enjoy those benefits, they remain small.

However, these problems can be overcome through the following measures:

- **Finance:** We need banks that specifically cater the needs of the small firms- Recently launched Payments Banks, MUDRA Bank, and Small Finance Banks.
- **Regulations:** Self-certification to some compliances and single online portal for registration, clearances and approvals as envisaged in different programs (like Start Up India).
- **Collaboration Hub:** Setting up a hub like Start Up India hub for collaboration of governments, consultants, R&D institutions etc. that would assist small firms to

adopt best practices through exchange of ideas can be a way for adoption of better technology.
- **Incentives:** Innovation awards as provisioned in Atal Innovation Mission should be provided to prompt small firms to spend on R&D and hence become more competitive.
- **Focus on manufacturing:** The recently launched Make in India program is another move by the government to promote manufacturing, with a focus on SME sector.
- **Skill development:** Since majority of people employed in this segment is unskilled or semi-skilled, therefore skilling programs can be important game changer. In this regard, the government has launched the Skill India Mission.
- **Dedicated e-commerce porta**l with the help of National Small Scale Corporation has been launched to provide wider market coverage.

Apart from these already launched, or proposed measures, there is a need to bring in much awaited tax reforms for streamlining the tax structure. SMEs is really the backbone of our economy, a very strong tool for poverty alleviation, and empowerment of marginalized segment, therefore there is an urgent need to bring in reforms to this sector.

3. While India has made great strides in removing the barriers to the entry of firms, talent and technology, less progress has been made in relation to exit. In this context, discuss the causes of and costs associated with impeded exit in India.

Approach:

- First, briefly explain the statement.
- Then bring out the causes that impede exit in India.
- Also discuss the costs associated with impeded exit.

Answer:

A market economy requires unrestricted entry of new firms, new ideas, and new technologies so that the forces of competition can guide capital and labour resources to their most productive and dynamic uses. But it also requires exit so that resources are forced or enticed away from inefficient and unsustainable uses. Over the course of six decades, the Indian economy has moved from 'socialism with limited entry to "marketism" without exit'.

Since the early 1980s, the Indian economy has made remarkable progress in increasing entry: industrial licensing has been dismantled, public sector monopolies have been diluted, some public sector assets have been privatised, foreign direct investment has been considerably liberalised and trade barriers have been reduced. However, there has been less progress in relation to exit and impeded exit has been resulting in substantial fiscal, economic and political costs.

Associated costs

- **Fiscal costs**: Exit is impeded often through government support of incumbent, mostly inefficient, firms. This support – in the form of explicit subsidies (for example, bailouts) or implicit ones (tariffs, loans from state banks) – represents a fiscal cost to the economy.
- **Economic costs**: Economic losses result from resources and factors of production not being employed in their most productive uses. In a capital scarce country such as India, misallocation of resources can have significant costs. Another cost, in the current context, stems from the overhang of stressed assets on corporate and bank

balance sheets. The consequence is a reduced flow of new investment, dampening medium term growth.

- **Political costs**: The lack of exit can have considerable political costs for governments attempting to reform the economy. The benefits of impeded exit often flow to the rich and influential in the form of support for "sick" firms. This can give the impression that governments favour large corporates, which politically limits the ability to undertake measures that will benefit the economy but might be seen as further benefitting business.

In India, the exit problem arises because of three types of reasons, what might be called the three I's: interests, institutions, and ideas/ideology.

Causes of impeded exit in India:

- **Interests**: The first, most obvious, and perhaps most powerful reason for lack of exit is the power of vested interests. Often, this vested interest problem is aggravated by a certain imbalance or asymmetry that confers greater power on concentrated producer interests in relation to diffused consumer interests. An example of interest groups blocking reforms is the introduction of JAM for MGNREGA. In case of administrative schemes, vested interests often create a market of their own, planning their actions to benefit from it. Thus, schemes may become an instrument of granting favours.
- **Institutions**: Another reason for impeded exit is institutions – both weak and strong institutions. Examples of weak institutions are legal procedures that increase the costs – time and financial costs – of exit. One example is the debt recovery tribunals (DRTs). On the other hand, strong investigative agencies are responsible for the tendency of risk-aversion in decision makers, perpetuating status quo and impeding exit. **Ideas/ ideology**: A third reason for impeded exit relates to ideas/ideology. In a democratic country like India with sizable poverty and inequality, it is very difficult to phase out entitlements/incentives.

To address the exit problem, the government must allow inefficient firms to exit through its direct policies and transparent actions. Recent initiatives like Bankruptcy Code, rehabilitation of stalled projects, changes in Prevention of Corruption Act etc. are steps in the right direction.

4. What is the significance of start-ups for Indian economy? Critically analyse the provisions of "Start-up India" program and the challenges that lie ahead in its effective implementation.

Approach:

- Discuss the significance of start-ups.
- Critically analyse the provisions of Start-up India program.
- Mention the challenges that lie in its implementation.

Answer:

The significance of start-ups for Indian economy is manifold:

- *India needs 10 million jobs a year and Start-ups being the centers of innovation will enhance employment creation in economy when the manufacturing sector is down.*
- *With more start-ups India can aspire to be world leader in skilled labour more than an outsourcing destination.*
- *They will enable India to reap its demography dividend.*

- *They encourage competition in the market.*
- *They induce backward and forward linkages stimulating multi-sectoral development.*
- *They lead to formalisation of the work force.*
- *They have the potential to create demand within the country, which may last longer given the global economic prospects.*
- *They can provide a boost to the "Make in India" and other initiatives of the government.*
- *They have the potential to bring social change in the society by empowering the weaker sections.*

*The provision of **Start-up** policy are as follows:*

- **Self certification** with regard to labour and environment laws. However, this must be done for all businesses and not just start-ups to improve ease of doing business.
- **Startup India Hub** single point of contact for the startup community.
- **Mobile app and portal** will allow startups to register in one-day.
- **Legal support and fast-tracking patent applications:** Startups entitled to 80 percent rebate in filing patents. However, corruption makes this difficult and IPR procedure must be made transparent, not just for startups but for everyone. The cost of filing an IPR has been kept very low for them, which is a welcome step.
- **Faster Exit:** To make it easier for startups to wind up operations in 90 days thus preventing stuck of funds.
- **Tax exemption from capital gains** but higher risk involved make this step nominal.
- **Income tax** exemption for a period of three years. But most start-ups become profitable only after 3-5 years.
- **Fund of Funds** of Rs 10,000 crore will support startups but, this is very small amount
- **Credit Guarantee Fund to** catalyse entrepreneurship by providing credit to innovators.
- **Relaxed procurement norms** especially in the manufacturing sector. But the nexus that exists in government procurement needs to be broken.
- **Setting up of incubators and research parks** across different educational institutes which must treat everyone equally, should not give preference to their alumni.

However, to make this policy successful the government needs to focus on the following:

- Creating infrastructure across the country like connectivity through roads, rails, electricity.
- Technology must be deployed at every level for reducing corruption and faster service delivery.
- Reduce red-tape from the administration.
- Streamlining of labour laws and wage payment issues.

5. Highlight the reasons for the importance attached to the MSME sector. In this context, enumerating the government schemes to promote this sector explain the role that the MSME sector can play in the success of the Make in India initiative.

Approach:

- Attribute the importance of MSME to its share in production, exports and employment creation etc.
- Explain how MSME sector complements "Make in India" and how the various Government schemes promote the development of MSME.

Answer:

Importance of MSME in India

MSME sector in India employs 8.05 crore people, contributes 37.5% to India's GDP, 45% to the total manufacturing output and 40% to exports from country. The sector has huge potential to address problems like unemployment, regional imbalances, unequal distribution of income and wealth across the country.

MSME related schemes and impact on Make in India:

MSMEs are complementary to large industries as ancillary units and possess forward-backward linkages with other sectors (many of which are priority sectors under Make in India). A robust growth of this sector will therefore be crucial to the Make in India initiative. However the sector is mired by inadequate finance (especially in rural areas), low level of technology, low productivity and competitiveness etc. Improvement on these indicators will invariably give a boost to "Make in India".

Various initiatives by the government aim to address the same are listed below:

- **Providing more credit to MSME sector, especially in the rural areas**
  - **MUDRA:** credit linked scheme to facilitate participation of financial institutions for higher credit flow to micro sector.
  - **Prime Minister's Employment Generation Programme (PMEGP)** - credit flow scheme
  - ***Credit Guarantee Trust Fund for Micro and Small Enterprises (CGTMSE)*** – provision of collateral free loans
- **Promoting entrepreneurship**
  - **Employment Exchange for Industries:** To facilitate link between job seekers and employers.
  - **Micro and Small Enterprises Cluster Development Programme (MSECDP)** for establishment of new enterprises and development of existing ones.
  - **A scheme for Promoting Innovation and Rural Entrepreneurs (ASPIRE)**: setting up a network of technology centers and incubation
  - **Start-up India:** To promote entrepreneurship
- **Quality upgradation for world class competitiveness and leveraging technology**
  - **Credit Linked Capital Subsidy Scheme (CLCSS) for Technology Upgradation**-technology Upgradation of MSME.
- **Ensuring Ease of Doing Business**
  - **Udyog Aadhar Memorandum (UAM):** online entrepreneurs' memorandum to instantly get a unique Udyog Aadhaar Number (UAN) and get registered to avail various government benefits.
  - **Framework for Revival and Rehabilitation of MSME**-banks to constitute a Committee for Distressed MSME enterprises to prepare a Corrective Action Plan (CAP).

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  - **Bankruptcy Code** for easy exit.
  - **Reform in labor laws.**
- **Increasing Productivity, enhancing competitiveness and skill development**
  - **Scheme of Fund for Regeneration of Traditional Industries (SFURTI)** - to organize the traditional industries and artisans into clusters to make them competitive and sustainable.
  - **PMKVY**: Giving industry linked skills to youth

The success of Make in India invariably depends on the growth of MSME sector in the country. The government has taken commendable steps, but it should focus on their effective implementation so that they can bear fruit and Make in India achieves its potential.

6. Successive governments have resorted to disinvestment of sick and loss-making PSUs. What, according to you, are the targets which the government seek to meet from this exercise? Also explain why the disinvestment targets have not been met in the past.

Approach:

- Explain the reasons why disinvestment is required and what are its objectives.
- Explain why the disinvestment targets have not been met .
- End with positive note like how to overcome this kind of crisis.

Answer:

Often protected from competition and subsidized by government, PSUs frequently suffer from low productivity, higher costs, inefficiency and non-competitiveness. To address these challenges government resorted to disinvestment with following objectives:

- Reduce financial burden on Government
- Improve public finances
- Introduce, competition and market discipline
- Create Fund for infrastructure growth (NIF)
- Encourage wider share of ownership
- Depoliticise non-essential services
- Up gradation of existing PSUs.

Initially only sick PSUs were to be disinvested but later others were also included but with a cap of 49% so that government remains majority stakeholder. As per Department of Disinvestment it was decided that 20 per cent of equity of PSUs will be disinvested incrementally and they will be sold to financial institutions, banks and employees etc.

However, the disinvestments did not succeed as expected because:

- People were not taken into confidence before disinvestment was started; therefore whole move was opposed by certain group of people and parties in opposition.
- 2006 CAG report found that the valuation of the companies' assets was done without "due seriousness". In several instances substantial "surplus land" was sold along with the company when they were privatised.
- The unfavourable market conditions were mainly responsible for this downward trend of disinvestment hence the receipt generated was sub-optimal.
- The amount realized through disinvestment was not paid to the enterprise concerned for its expansion and improving efficiency but the Government has been using such disinvestment proceeds to bridge the budget deficit.

- The Government was not transparent about its approach towards sequencing the restructuring and methods of disinvestment of PE‟s.
- The offers made by the Government for disinvestment of PE‟s were not attractive and stringent bureaucratic procedures discourage the private sector interest.
- The Government had no clear cut policy on disinvestment of its PE‟s when the disinvestment process was started.
- Lack of consultation with the specialists.

In 2012, a government panel headed by Vijay Kelkar recommended monetizing surplus government land, which represents a huge opportunity cost, from port trusts, railways and PSUs as the ideal solution to India's urban problems in cities that are land-starved—allowing for civic infrastructure such as hospitals, schools and roads —besides the obvious benefits of unlocking huge revenue and betterment of the fiscal consolidation situation.

Recently government has transferred advising role of DIPAM on utilization of proceeds from disinvestment to Department of Economic Affairs (DEA). It has approved an alternative mechanism to decide modalities related to stake sales in PSUs, so as to speed up and streamline the process. Under this mechanism, the quantum of disinvestment in a PSU will be decided on a case-by-case basis subject to Government retaining 51% stake.

5. Previous Years UPSC Mains Questions

1. "Success of 'Make in India' programme depends on the success of 'Skill India' programme and radical labour reforms." Discuss with logical arguments.
2. Justify the need for FDI for the development of the Indian economy. Why there is gap between MOUs signed and actual FDIs? Suggest remedial steps to be taken for increasing actual FDIs in India.
3. There is a clear acknowledgement that Special Economic Zones (SEZs) are a tool of industrial development, manufacturing and exports. Recognizing this potential, the whole instrumentality of SEZs requires augmentation. Discuss the issues plaguing the success of SEZs with respect to taxation, governing laws and administration.
4. "Industrial growth rate has lagged behind in the overall growth of Gross-Domestic-Product (GDP) in the post-reform period" Give reasons. How far the recent changes in Industrial Policy are capable of increasing the industrial growth rate?
5. How globalization has led to the reduction of employment in the formal sector of the Indian economy? Is increased informalization detrimental to the development of the country?
6. Normally countries shift from agriculture to industry and then later to services, but India shifted directly from agriculture to services. What are the reasons for the huge growth of services vis-a-vis industry in the country? Can India become a developed country without a strong industrial base?

LAND REFORMS IN INDIA

Contents

1. Introduction

The genesis of the structure of power and authority in rural India can be traced to land. There is an ever-changing relationship between land, power and people. The shifting nexus between the rural elite and agrarian power structure centres around issues relating to land, which is one of the primary sources of existence in as much that land provides basic necessities like food, clothing and shelter to man.

The value of land is ever increasing and requires little renewal and replacement. Due to this basic utility, economists tend to treat land as a special kind of property. In a narrow sense, land reform means the distribution of surplus land to small farmers and landless tillers, accrued as a result of the implementation of the ceiling on agricultural holdings. More broadly, it includes regulation of ownership, operation, leasing, sales, and inheritance of land (indeed, the redistribution of land itself requires legal changes).

Land reforms have been major instruments of social transformation, especially in an economy based on feudal and semi-feudal production relationships. The main objective of land reform programme is not only to increase agricultural production, but also to build an egalitarian social order as contemplated under the Constitution of India. Thus, land and land reform issues are the focal point of the political and economic agenda of the country. This also lays a sound foundation for variable growth, to enable India to compete in the global market. A land reform policy is fundamentally a politico-economic issue and in most cases it is the result of a peoples' movement.

2. Need for Land Reforms in India

In India, the need for land reform can be traced to peasants' aspirations to own the land they cultivate, obtain tenancy rights thereupon, or seek rationalisation and reduction in rent. Land reform generally reflects public policy of land redistribution for the benefit of the landless, the tenants and the small farmers. It aims at diffusion of wealth, increase in income and productive capacity. There is a shortage of land and uneven distribution of ownership. Agriculture in India is small peasant based and as such land reforms assume greater importance, not only in the context of social justice and equitable distribution, but also from the point of view of production and agricultural trade. Not surprisingly, it received top priority on the policy agenda at the time of Independence.

Moreover, land reform policy has economic, social and political dimensions. The economic dimension of land reforms involved the ownership of land by a small group that did not actually cultivate but exploited the actual tillers who were the tenants and agricultural labourers. On the other hand, because of inadequacy of returns and absence of surplus with the tenants, they could not undertake improvements on land. The landlords, having no personal interest in the lands they owned, did not take interest in investing on land improvement. As a result, land productivity went on declining. This explained the dynamics of underdeveloped agriculture.

As far as the sociological dimension is concerned, traditionally, the upper castes owned land and the lower castes were the tenants/agricultural labourers. Even today, we do not find the lower castes owning land in any significant measure and the upper castes working as tenants/agricultural labourers in India. This social dimension perpetuated the social inequalities. It is here that the economic inequality created under the economic dimension got reinforced by the social inequality in agrarian relations.

Coming to the political dimension, it may be noted that, historically, the owners of land have been supporters of the governments in power. This was much more evident during British rule in India. Because of the numerical minority position of the former zamindars and the later landlords and their economic stranglehold over the tenants, they depended on the government for their protection, (thus promoting their own self-interest). At the same time, the government depended upon them for its own survival so long as tenants, though large in number, did not organise themselves against the exploitative political and social systems. This has been the experience of almost all countries that faced agrarian problems.

3. Objectives of Land Reforms in India

The important objectives of land reform measures in India were:

a) To enhance the productivity of land by improving the economic conditions of farmers and tenants so that they may have the interest to invest in and improve agriculture.
b) To ensure distributive justice and to create an egalitarian society by eliminating all forms of exploitation.
c) To create a system of peasant proprietorship with the motto of land to the tiller.
d) To transfer the incomes of the few to many so that the demand for consumer goods would be created.

4. Historical Background

During the ancient as well as medieval period, the principal unit of land settlement in India was the village. Land was never considered to be the property of the King or the Sultan; it was the property of the village, the entitlement of the King being limited to a share of usufruct for the protection he gave in return. Since land revenue was the main source of state revenue, the village became the agency for collection and unit of revenue assessment.

At the time of independence, there were three types of land tenure system prevailing in the country - the zamindari system, the mahalwari system, and ryotwari system. The basic difference in these systems was regarding the mode of payment of land revenue. In zamindari system, land revenue was collected from the farmers by zamindar, in mahalwari system by the village headman on behalf of the whole village, while in ryotwari system the land revenue was paid to the state directly by the farmers.

As a result of these systems, some features pervaded pre-independent India like feudal agrarian structure, exploitation, low agricultural productivity, shortage of food grains and unbalanced cropping pattern. These land systems were based on exploitation with difference only in degree, decreasing in order from zamindari to ryotwari. A small group of large landowners, including absentee landlords had land rights. The vast majority of cultivators did not have any right or had limited rights as tenants or sub-tenants. The poor mostly leased-in land for subsistence. If the tenants used improved seeds, manure or extra labour, they had to share half of the increased produce with the landlords. Even before independence it was widely recognised that the main cause of stagnation and social injustice in economy was the stagnation in the agricultural sector and this stagnation could, to a large extent, be attributed to exploitative agrarian relations. When India became independent, policy makers felt the system of cultivation by tenants had to be overhauled as it was highly exploitative.

5. Land Reforms in India

After Independence, attempts had been made to alter the pattern of distribution of land holdings on the basis of four types of experiments, namely:

a) Land reforms "from above" through legislation on the lines broadly indicated by the Central Government, enacted by the State legislators, and finally implemented by the agencies of the State Government.
b) Land reforms "from above" as in the case of Telengana and the naxalite movement also to some extent in the case of the "Land Grab" movement.

c) Land reforms through legislative enactments "from above" combined with peasant mobilisation "from below" as in the case of controlled land seizure in West Bengal and protection of poor peasants in Kerala.
d) Land reforms "from below" through permission of landlords and peaceful processions by peasants as in the case of Bhoodan and Gramdan.

5.1. Legal Framework for Land Reforms

While recognizing the need to bring about land reforms in the country, the Constitution of India provided under Article 39 that:

1) The ownership and control of the material resources of the country should be so distributed as best to serve the common good; and
2) The operation of the economic system should not result in a concentration of wealth or a means to production to the common detriment.

However, under the Indian Constitution, land reform is the responsibility of individual states so while the federal government provides broad policy guidelines, the nature of land reform legislation, the level of political will and institutional support for land reform and the degree of success in implementing land reform have varied considerably from state to state with the agenda remaining unfinished in most states.

5.2. Measures undertaken for Land Reforms

Land reform legislation in India consisted of four main categories:

a) Tenancy regulation that attempts to improve the contractual terms faced by tenants, including crop shares and security of tenure.
b) Abolition of intermediaries who were rent collectors under the pre-Independence land revenue system.
c) A ceiling on landholdings with a view to redistributing surplus land to the landless.
d) Attempts to consolidate disparate landholdings.

The first category of land reform, namely **tenancy reform**, imposed regulation that attempted to improve the contractual terms faced by tenants, including crop shares and security of tenure. Under the British land-revenue system, large **feudal landowners (zamindars)** received the rights to collect tributes from peasants in exchange for a land tax paid to the state. Almost half of the land was under this system at the time of Independence. This system was considered exploitative, and abolition of intermediaries was aimed at curtailing the power of these large landowners and ensuring that the cultivator of the land was in direct contact with the government, which minimized unjust extraction of surplus by the landowner.

The third form of land reform was the imposition of a **ceiling on landholdings** that aimed to redistribute surplus land to the landless. Finally, **consolidation of landholdings** constituted the fourth kind of land reform, which ensured that small bits of land belonging to the same small landowner but situated at some distance from one another could be consolidated into a single holding to boost viability and productivity. Because of variation in land quality across plots, this measure has been difficult to implement.

Abolition of intermediaries is generally agreed to be one component of land reforms that has been relatively successful. The record in terms of the other components is mixed and varies across states and over time. For example, under the ceiling law only 1.7 per cent of total cultivated area has been declared surplus and only 1 per cent of it has been distributed. Landowners naturally resisted the implementation of these reforms by directly using their political clout and also by using various methods of evasion and coercion, which included registering their own land under names of different relatives to bypass the ceiling, and shuffling tenants around different plots of land, so that they would not acquire incumbency rights as stipulated in the tenancy law, and possibly even outright eviction.

The general assessment on land reforms in the Indian context is rather negative. For example, the report of the Task Force on Agrarian Relations of the Planning Commission of India (1973) had the following overall assessment of land reforms in India: '*The programmes of land reform adopted since Independence have failed to bring about the required changes in the agrarian structure.*' The report directly blames the political will of the state governments for this failure:

> *The lack of political will is amply demonstrated by the large gaps between policy and legislation and between law and its implementation. In no sphere of public activity in our country since Independence has the hiatus between precept and practice, between policy pronouncements and actual execution been as great as in the domain of land reforms.*

Land policy in India has undergone broadly four phases since Independence.

1. **The first and longest phase (1950 - 72)** consisted of land reforms that included three major efforts: abolition of the intermediaries, tenancy reform, and the redistribution of land using land ceilings. The abolition of intermediaries was relatively successful, but tenancy reform and land ceilings met with less success.
2. **The second phase (1972 - 85)** shifted attention to bringing uncultivated land under cultivation.
3. **The third phase (1985 - 95)** increased attention towards water and soil conservation through the Watershed Development, Drought-Prone Area Development (DPAP) and Desert-Area Development Programmes (DADP). A central government Waste land Development Agency was established to focus on wasteland and degraded land. Some of the land policy from this phase continued beyond its final year.
4. **The fourth and current phase of policy (1995 onwards)** centres on debates about the necessity to continue with land legislation and efforts to improve land revenue administration and, in particular, clarity in land records.

Land policy has also been one of the important components incorporated in all the plans. The policy statements are sometimes quite explicit in the plan documents, but are more often implicitly stated. An overview of changes in the land policy as reflected through the various plan documents is as follows:

Land Policy formulation through Planning Period

Plan Period	Major Issue	Policy Thrust
First Plan 1951 – 56	Area under cultivation to be increased. Community Development (CD) networks to take care of the village commons. Vast uncultivated lands locked under large sizes of holdings.	Land reforms to bring in the fallow under cultivation and increase land use efficiency. Tenant to be given the rights to cultivate land. Abolition of intermediaries.
Second Plan 1956 - 61	Concern about vast rain fed agriculture, low land productivity and thrust on irrigated agriculture.	Soil conservation as an important programme. First phase of land reform implementation. Irrigation development for the rain fed areas. Training and extension work for the technology through CD.
Third Plan 1961 – 66	Food security concern dominated. Cultivable waste land to be brought under cultivation. Bringing the	Area development as an approach. Intensive area development programme adopted for selected districts. An

	lagging regions under mainstream growth.	integrated land policy approach was inherent. Soil surveys were taken up.
Fourth Plan 1969 - 74	Emphasis on food security continued as minimum dietary requirements to be met. Incentives were created for diversion of land towards food crops and enhancing the capacity of such land. Domination of large holding sizes and low allocation and technical efficiency.	Increased emphasis on irrigation and soil conservation in dry land regions and technological change introduced. Higher cropping intensity the main concern. Second phase of land reforms with land ceiling acts and consolidation of holding. Institutional changes brought in.
Fifth Plan 1974 – 79	Problems of degradation land management in irrigated command areas surfaced. Drought prone areas attracted attention.	Drought-prone area development. Desert area Development programmes, and soil conservation started and further enhanced. New impetus to dry farming.
Sixth Plan 1980 – 85	Underutilization of land resources. Drought prone areas continued to attract attention. Attention lagging areas on the background of green revolution required cultivation	Land and water management programme under drought-prone area programme in selected areas.
Seventh Plan 1985 - 90	Soil erosion and land degradation surfaced as major issues. Land going out of cultivation. Deforestation and degradation of forest lands.	Soil and water conservation and averting land degradation. Specific attention to degraded lands. Wastelands Development programmes. Long-term view of land management.
Eighth Plan 1992 - 97	Dry land and rain fed areas requiring attention. Degradation of land in irrigated command areas. Peoples' participation surfaced as major issue in land management at village level.	Emphasis on watershed approach. Soil conservation merged with watershed programmes. Agro climatic regional planning approach incorporated.
Ninth Plan 1997 - 2002	Land degradation increased significantly. Integrating Watershed Development Programme across various components. Rethinking on land reforms. Gap between potentials and actual crop yields need to be bridged. Need for a long-term policy document.	Bringing the underutilized land under cultivation. Management of wastelands. Maintenance of village commons. Decentralized land management system. Panchayat Raj institutions to manage the village lands. Rethinking on land legislation.
Tenth Plan 2002-07	Land Acquisition, Forest Land, Land record, urban land etc.	SEZ Act, Traditional Forest Dwellers (Recognition of Forest Rights) Act, 2006 and Rules, 2007 etc.
Eleven Plan 2007-12	Land records management	Merge the two existing Centrally-sponsored schemes of Computerization of Land Records (CLR) and Strengthening of Revenue Administration & Updating of Land Records (SRA&ULR) and to replace them with a modified Centrally-sponsored scheme in the shape of the National Land Records Modernization

		Programme (NLRMP).
Twelve Plan 2012-17	Land Acquisition, Rehabilitation and Resettlement	LARR 2013

Following the recommendation of Kumarappa Committee; the Indian National Congress appointed the Agrarian Reforms Committee under the Chairmanship of J.C. Kumarappa, for making an in-depth study of the agrarian relations prevailing in the country and the states enacted legislation for the abolition of intermediary tenures in the 1950s, although the nature and effects of such legislation varied from state to state.

The Bhoodan movement was launched in 1951. Vinoba Bhave hoped to eliminate private ownership of land through Bhoodan and Gramdan and maintained that the movement would go a long way to ensure just redistribution of land, consolidation of holding and their joint cultivation.

In May 1955, the Planning Commission set up a panel on land reforms under the chairmanship of Gulzarilal Nanda for reviewing the progress of land reforms in the country. The committee made recommendations related to absolute limit to the quantum of agricultural land (ceiling), inducting capital investment for land, encouraging personal cultivation, ending uncertainty in land sector; and providing work and security to the landless.

The chronological analysis of the all Five-Year Plans makes it clear that since the inception of planning in India, the approach to rural development and land reforms focussed on areas like consolidation of holdings, redistribution of ceiling surplus lands and wastelands, tenancy reforms, making legal provision for giving private land on lease for cultivation and agri-business; computerisation, updation and improvement of land records, recognition of women's rights in land etc.

In the wake of economic reforms, land reforms appear to have taken a back seat in India. Sometimes even the philosophy of redistribution of land through land reforms is questioned. However, the argument that land reforms stand in the way of market-led growth appears to be misplaced. The experience of countries like Japan and Korea shows that land reforms can help in faster and more sustainable development of capitalistic agriculture, without creating much pain for the rural population. But market-led economic reforms, not accompanied by land reforms, could be painful for the rural poor and may not be sustainable in the long run.

India's land policy interventions during the last five decades can be assessed based on their impact on various parameters, including alleviation of poverty, conflict management and equity, sustainable economic development, environmental impact, and production efficiency. The land policy interventions have had varying impacts across the states, depending in large part on the agrarian situation and the extent to which a given policy was implemented.

5.2.1. Digital India Land Record Modernization Programme

The Land Reforms (LR) Division was implementing two Centrally Sponsored Schemes viz.: Computerisation of Land Records (CLR) & Strengthening of Revenue Administration and Updating of Land Records (SRA&ULR). Later in 2008, the Cabinet approved merger of these schemes into a modified scheme named Digital India Land Records Modernization Programme (DILRMP) or NLRMP. The main aims of DILRMP are to usher in a system of updated land records, automated and automatic mutation, integration between textual and spatial records, inter-connectivity between revenue and registration, to replace the present deeds registration and presumptive title system with that of conclusive titling with title guarantee.

The DILRMP has 3 major components:

a) Computerization of land record
b) Survey/re-survey
c) Computerization of Registration

The District has been taken as the unit of implementation, where all programme activities are to converge. It is hoped that all districts in the country would be covered by the end of the 12th Plan period except where cadastral surveys are being done for the first time.

6. Land Acquisition in India

Till 2014, the Land Acquisition Act, 1894 regulated the process of land acquisition. While the 1894 Act provided compensation to land owners, it did not provide for rehabilitation and resettlement (R&R) to displaced families. These were some of the reasons provided by the government to justify the need for a new legislation to regulate the process of land acquisition. Additionally, the Supreme Court had also pointed out issues with determination of fair compensation, and what constitutes public purpose, etc., in the 1894 Act. To this end, the Right to Fair Compensation and Transparency in Land Acquisition, Rehabilitation and Resettlement Act, 2013 was passed by the Parliament, in 2013.

6.1. The Right to Fair Compensation and Transparency in Land Acquisition, Rehabilitation and Resettlement Act, 2013

- The Act provided for land acquisition as well as rehabilitation and resettlement. It replaced the Land Acquisition Act, 1894.
- The process for land acquisition involves a Social Impact Assessment survey, preliminary notification stating the intent for acquisition, a declaration of acquisition, and compensation to be given by a certain time. All acquisitions require rehabilitation and resettlement to be provided to the people affected by the acquisition.
- Compensation for the owners of the acquired land shall be four times the market value in case of rural areas and twice in case of urban areas.
- The new law stipulates mandatory consent of at least 70 per cent for acquiring land for public-private-partnership (PPP) projects and 80 per cent for acquiring land for private companies.
- Purchase of large pieces of land by private companies will require provision of rehabilitation and resettlement.
- The provisions of this act shall not apply to acquisitions under 16 existing legislations including the Special Economic Zones Act, 2005, the Atomic Energy Act, 1962, the Railways Act, 1989, etc.

6.2. The Right to Fair Compensation and Transparency in Land Acquisition, Rehabilitation and Resettlement (Second Amendment) Bill, 2015

- This Bill amends the principal Act passed in 2013.
- It enables the government to exempt five categories of projects from the requirements of: (i) social impact assessment, (ii) restrictions on acquisition of multi-cropped land, and (iii) consent for private projects and public private partnerships (PPPs) projects.
- The five categories of projects are: (i) defence, (ii) rural infrastructure, (iii) affordable housing, (iv) industrial corridors, and (v) infrastructure including PPPs where government owns the land.
- The Act would apply retrospectively, if an award had been made five years earlier and compensation had not been paid or possession not taken. The Bill exempts any period when a court has given a stay on the acquisition while computing the five year period.
- The Act deemed the head of a government department guilty for an offence by the department. The Bill removes this, and adds the requirement of prior sanction to prosecute a government employee.

7. Analysis of Land Reform Measures

While the abolition of intermediaries is no longer a pressing concern, success in achieving the objectives of redistribution of ceiling surplus land to the landless and security of tenancy varies among the states. There exist obstacles to identifying ceiling surplus land in the form of common subterfuges such as dividing the land between family members and benami transactions.

A related issue is the security of tenancy; along with ensuring protection from arbitrary eviction and overcharging of rent, land reform framework must also contend with the question of whether tenants are to be given ownership of the land.

Unfortunately, the implementation of land reform legislation has largely ignored the importance of providing special protection to women in granting them fair share of land. Nepal, for example, has a land reform law that pays special attention to the needs and issues of women. It is especially important that any programme of land reform provides for special protection of women, especially those who are managing small farms. Encouraging collective farming through self-help groups, credit schemes and agricultural extension programmes designed for women can help resolve this problem.

Deliberate policy interventions that see a shift in policy in favour of small farm holdings are needed. It has also been suggested by scholars that having a progressive land tax, based on the size of the ownership, could incentivise the sale of some of the larger land possessions. While such options cannot be discounted, they must be examined carefully before steps are taken.

8. Future of Land Reforms

Redistribution of public lands is an easy first step in land reforms. Land reform in Philippines is one of the best examples to learn from, having successfully redistributed 63% of the total land targeted, most of which have been either public land or have been obtained through voluntary sale.

However, in India, almost everywhere, land reform has met with strong resistance from the landed elite. During the Tebhaga movement in West Bengal, the resistance to amendments in the Bengal Tenancy Act was so great, that the government had to abandon the project. Enormous political will is the key to attaining fruition of the land reform agenda.

Experience further shows that simply redistributing land from the rich to the poor may not be enough to attain the objective of a more egalitarian rural society. First, an important problem that must be dealt with is the protection of the redistributed land against land-grab. Often, due to greater bargaining power and the use of muscle power, landowners have been able to regain the land allotted to the farmers, either through sale or through force. Therefore, land reform law cannot stop only at redistribution of the land, but must also ensure their security.

Secondly, the land that is redistributed may not be sufficient to meet the basic needs of those who have newly acquired it. For instance, it has been reported that, at times, while land was allotted to SC/ST families, it was useless because either the plot belonged to somebody else or was on stony, infertile land. Thus, any land reform measure must aim to procure 'secure and productive' land and redistribution rights.

A bottom up approach is necessary for success in land reform. Legislators must ensure participation of the farmers in deciding boundaries, noting claims and complaints and recording opinions and objectives of the village members. In Madhya Pradesh, the formation of district-level task forces to settle land related grievances greatly aided the reform process. In Kerala, the government officers went to the villages and spoke to the farmers to verify boundaries; in West Bengal the government conducted camps to spread awareness and familiarise them with official procedures.

9. Suggestions for the Future

a) **Awareness Creation:** Making farmers aware of their rights and familiarising them with official procedures will go a long way in building confidence and removing their fear of big landowners. At the same time, large landowners should be sensitised to the vulnerability of the landless and the important role of the owners in ameliorating their situation. A simple step towards this would be making available all rules and guidelines in the local language.

b) **Collective action:** Government should facilitate organization of farmers' groups and cooperatives so that they can lobby together for the fulfilment of their demands and also act as protection against abuse and exploitation. Collective action, especially for women, through self-help groups can greatly aid their empowerment.

c) **Preventing loss of farmland:** Farmers also lose land by a high degree of distress sales done due to lack of access to institutional credit, unfavourable pricing, contract farming, etc. Implementation of a Debt Relief Act to help with debt management as well as amendment to property law will help prevent loss of farmland.

d) **Plugging loopholes in existing land reform framework:** Often, landowners evade land ceiling laws by taking advantage of the loopholes in the existing system, by selling or transferring land to family members or through other subterfuges.

e) **Introducing a comprehensive reform package:** A land reform legislation is not complete without support policies and hence it is necessary to ensure that a comprehensive package is introduced, including easy credit facilities to farmers, asset and food subsidies, infrastructural facilities, establishment of cooperatives, etc.

f) **Drafting model central legislation:** A central legislation could be drafted that acts as a model for the states to use as a guide for framing their own law. Such legislation could suggest a common ceiling limit and include provisions for support facilities, etc.

g) **Inclusion of special protection for women in legislation:** It is important to make special provisions for the protection of women, by ensuring them individual land rights and granting equal status in credit and subsidy schemes.

h) **Periodic assessment of implementation:** Periodic assessment by independent research groups will help determine the effectiveness of the reform and make necessary changes.

i) **Updated recording of land title:** In many cases, existing land records are false or obsolete, and these need to be updated and verified to reflect the actual situation. Moreover, documentation must be modernized and computerised.

j) **Fast track courts on land disputes:** Setting up of fast track courts for the adjudication of land disputes and dealing with grievances related to land, can reduce the delays in acquiring title and reduce harassment and expense. Cases that involve Scheduled Castes and Scheduled Tribes should be given special cognizance.

k) **Strengthening National Land Reform Council:** The National Land Reform Council lacks mandatory powers as Land Reform related issues essentially fall under the domain of state governments. This can be remedied by amending the Constitution to include the National Land Reform Council and giving it powers to, among other things, ensure proper implementation of legislation. This is an important step in the struggle for emancipating the estimated forty percent of our population that forms the rural landless.

l) **Role of panchayats and gram sabhas:** Consultation with local bodies such as the gram sabha before framing rules on land distribution will ensure a more participatory process and will also hold greater chances of success, provided the landed gentry is not given a greater say.

10. Previous Years Vision IAS GS Mains Questions

1. The most appropriate way to counter the ills in the practice of tenancy in rural India is to legalise it. Discuss.

Approach:

Discuss the basic objectives and problems surrounding tenancy reforms in India. Answer should clearly bring out the inadequacies in current policy measures to effectively implement the tenancy reforms. The last part of the answer should suggest measures to improve the implementation of tenancy reforms (either by legalizing it or other methods).

Answer:

One of the major aspects of the land reforms in India has been the tenancy reform. The reforms aimed to eliminate all forms of exploitation and social injustice within the agrarian system, to provide security for the tiller of the soil and to remove such impediments to increase in agricultural production as arise from the agrarian structure inherited from the past.

The prohibition of tenancy has not really ended the practice. On the other hand, it has resulted in agricultural practices that are not conducive to increased production. This, in turn, also depresses employment opportunities for the landless agricultural laborers.

The ban on tenancy, which was meant to protect tenants, has only ended up hurting the economic interests of the tenants as they are not even recognized as tenants. As a result, they are denied the benefits of laws that provide security of tenure and regulate rent.

Although attempts have been made to provide security of tenure, redistribution of land and fixation of fair rents, yet informal or oral tenancy has continued to exist even to this day. The term informal tenancy is referred to as oral tenancy which refers to tenancy without legal sanctions and permissions, or without any written agreement. The principal of shifting to informal tenancy is to extract higher land rents from the tenants. This is primarily done so as to get high yielding varieties program that has brought a realization among the landlords that land is a very valuable asset and promises high rates of return. India, which is marked by land hunger, it is possible here to take advantage of the situation by charging higher rents. Also, informal tenancy arrangements are a convenient device with the landlords for nullifying tenancy reforms. Thus, unrecorded or clandestine tenancy perpetuates a semi-feudal land system that was sought to be abolished by measures of land reforms.

Thus it can be concluded that despite lot many efforts to keep away with ill practices associated with tenancy, it would be better to legalize it so as to get the tenants their due. What is needed at the moment is to formulate a proper policy backed by necessary amendments and changes in the existing laws. The need of the hour is to ensure the tenancy rights.

The policy dialogue and debates on agricultural land tenancy could benefit from:

1. More empirical evidence (translated into coherent policy recommendations) on current tenancy restriction impacts on the poor and the likely effects of liberalizing such restrictions;
2. A livelihoods perspective on the topic;
3. A more coherent and consistent message from pro-poor constituencies that tenancy liberalization may make sense.

2. The scope of Land reforms needs to be widened beyond the mere activity of redistribution of land and fixing land ceilings to a systemic restructuring that undertakes reforms in the sector of energy and water. Discuss.

Approach:

The answer should first explain the inadequacy of the current land reforms to make farming more productive and viable. Then it should illustrate the need for a multipronged approach, which includes building requisite infrastructure and distribution of services, with focus on irrigation and electricity, to develop the agricultural sector.

Answer:

Land reforms in India have been undertaken with the objective of achieving social equity in access to land and improving farm productivity to make agriculture economically more viable. Both the targets have met with only little success. One of the many reasons for their failure has been a compartmentalised approach to land reforms adopted in the country. The overall target of robust agricultural growth can only be achieved when land reforms are increased in scope from a mere redistribution exercise to an activity to improve inherent productivity and farming capability. Provision of infrastructure in form of electricity and water supply would be crucial for this.

Indian agriculture is now characterised by low viability and high vulnerability. High input costs and lesser realisation of final costs make agriculture less viable. Smaller size of landholdings, about 63 percent with less than 1 hectare, constrains the use of mechanised farm inputs to increase production. Also, in cases where land distribution has taken place, the land is often of poor quality, making economic viability even more challenging. Vagaries of monsoon, with about 2/3rd of total area dependent on rainfall for agriculture, lend high vulnerability to agriculture. Apart from it, exposure to volatile markets also increases vulnerability.

To address these issues, comprehensive agricultural reforms are required. Structural reforms include development of irrigation infrastructure and access to continuous power; institutional reforms include making available modern scientific inputs and data, along with modernisation of agricultural marketing methods and provision of insurance cover.

Following reforms in irrigation and energy sector can be considered for national rural development:

- Rationalizing water charges, improving collection rates and reforms in irrigation financing in order to make state irrigation departments financially self-sufficient.
- Improvements in irrigation systems by organizing farmers to take up operation and management responsibilities.
- Flood irrigation systems, which are wasteful as well increase salinity and water logging should be replaced by more efficient drip and sprinkler irrigation with government support.
- Institution of a system of water rights and modernization of irrigation agencies to make them more autonomous and accountable.
- Rationalisation of energy pricing – flat rate system should be disbanded to disincentivise over extraction from ground.
- Jyotigram scheme of Gujarat, where electricity to farm tube wells is provided only for certain part of the day, which achieved considerable success, should be tailored to all India level after incorporating local agricultural requirements.

- To address theft, High Voltage Distribution Systems (HVDS), which use Direct Current for transmission can be installed (as is being done in Punjab and Andhra Pradesh). These require initial high investment, but are efficient and will almost eliminate theft through technical barriers to tapping of power lines.

The movement from agriculture to other economic activities in past has been because of push from agriculture rather than a pull from the other activity. To make agriculture sustainable, it must continue to grow at least at 4 percent when national growth is 6-7 percent. It must be made economically attractive as well as sustainable to pursue as an occupation in order to sustain food security of the nation. Widening the scope of land reforms to energy and water sector would help meet these requirements.

3. "Contract farming with the government playing facilitator and umpire can be beneficial to farmers". In this context, critically analyse the scope and utility of contract farming in India.

Approach:

- Write briefly about the changing scenario of agriculture and its consumption.
- Write why there is a need of contractual farming and how it can act as a panacea for poor farmers.
- Write various ways in which government can encourage both the farmers and entrepreneur for contract farming.
- Conclusion.

Answer:

The Indian agri-food system is undergoing a rapid transformation with front end activities like wholesaling, processing, logistics and retailing are rapidly expanding and consolidating, the backend activities of production agriculture have been continuously fragmenting. The challenge lies in linking the two ends and ensuring viable business opportunities for both farmers and agri-business.

The recent growth and diversification of consumer demand and the expansion of organized agricultural processing and marketing ventures has given large scope to the contract farming. There are other various emerging scenarios which ensure wider scope and utility of contract farming. These can be summed up as follows:

- Loss of actual price realisation to farmers in the present system.
- Fragmentation of land holdings put limit on profitability of farm produce.
- While smallholders, by virtue of available family labour and intensive cultivation practices, can be highly productive, they typically have a small marketable surplus and face high transaction costs in marketing their produce. The contract farming can provide them direct access to market without intermediates and thus can be instrumental in development and welfare of small farmers.
- Contract farming provides the mechanisms for streamlining procurement and logistics services that are high on the agenda of organized retailers and agro-processors.

In order to augment the reach of bank credit and increase the production of commercial crops as also for creation of marketing avenues for the farmers, all contract farming arrangements are made eligible for availing special refinance package from NABARD.

Government need to provide necessary support for sensitising initiatives and to study the details of functioning and performance of contract farming arrangements. The government may conduct workshops for better interface among farmers and entrepreneurs, conduct crop specific studies, follow-up with National Agricultural Insurance Corporation for insurance of crops grown under contractual arrangements etc. to enhance the utility of contractual farming.

For the development of contract farming in India, the government also needs to act as a regulator and power broker between the corporates and the farm owners where the power asymmetry is huge. The arrangement needs to be backed by an effective statutory and regulatory mechanism with avenues for the farmers for speedy redressal of their grievances.

4. *Highlight the role of institutional farm credit mechanisms in facilitating the process of land reforms in India. How can cooperative societies bring a faster change in this respect?*

Approach:

- Firstly mention how institutional lending sources i.e. banks affected the process of land reforms - impact on moneylenders, which section of farmers benefitted the most, effect on prevailing agrarian structure etc.
- Also mention the failure of institutional lending sources on this front.
- Mention how cooperative societies have affected the same structures and whether they could bring about a faster change in agrarian structures.

Answer:

Reorganizing agrarian relations was the main aim of land reforms in India. The hold of moneylenders over the peasantry was to be weakened by providing credit through institutional sources initially by credit societies and later by nationalized commercial banks.

With the imposition of social control and later their nationalization, commercial banks were asked to lend to the agricultural sector on priority basis. Over the years the dependence of rural households on informal sources has come down significantly. While empowering the vulnerable marginal land holder, institutional lending has also empowered women.

However, institutional farm credit mechanisms had limited impact on overall agrarian relations. The low level of education and awareness among the rural populace keeps them from utilizing credit facilities to their potential. Also, informal tenants cannot gain access to capital from banks and financial institutions. A recent study of a spate of farmers' suicides in Karnataka found that many of them were informal tenants who borrowed from moneylenders and could not pay back because of high interest rates.

Yet institutional credit has played an important role in making the green revolution a success and uplifting of millions out of poverty.

Also, cooperatives working in rural areas are playing noteworthy role in rural lending. Initially cooperatives were just to provide credits to the farmers through resource pooling. Gradually the role of cooperative societies grew to encompass socio-economic development and eradication of poverty in rural India. It also became an integral part of five year plan, and thereby, a fundamental part of our economy.

However, assessment studies have showed that much of their credit went to relatively better of sections and the poor continued to depend on more expensive informal sources. This was explained as a consequence of the prevailing structure of land tenures. The state response was to bureaucratize the cooperative societies, though in some regions this helped in releasing credit societies from the hold of big landowners.

Overall the contribution of cooperatives has been positive, but there is scope for improvement by improving women participation. Legalizing tenancy will also help to bring the small and marginal tenants within the ambit of institutional credit. Recent amendment of Constitution making provisions for autonomous and democratic functioning of *cooperatives* will go a long way in this regard.

5. Explaining the rationale behind ceiling on agricultural land holdings, discuss whether land ceiling has stifled agricultural growth in India.

***Approach**:*

- In the introduction explain land ceiling and the logic behind its implementation.
- While giving points both in favour and against the positive relation between land ceiling and agricultural growth.
- Conclude by logically favouring one of the two.

Answer:

Land ceiling refers to fixing the maximum size of a land holding that an individual or a family can own. The surplus land may then be appropriated and distributed according to the law. By the end of 1961, as per the directions from the centre, most of the states passed their land ceiling acts.

Rationale behind ceiling on agricultural land holdings:

- Largely the rationale behind ceiling on agricultural land holdings aligned with the objectives in the provisions of the Directive Principles of State Policy delineated in Articles 38 and 39 (c) of the constitution.
- To reduce the exploitation of the landless tenant farmers.
- To reduce concentration of wealth in the hands of a few.
- To promote of social justice by reducing the inequality in power and fostering cooperation among the people.

The impact of land ceiling on agricultural productivity has engendered a debate that can be understood through following arguments:

- **Arguements in Favour:**
  - Before ceiling, large areas belonging to big farmers remained uncultivated. Ceiling brought more area under cultivation.
  - Ownership of land led small farmers to take more interest in increasing production.
  - Studies testify that because of involvement of the entire family, small farms yielded more production per hectare.
  - Overall, agricultural output has increased manifold over the years.
- **Arguements Against:**
  - Because of land ceiling, enterprising farmers were unable to enlarge their holding by buying or leasing lands of small farmers. This way, large economic holdings with high agricultural productivity could not become a reality.

- Small farms hinder mechanised farming thus hampering productivity.
- Small farmers have limited capital to improve production.
- Because of small land holding size, the input costs are high, causing agriculture to be non-remunerative and productivity to be low.
- Very little of the surplus land was distributed, and hence a most of it remained uncultivated.

At the outset land ceiling was an important, and necessary, measure for equitable growth in the country. Over the years the size of an economic agricultural holding decreased due to scientific advancements. It is evident that Indian farmers have produced record crop year after year. Thus, it cannot be argued that land ceiling has had an adverse impact on the agricultural productivity in India.

6. ***Enumerating the objectives of land reform policy in post-independence India, critically examine its implementation and achievements.***

Approach:

- Mention the objectives of land reforms and explain its significance in post-independence era.
- Mention the measures taken for land reforms since independence. Substantiate your points.
- Evaluate their implementation and achievements. Discuss both the pros and cons of land reform policies undertaken by the successive governments.

Answer:

The important objectives of land reform measures in India were:

- To enhance the productivity of land by improving the economic conditions of farmers.
- To ensure distributive justice and to create an egalitarian society by eliminating all forms of exploitation.
- To create a system of peasant proprietorship with the motto of land to the tiller.
- To transfer the incomes of the few to many so that the demand for consumer goods would be created.

Keeping in mind these objectives, land reform legislations touched upon these measures:

- Abolition of intermediaries
- Tenancy reforms
- Ceilings on holdings
- Consolidation of holdings
- Development of cooperative farming

Implementation of land reforms

- Abolition of intermediaries: By 1972, all the States had passed laws to abolish intermediaries. But there was no clear mention about just and equitable compensation. Nearly 57.7 lakh hectares were distributed to landless agriculturists after the successful completion of the Zamindari Abolition Act. Although, intermediaries were abolished, but the rent receiving class continued to exist.
- Tenancy reforms: The objective of providing security of tenure to all tenants met with only limited success. But there are success stories such as those of Kerala and West Bengal. The continued existence of large number of insecure tenants made the successful implementation of the second major objective of reducing rents to a

'fair' level, almost impossible to achieve. The objective of the acquisition of ownership rights by tenants too was achieved only partially.

- Land ceilings: The long delay, and the nature of the legislation, ensured that the ceilings would have a limited impact.

There are many factors responsible for the tardy progress but important among them are the lack of adequate direction and determination, lack of political will, absence of pressure from below, inadequate policy instrument, legal hurdles, absence of correct-up-dated land records and the lack of financial support.

Achievements

- Land reforms were implemented within a modern democratic structure without any violence or use of force.
- Institutional changes enabled the bringing in of modern, progressive farming.
- Rack-renting the peasantry and extraction illegal cesses had become a thing of the past.
- State demand from the peasant also gradually virtually disappeared.

7. *It is argued by many that there is an urgent need for states to reform land laws and, in particular, tenancy laws. What are the factors cited for the need of such reforms? Identify the impediments in the way of such reforms and highlight the benefits that would accrue from them.*

Approach:

- The answer should begin with brief introduction about land and tenancy laws.
- Mention the factors responsible for the need of tenancy law reforms in India.
- Then, identify the roadblocks in the way of reforming them. Further, mention the expected benefits after successful reforms in tenancy laws.

Answer:

Tenancy reforms aim at redistributing ownership over the land holding from the view point of social justice, and reorganizing operational holdings from the viewpoint of optimum utilization of land. Growth in population and the decline in joint families in Indian society have led to the fragmentation of land holdings leaving nuclear families with small plots that barely meet their food requirements.

Need for tenancy reforms:

- Significant tracts of land remain barren and uncultivated even after fragmentation of the land among nuclear families.
- To give legal status to tenancy: Land leasing option faces legal difficulties as most States either ban tenancy or permit it strictly in certain circumstances. This has become a hindrance in progressive revenue models like that of Contract farming.
- To encourage owners to take up non-farm jobs as they are hesitant now as they may lose the ownership over the land if leased out.
- Due to flawed tenancy laws or their absence, farmers don't have farm security, which reduces their incentive to improvise and make long term investment in that farm.
- It is essential that we raise prosperity in agriculture as rapidly as possible as a large number of workforce will still remain dependent on agriculture in the years to come.

- The existing tenancy laws only pertain to individual tenants and cultivators and not institutions. Land owners who have land that they are unable to cultivate can be encouraged to lease them to land banks.

Roadblocks in the way

- We lack digitised data and records of the landholdings of the people with the government, which act as a major impediment in the way of tenancy reforms.
- Complexity of land laws and the conflicts between centre and state implementing agencies creates issues.
- There is a plethora of pending cases in the courts of laws.
- Government on various occasions face protest from the public and opposition in an attempt to introduce the land bill. Political will, hence, remains a major case of concern too.

Expected benefits after tenancy reforms:

- Reforming tenancy laws and replacing them with contracts will protect property rights, bring more land under cultivation, and encourage investment. Returns for cultivators and owners both will increase.
- Legal documents can lead to improvement in the terms of land use and facilitate access to credit and other social security benefits from the government for tenants and cultivators.
- This would give greater sense of security to the owner who wants to lease out land and it will also give greater certainty of tenure to the tenant.
- It will open doors for the consolidation of the operational land holdings.

The tenancy reforms indeed are an important step. The equitable distribution will require creating good jobs in the industries and services to which some landless rural workers and marginal farmers can migrate. To achieve this aim we should enact Model Land Leasing Act proposed by NITI Ayog.

11. Previous Years UPSC Mains Questions

1. Discuss the role of land reforms in agricultural development. Identify the factors that were responsible for the success of land reforms in India.
2. Establish the relationship between land reform, agriculture productivity and elimination of poverty in Indian Economy. Discussion the difficulty in designing and implementation of the agriculture friendly land reforms in India.