GS FOUNDATION FOR CSE 2024
ECONOMY-1
ORIENTATION & SOME BASIC CONCEPTS

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1. SYLLABUS, SIGNIFICANCE AND PLAN

A) PRELIMS SYLLABUS

1. Economic and Social Development – Sustainable Development, Poverty, Inclusion, Demographics, Social Sector Initiative, etc.

B) MAINS SYLLABUS

1. Indian Economy and issues relating to planning, mobilization of resources, growth, development and employment.
2. Inclusive growth and issues arising from it.
3. Government Budgeting.
4. Major crops cropping patterns in various parts of the country, different types of irrigation and irrigation systems storage, transport and marketing of agricultural produce and issues and related constraints; e-technology in the aid of farmers.
5. Issues related to direct and indirect farm subsidies and minimum support prices; Public Distribution System- objectives, functioning, limitations, revamping; issues of buffer stocks and food security; Technology missions; economics of animal-rearing.
6. Food processing and related industries in India- scope and significance, location, upstream and downstream requirements, supply chain management.
7. Land reforms in India.
8. Effects of liberalization on the economy, changes in industrial policy and their effects on industrial growth.
9. Infrastructure: Energy, Ports, Roads, Airports, Railways, etc.
10. Investment models.

1) CLASS PLAN:

1. 15-20 Lectures - Fundamental Concepts
    a. Micro-Economics Basics
    b. Macro Economics
        i. National Income
        ii. Inflation and Associated Issues
        iii. Fiscal Policy, Government Budgeting
        iv. Money Supply, Monetary Policy and Banking

v. External Sector (BOP, Current Account, Capital Account, Foreign Investment, Forex Reserves, Exchange Rates, Trade, Import Exports etc.)
vi. International Agencies (WTO, IMF, World Bank - Key contributions and need of reform)

2. 15-20 Lectures - Key Issues in Indian Economy as per the Mains Syllabus
   a. Cover each and every bullet point of the syllabus along with Mains PYQs

2) SIGNIFICANCE OF ECONOMICS FOR EXAM:

Prelims:

Year	**Number of Questions** (from Core Economy, Economy CA, ESI and Budget)
2013	19
2014	18
2015	18
2016	17
2017	17
2018	22
2019	20
2020	23
2021	14
2022	18
2023	16

Mains:
Around **10 Questions** every year will be coming from the 10 bullet points related to economy given in the syllabus.

Pre-Requisite: 0

Study material: Class Notes + CA Notes
Indian Economy by SANKARGANESH (if students want to read anything for fundamentals)

2. ECONOMICS AND ECONOMY

1) WHAT IS ECONOMICS?

- The term economics in English language has its origin in **two Greek words**: *Oikos* (Household), and *Nemein (management).* Together, it means management of household.

- It is that branch of knowledge in which those activities of human beings are **studied** which they undertake to **acquire scarce means** (that is wealth/resources) to **satisfy their unlimited wants.**

OR

- It is a science of human behaviour concerned with **allocation of scarce resources/means** in such a manner that consumers can maximize their satisfaction, producers can maximize their profits and the society can maximize its social welfare.

- **Scarcity** and **Choice** is the essence of economics:
    - **Scarcity**: It refers to the situation when what you have is less than what you wish to have.
    - **Choice** refers to the process of selection from available limited alternatives. It emerges because resources are scarce, and resources can be allocated to alternative uses.

- **Summarizing the essence of Economics**:
    - Economics is a **science of human behaviour** when confronted with the problem of choice or the problem of allocation of scarce resources to their alternative uses for achieving the **objectives** of maximizing of satisfaction for the consumers, maximizing the profit for producers, and maximization of welfare for the society.

2) MICROECONOMICS AND MACROECONOMICS

- **Microeconomics** studies **economic relationships or economic problems at the level of an individual** - an individual household, an individual firm or an individual consumer.
    - It is concerned with determination of output and price of an individual firm or industry. Therefore, microeconomics is also sometimes referred as Theory of Price.
    - It includes the study of demand theory, production theory, price determination, and factor pricing.
        - » It examines how individual consumers make decisions about what to buy and how much to buy, as well as how firms decide what to produce, how much to produce, and at what prices to sell the goods and services.
        - » It also explores price elasticity, market structures (perfect competition, monopoly, oligopoly etc.)
    - Study of micro-economics **assumes that macro variables remain constant**, for e.g., it is assumed that aggregate output is given when we are studying determination of output and price of an individual firm or industry.

- **Market Forces** (of supply and demand) play a significant role in the context of microeconomic problems, like the problem of product pricing or factor pricing.

- When the problem of choice is studied at the level of the country as a whole (or at the level of different regions in the country) it is called **macroeconomics**.
    - It deals with topics like aggregate demand and supply, National Income, economic growth, inflation, employment, fiscal policy, monetary policy, and eternal sector.
    - It is also referred to as the **Theory of Income and Employment**.
    - Study of macroeconomics **assumes that micro-variables remain constant**, e.g., it is assumed that distribution of income remains constant when we are studying the determination of aggregate output and income level.

3) POSITIVE AND NORMATIVE ECONOMICS

- They are two distinct branches of economics that serve different purposes and have different methodologies. They are used to **analyze economic issues** and provide different types of economic analysis.

i. **Positive Economics**:
   - » It is concerned with describing economic phenomena as they are, without making judgements or value judgements.
   - » It seeks to provide objective, verifiable statements about economic behaviour and events.
   - » It is often considered "science" of economics because it relies on empirical data and factual analysis to draw conclusions. The positive economists aim to develop testable hypothesis and use empirical evidence to evaluate them. They deal with questions like "What is?" or "What will happen if". It focuses on understanding economic cause and effect relationships without expressing personal opinions or normative judgments.
   - » **Positive Economic Statements** can be proven true or false through empirical research, and they don't involve subjective value or moral considerations.
   - » **E.g.,** of Positive Economic Statements:
     - An increase in minimum wage will lead to reduction in employment among low-skilled workers.
     - Inflation rates over the past decade has hovered around 4.5%.
     - As the price of smart phone decrease, their demand also increases.

i. **Normative Economics**:
   - » Normative economics is concerned with **making value judgements** and expressing opinions about what should be done or what is desirable in the economy.
     - It deals with questions like "What ought to be?" or "What is the best policy?" etc.

   - » It involves subjective analysis and personal preference. It often takes into consideration ethical, political, and social considerations when evaluating economic policies and outcomes.

- It is inherently subjective and thus can't be proven true or false through empirical analysis because it relies on value judgements that may vary from person to person.
  - **Examples** of normative statements are:
    1. Government must increase spending on healthcare to ensure access to affordable healthcare for all citizens.
    2. Tax cuts for high income earners are unfair and should be reversed to redistributive wealth.
    3. Policies that prioritize environmental sustainability should take precedence over short-term economic growth.

In summary, the **Positive economics** seeks to provide objective, value free analysis of economic phenomenon, while **normative economics** involve making subjective value judgements and recommendations about economic policies and outcomes. Though both branches are important for understanding and addressing economic issues, they serve different purposes and use different methods of analysis.

4) ECONOMICS VS ECONOMY

- **Economics** is the **academic discipline that studies** how individual businesses, governments, and societies allocate their limited resources to satisfy their wants and needs.

- **Economy** refers to system or structure of a region, country or even the world that involves production, distribution, consumption of goods and services.
  - It encompasses all economic activities and include various elements like businesses, households, government entities, financial institutions, and international trade.

- In Summary, economy refers to the actual system or structure of economic activities in a given area or sector, while "economics" is the academic field that studies the principles, theories, and concepts related to these economic activities. Economics help us understand and analyze the functioning of economies and the choices made within them.

5) SIMPLE ECONOMY VS COMPLEX ECONOMY

- **These terms are used to describe the level of sophistication, organization and diversity of economic activities within a given system.**
  1. **Simple Economy**: This is characterized by limited range of economic activities, products, and transactions. It often exists in small, traditional, less developed societies or communities which are characterized by farming, hunting, gathering, or barter system. In this kind of economy, the interactions are localized, and there is very less specialization of labor or production. Money, if used, is very scarce, and economy relies on barter system. The economic decisions are often based on tradition, customs, and immediate needs.

  2. **Complex Economy**: This economy is characterized by high degree of specialization, division of labor, and a wide range of economic activities and products. It exists in modern,

industrialized societies and nations with advanced market and extensive infrastructure. Here degree of exchange is very high, mutual inter-dependence is high, income levels and wants of people are also high.

6) TYPES OF ECONOMY: CENTRALLY PLANNED, MARKET ECONOMY AND MIXED ECONOMY

Aspect	**Centrally Planned Economy**	**Market Economy**	**Mixed Economy**
Ownership of Resources	Government owns most resources and controls production and distribution.	Private individuals and businesses own resources and production is driven by private enterprise.	Combination of public and private ownership of resources and production.
Resource Allocation	Government decides what, how, and for whom to produce	Decisions are made by consumers and producers (Market) on the basis of demand and supply in the market.	Combination of government and market forces.
Price Determination	Prices are typically set by government and may not reflect market.	Prices are determined by market dynamics (demand and supply)	Prices are influenced by market forces, but regulations may exist.
Role of Competition	Limited competition and monopolies controlled by the state.	High degree of competition with minimal government intervention.	Competition exists, but some industries may be regulated or controlled to varying degree.
Government Intervention	Extensive government involvement in the economy, including planning, production, and distribution.	Limited government intervention in the economy, primarily to enforce property rights, contracts, and maintaining market competition.	Government plays a role in regulating certain aspects such as consumer protection, and environmental concerns.
Economic Flexibility	Limited flexibility in responding to changing market conditions.	High degree of flexibility and ability to adapt to market changes.	Greater flexibility than in a centrally planned economy but less than in a pure market economy.
Consumer Sovereignty	The consumer is not sovereign/God	The consumer is sovereign/God (and its consumer who decide demand)	Consumer is sovereign but some government control may be there.

Private sector vs Public Sector	Public sector dominates the economic activity	Private sector dominates the economic activity	Both public sector and private sectors dominate the economic activity.
Examples	North Korea, Cuba, former soviet Union.	United States, UK, Singapore,	Many Western European Countries, Canada, India.

3. CENTRAL PROBLEM OF AN ECONOMY

- Since the resources are scarce/limited, and not every need of every individual can be satisfied, an economy has to make some choices.

- **Economic Problem** is basically the problem of choices.
    - Since the resources are scarce/limited (and given the fact that resources have alternative uses), we have to make a choice regarding allocation of resources to alternative uses with a view to maximize economic gain at the individual level and maximizing social welfare at the level of economy as a whole. Thus, economic problem is basically a problem of choices.

- **Key factors behind Economic Problem**:
    - Unlimited Wants
    - Limited or Scarce Resources
    - Alternative Uses

- **Central Problem of an Economy:** Every kind of economy (advanced or developing, large or small) face three central problems: What to Produce? How to Produce and for whom to Produce.
    a. **What to Produce?**
        - Since the means are scarce, every economy has to make a choice as to which wants needs to be fulfilled and which ones can be forgone.
            - For e.g. If consumer goods need to be prioritized or capital goods.

    b. **How to Produce?**
        - It involves the question about how to organize the production to produce something more efficiently.i.e. more production at less cost.
        - It is essentially the Problem of Choice of **Techniques**.
            - In developing countries like India it involves the question weather we should use a labor intensive technology or Capital Intensive technology.
            - For e.g., handloom or machine-made clothing. This will bring the conflict between employment on one hand and efficiency on the other hand.

    c. **For Whom to Produce?**
        - Since resources are scarce, needs of everyone can't be fulfilled.
        - This question basically revolves around whether to produce for **rich** or to produce for **poor**.
            - Producing for poor promote social justice, reduce inequality. But there is a hidden cost here, by producing for poor, the production for rich reduces. Rich could have given more profit which could have contributed to more investment and thus more economic growth.

- Thus, **the problem is of choice - Social Equality** or **GDP Growth**.

- **Add on problems for developing countries**:
  - When compared to developed economies, developing economies like India face some other add on problems. They include:
    i. **How to achieve fuller utilization of Resources?**
       - Underutilization of resources (unemployed resources) leads to output being lesser than **potential output**. i.e., low level of GDP.

    ii. **How to achieve growth of resources?**
       - Because of less developed technology various resources like minerals, natural gas etc remain underutilized.

- **Solution of Central Problems in different economies:**
  - Various approaches can be taken to solve the above central problems of economy. They include Market Economy Approach, Socialist Economy (Centrally Planned Economy) approach or Mixed Economy Approach.
  - In Market Economy the central problems (What, how and for whom to produce) are **solved through market forces of supply and demand**.
  - In **Centrally Planned economies**, the central problems (what, how and for whom to produce) are solved by the central authority.
  - In **mixed economies**, both 'market forces' as well as 'central authority' play their role. While market forces allow maximization of profits, the central authority focuses on social welfare.

4. FUNDAMENTALS OF MACRO-ECONOMICS

1) CLASSIFICATION OF GOODS:

- There are so many types of goods in the economy. Shoes, shirts, machines, farm tools, staplers, cement, minerals etc. These goods can **be classified in two different ways**:
  - **Final Goods and Intermediate Goods**, and
  - **Consumption Goods and Capital Goods**

A) FINAL GOODS AND INTERMEDIATE GOODS

- **Final Goods** (also known as consumer goods or end products) are items that are purchased by households or businesses for direct consumption or use. They are ready for consumption and don't require further processing or transformation.

  » They can be classified in two types:
    - **Final Consumer Goods**: Finally purchased by the consumers for the satisfaction of their wants.
      - Bread and Butter

- **Final Producer Goods**: Finally purchased by producers and are generally used as fixed assets in the process of production.
  - Agri-tools used by farmers.

» Expenditure on final consumer goods by the households is called consumption expenditure and the expenses on final producer goods by the producers is called Investment Expenditure.
  - **Expenditure on Final Goods** = Consumption Expenditure + Investment Expenditure.

» **Note**: Only final goods are included in the estimation of national product or national income.

- **Intermediate Goods** (also called producer goods) are used in production process to create other goods and services. They are not meant for final consumption but for further processing or assembly.
  - » **E.g.**
    - Raw material, semi-finished materials, other products used during manufacturing.
    - Note: Shirt purchased by retailer from wholesaler for resale are intermediate goods. This is because value is still to be added to shirt through sale.
  - » **Expenditure on intermediate goods by producers** during an accounting year is called intermediate consumption or intermediate cost. If intermediate consumption is deducted from the value of output, we get 'gross value addition' (also called Gross Value Added, or Gross Product of the producer). Thus,
    - **Value of output - Intermediate consumption = Gross Value Added**

- **Note: The same goods may be final or intermediate**
  - » For e.g.
    - Onion bought by a household is a final good whereas Onion bought by a restaurant which is going to cook some food for customers and sell this food is an intermediate Good.
  - » **What matters is the end use of the goods.**
    - If the good is used by producer as raw material, it is an intermediate good. If it is **purchased and resold,** then also it is intermediate good.
    - If it is used by producer as a **fixed asset** (like chairs used in the classroom or tractors used by farmers), it is treated as final goods. Goods purchased by households for final consumption is to be treated as final goods.

- **Question?**
  - » **Purchase of a Display Screen always means the purchase of a final good. Do you Agree?**

B) CONSUMPTION GOODS AND CAPITAL GOODS:

- **Consumption Goods or Consumer Goods**:
  - Consumer Goods are items that are produced and sold to satisfy the needs and wants of humans.
    - E.g., sugar used by households.

- **Consumption goods** can be categorized in the following ways:
  a. **Durable Consumption Goods**: Can be used for several years and are of relatively high value (e.g. TV, Car etc.)
  b. **Semi-Durable Consumption Goods**: Can be used for around 1 year. E.g., Clothes, electric bulbs etc.
  c. **Non-durable or Single Use Consumption Goods**: Used in a single act of consumption. (for.e.g. toothpaste, bread, butter, LPG etc.). They are of relatively low value.
  d. **Services**: Non-material goods which satisfy human wants for e.g., medical services, legal services, househelp services etc.

- **Capital Goods**:
  - They are also known as **producer goods** and are used by businesses to produce other goods and services. They are not used for immediate consumption but for the production of additional goods and services. They are **fixed assets** of the producers and are **repeatedly used in the process of production**. They are also of high value.
    - E.g., Buildings, machinery, factories, vehicles used for business purposes etc.

  - They are used by the producers either for (i) the replacement of capital stock, or for (ii) addition to the capital stock.
  - Capital goods **also involve depreciation**.
  - **Expenditure** on capital goods is called investment expenditure.

- **Note**:
  - Both consumption goods and capital goods are final goods and therefore are used in the estimation of national income.

- **Question:** All producer goods are not capital goods. Why?

2) CONCEPTS AND COMPONENTS OF CONSUMPTION EXPENDITURE

- In macroeconomics, consumption expenditure refers to aggregate consumption expenditure in the economy.
- **Consumers** in an economy are broadly classified as: (i) **Households** (ii) **Government** (iii) non-profit private institutions (like NGOs, gurudwaras etc.)
- **Aggregate Consumption Expenditure** = Consumption expenditure by the households + consumption expenditure by the government + consumption expenditure by the nonprofit private institutions (NGOs, temples, mosques, gurudwaras etc.)

3) CONCEPTS AND COMPONENTS OF INVESTMENTS

- Investments refers to increase in the stock of capital. Change in the stock of capital is called 'capital formation'.

- **Fixed Investment vs Inventory Investment**:

- Investment has two components: Fixed Investment and Inventory Investment
  - **Fixed investment** refers to increase in the stock of fixed assets (like plant and machinery) during an accounting year. It is also called fixed capital formation. This implies increase in the stock of capital formation in terms of fixed assets.
    - **Significance of Fixed investment**:
      - **Raises production capacity; Leads to higher level of output -> leads to economic growth.**

  - **Inventory Investment** refers to increase in inventory stock.
    - Inventory stock includes (i) Stock of finished goods (unsold once) (ii) semi-finished goods (iii) Raw materials.
    - **Significance** of inventory investment:
      - Ensures uninterrupted supply of inputs to producers.
      - Help in dealing with uncertainty of market.
      - Helps in dealing with increased demands quickly.

- **Gross Investment, Net Investment and the Concept of Depreciation**
  - Gross investment refers to total production of capital goods during the year. This include (i) capital goods used for the replacement of existing capital stock (which is worn out) and (ii) capital goods used as a net addition to the existing capital stock.
  - **Gross investment** = Net Investment + Depreciation (expenditure on replacement of worn-out fixed assets or replacement investments)

- **Concept of Depreciation**
  - Depreciation is a loss of value of fixed assets in use on account of:
    1. Normal wear and tear
    2. Accidental Damage
    3. Expected Obsolescence (going down of value when fixed assets become obsolete due to change in technology or demand)
  - It is also called consumption of fixed capital.
  - Thus, due to depreciation, fixed asset needs to be **replaced from time to time**.

4) STOCKS AND FLOWS

- **Meaning of Stock**: A stock is a quantity measured at a particular point of time.
  - For e.g., Bank Balance; wealth; Capital; water in overhead tanks; amount of stored food; number of workers in a company; population of the country etc.
  - All such values are stock values as these are measured at a specific point of time.

- **Meaning of Flow**: A flow is quantity measured over a specified period of time.
  - For e.g., wages (per day or per month); flow of water (per second); production (per year); capital formation; interest on capital; sale; number of births etc.

- **Note:**

- Flow impacts the stock. (e.g., greater the salary, more would be bank balance).
- Stock impacts the flow (e.g., greater the capital, more will be annual production)

- **Question**: Which of the following is stock and which is flow?
  - Investment; Monetary Expenditure; A hundred rupee note; a family's consumption of milk; services of a driver; production of cement; machinery of an automobile company.

5) FACTORS OF PRODUCTION

- In economy, factors of production are resources/inputs that are used to produce goods and services. These factors are inputs required in the production process and are essential for creating economic value.
- The **Four primary factors of production** are:
  1. **Land**: It refers to all natural resources used in the production process. It includes not only the land area but also minerals, water, forests, and other natural resources that can be found on or beneath the land's surface.
     - **Rent** is the payment made by producer to owner of the land.
  2. **Labor**: It refers to human efforts that go in the production of goods and services. This includes physical labour, skills, knowledge abilities of the workforce.
     - **Wage** is the payment made by the producer to the Laborers.
  3. **Capital**: Capital refers to the tool, machinery, equipment, building, and other physical assets that are used in the production process.
     - It includes both physical capital as well as financial capital. It is important for increasing the productivity and expanding the capacity of an economy.
     - **Interest** is the payment made by the producer to the capital owners.
  4. **Entrepreneurship**: It represents human innovation, risk taking abilities etc that drive the production process. Entrepreneurs identify the opportunities, organize the other factors of production, and assume the risk associated with starting and managing the business. They play a critical role in economic development and growth.
     - **Profit** is the payment made by the producer to the entrepreneurs.

- **A fifth factor of production**: Some economists include technology and knowledge as a fifth factor of production, emphasizing the importance of innovation and information in modern economies.

6) FOUR SECTORS OF ECONOMY

- From macro-economic point of view, Economy is often divided into **four sectors**: **1) Household Sector 2) Producer Sector (Business Sector) 3) Government Sector 4) External Sector** (Foreign Sector)

  1. **Household Sector**:
     - It represents the individual consumers and families within the economy. I.e., All the 140 crores plus population residing in India will constitute India's household sector.
     - They are consumers of goods and services.

- They are also **owners of factors of production** and thus receive income through wages, rents, interests, profit etc.
- They use this income to purchase goods and services for personal consumption.

2. **Business Sector (Producer Sector/ Private sector)**:
    - They include businesses, firms etc. involved in production of goods and services and owned by private individuals.
    - They include manufacturing units, service providers and all other types of businesses. They generate output, create jobs, **and contribute to economic growth**.
    - For production purposes, the firms hire/purchase factors of production (land, labour, capital, entrepreneurial skills) from households.
    - **Note:**
        - Reliance Industries is business sector, but Mukesh Ambani is part of Household sector.
        - A PSU is part of government sector, but employee of PSU (as an individual) is part of household sector.

3. **Government Sector**: It encompasses government at all levels (Central, state, local etc.). They collect revenue through taxes, fees, etc. and they fund public goods and services, such as infrastructure, education, healthcare, and defense.
    - **Government sector may act as both a welfare agency as well as a producer.**

4. **External Sector (Foreign Sector)**:
    - This sector represents economic interaction with the rest of the world including the import and exports of goods, services or capital.

GS FOUNDATION FOR CSE 2024
ECONOMY-2
CIRCULAR FLOW OF INCOME, NATIONAL INCOME

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1. BASIC CONCEPTS OF MACRO-ECONOMICS CONTINUES

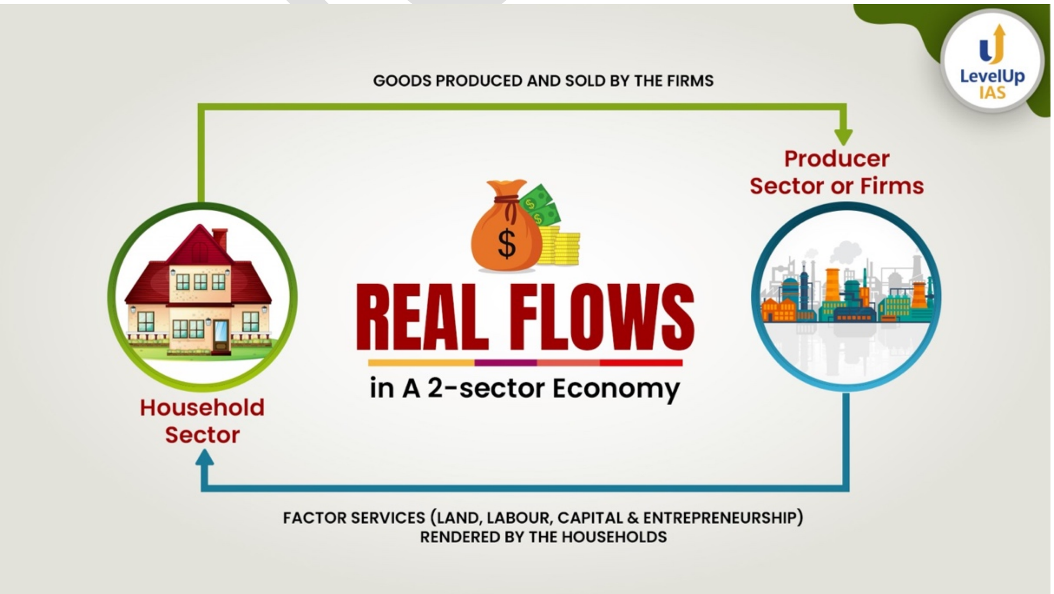
1) INTER-SECTORAL FLOW

- The four sectors of economy depend on each other. This is called **inter-sectoral dependence**.
    - The household sector depends on business sector for supply of goods and services, needed for the consumption.
    - The Producer sector/Business sector depend on household sector for the supply of factors of production.
    - The government sector depends on household sector and business sector for tax and non-tax revenue.
    - Producer and Household depend on government for administrative services, law & order, defence etc.

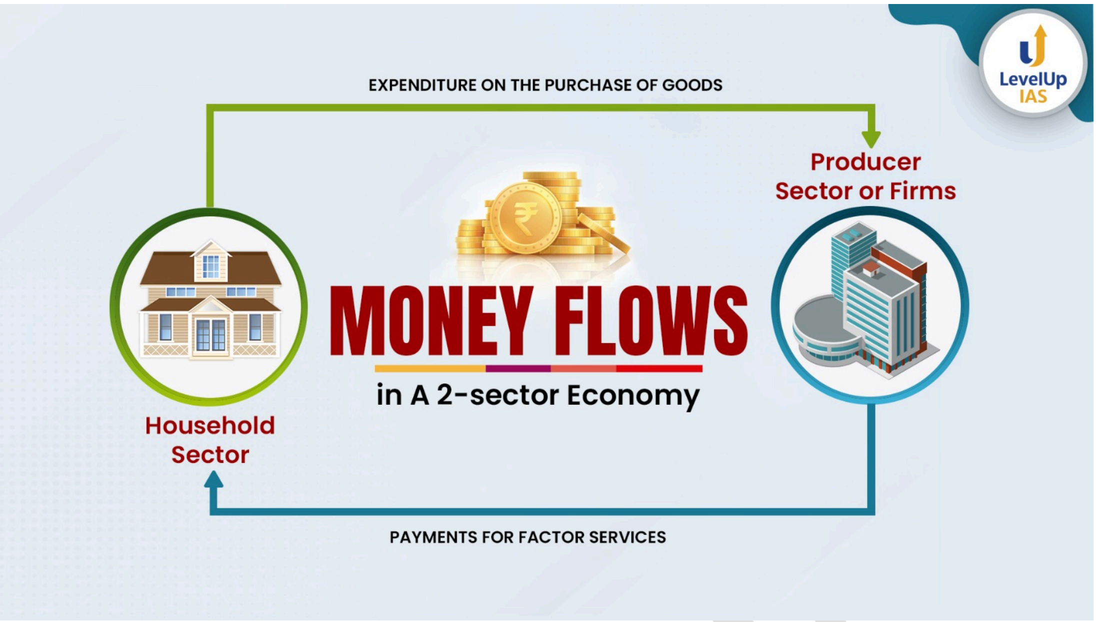
- This intersectoral dependence leads to **intersectoral flow**, either in the form of goods and services or in the form of money.

- Intersectoral flow in the form of money is called **money flow** and intersectoral flow in the form of goods and services is called '**Real flow.**'

    - E.g., of **real flow:**
        - **Household sector** supplies Factor Services (Land, Labour, Capital and Entrepreneurship) to **Producer Sector** and **Producer Sector supplies** goods and services to household sector.



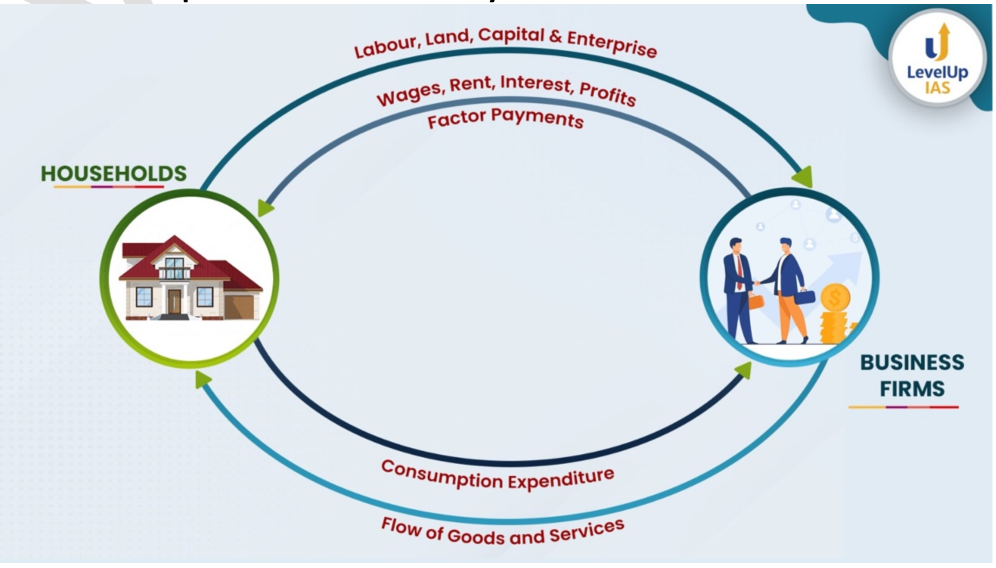
- E.g., of money flow:
    - Following figure shows money flow in terms of (i) flow of money in households to the producers (firms) for the purchase of goods, and (ii) flow of money from the producers to the households for the purchase of factor services.



- Money flow is reciprocal of the real flow. Thus, money flow from households to the producers (for the purchase of goods) is a reciprocal of the real flow of goods from the producer to the households. Likewise, money flow from producer to household (as payment for factor services) is a reciprocal of the real flow of factor services from the household to the producers.
- **Note**: **Money flows are opposite to real flows** as they are in response to the real flows.

2) CIRCULAR FLOW OF INCOME

- For simplification purpose, let's assume that there are only two sectors in an economy - the Household sector and the Producer Sector (firms/Businesses).
- In every economy three activities never stop:
  1. **Production of Goods and Services**
  2. **Generation of Income** (in terms of wages, interest, rent and profit)
  3. **Expenditure** (in terms of consumption expenditure and investment expenditure)
- **Circular Flow of Income in a simple two sector economy:**



- Circular flow of income refers to the unending flow of the activities of production, income generation and expenditure involving different sectors of economy.
    - **Phase of Production**: It refers to value addition done by business firms. The producing sector hires/purchases factors of production from the household who are the owners of these factors (land, labour, capital and entrepreneur). The factor inputs are used along with non-factor inputs (e.g., raw material etc.) for the production of goods and services.

    - **Phase of Income Generation**: For rendering their factor services to the producers, the household get factor payments: rent for land, interest for capital, wages for labour and profit for entrepreneurship.

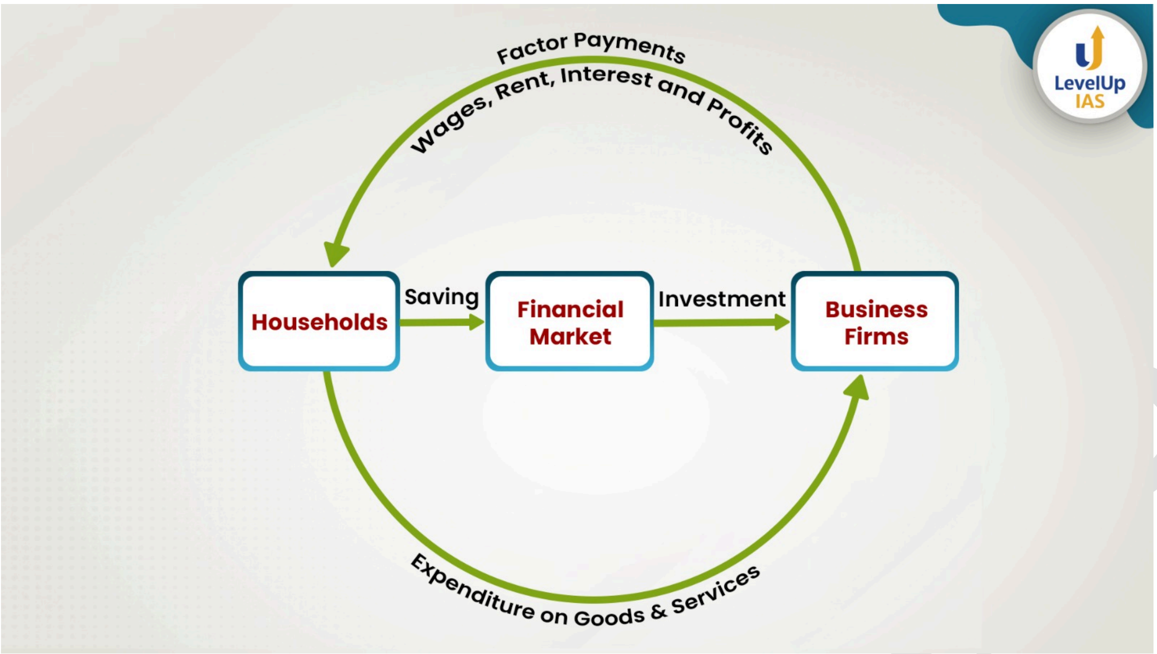
    - **Phase of Expenditure**: The income generated is disposed of on the purchase of final goods and services.
        - When households buy the final goods, there is consumption expenditure.
        - When producers buy the final goods, there is investment expenditure.

- This expenditure (both consumption and investment) will generate demand for goods and services which will again cause production, which will in turn cause income generation further leading to expenditure (consumption + investment) and this process goes on and on. Therefore, it is called circular flow.

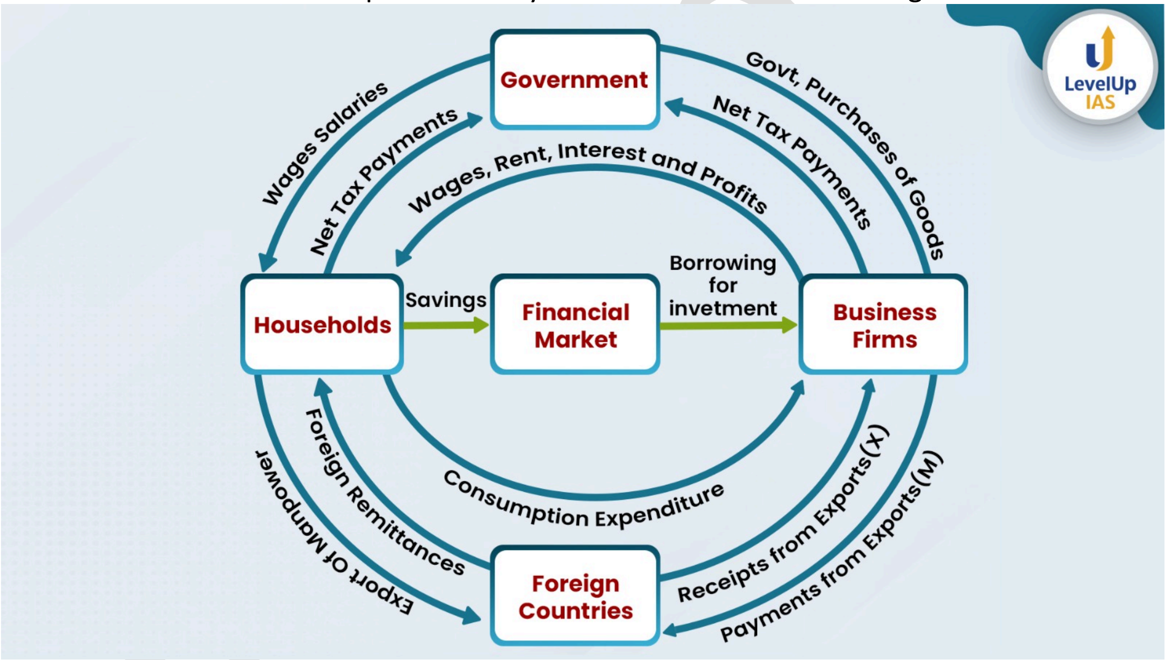
- **Also note** that, **the three types of flows, Production (output), Income and Expenditure (in terms of C and I) are always equal to each other** for a particular period of time giving rise to what is called the **triple identity:**
    - Production (the value of goods and services) = Income Generated = Expenditure (in terms of C and I).

- **Significance of Circular Flow**:
    - **Estimation of Nation Income**: Circular flow model facilitates the estimation of national income. National income is the sum total of **factor incomes** (rent + profit + wages + interest) flowing from producers to households of a country.
        - It may be defined as **market value of goods and services** flowing from producers to other sectors of the economy.
        - Further, it may be defined as the **sum total of all expenditure** on the goods and services produced by the producer sector.
    - **Knowledge of inter-sectoral dependence**: A circular flow model helps understand interdependence among different sectors of the economy.

- **Circular Flow of Income** (where some saving and thus investment is there)



- **Circular Flow of Income** in an Open Economy with Government and Foreign Sector



2. NATIONAL INCOME (GDP, NDP, GNP, NNP ETC.)

- Gross Domestic Product is the **total monetary or market value of all the finished goods and services** produced **within a country's domestic territory (economic territory)** in a **specific time period** (usually a year)

- **What are the components of a domestic territory**?
  - **Note**: Physical geographical area of a country is different from its Domestic/Economic territory.
  - **Components of Domestic Territory**:
    - » Territory lying within the political frontier (including the territorial waters)
    - » **Ships and Aircrafts** operated by residents of the country across different parts of the world.
      - E.g., Indian aircrafts moving between Singapore and USA are also part of domestic territory.
    - » **Fishing Vessels**, Oil and Natural gas rigs and floating platforms operated by the residents of the country in the international waters or engaged in extraction in areas in which the country has the exclusive right of exploitation.
    - » **Embassies, consulates and military establishments** of the country located abroad.
      - For e.g., Indian embassy is USA is part of India's domestic territory and US embassy located in India is not part of domestic territory of India.

  - **The domestic territory** refers to areas of operation where our persons, our goods, and our capital can circulate freely to serve our economic interest. Thus, factor income generated within the domestic territory of a nation amounts to domestic income.

1) GROSS DOMESTIC PRODUCT (GDP)

- The final value of all goods and services produced within the domestic territory of the country within a specific time period.
- **Net Domestic Product (NDP)** = GDP - Consumption of Fixed Capital (depreciation)

2) GROSS NATIONAL PRODUCTION (GNP)/ GROSS NATIONAL INCOME (GNI)

- As per SNA 2008, GNI is equal to GDP less primary income payable to non-resident units plus primary incomes receivable from non-resident units.

- **GNP = GDP + Net Primary income from rest of the world (ROW).**

- **What is Primary Income?**
  - » Primary income is the income accrued to institutional units as a consequence of their involvement in processes of production or ownership of assets that may be needed for the purpose of production. It basically includes **income from all the factors of production** (wages, property income, interest, profit etc.).

- **What is not included in primary income?**
  - Primary incomes don't include the payments of social contributions to social insurance schemes and the receipt of benefits from them, current taxes on income, wealth etc. and other current transfers. In short, **it doesn't include current transfers.**

- **So, Net primary income from rest of the world include:**
  - ***Net Compensation of Employees + Net Property Income + Net Entrepreneurial Income***.
  - So, GNP = GDP + Net Factor Income from Abroad (NFA)

- **Question -> To be discussed in class**.
  - What will be higher GDP or GNI??
  - Whose growth rate will be higher GDP's or GNP's?

- **Net National Income (NNI)** = GNI - Consumption of Fixed Capital (Depreciation)

  - So, **National Income** is the sum total of factor incomes accruing to normal residents of a country. It doesn't account for transfer incomes.

    - **Transfer Income** are unrelated income. These include gifts in cash, scholarships to the students, old age pensions to the senior. They are not included in the estimation of national income.
    - **Normal Resident of a country** are the people who (i) normally reside in the country concerned, and (ii) whose centre of economic interest lies in the country concerned.

  - **Remember:** This is also known as **net national income** and by dividing it by population of the country we can get **per-capital income**.

3) GROSS NATIONAL DISPOSABLE INCOME (GNDI)

- It refers to **income that is available (which can be disposed (spent))**. It measures the **income available** to the nation for final consumption and gross saving.

- **GNDI** = **GNI** + **Net Current Transfers from ROW** (Current transfers receivable by resident units from the Rest of the World - Current Transfer payable to non-Resident units to the Rest of the World)
  - **Note:** GNI doesn't include current transfers, the GNDI is arrived at by adding it to GNI.

  - **Note: Understanding Current Transfers**:
    - **Current Transfer** is a transaction in which one institutional unit provides a good or service to another unit. It is provided without receiving any good or service directly in return. It doesn't oblige one or both parties to acquire or dispose off an asset.
    - **Three main kinds of current transfers are**:
      a. **Current Taxes on Income, wealth, etc.,**
      b. **Social contribution and benefits.**
      c. **Other Current Transfers**

- **Current Taxes on Income, wealth etc.,**
    - It consists of income tax and wealth tax payable by households and corporations.

- **Social Contributions and Benefits:**
    - **Social Contributions:** These are payments to social insurance schemes and other social security payments like provident fund, payment to new pension scheme, etc. These payments may be made by employers/employees or both.
    - **Social benefits** are current transfers received by households. They are intended to provide for the needs that arise from certain events or circumstances (e.g. sickness, unemployment, retirement, housing, education etc.)

- **Other Current Transfers**:
    - The current transfers other than current taxes and social contributions and benefits:
        - i. **Premium and claims** under non-life insurance policies.
        - ii. Current transfers between different kinds of government units, usually at different levels of government, and also between general government and foreign governments, such as transfers under aid programs intended to sustain the consumption levels of populations affected by war or natural disasters such as droughts, floods or earthquakes.
        - iii. Current transfers between resident and non-resident households i.e., foreign remittances between resident and non-resident households.

- **Note:** To calculate Net Current Transfers from ROW, we only consider net current transfer paid to and received from non-resident units.

4) NET NATIONAL DISPOSABLE INCOME

- NNDI = NNI + Net other current transfers or,
- NNDI = GNDI - Consumption of Fixed Capital (Depreciation)

5) GROSS DISPOSABLE INCOME OF HOUSEHOLD (GDIH)

- The GDIH can be arrived from Gross National Disposable Income by deducting Gross Disposable Income of Government and Gross Saving of All corporations.
- **GDIH = GNDI - GDIG (Gross Disposable income of Government) - Gross Saving of All Corporations**

6) SUMMARY

GDP	**Market value of final goods and services produced within the domestic territory of the country in an accounting year**

NDP	**GDP** – **Depreciation**
GNP	**GDP + NFIA**
NNP	**GNP – Depreciation**
GNDI	**GNP** + Net Current Transfer from Abroad
NNDI	**GNDI – Depreciation**
GDIH	**GNDI – Gross Domestic Income of Government (GDIG) – Gross Saving of all Corporations**

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ECONOMY-3
NATIONAL INCOME-2

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1. GDP AND RELATED ISSUES CONTINUE

1) VARIOUS WAYS OF MEASURING GDP

- Product or Output Method or Value-Added Method
- **Income Method**
- **Expenditure** or **Consumption Method**

All three approaches will give the same figure if correctly calculated.

A) PRODUCTION (OUTPUT) APPROACH (VALUE ADDED METHOD)

Here GDP is calculated as the final value of all goods and services produced.

B) EXPENDITURE APPROACH

- As per System of National Accounts (SNA), 2008 in India the formula for GDP under **expenditure method** is as follows:

- **GDP =** PFCE + GFCE + GCF + (Export of Goods and Services - Import of Goods and Services) + Discrepancies
- It is commonly represented as: **GDP/Aggregate Demand = C + G + I + NX**

- Under this method spending by the different groups that participate in the economy is calculated.
    - Where:
        1. PFCE/C = Private final consumption expenditure.
            - This is generally the biggest component of GDP and thus consumer confidence is crucial for economic growth.
        2. GFCE/G = Government Spending (Government Final Consumption Expenditure)
        3. GCF/I = Investment (Gross Capital Formation)
            - Gross Capital Formation refers to addition of new capital assets. The net addition of capital assets obtained by deducting the disposed assets from new assets added is called **Gross Capital Formation**. The capital assets are fixed assets like buildings, machinery plus inventories and valuables.
            - It is a critical component of GDP since it increases the productive capacity of an economy and boosts employment levels.
        4. NX = net exports (Exports - Imports)
        5. Discrepancies: The GDP calculated by gross value-added method and expenditure method differ as there are considerable differences in value recorded for a product between the time it is produced and the time it is consumed.

- **Note**: In India's GDP, the biggest component is the private consumption which is around 60% of the GDP, Government Consumption is around 11%, Gross Capital Formation (Investment) is around 30% and Net exports is around -2%.

- **Connecting it with income methods:**
    - Income = Consumption + Saving
    - In the above Formula: PFCE, GFCE and X-I are consumption; GCF is a saving item.

C) INCOME APPROACH (FACTOR INCOME APPROACH)

- The calculation of National Income by compiling incomes of all household is called **Income Method/ approach**.
- Here, income earned by all the factors of production in the economy is calculated. This includes wages earned by laborers, the rent earned by land, the return on capital in the form of interest, and profits for entrepreneurs.
- **GDP** = Profit + Interest + Rent + Wages

- **Why three different methods?**
    - In different sectors, different methods may be useful.
    - For e.g., in service sector, (expenditure/income method) is easy use, when compared to production method.

2) CAPITAL OUTPUT RATIO (COR) AND INCREMENTAL CAPITAL OUTPUT RATIO (ICOR)

- **Capital Output Ratio** (COR): It is a concept used to measure the efficiency of capital utilization in the economy. It is also known as capital intensity ratio.
    - The ratio quantifies the amount of capital (such as machinery, building, equipment etc.) required to produce a unit of output (goods or services)
    - **COR** = Total Capital Input / Total Output Produced
    - **Significance**:
        - The COR can be used to assess the efficiency of an economy, industry or individual firm.
        - A **low COR** indicates that a relatively small amount of capital is required to produce each unit of output, suggesting **efficient capital utilization**.
        - On the other hand, a **high COR** suggests that a significant amount of capital is needed to produce the same level of output, indicating **capital intensive production**.
    - **Key points about COR**:
        - **Variation by Industry**: Capital intensive industry has high COR.
        - **Changes over time** with changes in technology, changes in methods of production, or shift in the composition of output.
        - **Investment Decisions**: A low COR shows that additional investment can be productive, and a high COR will show the need of other strategies to improve efficiency.

- **A declining COR** indicates that economy is becoming more efficient in its use of capital.

- **Incremental Capital Output Ratio (ICOR)** means the additional amount of capital required to produce one additional product.
    - **ICOR = Incremental Capital / Incremental Output**
    - It helps to assess how much additional capital investment is needed to generate an additional unit of economic output (typically GDP or Gross Domestic Product).
    - It **quantifies the amount of capital required** for an increase in economic output.
        - **Capital Investment = Growth Rate * ICOR**

    - A lower ICOR indicates that the economy can produce more output with less additional capital, suggesting that the capital allocation is more efficient.
    - A higher ICOR implies that a significant amount of capital is needed to achieve the same level of economic growth, indicating that the capital investment may be less efficient.
    - This helps in understanding the amount of capital required to achieve a particular growth rate.

3) REAL GDP VS NOMINAL GDP

- GDP can be calculated on either a **nominal basis** or a **real basis**. In the later method, we account for inflation.

    - In case of **nominal GDP** all the goods and services are valued at the **prices that are actually sold for in that year**.

    - **Real GDP** is an inflation adjusted measure that reflects the quantity of goods and services produced by an economy in a given year, with **prices held constant from year to year** in order to separate out impacts of inflation or deflation from the trend in output over time.

    - Here, while calculating the value of total output produced, the price of a **base year** is used. This allows for the adjustment of inflation's impact.

	Quantity of Wheat	**Market Price of Wheat**	**Nominal GDP**	**Nominal GDP Growth Rate**	**Real GDP** (considering 2011-12 as the base year)	**Real GDP Growth Rate**
2011-12	10 KG	Rs 10/Kg				
2012-13	12 KG	Rs 15/Kg				
2013-14	15 Kg	Rs 15/Kg				
2014-15	18 Kg	Rs 18/Kg				
2015-16	20 Kg	Rs 20/Kg				

- **GDP Price Deflator**: Real GDP is calculated using GDP price deflator. It is the different in prices between the current year and the base year.
  - For e.g., if the price rose by 20% since base year, the GDP Price Deflator would be 1.20.
  - Nominal GDP is divided by this deflator to get real GDP.

- Nominal GDP is generally higher than real GDP since generally inflation is a positive number.

4) 2015 CHANGES IN GDP CALCULATION METHOD

- In 2018, The Ministry of Statistics and Program Implementation (MoSPI), GoI, introduced a new series of National Income Estimation (net method of calculating GDP). This was guided by international norms and is in sync with the UN System of National Accounts (SNA), 2008.

- **Key Changes Made (1. GVA Method 2. Base Year Change 3. Change in the data source)**
  a. **Gross Value-Added Method**
    - **Earlier**, the economic growth was measured in terms of growth rate at GDP at factor cost at constant prices.

    - **GVA Method of GDP calculation**
      - **$GVA_{\text{Basic price}} = GVA_{FC}$ + production taxes - production subsidies**
        - Note: GVA at Basic Price is also called as GVA Producer's price.

    - **$GDP_{MP} = GVA_{BP}$ + Product taxes - product subsidies** ($GDP_{MP} = GVA_{BP}$ + Net Indirect Taxes)
      - Note: GDP_{MP} is also known as Buyer's price.

      - **Note:**
        - **Production taxes or subsidies** are paid or received with relation to production and are independent of the volume of actual production.
          - **Production Taxes**: Land Revenues, Stamps and registration fees and tax on profession.
        - **Production Subsidies** - Subsidies to railways, input subsidies to farmers, subsidies to village and small industries, administrative subsidies to corporation or cooperatives, etc.

      - For arriving at the new value of added (GVA) at basic prices, **production taxes**, such a property tax license fee, are added and **production subsidies** (subsidies to railways, input subsidies to farmers etc.) are subtracted from GVA at factor cost.
      - Product taxes are paid on per unit of product. E.g., GST, import and export duties etc.
      - Product Subsidies are received per unit of product. It includes petroleum or fertilizer subsidy.

- The new method was recommended by the **United Nations System of National Accounts** in 2008 and made India's GDP growth numbers comparable with that of the developed nations.

b. Base Year Change

- The change in base year was done in accordance with the recommendation of the National Statistical Commission, which had advised to revise base year of all economic indices every five years.
- Current Base Year: 2011-12 (starting Jan 2015)

c. **Shift from Establishment Approach to Enterprise Approach** in calculating manufacturing production.

- The **establishment approach** [calculating production plant by plant] used in Annual Survey of Industries did not capture the activities of a unit other than manufacturing.
- Whereas an **enterprise** along with its manufacturing activities is also engaged in activities other than manufacturing such as ancillary activities etc. So, under **Enterprise approach**, the activities of a manufacturing company other than manufacturing (e.g. advertisement, brand building, etc.) are accounted in manufacturing sector.

- The enterprise approach is facilitated by **MCA21** with Ministry of Corporate Affairs.
  - MCA-21 is an e-governance initiative of Ministry of Corporate Affairs.
  - MCA 21 is an annual account of companies filed with Ministry of Corporate Affairs.
  - This ensures more comprehensive data on corporate activities is considered than older methods.
    - It captures the **entire value addition done by an enterprise including on advertisement and brand building**. This is called **Enterprise based data method**. Here selling and marketing expenses are also reckoned with, instead of just production cost.
- These changes possibly have **increased the coverage of registered sector of manufacturing**

d. Incorporation of Findings of NSSO Surveys -> **better representation of activities in unorganized sector**

- The details of new NSS Surveys viz. Unincorporated Enterprises Surveys (2010-11) and Employment & Unemployed Survey, 2011-12 are incorporated in the new series.

- **Significance of using GVA data**
  - The GVA data is crucial to understand how various sectors of real economy is performing. The output or domestic product is essentially a measure of GVA combined with net taxes.
  - It helps policy makers to make policy interventions, where needed.
  - Further, GVA is an integral and necessary parameter in measuring a nation's economic performance as per global standards.

- **Impact of Changes**

- India's GDP calculation in sync with global practice; increased size of economy; lower fiscal deficit; more incentives to raise indirect taxes and reduce subsidies;
- **Increase in share of manufacturing sector in overall GDP:** Trading activities by manufacturing firms are now included in sector's share. This change along with better data compilation has led to manufacturing sector increase its share and so for other sectors

5) GDP BACK-SERIES DATA

- **What is back-series Data?**
  - Base years for GDP estimates are revised from time to time throughout the world over to account for changes in the production structure of the economy.
  - Whenever the base years are changed, the statistical authorities also provide comparable back series data with macro policy analysis. In India, MoSPI has produced such back series whenever base years have changed.

- **What was the problem in developing back series data this time?**
  - The GDP calculation method was changed.
  - But, more importantly, the MCA21 database was not available for the period prior to 2006-07.

6) TECHNICAL RECESSION

- What is **Recessionary Phase?**
  - When the overall output of goods and services (GDP) **- contracts** from one quarter (or month) to another, the economy is considered to be in **recessionary phase** (as opposed to expansionary phase).

- **What is recession?**
  - When a recessionary phase sustains for long duration, it is called recession i.e. when GDP contracts for a long enough period, the economy is said to be in recession. This decline in economic activities can last from a few months to more than a year.
  - Expert bodies consider various data like employment, consumption, GDP growth etc. to arrive at a decision. They also look at depth, diffusion and duration of decline in economic activity to determine whether an economy is in recession or not.
    - For e.g. Due to sudden lock down due to COVID-19 the slowdown was so well diffused throughout the economy, it would have been turned a recession even if it was for a brief period.

- **What is technical recession?**
  - This is a technical way of measuring recession, in which real quarterly GDP is used as benchmark of measurement. It occurs if real quarterly GDP remains in negative territory for **two consecutive quarters**.

7) POTENTIAL GDP (NATURAL GDP)

- It is the **sustainable level of GDP** (i.e. at a constant inflation) that is possible or attainable while the **economy is operating at a maximum resource usage rate over a period**. It represents **full employment GDP** and gauges the economy's productive capability, especially at a constant inflation rate.

    - **Sustainability** is the key concept here. Every economy has certain natural limits, determined by its available labor force, technology, natural resources, and other limitations.

    - **When GDP falls short of its natural limit**, it means the country is failing to live upto its economic potential. When GDP exceeds that natural limit, inflation is likely to follow. Therefore, Potential GDP is also sometimes referred to as Natural GDP.

- **What does the potential GDP reveal about the health of the economy**?
    - If real **GDP is less than potential GDP** (i.e. if output gap is negative), it means demand for goods and services is weak. It's a sign that economy may not be at full employment.
        - Here, central banks may consider lowering of interest rates to stimulate income.
    - If the real GDP exceeds potential GDP (i.e. if the output gap is positive), it means that the economy is **producing above its sustainable limits**, and the aggregate demand is outstripping aggregate supply. In this case, inflation and price increase are likely to follow.
        - Here, the central banks may consider increasing the interest rates to control inflation.
    - Thus, potential GDP provides policy makers an important benchmark when making decisions about monetary policy.
    - The, Central Bank (fed in USA) wants to keep real GDP aligned with potential GDP.

- **Key factors in estimating potential GDP:**
    - Capital accumulation is a key factor in estimating Potential Gross Domestic Product and Potential GDP growth.
    - Growth of workforce is another significant factor in determining sustainable Potential GDP growth.

- **Potential GDP is not the most useful took for** forecasting or guiding policy because it is unpredictable and varies greatly in value, especially in recent years.

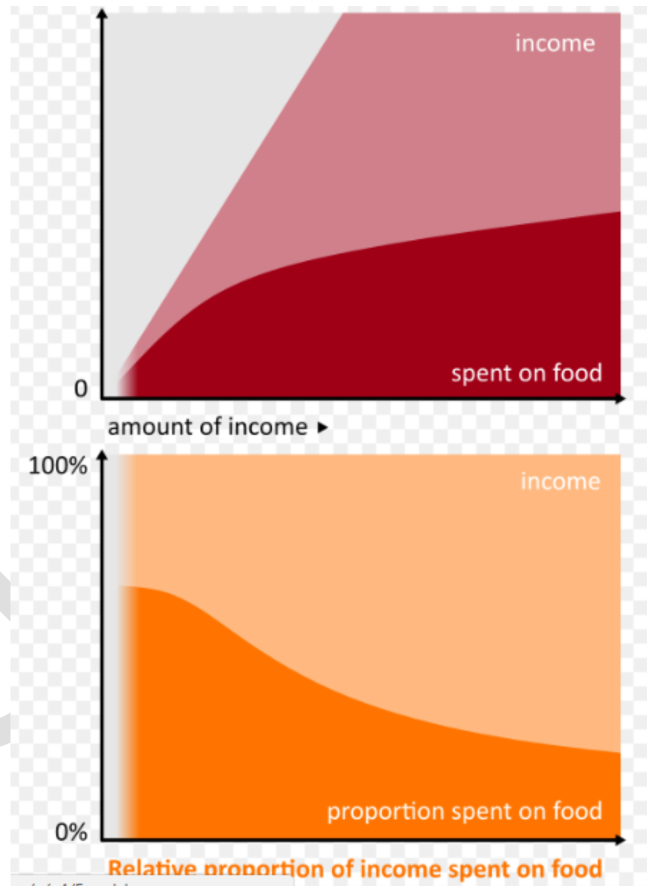
- **How is Potential GDP estimated?**
    - Different economists use different methods.
        - The Congressional Budget Office (CBO) uses a combination of growth forecasts and gauges of inflationary pressures for its estimates of potential GDP.
        - Other economists use other methods. But the differences aren't mere academic. These differences have serious implications for what monetary policies like fed and other central banks pursue.
            - For e.g., calculating natural rate of unemployment is an especially thorny problem.

- **Factors inhibiting India from achieving its Potential GDP**

- Weakness in manufacturing sector
- Global Financial Crisis
- Decline in total factor productivity.
- Crisis in financial sectors

8) ENGEL'S LAW

- It is an economic theory introduced in 1857 by Ernst Engel, a German statistician, which states that <u>the percentage of income spent on food decreases as income rises</u>. In other words, <u>the income elasticity of demand of food</u> is **between 0 and 1**.



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9) GDP (PPP)

- **Understanding Nominal Exchange Rate** (NER): It is the rate at which <u>one country's currency can be exchanged for another country's currency</u>.
  - NER = Price of one unit of foreign currency / Price of one unit of domestic currency
  - Or **<u>NER = Price of one unit of foreign currency in terms of domestic currency</u>**
    - For e.g. 1$ = 80 Rupees
    - NER = 80.
  - NER depends on <u>market forces</u> of <u>demand and supply</u>.
    - If <u>demand of foreign currency increases wrt domestic currency</u>, <u>NER increases and vice versa</u>.

- **Purchasing Power Parity (PPP) Exchange Rate**:
  - **PPP Exchange Rate** is a theoretical exchange rate used in economics to compare the relative value of currencies and assess whether a currency is overvalued or undervalued.

  - It is based on the concept of the **law of one price,** which suggests that identical goods in different countries should have the same price when expressed in common currency, taking into account the exchange rates.

  - **Let's understand this with an example**:
    - **Suppose** an Apple costs 1$ in USA, the same apple (in terms of quality, weight and other features) cost Rs 40 in India.
    - If the two economies only produce apple, we can say that:
      - 1$ = Rs 40 (both would just by an apple). This is what is called PPP Exchange rate.

  - **In reality**, there are several goods and services produced by both countries. Therefore, to calculate the PPP exchange rate, the same basket of commodities being produced in both the countries is considered.
    - Suppose this basket of commodities cost $100 in USA and Rs 4,000 in India.
    - It will give us $100 = Rs 4,000 or 1$ = Rs 40
    - This is the PPP Exchange rate.

- **How does PPP exchange rate changes with inflation**?
  - If inflation is same in both countries:
  - If inflation is zero in both countries:
  - If inflation is higher in one country and lower in another:

- When Nominal Exchange Rate is equal to the PPP Exchange rate, the exchange rate accurately reflects the relative price levels of the two countries, and the currencies are neither overvalued nor undervalued. They are at **Purchasing Power Parity (PPP)**.

- **GDP at PPP**:
  - Let's say India's GDP is Rs 300 Lakh crore.
  - If we convert this in $ using the NER (1$ = 80 Rs), we would get **$ 3.75 lakh crores**.
  - If we convert this in $ using the PPPER (1$ = 40 Rs), we would get **$7.5 lakh crores**.

- So, GDP at PPP is a measure of GDP in "international dollars" while adjusting for differences in local price and cost of living in order to make cross-country comparisons of real output, real income, and living standards.
  - For e.g., Currently, India's economy is fifth largest in the world after US, China, Japan and Germany.
  - But, in terms of PPP, since 2011, India's economy is the third largest in the world.

10) REAL GDP AND WELFARE

- Real GDP is considered as an index of welfare of the people. Welfare thus is measured in terms of availability of goods and services per person.

- Increase in real GDP thus implies increase in the level of output in the economy. Other things remaining constant, this would mean an increase in availability of goods per person implying higher level of welfare. Therefore, economic planners lay emphasis on the GDP growth rate.
- **Limitations of this measure of welfare:**
    - **Distribution of Income**
    - **Composition of GDP**: For e.g., increase in the production of defence goods doesn't lead to any direct increase in welfare of people.
    - **Non-Monetary Exchanges**: For e.g., in rural areas, some barter system may continue. Payment to farm laborers is often made in kind. These transaction remains unrecorded. This causes under-estimation of GP.
    - **Externalities**: Externalities refer to good and bad impact of an economic activity without paying the price or penalty for that.

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ECONOMY-4
INFLATION

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1. SMALL CORRECTION FROM PREVIOUS CLASS

Capital (stock) vs **Investment** (Flow)

2. PRICE INDICES AND INFLATION

- A **price index** measures the average change in prices of a basket of goods and services with respect to **a base year**.
    - Any Price Index (CPI or WPI) is calculated by measuring the rise in price of current year with respect to base year.
    - Price Index = (Weighted Price for current Year / Weighted Price for base year) * 100
- **Inflation** is defined as an upward movement in the general prices of goods and services and is estimated as the percentage rate of change in a price index over the reference time period.
    - It can be measured on the basis of Consumer Price Index or Wholesale Price Index.
    - Inflation = [(Current Period Price Index - Last Period Price Index) / Last Period Price Index] * 100
- **Note:** Base year is only used for calculation of index and not for the calculation of inflation.
- **Weight** in CPI is decided on the basis of expenditure surveys conducted by NSSO.

Various Indices Calculated in India	**Calculating Authority**
CPI- Combined (CPI-C)	**CSO**
CPI-Urban	**CSO**
CPI-Rural	**CSO**
Wholesale Price Index (WPI)	Office of Economic Advisor, **Ministry of Commerce and Industry**
Consumer Price Index for Industrial Worker (CPI-IW)	**Labor Bureau**, Shimla, Ministry of Labor
Consumer Price Index for Urban Non-Manual Employees (CPI-UNME)	**CSO** (it WAS discontinued in 2012)
Consumer Price Index for Agricultural Laborers (CPI-AL)	**Labor Bureau**, Shimla, Ministry of Labor
Consumer Price Index for Rural Laborers (CPI-RL)	**Labor Bureau**, Shimla, Ministry of Labor

- **Note: CPI-AL/RL** is used for determining the minimum wages and those for the government's rural jobs under the MGNREGA.
- **Note:** CPI-AL is a subset of CPI-RL and is used for revising minimum wages of agricultural laborers.
- **Note:** CPI-IW is used for wage indexation in organized sector and government jobs.

- **Core Inflation:**

- Core inflation is the change in the costs of goods and services but **doesn't include** those from **food** and **energy sector.** These items are excluded as they are very volatile and temporary/seasonal.
- Core inflation is studied **to understand the long-term trend of price rise** which can help in better framing of **long-term policies**.

1) CONSUMER PRICE INDEX (CPI)

- **Consumer Price Index** measures the average change of prices paid by the final consumer for a basket of goods and services.
    - CPI = (Weighted Price for Current Year / Weighted Price for base year) * 100

- **CPI** (Rural, Urban and Combined) are three new all India indices.
    - The indices such as CPI-AL/RL or CPI-IW only covered a segment of population and didn't give complete countrywide picture.
    - CPI (Rural, Urban and Combined) cover all segments of population and gives a general idea about the price rise in the country.
    - These are published at all India as well as state wise levels.

- **In Feb 2015, Central Statistical Organization (CSO), Ministry of Statistics and Programme Implementation has made some changes in the method of calculation of CPI.**

i. Base Year: Base year has been changed from 2010 = 100 to 2012 = 100.

ii. **The Basket of Items and their weights**

- The basket of items and their weight diagrams have been prepared using the Modified Mixed Reference Period (MMRP) data of Consumer Expenditure Survey (CES), 2011-12, of the 68th Round of National Sample Survey (NSS).
- **Earlier,** the weighing diagrams of old series of CPI were based on the Uniform Reference Period (URP) data of CES, 2004-05, of the 61st round of NSS.
- **Benefits**
    - The new method is more consistent with the **international practice** of shorter reference period for most of the food items and longer reference period for the items of infrequent consumption/purchase.
    - The **gap between weighing reference year and price reference year (Base Year)**, which was six years in the old series, has now been reduced to six months only.

iii. Increase in number of groups.

- Earlier, number of groups were 5.
- Now, they have increased to 6.
    - Pan, tobacco and intoxicants, which was a subgroup under the Group 'Food, beverages and Tobacco', has now been made as a separate group.

S No.	Subgroup	Description	Weight Rural	Weight - Urban	Weight-Combined
1.	**Food and Beverage**		54.18	36.29	45.86

2.	**Pan, tobacco and intoxicants**		3.26	1.36	2.38
3.	**Clothing and footwear**		7.36	5.57	6.53
4.	**Housing**			21.67	10.07
5.	**Fuel and Light**		7.94	5.58	6.84
6.	**Miscellaneous**	Household goods and services, health, transport and communication, recreation, education, personal care and effects	27.26	29.53	28.32

iv. Increase in number of items in the basket.

- 437 to 448 (Rural)
- 450 to 460 (Urban)

v.The weight of the Core group (CPI ex-food and fuel) increased.

- From 42.9% to 47.3%

2) CPI INDUSTRIAL WORKER (CPI-IW)

– CPI-IW is a price index released by **Labour Bureau** to measure the impact of price rise on cost of living for working class families spread across certain select industries. It is disseminated on monthly basis.

– **Significance**
  - Guide for policy formulations
  - Fixing/revising wages
  - Regulation of dearness allowances (DA) paid to large number of manual workers and Central/State government employees.

– **Revision of base year from 2001 to 2016** (Oct 2020)
  - Why? To capture the latest consumption pattern.
    - FROM CPI-IW Series 2001 = 100 to a more recent base year 2016 = 100.
  - The new Series of CPI-IW covers the industrial workers from **existing seven sectors** viz. **Factories, Mines, Plantation, Public Motor Transport Undertaking, Electricity Generating & Distribution Establishments** and **Ports & Docks**.
  - The new series has a wider coverage in terms of sample size, number of centres, markets/outlets, items etc.
  - As recommended by **Technical Advisory Committee on Statistics of Prices and Cost of Living (TAC on SPCL)**, Labour Bureau has revised the **classification of items in CPI-IW into different Groups and Sub-Groups** in line with NSO's Classification of Individual Consumption by Purpose (COICOP). The revised six groups based on the COICOP classification and their respective weights for different series are as follows:

All India group weight distribution for different series of CPI-IW			
Groups	Weights (%)		
	1982	2001	2016
Food & Beverages*	57.0	46.2	39.17
Pan, Supari, Tobacco & Intoxicants	3.15	2.27	2.07
Fuel & Light	6.28	6.43	5.5
Housing	8.67	15.27	16.87
Clothing & Footwear**	8.54	6.57	6.08
Miscellaneous	16.36	23.26	30.31
General Index	100.00	100.00	100.00

3) CPI FOR RURAL LABORERS AND AGRICULTURAL LABORERS (CPI-AL)

- It measures the changes in price of commodity basket consumed by rural laborers like agri laborers, laborers of village and cottage industries etc.
  - Consumer Price Index for Agricultural Laborers (CPI-AL) is a subject of CPI for Rural Laborers. It is used for revising minimum wages for agricultural laborers in different states.

- **Authority**: Labour Bureau, Shimla, Ministry of Labour.

- **Recent Updates:**
  - The All-India Consumer Price Index Number for Agricultural Labourers and Rural Labourers (Base: 1986-87) for the month of Oct 2022 increased by 10 points and 9 points to stand at 1159 (one thousand one hundred and fifty-nine) and 1170 (one thousand one hundred and seventy) points respectively.

4) WHOLESALE PRICE INDEX (WPI)

- The index measures the change in the price of commodities supplied to wholesale market. It is based on the **value of production adjusted for net imports**.
  - For e.g., price of mineral at ex-mines, price of manufactured products at ex-factory, price of agri products at mandi price are considered for the calculation of WPI.

- **Some features**
  - Captures inflation closest to producers and has a broader coverage of manufactured goods.
  - Doesn't capture price inflation in **services.**
  - It is measured **year on year** basis i.e., rate of change in present level in a given month vis a vis corresponding month of last year. This is also known as point-to-point inflation.
  - **Indirect taxes** are excluded from the price.

- **Authority responsible for compilation and release**
  - Office of the Economic Advisor, DPIIT, Ministry of Commerce and Industry.

- **Base Year:** 2011-12 = 100.
- **Recent Changes in WPI calculations (May 2017)**
  i. **Change in base year:** 2004-05 => 2011-12

- More recent base year is more in keeping with international best practices and also provide more representative and accurate data.

ii. **Updating the weight basket and weighting structure** conforming to the structure of economy in 2011-12

a. **Number of items:** Increased to 697 from earlier 676.

b. **Increase in weight of primary items.**
   - From 20.1% to **22.6 percent**

c. **Decrease in the weight of fuel and power.**
   - From 14.9% to **13.1**%.

d. **Decrease in weight of manufacturing items.**
   - From 64.9 percent to **64.2 percent.**

Table showing new commodity group and their weights in WPI.

S. No	Commodity Groups	Weight	No of Articles
1	**Primary Products**	22.6%	117
2	**Fuel, Power, Light & Lubricants**	13.1%	16
3	**Manufactured Products**	64.2%	564

iii. **Doesn't include Indirect taxes.**

- 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 standards and will make the WPI conceptually closer to Purchasing Price Index

iv. **A new WPI food Index** is compiled to capture the rate of inflation in food items.

v. **Seasonality of fruits and vegetables has been updated** to account for more months as these are now available for longer duration

vi. **Item level aggregate for new WPI are compiled using geometric mean (GM)** following international best practices and as is currently used for compilation of all India CPI

vii. **A High-level technical review committee**

- Government has also set up a high-level technical review committee for dynamic review in order to keep pace with the changing structure of the economy

A) WHY THE METHODS OF CPI/WPI CALCULATION NEEDS TO CHANGE REGULARLY

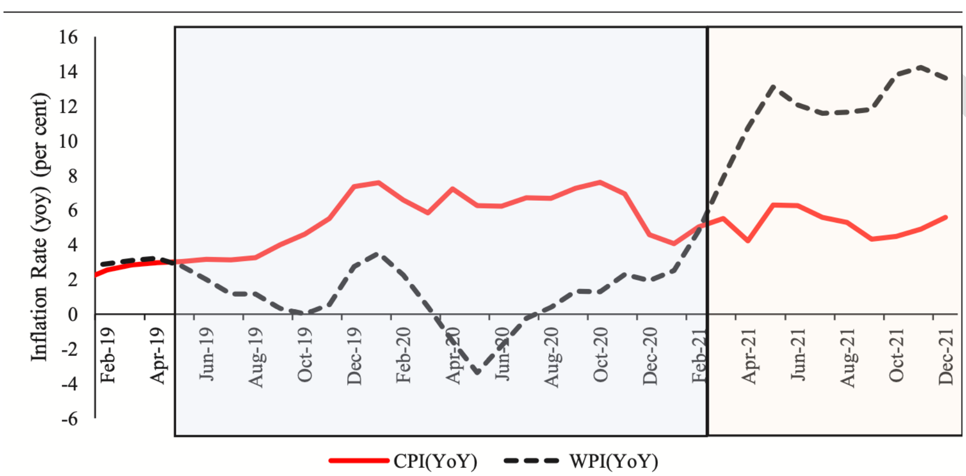
- The changes are aimed at **capturing the structural changes in the economy** and improving the quality, coverage and representativeness of the indices.
- The new methods are **more in consonance with International standards** and hence international comparison also becomes easier.
- **Changes GDP numbers**
- WPI is used as deflator for many sectors of the economy for estimating real GDP and the earlier GDP estimates were based on inflation calculated on 2004-05 base.

- Technical review committee will ensure that the changes in the economy are captured more frequently, and you do not wait for next revision of the base year.

5) DIFFERENCE BETWEEN CPI, WPI AND GDP DEFLATOR

- CPI measures prices at consumer level and WPI does it at whole sale level.
- CPI includes services, WPI doesn't
- CPI includes impact of indirect taxes, WPI doesn't
- WPI also includes capital goods (goods not directly consumed by consumers), CPI doesn't
- Both CPI and WPI take into consideration the imported goods but GDP deflator only takes into consideration the domestically produced goods and services.
- **Note**: GDP deflator is released by CSO

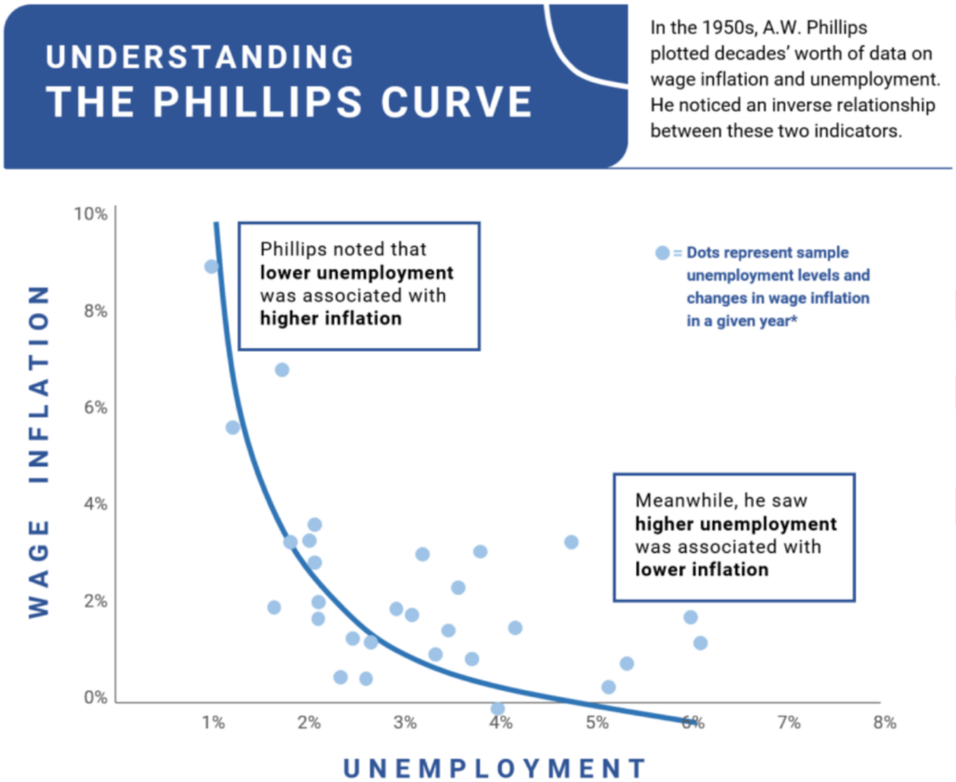
6) DIFFERENCE BETWEEN WHOLESALE PRICES AND RETAIL PRICES INFLATIONS



- **Why retail inflation becomes higher than whole sale inflation?**
  - **High Transaction cost**
  - Weak **infrastructure** system
  - Weak **information** system
  - Poor **marketing facilities**
  - Huge margin of **middlemen**
  - **Collusion among traders** -> Poor competition
  - **Asymmetry** in the transmission of price signals from wholesale to retail prices and vice versa

7) OTHER BASIC TERMS TO UNDERSTAND

- Deflation -> Opposite to inflation (fall in prices i.e. rate of change in price index is negative)
- Reflation -> deliberate action of government to increase the rate of inflation. Done to redeem the economy from deflationary situations
- Disinflation -> decreasing rate of inflation (but inflation is still positive)
  - E.g. inflation last month 6%, this month 5% -> it is termed as disinflation.
- **Phillips Curve**



- **Stagflation**
  - Situation of <u>co-existence of stagnation and inflation</u> in the economy. Stagnation means low National Income growth and high unemployment.

8) FACTORS AFFECTING INFLATION

- **Increase in Demand** of a product/service.
  - More money with people -> cheap loans (i.e., cheap monetary policy), increased disposable income etc.
  - Fiscal Stimulus by government i.e., increase in government expenditure
  - Repayment of public debt by government

- **Decrease in Supply**
  - Natural disasters, calamities
  - Lack of production (e.g., pulses)
  - Industrial disputes
  - Hoarding
  - Trade War -> high duties, restriction on imports etc.

A) WHO BENEFITS FROM HIGH INFLATION

Debtor, producer, Groups whose income is linked to inflation (flexible income groups); Equity Holders

B) WHO SUFFERS FROM HIGH INFLATION

Creditors, Consumers, Fixed income groups, Equity holders (monetary tightening may reduce the money supply and hence stock prices), debentures or bond holders.

C) OTHER IMPACTS OF HIGH INFLATION

- **Depreciation of Rupee**
- **Imports become expensive** (BoP issues) etc.

D) FACTORS WHICH CONTRIBUTE TOWARDS INFLATION CONTROL

- **Resilient Fiscal and Monetary Policy Framework**
- **Structural Reforms** of labor and product markets that **strengthen competition.**
- Adoption of **Monetary Policy Framework** for fiscal targeting
  - According to World Bank, there are 24 emerging market and developed economies which have introduced monetary policy framework for inflation targeting, since the late 1990s.

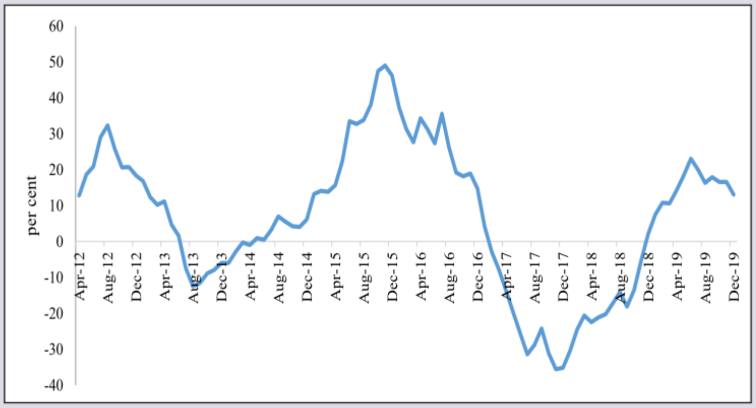
E) INFLATION AND BASE EFFECT

- When changes in the CPI in the base month have a considerable impact on changes in YoY inflation, this is referred to as base effect.
  - Base effects are therefore the contribution to changes in the annual rate of measured inflation from abnormal changes in the CPI in the base period.

F) COBWEB PHENOMENON

- **Cobweb** theory is the idea that **price fluctuations can lead to fluctuations in supply** which cause a **cycle of rising and falling prices**.
  - The farmers are caught in the cobweb phenomenon when they base their sowing decisions on prices witnessed in the previous marketing period.

WPI inflation rate of Pulses from April 2012 to December 2019



Source: Office of Economic Advisor, DPIIT.

  - So, if the farmer observes a higher price for a specific crop in period 't-1', he would opt to produce more of it in period 't'. However, if the production of the crop exceeds market demand, prices fall in period 't', signaling farmers to produce les of the commodity in period 't+1'.

9) HOUSING SECTOR PRICES

- **ESI 2022-23:**
  - The **National Housing Bank (NHB)** publishes **two housing price indices** with FY18 as the base year.
  - HPI Assessment Price
  - HPI Market Price Quarterly

- **HPI Assessment Price** is based on the valuation of prices of residential units collected form primary lending institutions.
- **HPI Market Price** is based on the market prices for **unsold inventories** collected from developers.

- A **composite index** is calculated for 50 cities across India using the population of the cities as weight.

HPI Market price have shown a general increasing trend in most cities. **COVID-19** crisis had significantly impacted the residential real estate market. The real estate industry started gaining momentum from Sep 2020 on wards and peaked at the end of March 2021. But, the second wave again impacted it. However, timely policy intervention by the government coupled with low home loan interest rates propped up demand and attracted buyers more readily in the affordable segment in FY23. The **overall increase** in composite HPI assessment and HPI market prices indicate a revival in the housing finance sector. A stable to moderate increase in HPI also offers confidence to homeowners and home loan financiers in terms of the retained value of the asset.	

10) PHARMACEUTICAL PRICES (CONTROL EFFORTS)

a. National Pharmaceutical Pricing Policy, 2012

- The principles for the regulation of the prices of drugs are based on the **National Pharmaceuticals Pricing Policy, 2012**, administered by the Department of Pharmaceuticals. The key principles of the policy are the essentiality of drugs, control of formulation prices and market-based pricing.

- **NLEM 2022** was promulgated by Ministry of Health and Family Welfare in September 2022 and **revised Schedule I of Drugs (Prices Control) Order (DPCO) was notified on 11 November 2022** by Department of Pharmaceuticals incorporating NLEM, 2022. **Ceiling prices of 119 formulations under NLEM, 2022**

have been fixed until 31 December 2022. In addition, retail prices for **2,196 formulations have been fixed under the DPCO, 2013**.

b. Jan Aushadhi Scheme (Now known as Pradhan Mantri Jan Aushadhi Yojna (PMJAY))

11) EFFORTS TO CONTROL INFLATION

- Monetary and Fiscal Policy measures
- Advisories to state governments for strict action against hoarding & black marketing and effectively enforce the Essential Commodities Act, 1955 & the Prevention of Black-Marketing and Maintenance of Supplies of Essential Commodities Act, 1980 for commodities in short supply.
- **Higher MSPs to incentivize production of food item**s in short supply.
- **Prize Stabilization Fund Scheme (PSF)** is being implemented to control price volatility of agri commodities like Potato, Onion, pulses etc.
- Enhancement of **buffer stocks** of pulses
- Export duties on export of certain food items.
- Essential Commodities Act

12) DIFFERENT

Creeping (< 3%), Walking or Trotting (3-7% to less than 10%), Running (10-20%), Hyper/Runaway/Galloping (20 - 100% 0r more)

3. SOME MAINS TOPICS

1) ANALYZING THE CAUSES AND CONSEQUENCES OF INFLATION

- **Introduction:**
  - Inflation refers to rate of increase in the average price of goods and services in an economy. The recent past have seen an increase in inflation in both advanced and emerging economies including India.
- **Reasons for Rise in Inflation:**
  - **Demand Side Factors:**
    - **Expansionary Fiscal** Policy has led to rise in aggregate expenditure. E.g. Atmanirbhar Bharat, PMGKAY etc.
    - **Expansionary Monetary Policy** by RBI in 2021 ensured easy credit flow in the market. Though, this has changed in 2022, with RBI tightening the policy rates.
    - **Pent up Demand during COVID-19** has also fueled consumer spending
- **Supply Side Factors:**

- **High logistical cost in India**, especially cost of storage and grading, due to **infrastructural constraints**.
- **Disruption in global supply chain** due to COVID-19 lockdowns in countries like China, war in Europe and rising price of **freight cost**.
- **Agri-commodities** like fruits, vegetables and edible oils have pushed the food side inflation.
  - India's huge dependency on vegetable oil import and disruptions in edible oil availability due to temporary disruptions in Indonesia.
- **Shortage of Industrial Raw materials** like pharma-ingredients, semi-conductors, rare earth metals etc.
- **Increasing Crude Oil Prices** has not only increased the price of transportation but it also has cascading effect on other sectors. The crude oil prices increased due to:
  - Disruptions due to Russia-Ukraine war and sanctions imposed on Russia
  - Supply Cut by OPEC+ Countries
  - Rise in demands due to revival of economy

– **While both**, demand side and supply side factors are responsible for the rise of inflation in India, the supply side factors are more prominent.

– **Negative Impact of Inflation:**
- **Increase in prices** of basic goods and services **impact the vulnerable and poor section the most** and creates **further inequality**.
- **Negatively hampers Investment:** Withdrawal of FPIs from the country.
  - For e.g. in 2022 when inflation increased all over the world, India saw record withdrawal of FPIs.
- **Impacts Economic Growth and Employment**: With inflation, RBI would increase policy rates, leading to borrowing becoming more expensive.
- Inflation causes **depreciation of rupee** which further contributes to Current Account Deficits.

– **Key steps that can be** taken to fight inflation:
- **Prudent Fiscal Policy**: Government needs to direct more expenditure towards capital creation and reduce the wasteful expenditure.
- **RBI's monetary policy** should be tightened whenever there is a inflation.
- **RBI's Monetary policy has to be tightened further.** This will not only reduce the flow of easy money but also decrease scope of hoarding which pushes inflation.
- **Logistical Reforms** to reduce logistic cost of Indian industries and businesses. Effective implementation of National Logistic Policy, 2023.
- **Increasing India's participation in global supply chain** with diversified sources to prevent sudden shortages.
- **Rational and Stable Trade Policy**:
  - Knee jerk reaction to price rise in the form of ban on exports of wheat, and imposed restrictions on sugar exports etc. may help consumers in short run, but in long run it creates problems as producers are discouraged.
- Long term **consistent import policy** would be crucial.
  - A knee jerk reaction to price rise in the form of import duty/tariff etc. may help consumers in short term, but in long term it sends wrong signals to domestic producers and create and environment of uncertainty.

- **Initiating and Implementing Structural** Reforms like labor law reforms, swamitva, land use clarity, ease of doing business etc. This will reduce cost of production and counter supply side inflation.
- **Focus on Transportation and storage infrastructure** (especially in rural areas) for perishable commodities.
- **Reduce dependence on imported fossil fuels**. This can be done by increased focus on renewable energy in the country.
- **Encouraging MSME to scale up** to reduce cost of production.
- **Agriculture Reform -**
    - **Changing Production Pattern:**
        - Encourage farmers to diversify from wheat, rice etc. to pulses, oilseeds, etc. This will not only reduce import dependency but would also improve buffer management and reduce subsidy burden.
    - **Agri-Marketing Reforms**, strengthening storage and transportation infrastructure.

2) INDIA'S TOMATO AND ONION CONUNDRUM

- **Introduction:**
    - Onion and Tomato are two of the three most consumed vegetables in India. But the prices of onion and tomatoes fluctuate regularly. Sometimes, we see instances of farmers dumping truck load of tomatoes due to low prices and the very next year we see tomato prices going sky-high.

- **The reasons for price shocks of Onion and Tomato can be divided under three heads:**

i. **Seasonality:**
- It refers to varying pattern of production of these crops during different months of a year.
    - 70% of tomatoes and 70% of onions are grown in Rabi season (this feeds people from March where prices will be low). But by July-Aug there is an upward trend in prices.

ii. **Irregular Shocks:** These shocks originate from:
- Uncertain weather conditions and Unpredictable weather events.
    - For e.g. in 2023, despite ample stock of onion in the country, a high proportion of bad quality onions due to a prolonged period of excess summer heat had made good quality onions expensive.
- Disease/pests.

iii. **Poor Infrastructure -> lots of wastage**
- Lack of proper cold storage and transportation facilities lead to a large percentage of perishable food items getting wasted.

- **Some steps which have been taken:**

i. Mission on **Integrated Development of Horticulture** envisages holistic development of horticulture and provides assistance of 50% of total cost of Rs 1.75 lakh per unit for low cost onion storage structure having a capacity of 25 tonnes each.

ii. **Scheme for Agriculture Marketing and Infrastructure for rural godowns**: It enables small farmers to enhance their holding capacity to sell their produce at remunerative prices and avoid distress sale.

iii. **Operation Greens -** Initially it was focused on the integrated development of Tomato, Onion and Potato (TOP) value chain. It provided 50% subsidy on transportation and storage. Later it has been extended to other vegetables and fruits as well.

iv. **Kisan Rail and Krishi Udan** are also focused on speedy movements of perishables.

v. **Immediate/Temporary steps**:
   - **In Aug 2023, GoI imposed a 40% duty on Onion exports.**

- **Seasonality can be dealt with policy actions**:
  - Incentivize production during lean season.
  - Investment in better storage and processing facilities.
  - Better supply chain management and cutting of wastage.

- **Other steps that can be taken:**
  - Promote Food Processing Industries

3) RBI AND INFLATION TARGETING (WILL BE DONE WITH MONETARY POLICY)

GS FOUNDATION FOR CSE 2024
ECONOMY-5
PRACTICE QUESTIONS (NATIONAL INCOME AND INFLATION)

#	QUESTIONS
National Income; Economic Growth and Related Issues	
1	Consider the following goods: 1. Onion bought by household for daily consumption 2. A shirt bought by a retailer for further resale 3. A display screen bought by an educational institute for use in the classroom 4. Steel sheet bought by a tractor factory for use in manufacture of tractor component How many of the above goods can be considered final goods produced in an economy? A. Only one B. Only two C. Only three D. All four
2	Final goods are used by the: A. Consumers B. Producers C. Government D. All of the above
3	Mixer-grinder used in an household is an example of: A. Capital goods B. Intermediate goods C. Consumption goods D. None of these
4	Consider the following pairs: 1. Net Investment — Gross Investment - Depreciation 2. Final Goods — Goods which have crossed the boundary line of production 3. GDP — Final value of goods and services produced in the economy How many of the above pairs are correctly matched? A. Only one pair B. Only two pairs C. All three pairs D. None

5	Consider the following: 1. Income 2. Wages 3. Investment 4. Bank Balance 5. Capital 6. Number of Workers in a economy How many of the above are stock quantity: A. Only two B. Only three C. Only four D. All six
6	Consider the following statements about National Income: 1. GDP = Gross Primary income receivable by resident units in the domestic territory + Gross Primary income receivable by non-Resident Unit in the domestic Territory 2. Gross National Income (GNI) is the sum of gross primary income receivable by resident units or sectors from domestic economic territory and foreign economic territory Which of the above statements is/are correct? a. 1 only b. 2 only c. Both 1 and 2 d. Neither 1 nor 2
7	Consider the following activities: 1. Indian vessels operating in International Waters 2. Foreign tourists buying clothes in India 3. Indian company providing online coaching to foreigners 4. Reliance industries oil and gas rig in Krishna Godavari Basin Which of the above activities will contribute to India's GDP? A. 4 only B. 2 and 4 only C. 1, 2 and 3 only D. 1, 2, 3 and 4
8	Which of the following correctly define(s) Gross National Product (or Gross National Income): 1. GNP = GDP + Net Primary Income from Rest of the World (ROW) 2. GNP = GDP + Net Factor Income from Abroad (NFA) Choose the correct answer from the codes given below: A. 1 only B. 2 only

	C. Both 1 and 2 D. Neither 1 nor 2
9	Consider the following statements; 1. Real GDP growth rate is always higher than the nominal GDP growth rate 2. Real GDP is always lower than the nominal GDP Which of the above statements is/are correct? A. 1 only B. 2 only C. Both 1 and 2 D. Neither 1 nor 2
10	Which of the following will form part of Net Current Transfer from Rest of the Word? A. Income tax charged by GoI on the resident citizens B. PMJAY contributions made by GoI C. Insurance benefits received by an Indian entity from an International player D. None of the above
11	Which of the following is **not** a correct definition of GDP? A. It is the sum total of the value of all the final goods and services produced in the territory of the country within a financial year B. It is the sum total of all the consumption and investment expenditure made by Individuals, Government sector and private business in India C. It is the income earned by all the factors of production in the economy D. None of the above
12	If India is witnessing a growth in real GDP every year, which of the following must necessarily be true? A. India is witnessing a positive GDP growth rate every year when calculated at constant price B. India is witnessing a positive GDP growth rate every year when calculated at current market price C. Employment is increasing in India D. Income inequality is decreasing in India
13	Consider the following statements: 1. Net Factor Income from abroad is zero in case exports are equal to imports 2. Brokerage paid to real estate agents on the sale and purchase of only new (and not the old) houses is included in the estimation of National Income Which of the above statements is/are correct? A. 1 only

	B. 2 only C. Both 1 and 2 D. Neither 1 nor 2
14	Which of the following statements is correct with respect to National Income? a. National Income exceeds domestic income only when exports are greater than imports b. Remittances from a relative working abroad are included in national income c. Sum total of factor incomes generated within the domestic territory of a country during an accounting year is National Income d. Services rendered by the housewives are not included in national income
15	If an economy is going through recession it must mean: 1. It's nominal GDP is decreasing 2. It's rate of inflation is decreasing 3. Employment rate has become stagnant/decreasing 4. It's rate of economic growth is decreasing How many of the above statements is/are correct? A. None B. Only 1 C. Only 2 D. Only 3
16	Consider the following statements about India's economic growth since the LPG reforms of 1991: 1. India's annual economic growth has always been positive (except for the FY 2020-21 due to COVID-19 lockdown) 2. India's economic growth rate has always been increasing (except for the FY 2020-21 due to COVID-19 lockdown) Which of the above statements is/are correct? A. 1 only B. 2 only C. Both 1 and 2 D. Neither 1 nor 2
17	In the past decade, India's real annual GDP growth rate was highest in the FY 2021-22. The most important factor behind it was: A. Economic reforms of the FY 2020-21 and various initiatives under the Atmanirbhar Bharat initiative B. One of the highest flows of FDI and FIIs in the country C. Base Effect D. India's increasing middle class population

18	The 'Base Effect' can play a role in subduing/enhancing the growth rate of which of the following indicators: 1. GDP Growth 2. Consumer Price Index - Inflation 3. Wholesale Price Index - Inflation 4. Index of Industrial Production growth Choose the correct answer from the codes provided below: 1. 1 and 2 only 2. 2 and 3 only 3. 1 and 4 only 4. 1, 2, 3 and 4
19	Which of the following factors have led to an increase in government's capital expenditure in recent years? 1. Increased budgetary allocation for capital expenditure in the Union Budget 2. Center's Grant in Aid to states for capital works Which of the above statements is/are correct? A. 1 only B. 2 only C. Both 1 and 2 D. Neither 1 nor 2
20	An economy is said to be in technical recession when: A. The GDP growth has been negative for at least 1 quarter and there has been a decline in consumption and employment as well B. The GDP growth has been negative for at least 2 quarters and there has been a decline in consumption and employment as well C. The GDP growth has been negative for at least 1 quarter D. The GDP growth has been negative for at least 2 quarters
21	If in FY2024, the rate of inflation is very high in India, very low in the USA and the rupee-US$ exchange rate doesn't change in the FY2024. Then which of the following would by true for FY 2024? 1. Weakening of India's purchasing power parity 2. Strengthening of India's purchasing power parity 3. Purchasing power parity will not be affected 4. Cannot be determined
22	India moved to a new method of Gross Domestic Product Calculation in 2015. Which of the following is/are correct regarding the changes brought in this new system? 1. Under the new system, the final GDP is calculated on the basis of Market Price

	2. The real GDP is calculated on the basis of current market price 3. For manufacturing sector, the new system has shifted on establishment approach from enterprise approach Choose the correct answer from the codes provided below: A. 1 only B. 2 only C. 1 and 3 only D. 1, 2 and 3
23	India moved to GVA method of GDP calculation in 2015 and did appropriate changes in its methodology. Which of the following was/were the impact of these changes? 1. It increased the share of manufacturing sector in India's GDP when compared to earlier method 2. India's national accounting system was brought more in sync with global practice. Choose the most appropriate answer from the codes provided below: A. 1 only B. 2 only C. Both 1 and 2 D. Neither 1 nor 2
24	Consider the following statements about Middle Income Trap: 1. According to the World Bank those countries whose Gross National Income per Capita is between \$1000 - \$12000 in 2011 prices are in middle income trap 2. India, South Korea, and Taiwan are some countries which have remained trapped in the middle income category Which of the above statement(s) is/are incorrect? A. 1 only B. 2 only C. Both 1 and 2 D. Neither 1 nor 2
25	Despite being a high saving economy, capital formation may not result in significant increase in output due to [2018] (a) weak administrative machinery (b) illiteracy (c) high population density (d) high capital-output ratio

26	Increase in absolute and per capital real GNP don't connote a higher level of economic development, if [2018] (a) Industrial output fails to keep pace with agricultural output (b) agricultural output fails to keep pace with industrial output (c) Poverty and unemployment increase (d) Imports grow faster than exports
27	With reference to Indian economy, consider the following statements: [2015] 1. The rate of growth of Real Gross Domestic Product has steadily increased in the last decade. 2. The Gross Domestic Product at market prices (in rupees) has steadily increased in the last decade. Which of the statements given above is/are correct? (a) 1 only (b) 2 only (c) Both 1 and 2 (d) Neither 1 nor 2
28	The national income of a country for a given period is equal to the [2013] (a) total value of goods and services produced by the nationals (b) sum of total consumption and investment expenditure (c) sum of personal income of all individuals (d) money value of final goods and services produced
29	A "closed economy" is an economy in which [2011]: (a) The money supply is fully controlled (b) Deficit financing takes place (c) Only exports take place (d) Neither exports nor imports take place
30	Economic growth is usually coupled with [2011] (a) Deflation (b) Inflation (c) Stagflation (d) Hyperinflation
31	In the context of Indian economy, consider the following statements [2011] 1. The growth rate of GDP has steadily increased in the last five years. 2. The growth rate in per capita income has steadily increased in the last five years. Which of the statements given above is/are correct? (a) 1 only (b) 2 only (c) Both 1 and 2 (d) Neither 1 nor 2
32	In the context of Indian economy, consider the following pairs: [2010]

Term	Most Appropriate description
1. Melt down	Fall in stock prices
2. Recession	Fall in growth rate
3. Slow down	Fall in GDP

Which of the pairs given above is/are correctly matched?
(a) 1 only
(b) 2 and 3 only
(c) 1 and 3 only
(d) 1, 2 and 3

33

Which one of the following is the correct sequence in the decreasing order of contribution of different sectors to the Gross Domestic Product of India? [2007]
(a) Services - Industry - Agriculture
(b) Services - Agriculture - Industry
(c) Industry - Services - Agriculture
(d) Industry - Agriculture - Services

34

The most appropriate measure of economic growth is its: [2001]
(a) Gross Domestic Product of a country
(b) Net Domestic Product
(c) Net National Product
(d) Per Capita Real Income

35

Match List I with List II and select the correct answer using the codes given below the lists: [2000]

List - I	List-II
A. Boom	1. Business activity at high level with increasing income, output and employment at macro level
B. Recession	2. Gradual fall of income, output and employment with business activity in a low gear

	<table><tr><td>C. Depression</td><td>3. Unprecedented level of under employment, and unemployment, drastic fall in income output and employment.</td></tr><tr><td>D. Recovery</td><td>4. Steady rise in the general level of prices, income, output and employment.</td></tr></table> **Codes:** (a) A-1; B-2; C-3; D-4 (b) A-1; B-2; C- 4; D-3 (c) A-2; B-1; C- 4; D-3 (d) A-2; B-1; C-3; D-4
36	In an open economy, the national income (Y) of the economy is: (C, I, G, X, M stand for Consumption, Investment, Govt. Expenditure, total exports and total imports respectively.) [2000] (a) Y = C + I + G + X (b) Y = I + G –X + M (c) Y = C + I + G + (X – M) (d) Y = C – G + I + (X – M)
37	Since 1980, the share of the tertiary sector in the total GDP of India has: [1999] (a) shown an increasing trend (b) shown a decreasing trend (c) remained constant (d) been fluctuating
38	National Income is: [1997] (a) Net National Product at market price (b) Net National Product at factor cost (c) Net Domestic Product at market price (d) Net Domestic Product at factor cost
39	The main reason for low growth rate in India, in spite of high rate of savings and capital formation is: [1995] (a) high birth rate (b) low level of foreign aid (c) low capital output ratio (d) high capital output ratio

40	Consider the following pairs: <table><tr><td>**Price Index**</td><td>**Calculating Authority**</td></tr></table>

1. Consumer Price Index - Rural (CPI-R)	CSO
2. Consumer Price Index - Industrial Worker (CPI-IW)	Labour Bureau
3. Wholesale Price Index (WPI)	Office of Economic Advisor, Ministry of Commerce and Industry

How many of the above pairs are correctly matched?
(a) only one pair
(b) only two pairs
(c) All three pairs
(d) None of the pairs

41

Consider the following statements about inflation:

1. Inflation indicates upward movement in the prices of general goods and services in current year with respect to base year
2. Consumer Price Index - Combined (CPI-C) Inflation has shown a consistent growth since 2012-13

Which of the above statement(s) is/are correct?

A. 1 only
B. 2 only
C. Both 1 and 2
D. Neither 1 nor 2

42

Consider the following statements:

1. In India, both Wholesale Price Index (WPI) and Consumer Price Index (CPI) is released by Central Statistical Organization (CSO), MoSPI
2. Increased competition in the market leads to huge variation in WPI inflation and CPI inflation

Which of the above statement(s) is/are correct?

A. 1 only
B. 2 only
C. Both 1 and 2
D. Neither 1 nor 2

43

Which of the following is true about Core Inflation?

A. It measures the rate of increase of prices of food items like wheat and rice
B. It measures the rate of increase in prices of products of core industries like petroleum, steel, Cement etc.
C. Core inflation shows long term trend in price rise

	D. None of the above
44	The Labour Bureau has recently revised the base year of the existing Consumer Price Index - Industrial Worker (CPI-IW) and have made appropriate changes. The new series of CPI-IW covers which of the following industrial worker category? 1. Public Motor Transport workers 2. Factory workers 3. Mines workers 4. Plantation Workers Choose the correct answer from the codes provided below: A. 1 only B. 1 and 3 only C. 2 and 3 only D. 1, 2, 3 and 4
45	If the rate of inflation is high in an economy, which of the following entities would be on an advantageous side? 1. Debtors 2. Producers 3. Consumers 4. Creditors Choose the correct answer from the codes provided below: A. 1 and 2 only B. 3 and 4 only C. 1, 2, 3 and 4 D. None of the above
46	Which of the following is **not** true about Consumer Price Index - Rural Laborers/ Agricultural laborer: A. Currently (as of Sep 2023), it uses the base year of 1986-87 B. Separate CPI-AL/RL indices are produced for all the states and Union Territories C. It is released by Labor Bureau D. CPI-AL/RL is used for revising the minimum wages of agricultural laborers
47	Consider the following statement(s) about Wholesale Price Index (WPI)Inflation in India: 1. It measures inflation of both goods and services 2. It measures inflation closest to producers

	Which of the above statement(s) is/are correct? A. 1 only B. 2 only C. Both 1 and 2 D. Neither 1 nor 2
48	Which of the following may be responsible for divergence between CPI-Inflation and WPI-Inflation? 1. Passthrough of international prices to wholesale prices are faster 2. Difference in the basket of CPI and WPI 3. Less Competition at retail levels Choose the correct answer from the codes given below: A. 1 only B. 2 only C. 1, 2 and 3 D. 2 and 3 only
49	Which of the following factors may be responsible for variation between wholesale and retail price of a product? 1. Weak Information System 2. Excellent Marketing Facilities 3. Very less margin for middle men 4. High Competition 5. Asymmetry in transmission of price signal Choose the correct answer from the codes provided below: A. 1 and 4 only B. 2, 3, and 4 only C. 1 and 5 only D. 2, 3, 4, and 5 only
50	Which of the following is true about Cobweb theory in economics? a. Cobweb theory highlights how the prices of different food items are inter-linked b. Cobweb theory highlights how the prices of commodities are interlinked globally c. Cobweb theory is the idea that price fluctuation leads to supply fluctuation which causes a cycle of rising and falling prices d. None of the above
51	Which of the following is true regarding the impact of high inflation? A. Debtor who has taken loan on fixed interest rate benefits B. Consumers will be benefitted C. Groups whose income is fixed benefits D. Producers of goods suffer

52	Which of the following laws may be contributing towards controlling inflation in India? A. Essential Commodities Act, 1955 B. Prevention of Black Marketing and Maintenance of Essential Commodities Act, 1980 C. Insolvency and Bankruptcy Code, 2016 D. All of the above
53	According to Essential Commodities Act, 1955, the food stuffs can only be regulated in which of the following circumstances? 1. War 2. Famine 3. Extra Ordinary Price Rise 4. Extra Ordinary Price Fall Choose the correct answer from the codes provided below: A. 3 only B. 3 and 4 only C. 1 and 2 only D. 1, 2 and 3 only
54	Other things remaining unchanged, market demand for a good might increase if: [2021] 1. Price of its substitute increases 2. Price of its complement increases 3. the good is an inferior good and income of the consumers increases 4. its price falls Which of the above statements are correct? (a) 1 and 4 only (b) 2, 3 and 4 only (c) 1, 3 and 4 only (d) 1, 2 and 3 only
55	With reference to inflation in India, which of the following statements is correct? [2015] (a) Controlling the inflation in India is the responsibility of the Government of India only (b) The Reserve Bank of India has no role in controlling the inflation (c) Decreased money circulation helps in controlling the inflation (d) Increased money circulation helps in controlling the inflation

56	Which of the following brings out the "Consumer Price Index" numbers for Industrial Workers? (a) The Reserve Bank of India (b) The Department of Economic Affairs (c) The Labour Bureau (d) The Department of Personnel and Training
57	Which one of the following is likely to be the most inflationary in its effect? [2013] (a) Repayment of public debt (b) Borrowing from the public to finance a budget deficit (c) Borrowing from banks to finance a budget deficit (d) Creating new money to finance a budget deficit
58	A rapid increase in the rate of inflation is sometimes attributed to the “base effect”. What is “base effect”? [2011 - I] (a) It is the impact of drastic deficiency in supply due to failure of crops (b) It is the impact of the surge in demand due to rapid economic growth (c) It is the impact of the price levels of previous year on the calculation of inflation rate (d) None of the statements (a), (b) and (c) given above is correct in this context
59	India has experienced persistent and high food inflation in the recent past. What could be the reasons? [2011] 1. Due to a gradual switchover to the cultivation of commercial crops, the area under the cultivation of food grains has steadily decreased in the last five years by about 30%. 2. As a consequence of increasing incomes, the consumption patterns of the people have undergone a significant change. 3. The food supply chain has structural constraints. Which of the statements given above are correct? (a) 1 and 2 only (b) 2 and 3 only (c) 1 and 3 only (d) 1, 2 and 3
60	Which one of the following statements is an appropriate description of deflation? [2010] (a) It is a sudden fall in the value of a currency against other currencies (b) It is a persistent recession in both the financial and real sectors of economy (c) It is a persistent fall in the general price level of goods and services (d) It is a fall in the rate of inflation over a period of time

GS FOUNDATION FOR CSE 2024
ECONOMY-6
MONEY, MONEY SUPPLY, MONETARY AGGREGATES, RBI, MONETARY POLICY

1. TABLE OF CONTENTS

2. MONEY

1) MEANING AND EVOLUTION:

- A thing which is commonly accepted as **medium of exchange** is called Money.
  - E.g.
    - A rupee in India is money. In older times coins of gold and silver were considered money.
- Other than acting as medium of exchange, **money has following uses**:
  - Store of value (instrument of saving)
  - Measure of value
  - Standard of deferred payments (payments made sometimes in future)
- So, **more comprehensively**, money can be defined as an instrument that serves as medium of exchange, store of value, measure of value and standard for deferred payments.

2) BARTER SYSTEM OF EXCHANGE:

- It is a system in which goods are exchanged for goods.
- **Drawbacks:**
  - **Requirement of double coincidence of wants**
    - Introduction on money has separated the acts of sale and purchase.
  - Lack of common unit of value
  - Difficulty of future payment and contractual payment
  - Difficulty of storage of value and transfer of value
- Money has taken care of all these drawbacks.

3) FORMS OF MONEY:

i. Fiat Money and Fiduciary Money

- **Fiat money** is that money which is issued by order/authority of the government. It includes all notes and coins which the people in the country are **legally bound to accept** as a medium of exchange.
  - **Understanding Legal Tender and Fiat Money**
    - **Fiat money** doesn't have an intrinsic value. What value it has depends on the public confidence in the currency's issuer.

- **Legal Currency** is any currency declared legal by a government. It is legally accepted mode of payment in a country, usually its currency.

» Generally, governments issue a fiat currency and then make it legal tender by setting it as the standard for repaying debt.

» **Fiduciary Money** is that money which is accepted as a medium of exchange because of the trust between the payer and the payee.

- **E.g., Cheques** are fiduciary money as they are accepted as a means of payment on the basis of trust, not on the basis of any order of the government.
- **Note:** Cheques are not legal tender, as they can be refused as a mode of payment by a party.

ii. **Full Bodied Money** and **Credit Money**

- **Full bodied money** refers to money in terms of coins whose **commodity value is equal to the money value** as and when these are issued.
    - E.g., A rupee coin during the British period in India was made of silver. Commodity value of the coin was equal to its money value at the time of its issue.
- **Credit money** refers to that money of which money value is more than commodity value.
    - E.g., money value of a Rs 20 coin today is more than the commodity value of the coin.
        - Otherwise, people would have melted the coins and sold the metal in the market at a price greater than 20 rupees.
- **In Summary:**
    - **In Full bodied money (Money value = Commodity value)**
    - In **Credit Money** (Money value > Commodity value)

3. MONETARY AGGREGATES

- **Money Stock/Money Supply**: Money stock or money supply refers to the total amount of money available in the economy at a particular point of time. It is also called Money Supply.
    - It is important to measure money supply as it plays important role in an economy.

- **How is money supply measured in India?**
    - Reserve bank of India, over the years have used various methods of measuring money supply. The **current method followed by RBI** is based on the recommendations of '**Working Group on Money Supply: Analytics and Methodology of Compilation)** which was formed in **1997** under the chairmanship of **Dr. Y. V. Reddy**. This working group considered the changing circumstances of Liberalization, Privatization and Globalization (LPG) and suggested changes to ensure that the Indian standards are close to international standards.

    - **Sectorization of the Economy** (for the purpose of monetary and liquidity aggregates)

- The third working group on Money supply (chaired by Y.V. Reddy) has divided the economy into the **domestic sector** and the **rest of the world**.
- The **domestic sector** is further divided into **four exclusive sectors**: viz.,
  i. Households
  ii. Non-Financial Commercial Sector
  iii. General Government
  iv. Financial Corporations (It comprises of the banking sector, consisting of the RBI and the banking systems in India and the other financial corporation sector). The other financial corporation sector comprises development financial institutions such as term lending institutions, refinancing insurance corporations, mutual funds and NBFCs accepting deposits from the public.
- The **domestic sector** can also be classified as money issuing sector and money holding sector.
  i. Money issuing sector comprises of RBI and Banking systems in India.
  ii. Money Holding Sector comprises households, other financial corporations, and non-financial commercial sectors.

- **Monetary and Liquidity Aggregates:**
  - The third working group on monetary supply recommended **two different financial aggregates** namely, monetary aggregates and liquidity aggregates.

  - The working groups observes: "The partition between **monetary and liquidity aggregates** has been dictated by the fact while the first relates only to monetary liabilities of the Central Bank and **depository corporations**', i.e., the banking system, the latter also includes select items of financial liabilities of **non-depository corporations** such as development financial companies, and non-banking financial companies accepting deposits from the pubic apart from post office savings.
    i. **Note:** The Development finance institutions which don't accept time deposits from public are called **non-depository corporations.**
    ii. **Note:** Liquidity aggregates include a greater number of financial assets than those included in the Monetary aggregates.

- **Monetary Aggregates:** The new monetary aggregates (money supply) are of four types. They are:
  i. Reserve money or Base Money (M_0)
  ii. Narrow Money (M_1)
  iii. Intermediate Money (M_2)
  iv. Broad Money (M_3)
  v. **Note: Till 1997**, RBI followed the older method which included M1, M2, M3 and M4.

A) M_0 (RESERVE MONEY OR BASE MONEY OR HIGH-POWERED MONEY): CURRENCY IN CIRCULATION [BANK + PUBLIC] + BANKERS DEPOSIT WITH RBI

M0 (Reserve Money or **High-Powered Money**): Currency in Circulation (currency with Bank and Currency with Public) **+** Bankers' deposit to RBI.

Currency in circulation = Currency with Public + Currency in deposits of Banks

M0 is also known as the **base money** as it would set the base of the economy. It is **roughly equal to total liability of the RBI** (how many notes have been printed by RBI)

B) MONEY SUPPLY: NARROW MONEY (M1) = C + DD + OD

- **Where do people keep money when they don't invest** (i.e., where do people keep liquid money)
  - **C: Currency with public**
  - **DD: Net Demand deposits in Bank** (Saving Account + Current Account)
    - Note1: We don't use time deposits (fixed deposits) here as they are not perfectly liquid.
    - Note2: **Understanding Net Demand Deposits**
      - **Gross Demand Deposits** include inter-banking claims i.e., claims of one bank against the other. **Net Demand Deposits** don't include inter-banking claims. Inter-banking claims are not a part of demand deposits of people.
  - **OD:** Other Deposits with RBI. It includes:
    - **Demand deposits** with RBI of public financial institutions like NABARD
    - Demand deposits with RBI of foreign central banks and of the foreign governments
    - Demand deposits of International financial institutions like IMF and World Bank
  - **Note:** M1 doesn't include:
    - Deposits of the government with the RBI
    - Deposits of the country's banking system with the RBI
  - **Why are cash deposits of the government and of the commercial banks with the RBI not treated as a part of the money supply?**

- Because government and commercial banks are creators/suppliers of money. And money held by the creators/suppliers of money is never treated as a part of money supply.

- **Understanding the relation between reserve ratio and money supply:**
  - Person 1 has 100 rupees. He deposits this in ICICI Bank.
  - If CRR Is 100%, then M1 = 100
  - But if CRR is 10%, Bank will lend this money, 90 rupees to someone (money with public), which in turn may become deposit in another bank (let's say HDFC). This cycle would continue.
  - Here M1 = Deposit with ICICI + Deposit with HDFC + Deposit with third bank + and so on…
  - So, if Reserve ratio reduces -> M1 increases (i.e., **higher the reserve ratio, lower the money supply**)
  - **In a functional economy, money supply is always greater than 1**.

- **Money multiplier** = Stock of Total Money / Stock of High-powered Money (M0)

C) M2 (INTERMEDIATE MONEY):

- This is called intermediate money because financial assets included in this category are more than those included in M1 but less than those included in M3.
  - **M2 =** M1 + **Time Liabilities portion** of the saving deposits with the Banking System + Certificates of Deposits issued with Banks + Term Deposits (excluding Foreign Currency Non-Resident (Bank) (FCNR(B)) Deposits) upto one year maturity with banking system.
  - It can be rewritten us:

    = **Currency with the public** + Current Deposits with the Banking System + Saving Deposits with the Banking System + Certificate of Deposits issued by Banks + Term Deposits (excluding FCNR(B). Deposits) upto and including one year maturity with the banking system + other deposits with the RBI.

D) M3 (BROAD MONEY):

- The financial assets included in this category are more than those included in the category of M2. Thus, it defines money in a wider sense. So, it is called Broad Money.
- **M3 =** M2 + Term Deposits (excluding FCNR (B) deposits) over one year maturity with the Banking System + call borrowings from 'Non-Depository' Financial corporations by the banking system.

Older Methods	**M1: Narrow Money:** Currency with public + Demand Deposits of Banks + Other Demand Deposits with RBI

	M2: Intermediate Money: M1 + Post office's demand deposit (only savings) **M3: Broad Money:** M1 + net time deposits (fixed deposits) with commercial banks ▪ If money supply in the country is measured using M3 measure, it is called '**aggregate monetary resources'** of the country. **M4: Broad Money:** M3 + Post Office deposits (both demand and time) [other than in the form of National Saving certificates]

- **'Narrow Money' and 'Broad Money**' concept of money supply:
  - If M1 or M2 measure are used for estimating total money supply in the country, it is known as '**narrow money**' concept of money supply.
  - If M3 or M4 measures are used for estimating total money supply in the country, it is known as **'broad money**' concept of money supply.

- **The Concept of Liquidity:**
  - Liquidity of an asset refers to its convertibility into money/cash. Faster an asset can be converted into cash, **more liquid** it is.
    - **Chequeable deposits/ demand deposits** are highly liquid assets. We can state that **M1** includes **only those components** of money supply which are most liquid.

    - **Time deposits or time deposits/ fixed deposits** are not chequeable deposits. These can't be withdrawn by issuing a cheque. These deposits are, therefore, less liquid than the demand deposit.
      - Accordingly, **M3 and M4** measures of money supply includes such components of money supply which are less liquid.

- **Liquidity:** M1 > M2 > M3 > M4

- **Money Multiplier (M_b) = M_3/M_0**
  - M3 = M_0 * M_b
  - So, if M_b is equal to 5, in this case M0 will be multiplied by 5 to achieve broad money.
    - It means, money supply will increase five times.
  - Money multiplier is thus telling how the base money multiplies in the banking system of the economy.
    - Banks create new money whenever they create loans. When Money multiplier is higher, it indicates the banking system is able to create higher money supply out of money given by central bank.

- **Liquidity Aggregates:**
  - **L_1 =** M3 + All deposits of post office saving banks excluding National Savings Certificates (NSCs)
  - L2 = L1 + Term Deposits with Term Lending Institutions and Refinancing institutions (FIs) + Term borrowing by Refinancing Institutions + Certificate of Deposits issued by FIs.
  - L_3 = L2 + Public Deposit of Non-Banking Finance Companies (NFBCs)

4. MONEY SUPPLY MEASURES REPORTED IN ESI 2022-23

Item
1. Reserve Money (M0)
1.a. Currency in Circulation (CiC)
1.b. Bankers' Deposits with the RBI
2. Narrow Money (M1)
3. Broad Money (M3)
3.a. Currency with the Public
3.b. Aggregate Deposits
Demand Deposits
Time Deposits

– **Reserve Money (M0): Currency in Circulation (CiC) + Bankers' deposit with RBI**. Reserve Money has increased 10.3% as of Dec 2022 compared to 13% last year. So far, increase in M0 was mainly driven by **Banker's deposit with RBI**, with an increase in CRR. **CiC** has broadly remained stable.

– **Broad Money (M3)**: increased by 8.7% YoY as of Dec 2022. From Component side, Aggregate deposit has been the largest component and contributed most to the expansion of M3 during FY23. Among sources, **Bank Credit** to the commercial sector drove the expansion of broad money and the net bank credit to government supplemented the expansion.

– **Share of Bank Credit to commercial sector** in M3 increased to 64.3% as on 30th Dec 2022 from 61.1% in the corresponding period of the previous year, reflecting the upswing in the credit disbursal by commercial banks.

5. RESERVE BANK OF INDIA

- It is India's central bank which was set up in 1935 under the **RBI Act, 1934**.
- **Other facts about RBI:**
    - Initially, RBI also had private ownership, but **in 1949 it was nationalized**.
- **Administration**
    - The **Board of Directors** (21 members) is the key decision-making body of RBI. It consists of:
        i. RBI Governor
        ii. Four Deputy Governors
        iii. Two Finance Ministry Representatives (usually Economic Affairs Secretary and the Financial Services Secretary)
        iv. Ten government nominated directors to represent important elements of India's economy.
        v. Four directors to represent local boards headquartered at Bombay, Calcutta, Madras and New Delhi.

6. FUNCTIONS OF RBI

RBI is a "**Full Service Central Bank"** and is responsible for:

1) MONETARY FUNCTIONS:

These are the functions concerned with money like issue of money, quantity of money, control of money supply etc.

A) ISSUE OF CURRENCY (RBI IS THE BANK OF ISSUE)

- All currency in India (except Rupee 1 notes and Coins of all denominations) are issued and circulated by RBI.
    - **Note:** Rupee 1 note and All coins are issued by Ministry of Finance, GoI, but is circulated, distributed and handled by RBI.
- Currencies are issued by the RBI with the **backing of reserves** comprised of gold and foreign exchange. This is **Minimum Reserve System** which has been followed from 1956 onwards.
    - Under this system, RBI has to keep a minimum reserve of Rs 200 crore comprising of Gold and foreign exchange.
        - » **Rs 115 crore should be in gold and Rs 85 crore in foreign securities.**
- **Note:** This minimum reserve is a token of confidence and doesn't have any practical implication for the amount of currency that can be printed. Unlimited amount of currency can be printed by keeping this reserve of 200 crore.
- Money supply expansion is decided on the basis of economic growth. Higher the economic growth, higher will be the newly issued money by RBI

B) BANKER AND DEBT MANAGER TO GOVERNMENT (CENTRAL GOVERNMENT AND STATE GOVERNMENTS (EXCEPT SIKKIM))

- RBI maintains bank account for government, receive payments into and makes payment out of it.
- It also helps the GoI to raise money form public via issue of bonds and government securities.
- In **Sep 2019**, RBI decided to align its financial year (July-June) to April-March to get in sync with the central government.
- **Note:** For Sikkim, State Bank of India is the banker.

C) BANKER'S BANK

- It is the central bank where commercial banks are account holders and can deposit money. It maintains a banking account of all scheduled Banks.
- Further, it provides financial assistance to banks against mortgaged securities. It rediscounts the bills of exchange.
- RBI is thus a lender of last resort.

D) MANAGEMENT OF FOREIGN EXCHANGE (WILL COVER IN DETAILS WITH EXTERNAL SECTOR)

E) CONTROLLER OF MONEY IN THE MARKET (CREDIT)

F) KEEPS INFLATION IN CHECK.

- It does it through regulating money supply and credit in the country.
- It is thus responsible for India's Monetary Policy (now being taken care of by **Monetary Policy Committee**)

2) REGULATE BANKING SECTOR (COMMERCIAL BANKS, NBFCS ETC.)

3) REGULATE AND SUPERVISE PAYMENT AND SETTLEMENT SYSTEM.

- The Payment and Settlement System Act of 2007 (PSS Act) gives the Reserve Bank oversight authority, including regulation and supervision, for the payment and settlement systems in the country.
- Here RBI focuses on payments systems like IMPS, NEFT and RTGS.

4) IT ALSO PLAYS AN IMPORTANT ROLE IN DEVELOPMENTAL STRATEGY OF THE GOI.

7. RBI'S FUNCTION AS CONTROLLER OF MARKET CREDIT (IN DETAILS)

- The method of credit control is of two types - **Quantitative Method and Qualitative Method**. Both these methods can further be divided into conventional and non-conventional measures.
    - **Conventional measures** are those which are being used for a long time. Non-Conventional measures are those which have been introduced recently, say after 1990s.

- **Quantitative Methods:** These are aimed at controlling the cost and quantity of credit. It doesn't discriminate between different sectors and end use of the credit. These are applicable to whole economy.

1) CONVENTIONAL QUANTITATIVE METHODS INCLUDE BANK RATE, OPEN MARKET OPERATIONS, AND VARIABLE RESERVE RATIO.

A) BANK RATE POLICY (OR) DISCOUNT RATE POLICY:

- Bank rate or the discount rate is the rate fixed by the Central bank at which it rediscounts first class bills of exchange and government securities held by commercial banks.
- By varying this interest rate, RBI controls the credit. At high Bank rate, money supply will be low and at low bank rate money supply can increase.

B) OPEN MARKET OPERATIONS:

These are market operations conducted by RBI by way of **sale/purchase of government securities, bills and bonds of the government as well as private financial institutions** to/from market with an objective to **adjust rupee liquidity conditions** in the market.

- For instance, in March 2020 due to COVID-19 crisis, more money was required in the market. RBI decided to infuse Rs 10,000 crore liquidity in the banking system by buying securities through Open Market Operations.

C) VARIABLE RESERVE RATIO:

In this method the reserves which schedule banks have to maintain are varied to control the credit creation. There are two types of reserves.

CASH RESERVE RATIO

- **Under RBI Act, 1934** - Scheduled Banks are required to **keep a % of their net time and demand deposits** (i.e., total deposits of customers) in the form of cash (in their vaults) or as deposits with RBI.
- **Objectives of CRR:**

- Since a part of total deposits in bank is available in the form of cash, it can be used to readily make money available to customers when they demand it.
- Further, RBI also controls the amount of money in market and thus inflation through CRR.

- **Note:**
  - Banks don't get any interest for this money deposited with RBI.
  - CRR has to be maintained in cash only.

STATUTORY LIQUIDITY RATIO (SLR)

- **Under Banking Regulation Act, 1949**, Banks have to maintain a stipulated proportion of their net demand and time liabilities in the form of liquid assets like cash, gold or government securities in their vault itself. It need not be deposited with RBI.
- Banks have to report to RBI every alternate Friday about their SLR maintenance and pay penalties for failing to maintain SLR.
- Interest income is available on SLR (for e.g., when bank earns from investing in government securities)
- **Purpose**
  - Ensure the solvency of the banks by ensuring that banks don't lend all their deposits which would be very risky. Thus, SLR is used to control the bank's leverage for credit expansion.
  - Control the money flow to market.

- **NOTE:** CRR and SLR are to be maintained on daily basis as a % of NDTL on **last Friday of second preceding fortnight**.
- **Penalties** for not maintaining CRR and SLR:
  - Bank Rate + 3% on shortfall
  - Bank Rate + 5% on shortfall on subsequent default days.

2) NON-CONVENTIONAL QUANTITATIVE METHODS:

A) LIQUIDITY ADJUSTMENT FACILITY:

It is a short-term credit control measure. It absorbs the excess liquidity (money supply).

REPO RATE:

Rate at which banks borrow from RBI by mortgaging their dated government securities or treasury bill. This is for short period 2-14 days.

REVERSE REPO

It is the rate at which RBI borrows from commercial banks by mortgaging its dated government securities or treasury bills.

STANDING DEPOSIT FACILITY (SDF)

- In April 2022, MPC decided to institute a new instrument called the SDF as the floor in the Liquidity Adjustment Facility (LAF) corridor.
    - It was recommended by the 'Expert Committee to Revise and Strengthen the Monetary Policy Framework' (Urjit Patel Committee) in Jan 2014.
    - In 2018, the section 17 of the RBI Act was amended to empower the RBI to introduce this instrument.

- With this **fixed rate overnight reverse repo has ceased to be the floor of the LAF corridor**.

- **What happens to Reverse Repo:** It should be noted that reverse repo **continues to remain in the toolkit of the RBI** as a monetary policy instrument and its operation will be at the discretion of the RBI for purposes specified from time to time.

- **SDF, as it stands currently** has the **following features:**
    i. It is floor of the LAF corridor, replacing the hitherto fixed rate reverse repo.
    ii. It is a monetary policy instrument to absorb liquidity without collateral (collaterals in this case are normally government securities).
    iii. It is operated on **overnight basis**, with the flexibility to absorb liquidity for longer tenor with appropriate pricing.
    iv. Deposits under SDF shall not be reckoned as balances eligible for the maintenance of the CRR under section 42 of the RBI Act, 1934, but shall be an eligible asset for maintenance of the SLR under section 24 of the Banking Regulation Act, 1949.
    v. Both the standing facilities - the **MSF** (Marginal Standing Facility) and the **SDF** will be available on all days of the week, throughout the year.

- SDF is designed to **absorb surplus liquidity** which is transient in nature reflected in the increase in deposits of the government with the RBI.
    » This surplus liquidity is primarily on account of an increase in advanced tax receipts, sudden increase in public provident funds and small savings receipts and temporary postponement of certain expenditure.
    » The durable liquidity is in terms of net capital flows either in the form of equity such as FDI or debt such as ECB, NRI deposits and trade credit.

» SDF being a **non-collateralized instrument gives the flexibility for surplus liquidity management of larger magnitudes as it removes the "binding constraints"** on RBI to possess government securities in its balance sheet.

B) MARGINAL STANDING FACILITY (MSF)

- It is an overnight loan facility given by RBI to banks which have current and Subsidiary General Ledger account with RBI. The interest rate is generally 25 basis points above the repo rate.
- The loans are given against the mortgage of eligible securities, which are government date securities, treasury bills, and state development loans.
  - The loan size can be minimum one crore and further amount is in multiples of one crore.

C) MARKET STABILIZATION SCHEME:

- It is **not a purely monetary instrument**. It is a **fiscal cum monetary instrument**. It is a facility to control liquidity due to excess foreign exchange flow into the country. In this facility, the RBI issues government securities to absorb excess liquidity.
- The interest is paid by Ministry of Finance, GoI. The amount of issue and date of issue is decided by RBI in consultation with Ministry of Finance, GoI.

D) SPECIAL MARKET OPERATIONS:

RBI in recent times is undertaking the following special market operations:

- Operation Twist (OT)
- Long-Term Repo Operations (LTRO)

OPERATION TWIST:

Under this RBI buys Government Securities (GSECS) having long term maturities say five years and ten years and sells GSECS of shorter-term maturities say one year and three year.

- It is one of the methods of **quantitative easing** which is aimed at managing market yield of the bonds mainly to reduce rate of interest in long-term which would help to boost economy.
- Lower long-term interest will infuse money/credit into the economy.
- Higher short term interest rates prevent outflow of investments and foreign exchange.

LONG TERM REPO OPERATIONS:

- **Here,** RBI lends money to the banks for one to three years by accepting GSECS as collateral. It is lent at repo rate. It helps in infusing liquidity in the market at lower rate of interest.

3) QUALITATIVE (OR) SELECTIVE METHODS:

These methods control the use and direction of credit. These discriminate between sectors. Currently, RBI is not using most of these methods. It primarily uses the qualitative control method.

A) REGULATION OF MARGIN REQUIREMENTS:

Margin is the amount that has to be contributed by a borrower towards the purpose for which she/he borrows.

B) REGULATION OF CONSUMER CREDIT:

- Two devices are used here:
  - **Minimum Down Payment**
  - **Period of Repayment**

C) RATIONING OF CREDIT:

Here maximum about of credit flow to a particular sector is controlled. There are two methods:

- **Variable Portfolio Ceiling**
  - Under this the maximum amount of credit for various portfolios (various sectors) is fixed. Different ceilings for different sectors is fixed.
- **Variable Capital Risk Weighted Asset Ratio**
  - Capital to Risk Weighted Asset Ratio (CRAR) is also called Capital Adequacy Ratio (CAR). It signifies the availability of sufficient capital as a percentage of risk weighted assets.

D) DIRECT ACTION:

Central bank issues certain policy decisions from time to time on the prevailing situations in the economy.

E) MORAL SUASION

Methods of persuasion, methods of request, methods of informal suggestion and methods of advices to commercial banks, about dos and don'ts by calling a meeting.

F) PUBLICITY:

It denotes the publication of weekly or monthly statements of assets and liabilities of commercial banks. This brings transparency and puts moral pressure on erring banks not to violate norms. So, banks abide by credit control measures.

8. RBI AND INFLATION TARGETING

- **Introduction**
  - » The Monetary policy is generally focused on **regulating supply of money in an economy** by the monetary authority of the country for achieving **GDP growth**, **stable business cycle, price**

stability, and **exchange rate stability.** Like fiscal policy, it is an integral arm of public policy. It **cools down the economy** when it overheats (through contractionary monetary policy) and **boosts the economy** during depressed financial activity (through expansionary policy).

- **Expansionary** monetary policy is achieved by lowering Repo Rate, Reverse Repo Rate, CRR, SLR etc. i.e. by **increasing the availability of money in the economy**.

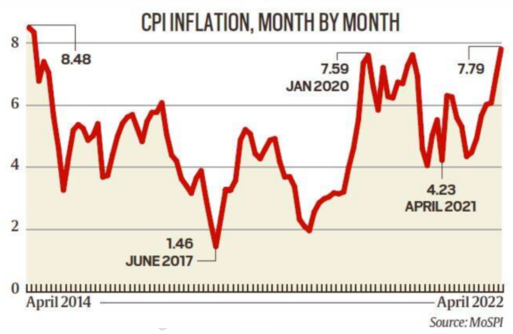
- **India's Current Monetary Policy**
  - **In the past**, RBI had pursued a **multiple indicator approach** i.e. it tried to control multiple outcomes - inflation, growth, exchange rate, and even balance of payment - through monetary policy.
  - But **RBI Act, 1934** was **amended in 2016** to introduce the framework of **Flexible Inflation Targeting** (FIT).
    - Under FIT, the primary objective of the Monetary Policy is to **ensure price stability** (i.e. ensure inflation in a particular range). Inflation is measured in terms of **Consumer Price Index (CPI),** thus making monetary policy contributes to **welfare of people**.
      - Further, it also **promotes transparency** as lay person can easily judge if the monetary policy is working for the betterment of the people of India.
    - The amendment provides that **inflation target** would be set by Central government, after discussing with the Reserve Bank, **once in every five years**.
      - **For 2016-2021,** the central government had set a target of 4% inflation rate with a **tolerance of +-2%**. Again for 2021-26, the centre has decided to **retain the inflation target of 4%, with a tolerance band of +/- 2 percentage** points for the MPC of RBI.
        - This tolerance band has been provided to deal with supply shocks like vagaries of Monsoon, crude price changes etc.
      - In case of **continuous deviation of actual inflation** from the target's tolerance bands for three consecutive quarters, the **RBI has to write a letter** to the GoI explaining the reasons for deviations and the time it will take to return inflation to its target. It thus **promotes Accountability**.

  - **Section 45ZB** of the RBI Act, 1934 also provides for a **six member Monetary Policy Committee (MPC)** to be formed by government for inflation targeting. MPC consists of:
    a. Governor of RBI - Chairperson of MPC - ex officio
    b. Deputy Governor of the RBI, in charge of Monetary Policy – Member, ex officio.
    c. One officer of the RBI to be nominated by the Central Board – Member, ex officio.
    d. 3 external members nominated by GoI.

  - The **decision is taken by majority** with the Chairperson having the casting vote. MPC conducts meetings at least four times a year (atleast every quarter) and monetary Policy is published after every meeting with each member explaining her opinion.

- **Before MPC**, all the interest rate related decisions were taken by Governor of RBI.
- Thus, the **MPC system replace individualistic decision-making by a collegial process** that brings in variety of experience, expertise and independence while avoiding groupthink and free-riding.

- **How has Flexible Inflation Targeting Worked so far?**
  - **Positives:**
    - FIT has been regarded as an important reform in country's economic management making it follow the **global best practices**.
      - It has promoted welfare of people, transparency, accountability and non-individualistic decision making system in RBI.



    - It has **effectively controlled inflation** as CPI has averaged 4.2%, between Sep 2016 and March 2020. Recent times have seen some fluctuation in inflation due to **COVID-19** supply disruptions, War in Europe and High Crude oil prices

  - Rating agencies and multilateral institutions have repeatedly mentioned the MPC and the inflation targeting framework as a **landmark structural reform towards sound macroeconomic management**.
  - **Negatives:**
    - **RBI hasn't been proactive and has remained behind the curve on inflation targeting**
    - **RBI has been very proactive on its non primary role** (i.e. dealing with decline in rupee (by selling forex); Keeping interest rates on government securities low, to help government finance its fiscal deficit; pay ample dividends to the government. With **RBI chasing five different targets,** it is hardly surprising that it lost sight of its inflation objective.
    - **Outside members of MPC** were supposed to give independent opinions. But the published minutes show that they haven't produced alternate inflation forecasts. Nor have they questioned the monetary strategy.

- **Conclusion:**
  - Inflation control is the lynchpin of macroeconomic stability which, in turn, is the foundation for sustained, inclusive growth
  - Considering the risks that the unanchoring of inflation and inflation expectation pose to macroeconomic stability, and the country's growth prospects, the central bank must continue to focus on maintaining price stability, attaching primacy to inflation targeting.

9. TRANSMISSION OF MONETARY POLICY: ISSUE OF STICKINESS IN BANK LENDING RATES

- **Introduction**
  - Stickiness in Bank lending refers to a situation where the RBI reduces its benchmark rates, but the benefit doesn't reach the final retail customers.
  - Banks tend to lower down the interest rates on deposits but doesn't reduce the interest rates on loans so swiftly.

- **Concerns due to this stickiness**
  - **Economic Growth** is negatively hampered and the purpose for which RBI reduces the policy rate is defeated.
  - **Small saving account holders** suffer as there deposits interest rate is reduced but loans still remain expensive.

- **Understanding Older System - BPLR, BASE Rate, MCLR System**
  - **Background (Prime Lending Rate)**
    - **Before the 1991 economic reforms**, lending rates of banks were **regulated by RBI**.
    - **Deregulation of lending rate:** In 1994, lending rate for **loans above Rs 2 Lakh were deregulated**. Banks could decide the lending rate based on risk perception and commercial judgment. Here bank was supposed to declare **Prime Lending Rate,** the rate that it would charge its most credit worthy customers.
    - In 2001-02, RBI permitted lending to credit-worthy customers at **sub-PLR rates**. This was done on the request of banks as well as to follow the international trend. So, PLR didn't remain the minimum lending rate anymore.

  - **BPLR System**
    - The rigidity and inflexibility in the PLR system, led to the introduction of **Benchmark Prime Lending Rate** (BPLR) system in **2003**.
      - The main objective was ensuring transparency in lending rate and not allowing exploitation of any section of borrowers.
      - Banks would fix BPLR with the approval of their board. However, RBI stipulated that the rate be influenced by the repo rate and CRR apart from the individual bank's policy.
      - BPLR was treated as reference for lending.
        - Clients with good credit will be offered rates below BPLR and those with risky credit, can be offered higher rates.
      - **Mis-use of BPLR**
        - Since, there was **no lower limit in BPLR**, it allowed banks to charge as low as 4% from big corporates (mostly because of lobbying) and charge high interest rate from retail borrowers (cross subsidization).

- This system turned out to be opaque as there was no mandated criteria to define the credit worthiness of a customer.
- Transmission of Monetary policy was also not ensured (and sometimes only ensured for new borrowers)

- **Base Rate System**
  - To deal with the problems of BPLR system (to achieve transparency in lending and transmission of monetary policy), RBI introduced **Base rate System** in 2010.
    - Base rate is the minimum lending rate prescribed by each commercial bank.
      - Banks (not RBI) fix this rate considering other factors and can't lend below this rate to attract borrowers. (**exceptions** include giving loans to employees, loans to bank depositors against their own deposits etc).
      - According to RBI policies, banks have to revise their base rate at least once every quarter.
      - Since 2010, it was mandatory for banks to offer new loans linked to base rate while NBFCs can still provide loans linked to prime lending rate.
    - This system was **successful in ensuring transparency**, but it **didn't ensure transmission of monetary policy**.
      - This was because banks used different methods to calculate base rates and used this flexibility to prevent transmission.
      - Further, sometimes only Base rates were changed and BPLR kept same, thus benefitting only new customers.

- **MCLR System**
  - The limitations of the BRS was intended to be overcome by the implementation of **Marginal Cost of Fund Based Lending Rates (MCLR)** system, which came into effect in April 2016.
    - This leaves banks with lesser flexibility while fixing lending rates.
      - All the loans sanctioned after April 1, 2016 have to be priced with reference to the marginal cost of fund-based lending rate (MCLR)

  - **Details**
    - MCLR is a **tenor linked internal benchmark**, which means the rate is determined internally by the bank depending on the period left for the repayment of loan.
    - MCLR is closely linked to deposit rates and is calculated based on **four components**:
      - The Marginal Cost of Fund
      - Negative Carry on account of CRR
      - Operating Cost
      - Tenor Premium

- **Two Main differences** from the Base Rate System
  - Under MCLR, the latest (at the time of review) rates offered on deposits or borrowings is taken into account.
  - The second major change is consideration of **Tenor Premium**.
    - It is a premium charged by banks to the borrower for the risks associated with the long-term tenor. The tenor premium is not specific to a loan class or borrower, and it will be uniform for a given residual tenor
    - Tenor Premium arises from loan commitments with longer tenors.
- **Advantages of MCLR**
  - Other than providing more transparency, it provides for better transmission of monetary policy.
  - The MCLR is based on current cost of funds for banks as compared to overall cost of funds for the banks. Thus MCLR rates are lower as compared to base rate.

- **Note:**
  - MCLR is the lowest interest rate that a bank or lender can offer. It is applicable for fresh corporate loans and floating **loans taken before Oct 2019. After this RBI has switched to the external Benchmark linked lending** rates (EBLR) system where lending rate is linked to benchmark rates like repo or Treasury Bill rates.

– **External Benchmark Linked Lending** Rates (EBLR)
  - RBI made it **mandatory for all banks to link floating rate loans** - to retail customers and loans to MSMEs to **an external benchmark from 1st of Oct, 2019**.
    - Bank can choose from one of the **four external benchmarks** - repo rate, three-month treasury bill yield, six monthly treasury bill yield, or any other benchmark interest rate published by Financial Benchmarks India Limited.
    - **Adoption of multiple benchmark** by the same bank is not allowed within a loan category.
    - Banks are allowed to decide on the **spread** over the external benchmark, **credit risk premium** can change only when borrower's credit assessment undergoes a substantial change.
    - Other components of **spread**, including operating cost, could be altered once in three years.
    - **Interest rate** under external benchmark shall be reset at least once in three months.
    - **Existing customers** under MCLR system with floating rate are eligible to switchover to the new external benchmark without any charges.
  - **Banks have linked their EBLR to the RBI's Repo Rate**.
  - **Why?**

        - Faster transmission of monetary policy. RBI had found transmission of monetary policy under MCLR framework as not satisfactory.
    - **Note:** The share of EBLR loans in total advances was 39.2% in Dec 2021 according to RBI.

- **Recommendation of Janak Raj Committee**
    - Key Highlights
        i. All floating rate loans advanced from April could be referenced to **one of the three external benchmarks**.
            - The committee has recommended a risk free curve involving rates on treasury bills, or certificate of deposits rates, or the RBI's repo rate.

        ii. Lending rate should be reset once every quarter, from the current practice of once a year.

        iii. Transfer all existing borrowers under BPLR, Base Rate or MCLR to the external benchmarked rate without any conversion fee or other charges within one year of its introduction
    - **Other observations**
        - **Arbitrariness of banks** in calculating MCLR and Base rate is leading to lower transmission of monetary policy
            - The spreads charged over these internal benchmarks has undermined the integrity of the interest rate setting process. In some cases, the tenor and risk premium charged was different for customers in the same risk category.

10. PRIORITY SECTOR LENDING (PSL)

- **Introduction:** In order to ensure all round development of the economy, RBI mandates banks to provide a specified % of the bank lending to few specific sectors like Agriculture and allied activities, MSME, Education, weaker section etc. This lending is known as priority sector lending.
    - **Rationale or Need of such norms:** Loans/credit to certain sectors may not be very profitable for banks and thus are ignored. But, these sectors are crucial for the development of the country and inclusive growth. Therefore, RBI mandates compulsory lending to these sectors.

- **Different Sectors/Categories under Priority Sector** (As on Oct 2023)
    i. Agriculture
    ii. Micro, Small and Medium Enterprise
    iii. Export Credit
    iv. Education
    v. Housing
    vi. Social Infrastructure
    vii. Renewable Energy
    viii. Others

– **Targets / Sub-targets for banks under priority sector (Oct 2023)**

Categories	**Domestic commercial banks (excl. RRBs & SFBs) & foreign banks with 20 branches and above**	**Foreign banks with less than 20 branches**	**Regional Rural Banks**	**Small Finance Banks**
Total Priority Sector	40 per cent of ANBC or CEOBE whichever is higher.	40 per cent of ANBC or CEOBE whichever is higher; out of which up to 32% can be in the form of lending to Exports and not less than 8% can be to any other priority sector.	75 per cent of ANBC or CEOBE whichever is higher; However, lending to Medium Enterprises, Social Infrastructure and Renewable Energy shall be reckoned for priority sector achievement only up to 15 per cent of ANBC.	75 per cent of ANBC or CEOBE whichever is higher.
Agriculture	18 per cent of ANBC or CEOBE, whichever is higher; out of which a target of 10 percent is prescribed for Small and Marginal Farmers (SMFs)	Not applicable	18 per cent ANBC or CEOBE, whichever is higher; out of which a target of 10 percent is prescribed for SMFs	18 per cent of ANBC or CEOBE, whichever is higher; out of which a target of 10 percent is prescribed for SMFs
Micro Enterprises	7.5 per cent of ANBC or CEOBE, whichever is higher.	Not applicable	7.5 per cent of ANBC or CEOBE, whichever is higher	7.5 per cent of ANBC or CEOBE, whichever is higher
Advances to Weaker Sections	12 percent of ANBC or CEOBE, whichever is higher.	Not applicable	15 per cent of ANBC or CEOBE, whichever is higher	12 percent of ANBC or CEOBE, whichever is higher

- **Note:**

- **ANBC**: Adjusted net bank credit
- **CEOBE:** Credit Equivalent of Off-Balance Sheet Exposures

– **Targets/ Sub-Targets for UCBs**

Categories	Primary Urban Cooperatives
Total Priority Sector	40% of ANBC or CEOBE whichever is higher, in FY20, which shall stand increased to **75%** of ANBC or CEOBE, whichever is higher, wef from FY26.
Micro Enterprise	7.5% of ANBC or CEOBE, whichever is higher
Advances to Weaker Section	12% of ANBC or CEOBE , whichever is higher. The revised target for weaker section will be implemented in a phased manner from 10% in FY20 to 12% in FY26.

– **Adjustments for weights in PSL Achievements**:
  - To address regional disparities:
    - From FY22 onwards, a higher weight (125%), would be assigned to the incremental priority sector credit in the identified districts where the credit flow is comparatively lower (per capita PSL less than Rs 6,000), and a lower weight (90%) would be assigned for incremental priority sector credit in the identified districts where the credit flow is comparatively higher (per capita PSL greater than Rs 25,000).

– **Agriculture sector is further classified under** three subcategories viz. Farm Credit, Agriculture Infrastructure and Ancillary Activities.

– **What is included under Weaker section under PSL**
  - Priority sector loans to following borrowers are eligible to be considered under weaker section category:
    i. Small and marginal farmers
    ii. Artisans, village and cottage industry where individual credit limit doesn't exceed Rs 1 Lakh.
    iii. Beneficiaries under NRLM, NULM, Self-Employment Scheme for rehabilitation of manual scavengers
    iv. SCs and STs
    v. Beneficiaries of Differential Rate of Interest (DRI) Scheme
    vi. SHGs
    vii. Distressed farmers indebted to non-institutional lenders
    viii. Distressed person (other than farmers), with loans not exceeding Rs 1 Lakh per borrower to pre-pay their debt to non-institutional lender.
    ix. Individual women beneficiary upto Rs 1 Lakh per borrower
    x. Person with disabilities
    xi. Minority communities as may be notified by Government of India from time to time.

– **What are priority sector lending Certificates (PSLCs)**

- It is a mechanism to **enable banks to achieve their PSL targets and sub-targets by purchase of these instruments in the event of shortfall**.
- This also incentivizes surplus banks as it allows them to sell their excess achievement over targets and thereby enhancing lending to categories under priority sector.
- In this mechanism there is no transfer of risk or loan assets.

– **Is rate of interest different for PSL**
  - The guidelines don't lay down any preferential rate of interest for priority sector.

– **What happens when bank doesn't meet the target?**
  - They have to invest an amount equal to the shortfall to Rural Infrastructure Development Fund **(RIDF** - it came into existence in 1996) maintained by NABARD.
    - » The primary purpose of RIDF is to encourage commercial banks to meet their targets.
    - » Interest rate levied on RIDF varies from two to four percent below bank rates depending on the extent of shortfall in PSL targets.

GS FOUNDATION FOR CSE 2024
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RBI, BANK NATIONALIZATION, BANK CONSOLIDATION

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2. RBI

1) **KEY FUNCTIONS –** DISCUSSED IN PREVIOUS BOOKLET

2) **CURRENT POLICY RATES** (AS OF OCT 2023)

3) RBI'S SURPLUS TRANSFER TO GOVERNMENT

- **Background:**
  - **Where does RBI gets its Revenue from?**
    - **Foreign exchange transactions** (RBI buys when dollar is cheap and sells when it is expensive (i.e. high in demand)
    - **Interest Income** (from government bonds, Liquidity Adjustment Facilities etc.)
    - It also earns a **management commission** on handling the borrowing of state governments and the central government.
  - **Where does RBI spend money?**
    - Most of the RBI's expenditure is on printing of currency notes, and on staff, besides the commission it gives to banks for undertaking transactions on behalf of the government across the country and to primary dealers, including banks, for underwriting some of these borrowings.

- The **Surplus (Revenue - Expenditure)** is used for transfers to government and increasing the RBI reserves.
  - **Section 47 of the RBI Act, 1934**: "After making provision for bad and doubtful debts, depreciation in assets, contributions to staff and superannuation fund [and for all other matters for which] provision is to be made by or under this Act or which are usually provided for by bankers, **the balance, of the profits shall be paid to the Central Government**"
  - **Section 48 of the RBI Act, 1934** exempts the bank from paying any income tax, wealth tax or super tax.

- **RBI's Reserves:**
  - The RBI has three mains funds that together comprise its reserves. These are:
    - **Currency and Gold Revaluation Account** (CGRA) (basically the Economic Capital Buffer)
      - It is mantained by RBI to take care of currency risk, interest rate risk and movement in gold prices risk.

        - Unrealized gains or losses on valuation of foreign currency assets (FCA) and gold are not taken to the income account but instead accounted for in the CGRA. Net balance in CGRA therefore varies as per the size of the asset base, its valuation and movement in the exchange rate and price of gold.
        - When CGRA is not sufficient to fully meet exchange losses, it is replenished from the CF.
        - **The balance** of CGRA increased from Rs 664,480 crores in June 2019 to Rs 977,141 crore as on June 30, 2020. It was mainly due to depreciation of rupee and the rise in the international prices of gold.
        - It is by far the **largest** reserve account of RBI and makes up the significant bulk of RBI's reserve.
    - **Contingency Fund** (CF):
        - It is a provision meant to meet **unexpected and unforeseen contingencies**, including depreciation in the value of securities, risks arising out of monetary/exchange rate operations, systematic risks and any risk arising on account of the special responsibilities enjoined upon the Reserve Bank.
        - The CF is the **second biggest fund** of RBI after the CGRA
    - **Asset Development Fund** (ADF)
        - It makes up a much smaller share of reserves and is also focused on contingent times.

- **Other RBI Accounts**
    - » **Investment Revaluation Account - Foreign Securities** (IRA-FS): The unrealized gains or losses **on revaluation of foreign dated securities** are recorded in the IRA-FS.
    - » **Investment Revaluation Account - Rupees Securities (IRA-RS):** The unrealized gains or losses on revaluation of Rupee securities (IRA-RS) is accounted for in Investment Revaluation Account - Rupee Securities (IRA-RS).

- In 2018, there was a difference between RBI and Finance Ministry on the amount of reserve RBI should keep.

- Following this, **RBI in consultation with the Central Government,** had constituted a **committee chaired by former RBI governor Bimal Jalan to review the Extant Economic Capital Framework (ECF) for the RBI**.
    - **Key Recommendations of the Revised Economic Capital Framework** (ECF) for the RBI:
        - » Make a **distinction** in the economic capital of the RBI between '**revaluation reserves**' and '**realized equity**'.
            - **Revaluation Reserves** are risk buffer against market risks and not available for transfers.

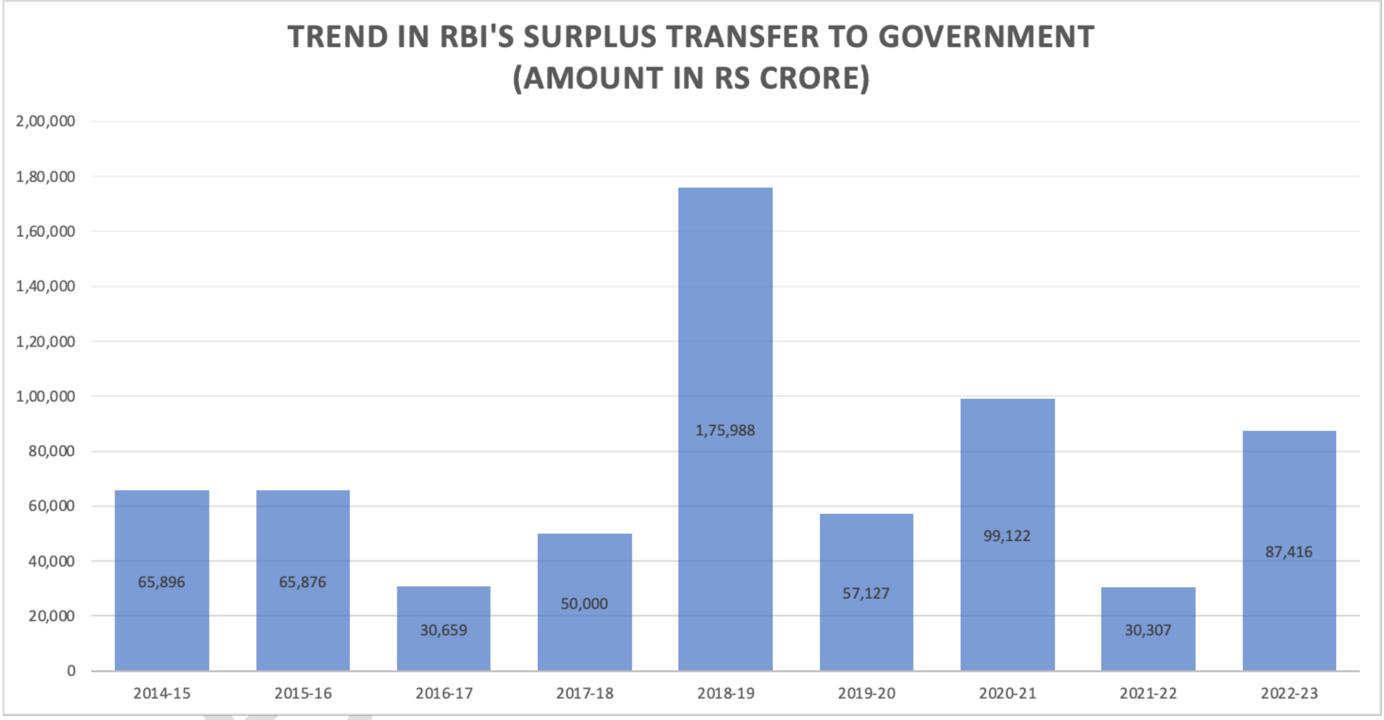
» **Economic Capital Levels** (basically CGRA) should be in the range of **20-24.5%** of the balance sheet

» RBI should maintain a **Contingent Risk Buffer** - which mostly comes from CF - of between **5.5-6.5%** of the Central Bank's Balance Sheet. **The excess amount** should be transferred to government.

» A transfer of surplus from the RBI to the government in a phased manner in accordance with the existing practice

- **The committees recommendations** were based on the consideration of the role of central banks' financial resilience, cross-country practices, statutory provisions and the impact of RBI's pubic policy mandate and operating environment on its balance sheet and the risk involved.

- In Aug 2019, **RBI board accepted all the above recommendations of the Bimal Jalan Panel committee to transfer Rs 1.76 lakh crore of surplus to government**.



– **RBI's Central Board** approves the transfer of surplus (i.e dividend) to the Union government for every accounting year.

– **Analysis: Positives**

i. **As RBI's only shareholder** government has rights over the profits of RBI.

ii. **Further, RBI is** amongst **the most capitalized central banks** in the world, so reduction of excess capital shouldn't be a bad idea.

iii. **More productive utilization of RBI's Cash**: Excess capital in the reserves of RBI is in a way underutilization of resource which could have been used in infrastructure development or other constructive purposes having higher multiplier effect.

iv. **Helps government deal with economic slowdown**

- For e.g., the transfer of 87,416 crores in FY23 boosted the fiscal position amid slowing disinvestment.

– **Analysis: Negatives**

i. **Strong RBI Buffer** is crucial to deal with crisis situation in the situation of financial catastrophe. With less reserves, RBI will have less wiggle room in the event of financial catastrophe.

ii. **Excess release of** money by RBI may also add to **inflationary pressure**.

iii. Further, the huge transfer may **also indicates erosion of RBI's independence**.

– **Conclusion1:**

» Jalan committee appears to have maintained a balanced approach in ensuring enough capital with RBI for contingencies and providing relief and maneuverability to the beleaguered Centre. The decision of RBI board should be welcomed, but at the same time, government should be prudent in using these funds.

– **Conclusion2**:

» RBI's surplus transfer isn't just a financial transaction. It's a testament to the institution's role in economic stability and a window into the dynamic relationship between the central bank and the government.

3. BANK NATIONALIZATION

– **Banking Structure: Nationalization to today**

» India's public sector banks (PSBs) are essentially legacy banks from the colonial period that were subsequently nationalized.

- For e.g.: **State Bank of India** was founded as Bank of Calcutta in 1806, took the name Imperial Bank of India in 1921 and became **state owned in 1955**.
  - Within 4 years, its seven subsidiaries were also amalgamated into the SBI branch.

» The **remaining PSBs** in India were formed through **two waves of Nationalization**, one in **1969** and the other in **1980**.

- On **19th July 1969**, the Indira Gandhi government promulgated an ordinance to nationalize 14 largest private banks of the country having deposits of at least Rs 50 crore. (foreign banks were excluded from the list). The ordinance was later replaced by **The Banking Companies (Acquisition and Transfer of Undertaking) Act, 1969**.
  - **List:** Central Bank of India, Bank of India, Punjab National Bank, Bank of Baroda, UCO Bank, Canara Bank, United Bank of India, Syndicate Bank, Dena Bank, Union

Bank of India, Allahabad Bank, Indian Bank, Indian overseas Bank and Bank of Maharashtra (in the order of total deposits).

- There were **three compensation options:** Cash; ten-year central government securities at par carrying 4.5% interest per annum, and thirty year central government securities at par carrying interest at 5.5% percent per annual.

» **The 6 banks** which were nationalized in 1980s included Punjab and Sind Bank, Vijaya Bank, Oriental Bank of India, Corporate Bank, Andhra Bank and New Bank of India.

– **Declining Share of PSB**

▪ After the 1980 nationalization, **PSBs** had 91% share in the national banking market with the remaining 9% held by "**Old Private Banks**" (OPBs) that were not nationalized.

▪ **As of 2019**, **PSBs** represent between 65%-70% of the aggregates for all scheduled commercial banks operating in India.

▪ The decline in PSBs share has been largely absorbed by **"new Private banks" (NBPs)**, which were licensed in early 1990s after a liberalization of licensing rules that earlier regulated the bank entry.

– **Why was nationalization done?**

» To **sync the banking sector with the goals of socialism** adopted by the Indian government after independence. Nationalization was done to **energize priority sector** at the time when large businesses dominated credit profiles.

» **Ending class banking:** there was a long standing perception that bankers were not ready to give loans to farmers. Further, since most of these banks were owned by industrialists, they ensured that a large section of money went to these industries.

» **Share of rural and semi-urban bank branches** were not going up i.e. banks were not willing to serve in rural areas.

– **Advantages of nationalization/ Achievements**

» The third volume of Reserve Bank of India's history termed nationalization of banks as the "single most important economic decision taken by any government since 1947. Not even the reforms of 1991 are comparable in their consequences - political, social, and of course, economic.

» **Between 1969 - 1980**:

  ○ The **number of rural branches** increased ten fold from about 1,443 in 1969 to 15,105 in 1980 compared to two fold increase in urban and semi-urban areas.

  ○ **Credit to rural areas** increased from Rs 115 crore to Rs 3,000 crore **[20 fold increase]**.

  ○ **Credit to agriculture expanded 40 fold**.

  ○ These growths represented a significant correction to the undersupply of credit to farmers that drove nationalization.

    - The key goals of nationalization such as energizing priority sector lending, ending class banking and promoting more bank branches in rural and semi-urban India have more or less been achieved.
  - Some **immediate advantages of Bank Nationalization** were:
    - **Rise in financial savings** (as banks opened branches in earlier unserved rural and semi-urban areas). **Gross domestic savings almost doubled** as a percentage of national income in 1970s.
  - In fact, some recent flagship initiatives like **Jan Dhan Yojna** have been successful because of the presence of so many Public Sector Banks.
    - Of the 46 crore accounts, only **2.82%** of them are in private sector.

- **Limitations of nationalization/ Failures**
  - Some experts say **that stunted growth of India's banking sector** has the bank nationalization as one of the key factors.
    - For e.g. As of 2020, India has only 1 bank in top 100 banks of the world (SBI at rank 55).
  - **Governance of the PSBS, political interference, incentive structure and lack of strict profit** goals have negatively impacted the Public Sector Banks. This can be seen in high % of NPAs accumulating in these PSBS.
    - Further, bank officials are avert of taking risks as that may lead to corruption cases against them.
  - **Financial inclusion** was also not very effective till 2014. It is only PMJDY which has ensured bank accounts to almost all households in the country.
  - **Expensive for government** - Government has had to investment several lakh crores for recapitalization of these banks in last decade only.

- **Conclusion**
  - The bank nationalization may have been necessary at the time, but now its time to provide more autonomy to PSBs. From a larger perspective of efficiency and better utilization of capital, it may be a good idea to move state-owned banks towards a more market-based framework.

1) BANK NATIONALIZATION CASE IN SUPREME COURT: RC COOPER CASE

- In response to nationalization of banks, **Rustom Cavasjee Cooper**, the majority shareholder of Central Bank & Bank of Baroda filed a writ in the Supreme Court for **violation of fundamental rights** mentioned under articles 14, 19(1)(f) & 31(2).

- **Judgment: 10:1 majority**
  - The court found that the impugned act was in **violation of the Article 31** since the act failed to comply with said provisions.
    - The said provision provided that the in case any **property** is acquired by the government then they have to provide compensation to the property owner.

    - The court held that compensation to be awarded 10 years later that too in bonds is too much illogical and detrimental to the affected parties. It is probable that some citizens will not be able to realize the fruits of the agreement due to reasons of emergency situation such as death.
    - **Therefore,** the court struck down the said act.
  - The court also held that the act was in **violation of Article 14(c)** since **only these 14 banks were restrained from conducting banking business** in the future while other banks including the foreign banks were allowed to continue Banking in India.
  - But the court found the act to be **not violative of Article 19(1)(f)**.
    - The court said that the act is not violative of the freedom to carry trade & business. State can always create a partial and absolute monopoly

- **The Banking Companies (Acquisition and Transfer of Undertaking) Act, 1970**
  - Later, the parliament enacted this new law which included the specific amount of compensation to be paid to each bank.

- **25th Constitutional (Amendment) Act, 1971**
  - Further, to negate the impact of RC Cooper case, the Parliament amended the constitution.
    1. The parliament in order to clarify their stance that **they are not bound to adequately compensate the landowners** amended Article 31(2) in case their property is acquired by the state. The word "*amount*" was placed instead of compensation in the provision.
       - Thus the amended permitted the acquisition of private property by the government for public use, on the payment determined by parliament.
       - The word amount can be interpreted as any figure of money and that is not necessarily an adequate, equitable amount.
    2. Article 19(1)(f) was delinked from Article 31(2).
    3. Article **31 C**, a new provision was added to the Constitution to remove all difficulties that
       i. Articles 14, 19 & 31 are not to be applied to any law enacted under the fulfilment of objectives laid down under Article 39(b) & 39(c).
       ii. Any law to give effect to Article 39(b) & 39(c) will be immunized from court's intervention.

4. CONSOLIDATION (MERGER) OF BANKS

- **Introduction**
  - **Narsimhan Committee** on financial sector, set up in **1991**, had recommended consolidation of the banking system by creating 3-4 larger banks which will be comparable to major global banks and around 10 smaller banks to have a national footprint.
  - As of July 2022, India has 12 PSBs. Government has plans to further reduce this number to bring it down to 3-4 large PSBs.
- **Recent Mergers:**
  - Currently, there are 7 larger public sector banks and five smaller ones (**total: 12)**. The aim is to have 4-5 large banks as large and strong as the country's biggest lender SBI.
    - **Note:** In 2017, there were 27 PSBs which have now been reduced to 12.
  - **Mergers So Far in Public Sector:**

- **Merger of SBI and Associate Banks**: In April 2017, SBI merged five associate banks and Bhartiya Mahila Bank with itself. This move projected SBI into the global banking sphere's top 50.
- **Vijaya Bank & Dena Bank** merged with **BoB in 2019** : This created India's third largest public sector bank. It also led to significant operational expansion and improved efficiency of Bank of Baroda.
- **2020 say the beginning of Mega Consolidation exercise**:
  - **Oriental Bank of Commerce** and **Union Bank of India** were merged with **PNB** (making PNB the second largest Public Sector Bank)
  - **Syndicate bank** was merged with **Canara** Bank.
  - **Andhra Bank** and **Corporation Bank** merged into **Union Bank of India**
  - **Allahabad Bank** merged with **Indian Bank**.

» **Mergers in Private Sector**:

- **The Unification of HDFC and HDFC Bank**: The Indian coporate ecosystem was treated to a historic event on July 1, 2023, when HDFC Bank and Housing Development Finance Corporation (HDFC) concluded a merger valued at a staggering $40 billion.
  - With its extraordinary market capitalization of around $172 billion, the newly unified entity holds an impressive global standing, challenging the incumbency of behemoths such as HSBC and CitiGroup.
- **Impact**:
  - **Banking Sector Consolidation gathers pace after HDFC merger**:
    - For e.g. Days after HDFC merger, IDFC First bank, announced its merger with its parent firm IDFC.
      - Note: IDFC Bank made its foray into the banking sector after IDFC limited, an infrastructure financing institution, received a banking license from the RBI in 2014.
    - Experts believe that mergers and acquisition in the financial services sector to continue as it would help them to get capital and increase their reach of new customers.

– **Advantages of consolidation / Bigger banks**

1. **Cost Advantages -> Economy of Scale -> Efficient use of Resources** -> Efficient Operations.
   - Centralized back office processing, elimination of branch overlap, eliminating redundancies in administrative infrastructure, better manpower planning, optimum fund management, and savings in IT and other fixed cost.
   - PSBs also target similar clients in same areas, which leads to unnecessary marketing burden and other extra cost.

- As per an RBI report in 2023, the Banking mergers in India have been beneficial to the banking sector: RBI Paper
    - Mean technical efficiency of acquirers increased from 90.88 in the pre-merger period to 93.80 three years post-merger, and 94.24 five years after merger.
  - **Merging of weaker, smaller bank into higher performing bigger banks** improves the functioning of smaller banks

2. **Alleviate capital requirements**
   - Reduction in the number of banks to a manageable count is expected to reduce the demand of capital infusion by government progressively because of increased efficiency and with more well capitalized banks.
3. **Capable of giving larger loans:** Can give larger loans and thus help in revival of the economy.
4. **Less susceptible to takeovers:** Bigger banks are less susceptible to being taken over by outsiders (if government ever ceded control)
5. **Globally significant bank**.

– **Disadvantages / Limitations of Mergers/ concerns**

1. **Increased Vulnerability of Banking Sector -> too big to fail.**
2. Mergers may **accentuate the strains**. A bank merger is never easy but when both banks have strained balance sheets, it can lead to a collapse.
3. **Eats up a lot of top management time** - IT system, organizational structures, risk systems, exposure limits and product portfolios need to be aligned.
4. **Larger banks doesn't necessarily means more efficient**.
   - E.g. the top banks in China, still end up following directions from the government and have recently faced a lot of issues.
5. **Reduces Competition and thus perhaps efficiency**
6. **Corporate governance Issues**
   - These mergers in India are generally forced by government who is the majority shareholders in PSBs. The views of minority shareholders are ignored.
   - Further, the decision making through ministerial mechanisms amount to an imposition from above. This attenuates the functional autonomy of the bank boards.
7. **Job losses**
   - Merger of banks generally leads to off laying of employees and closure of branches
8. **Negatively affects Financial Inclusion**
   - As the number of branches decrease, the reach of the banking sector decreases. India already has less number of bank branches per capita population when compared to our developing counterparts.
9. **Diverts attention from Other Bank Reforms**
   - Current focus should be on poor governance in public sector banks.

- **Way Forward**
  - While consolidation of the banking system may be a good idea, but the **focus from other banking reforms** like ending political interference, creating more autonomous boards by reducing governments shareholding, promoting more professionalism, giving more regulatory authority to RBI etc. should not be sidelined.
  - The **consolidation should also be done on commercial grounds** rather than for political reasons. The consolidation should be driven by complementarities, growth potential or cost efficiency.
  - The initiative should come from bank board, instead of being imposed from the top.
  - Allow natural failures - In a market economy, some banks would fail and thus will ensure that only the good performing once would survive. It is important that these failures should be allowed without creating a systematic shock for the economy.
  - And finally, the employees, in case being laid off, should be given a good golden handshake, so that their welfare is not hampered.

- **Conclusion**
  - Mergers will be beneficial only if the deep structural flaws which are being faced by banks are properly addressed.

GS FOUNDATION FOR CSE 2024
ECONOMY-8
BANKING SECTOR – CAPITAL ADEQUACY; D-SIBS, DEPOSIT INSURANCE, NPAS

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2. BASEL NORMS

- **What?**
  - Basel norms/standards are **global, voluntary, regulatory framework on bank Capital Adequacy, Stress Testing and Market Liquidity risks**. It is formulated by the Basel Committee on Banking Supervision (BCBS).

    - BCBS aims to enhance the understanding of key supervisory issues and improve the quality of banking supervision worldwide. The committee's **secretariat** is located at the **Bank of International Settlement (BIS) in Basel, Switzerland**.

  - **About Bank of International Settlement (BIS), Basel**
    - BIS, situated at Basel, Switzerland, is a promoter of Central Banks' cooperation in an effort to ensure global monetary and financial stability. It was established in 1930 and is the oldest global financial institution and operates under international law. It is owned by 60 central banks.

  - **Need?**
    - **Ensuring Risk preparedness**
    - **Uniform standards** ensure better understandability of banking system's stability. This helps investors and agencies to better decide their investment opportunities across the world.
    - **Global Village** -> vulnerability in one country affects other countries (e.g. the 2007-08 crisis). Therefore the banking system should be stable throughout the world.

- **Basic Terms**
  - **Risk Weighted Assets:**
    - **Risk weighted assets** of a bank are its assets weighted by their degree of credit risk.
      - For e.g.in India, according to RBI Regulations loans issued to government are weighted at 0.0%, while those given for housing purposes is given a weight of 50%.
    - Risk weighted assets are **used to determine the minimum amount of capital** that must be held by banks and other institutions to reduce the risk of insolvency.
    - **The financial crisis of 2007-08** was driven by financial institutions investing in subprime home mortgage loans that had a far higher risk of default.
    - **To avoid the problem** moving forward, regulators now insist that each bank must group its assets together by risk category so that the amount of required capital is matched with the risk of each asset.

  - **Capital to Risk Weighted Asset Ratio (CRAR) / Capital Adequacy Ratio (CAR)**
    - CAR is a measurement of a bank's available capital expressed as a percentage of a bank's risk-weighted credit exposure. It is used to protect depositors and promote the stability and efficiency of financial systems around the world.
    - It is calculated by adding a bank's Tier 1 Capital and Tier 2 Capital and dividing the total by its total risk-weighted assets.

The Formula for CAR:

$$CAR = \frac{Tier\ 1\ Capital + Tier\ 2\ Capital}{Risk\ Weighted\ Assets}$$

- CAR = (Tier 1 Capital + Tier 2 Capital) / Risk Weighted Assets

  - **Tier 1 Capital**
    - It is bank's **core capital**, which is used when it needs to absorb losses without ceasing its operation.
    - It consists of Paid up Capital, capital reserves out of sale of assets, Balance in P&L account.
    - **Additional Tier-1 capital** are perpetual bonds which carry a fixed coupon payable annually from past or present profits of the bank.

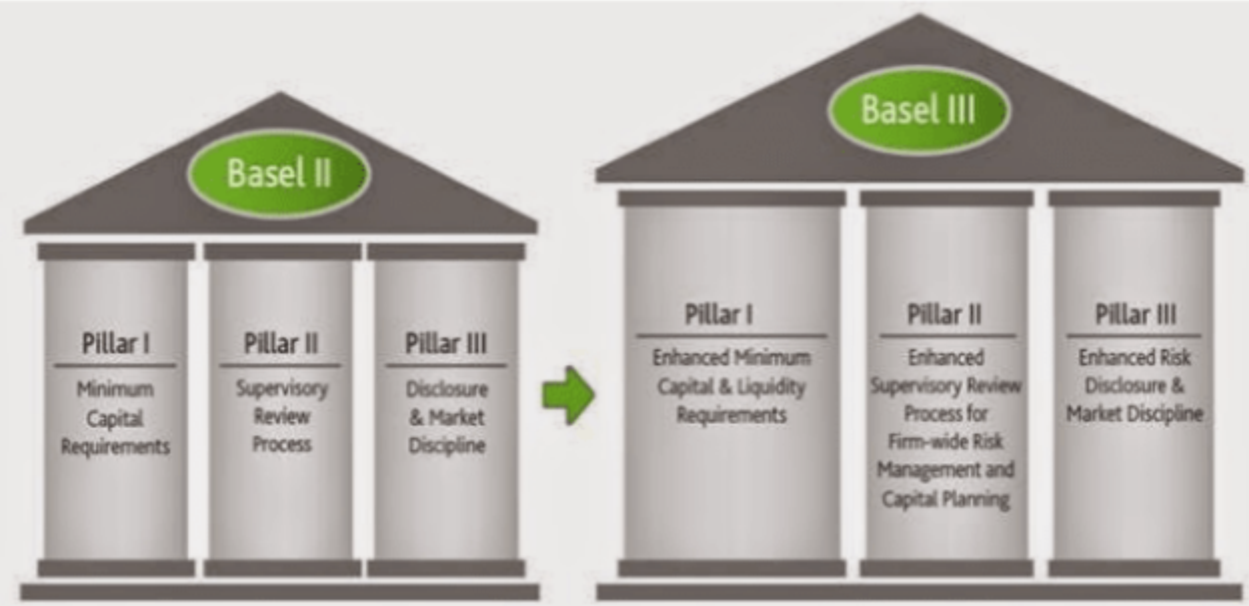
  - **Tier 2 Capital**
    - It is bank's **supplementary capital** used to absorb losses if a bank is winding up its assets. This provides a lesser degree of protection to depositors.
    - They include revaluation reserves, general provisions, subordinated term debt, and hybrid capital instruments.

- **Significance of CAR**
  - Minimum CAR are critical to make sure that banks have enough cushion to absorb a reasonable amount of losses before they become insolvent and consequently loss depositor's funds.

- **Basel 1 and Basel 2**
  - In **1988**, BCBS introduced capital measurement system called Basel Capital Accord, also called **Basel 1**. It **focused entirely on credit risk**. Here minimum CAR was kept at 8%.
  - **BASEL II**
    - These were introduced in 2004 by BCBS and were considered a refined and reformed version of Basel-I accord.
      - It expanded the scope of regulation to include operational risk and introduced more sophisticated risk assessment methods.
    - **In India** Basel-II was implemented from 2009.

  - **Basel 3**
    - They were released in Dec 2010. These guidelines were a response to the 2007-08 financial crisis where the banking system realized that the BASEL-II guidelines were not enough to protect bank depositors. It was realized that banks were under-capitalized, over-leveraged, and had a greater reliance on short-term funding.

- **Basel II -> Basel III**



- **Pillar -1: Enhanced Minimum Capital & Liquidity Requirements**: It sets out minimum amount of capital that banks must hold to cover their **credit, market and operational risks**. They are also required to hold a capital conservation buffer to absorb losses during period of stress.
- **Pillar -2: Supervisory Review Process**: Regulators are required to conduct a regular supervisory review of a bank's risk management practices and capital adequacy.
- **Pillar-3**: **Market Discipline**: It requires banks to disclose information about their risk profile, capital adequacy, and risk management practices.

- **Objectives**
  - Improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source
  - Improve risk management and governance
  - Strengthen bank's transparency and disclosure

- **Major Changes in the Basel Norm for Banking**
  - **Better Capital Quality: Minimum Common Equity and Tier 1 Capital Requirements:**
    - The **minimum requirement of common equity**, the highest form of loss-absorbing capital, has been raised under Basel-III from **2% to 4.5%** of total risk-weighted assets.
    - **The Overall Tier 1 Capital Requirement,** consisting of not only common equity but also other qualifying financial instruments, will also increase from the current minimum **4% to 6%**.
    - Although **the minimum total capital requirement will remain at the current 8%**, yet the required total capital will increase to **10.5%** when combined with **conservation buffer**.
  - **Capital Conservation Buffer**
    - Now banks are required to hold a capital conservation buffer of **2.5%**. The **aim** of asking to build capital conservation buffer is to ensure that banks maintain a **cushion** of capital that can be used to **absorb losses during period of financial and economic stress.**

  - **Counter cyclical Capital Buffer (CCCB)** is another key element of Basel-III norms

- Objective is to increase capital requirements in good times and decrease them in bad times.
- It will slow banking activities when it overheats and will encourage lending when times are tough.
- The buffer will range from **0% - 2.5%** consisting of common equity or other full loss-absorbing capital and will be stored with Central Bank.

» **Leverage Ratio**
- A leverage ratio is a **relative amount of capital to total assets** (not risk-weighted). The aim is to put a cap on swelling of leverage in the banking sector on a global basis.
  - LR = (Tier1 Capital)/ (Total Assets)
- Banks are expected to maintain a **leverage ratio of 3%** under BASEL-III norms.

» **Liquidity Ratio**
- A new **Liquidity Coverage Ratio** (LCR) and **Net Stable Funding Ratio** (NSFR) got introduced in 2015 and 2018 respectively.
- **Liquidity Coverage Ratio** refers to proportion of highly liquid assets held by financial institutions, to ensure their ongoing ability to meet short-term obligations**. Banks are required to hold an amount of high-quality liquid assets that's enough to fund cash outflow for 30 days**. This is aimed to ensure that financial institutions possess suitable capital preservation, to ride out any short-term liquidity disruptions, that may plague the market.
  - LCR is calculated by dividing a bank's high quality liquid assets by its total net cash flows, over a 30-day stress period.
  - **Note: Urjit Patel Committee** has recommended that India should move onto LCR and do away with Statutory Liquidity Ratio (SLR) mechanism. This will make our system aligned with international mechanism. India is still using SLR.

» **Net Stable Funding Requirement (NSFR)**
- Introduced by BASEL-III it is a liquidity standard requiring banks to **hold enough stable funding to cover the duration of their long term assets**. Banks must maintain **a ratio of 100% to satisfy the requirement**.
  - It is defined as the amount of available stable funding (ASF) in relation to the amount of required stable funding.
- The ratio **ensures** that banks do not undertake excessive maturity transformation, which is the practice of using short-term funding to meet the long-term liability.

» **Systematically Important Financial Institutions (SIFI):** As part of the macro-prudential framework, systematically important banks will be expected to have a **loss absorbing capability beyond the Basel-III requirements**.
- Also called G-SIBs (Globally Systematically important banks)
- **No Indian bank** has been listed in this.

1) CAR NORMS IN INDIA BY RBI

- Norms/guidelines regarding the capital required to be maintained by banks in India including the Basel III capital regulations, are **issued by RBI**.

- RBI had envisaged implementation of BASEL-III in March 2019. But it was pushed to March 2020. Due to COVID-19 pandemic it was again shifted by 6 months.

- **Capital Adequacy Ratio**: 11.5% (stricter than Basel-III norm of 10.5%)
    - Indian banks need to maintain a minimum capital adequacy ratio (CAR) of **9%**, in addition to a **capital conservation buffer**, which would be in the form of common equity at 2.5% of the risk weighted assets.
        - Indian banks as per RBI directions are required to maintain **5.5% of Common Equity Tier 1** (CET1) as against 4.5% required under the BASEL-III framework.
        - **Note: CAR requirements applied by RBI is stricter than the BASEL-III** norms.
        - **Note2:** In case of SFB and PB, the CAR requirement is that of **15%** from 1st March 2019.

- **Countercyclical Buffer**:
    - The RBI introduced a countercyclical buffer (CCB) for Indian banks, which ranges from 0% - 2.5% of risk weighted assets depending on macro-economic conditions.

- **Leverage Ratio**:
    - The RBI introduced a leverage ratio requirement for Indian banks, which measures leverage ratio (LR) = (Tier1 Capital)/ (Total Assets).
        - The minimum requirement was set at 4.5%, with a bugger of 2.5%.
- **LCR** requires banks to hold a minimum amount high-quality liquid assets (HQLA) to meet the short term liquidity needs.
    - In India LCR was introduced in a phased manner with a minimum requirement of 60% in 2015, increasing to 100% by Jan 2019.

- **NSFR** of **at least 100%** has been mandated by RBI
    - Individual banks may have to adopt stricter standards to reflect funding risks and compliance.
    - Date of applicability will be announced later.
- **Disclosure requirements** (under Pillar-3) have also been introduced.

- **RBI has also revised regulation on the implementation of leverage ratio for banks in India** under the BASEL-III capital regulation. (July 2019)
    - RBI has decided that the minimum leverage ratio shall be **4% for D-SIBS** and **3.5%** for other banks.
    - These guidelines shall be effective from the quarter commencing Oct 01, 2019.

- **RBI extends Basel-III capital framework to AIFIs (All India Financial Institutions)** (Oct 2021)
    - **All India Financial Institutions** include EXIM Bank, NABARD, NHB, SIDBI.
        - The AIFIs are increasingly being seen as key institutions to promote the flow of direct or indirect credit to the economic sectors they cater to.
    - **As per the draft Master Direction on Prudential Regulation or AIFIs**, AIFIs will implement all the three pillars of BASEL-III capital regulations - Pillar 1 covering capital, risk coverage, and

containing leverage, pillar 2 covering risk management and supervision and pillar 3 covering market discipline.
  - The RBI wants AIFIs to achieve **minimum total capital of 9% and capital conservation buffer** of 2.5%, with the minimum total capital and CCB adding to 11.5% by 1st April 2022.
    - For NHB, since the financial year is July-June, the implementation shall commence on 1st July 2022.
- **Current Situation in India**: ESI 2022-23:
  - The **Provisioning Coverage Ratio (PCR)** has been increasing steadily since March 2021 and reached 71.6% in Sep 2022.
  - The **CRAR** of SCBs has been rising sequentially in the post-asset quality review period.
    - It remains well-above the minimum capital requirement, including Capital Conservation Buffer (CCB) requirements of 11.5%.

3. DOMESTIC SYSTEMICALLY IMPORTANT BANKS

- **Introduction**
  - » D-SIBs means the bank is **too big to fail** i.e. their failure would be significant disruption to the essential services they provide to the banking system and the overall economy.
  - » According to RBI, these banks have become systematically important due to their size, cross jurisdictional activities, complexity and lack of substitution and inter-connection. Banks whose assets exceed **2% of the GDP** are considered part of this group.
  - » Too big to fail indicates that in case of distress **government is expected to support these banks**. Due to this perception, they enjoy certain advantages in funding/investment.
- **D-SIB framework**
  - » As per the framework, from 2015, every August, the central bank has to disclose the names of banks designated as D-SIB.
  - » It classifies banks under five buckets depending on order of importance.
    - ICICI and HDFC are in bucket-1 and SBI is in bucket-3. (Bucket 1 is lowest and Bucket 5 is highest)

Bucket	Banks	Additional Common Equity Tier 1 requirement as a percentage of Risk Weighted Assets (RWAs) for FY 2018-19	Additional Common Equity Tier 1 requirement applicable from April 1, 2019 (as per phase-in arrangement)
5	-	0.75%	1%
4	-	0.60%	0.80%
3	State Bank of India	0.45%	0.60%
2	-	0.30%	0.40%
1	ICICI Bank, HDFC Bank	0.15%	0.20%

- Banks classified as D-SIBs are **subjected to additional stability requirements**:
  - » They are subjected to additional common equity tier 1 (CET1) capital requirements in addition to capital conservation buffer.
    - The additional CET 1 requirement as a percentage of Risk Weighted Assets for SBI stands at **0.6%, and 0.2% each for ICICI and HDFC Bank**.
  - » **Higher Minimum leverage ratio** for D-SIBS: It shall be 4% for D-SIBs and 3.5% for other banks.

- **Note: Global SIBS**:

- » **The Basel - Switzerland based** Financial Stability Board (FSB), an initiative of G20 nations, has identified, in consultation with the Basel Committee on Banking Supervision (BCBS), a list of G-SIBS.
  - ○ There are 30 G-SIBs currently (no Indian Bank), including JP Morgan, Citibank, HSBC, Bank of America, Bank of China, Barclays, BNP Paribas, Deutsche Bank, and Goldman Sachs.

4. DEPOSIT INSURANCE

- **Introduction: Deposit Insurance Situation in India**
  - » The deposit insurance provisions in India were introduced through the Deposit Insurance Corporation Act, 1962.
    - ○ This insurance cover is provided by **Deposit Insurance and Credit Guarantee Corporation (DICGC)**, a fully owned **subsidiary of RBI**. The banks pay deposit insurance premium (0.1% per annum i.e. 10 paisa for Rs 100 insured), which is held by the DICGC and in turn is used to pay deposits if needed.
    - ○ Under the act, the Corporation is liable to pay the insured deposit to depositors of an insured bank. Such liability may arise **when an insured bank undergoes**:
      - i. **Liquidation** (sale of assets or closing down of the bank)
      - ii. **Reconstruction or any other arrangement under the scheme**
      - iii. **Merger or acquisition by another bank**
    - ○ **Note:**
      - ▪ Deposit Insurance and Credit Guarantee Corporation (DICGC) came into existence in 1978 with the merger of Deposit Insurance Corporation (DIC) and Credit Guarantee Corporation of India Ltd. (CGCI).
      - ▪ It is a fully owned subsidiary of RBI.

- This insurance cover is available to:
  - ▪ **Commercial banks**, including small financial banks, Payment Banks, and Indian branches of foreign banks.
  - ▪ Regional rural banks, Local Area Banks (LABs), and Cooperative Banks
  - ▪ **All bank deposits** - savings, fixed, current and recurring - payable in India are covered. However, deposits of central/state/foreign governments, inter-bank deposits, deposits of the state land development banks with the state cooperative banks etc. are not covered.

- **Budget 2020-21 increased the deposit insurance** to **Rs 5 lakh**.
  - ▪ This is the first time since 1993 that the deposit insurance cover has been raised. In 1993 the insurance cover was revised from Rs 30,000 to Rs 1,00,000.
  - ▪ The **raised cover** will address 98.3% of all deposit accounts by number, and 50.9% of deposits by value.
    - ▪ Globally, deposit insurance coverage is only 80 per cent globally and it covers only 20-30 per cent of deposit value.

- **Note-1**: If the funds are in different types of ownership or are deposited into separate banks, they would then be separately insured.
- **Note-2**: Banks have the right to set off their dues from the number of deposits as on cut-off date. The deposit insurance is available after netting of such dues.

- **Problems that remained even after this increased in insured deposit to 5 Lakh**:
  - **When various restrictions**, such as moratorium, etc are imposed on a bank by RBI, genuine depositors continued to face serious difficulties and were unable to access their own money even to the extent of the insured value, despite insurance being in place. Therefore, the **Deposit Insurance and Credit Guarantee Corporation (Amendment) Act, 2021** was enacted.

- **Key Features of the 2021 amendment**
  - ***Introduced interim payments:*** Interim payment will now be made by DICGC to depositors of those banks for whom any restrictions/ moratorium have been imposed by RBI under the Banking Regulation Act resulting in restrictions on depositors from accessing their own savings.
  - ***Timeline for interim payments*:** Clear-cut timeline of maximum of 90 days has been fixed for providing interim payment to depositors.
    - Within the first 45 days, the insured bank must furnish the details of all outstanding deposits to the Corporation.
    - Within 30 days of the receipt of details, the Corporation will verify the authenticity of the claims and
    - Within 15 days of the verification, the Corporation must make the payment to such depositors.
  - ***Repayment by banks to DICGC:*** *Deferment of repayments*: DICGC may defer repayments due to it from an insured bank after insurance pay out, on terms decided by DICGC's Board. It is in spirit with the rationale of interim payments, i.e., to help depositors while also enabling rescue efforts for the bank
  - ***Timely repayment by the bank to DICGC*:** To establish the priority of repayment to DICGC (both interest and principal amount), a **provision for penal interest** in case of delay has been put in the act.
  - **No ceiling on premium**: The earlier act earlier had a ceiling of 15 paise on premium, which has been removed. Now, the ceiling on premium will be notified by DICGC, with the prior approval of RBI.

- **Key concerns in deposit insurance mechanism in India and the way forward**
  - No **option for extending** the protection.
  - **Depositors are left in lurch in case of crisis** - for e.g., the recent restrictions on the amount of money that can be withdrawn from PMC. (2021 amendment would reduce this problem)
  - **Uniform insurance premium is unfair for well-functioning banks.**

            - **Jasbir Singh** committee in 2015 also recommended the introduction of risk-based premium for banks.
    - **Only one insurance company** -> limits accurate risk-based pricing of insurance.
        - For e.g., in FY19, DICGC collected Rs 12,043 crore as premium and settled only Rs 37 crore worth claims.

- **Conclusion**
    - The financial system runs on the trust of depositors and denying people the right over their hard-earned money is a colossal hazard for the financial system.
    - Other than the steps for increasing the insured amounts and ensuring immediate availability of deposits for depositors, steps should be taken to bring in more competition in the deposit insurance sector by promoting private players etc., so that banks would be able to choose the best services.

5. NPA ISSUE

- **Non-Performing Assets - Basics**
    - » Assets in a banking system comprises of loans given and investments (in bonds etc.) made by banks as these earn interest/profit for banks.
    - » If the interest/ principal instalment of a loan is not paid until due date, it is called **bad loan**.
    - » An asset including a leased asset, becomes non-performing when it ceases to generate income for the bank.
    - » According to RBI **A Non-Performing Asset** is a loan or advance where instalment/interest is due for more than **90 days** in case of a term loan or overdraft account/ credit account. Similarly in case of **agriculture loans** an account becomes an NPA if the instalment/interest remains overdue for two crop season for a short duration crop, or one crop season for a long duration crop.

- **Stressed Assets** refers to all NPAs plus restructured assets plus written off assets.

- **NPAs of Indian Banking System had reached 11.18% in 2018**.

- **Why had NPAs increased so much in the last decade?**
    - **I.** **Credit Boom in mid 2000s and then the global financial crisis**: In Mid 2000s large corporates were granted loans based on extrapolation of their recent growth and performance. But with stagnating economic growth due to Global financial crisis, their loan returning capabilities decreased.
    - II. **Indian creditors used the strategy of "Giving time to time" and hoped that economic revival will reduce NPAs -> this only led to evergreening of NPAs.**
    - III. **Poor Recognition:** Banks were initially reluctant to recognize NPAs. The true extent of NPA problem only started becoming clear once the RBI initiated the Asset Quality Review in 2015.
    - IV. **Poor Governance and Regulation of Banks - Crony Capitalism - Poor Recovery**
    - V. **Lack of specialization of banks in recovering bad loans / NPAs**
    - VI. **Other Factors which negatively impacted businesses**

- **Key Judicial Decisions**
  - Judicial decisions like abrupt cancellation of coal mines and spectrum allocation led to reallocation through expensive auctioning procedure and thus proved to be a fatal burden on respective business models of power, steel and telecom.
- **Land Acquisition and environmental clearance issues** also blocked a number of projects and contributed towards increasing NPAs.

VII. **Insolvency and Bankruptcy Procedure** has not proved very effective yet.

VIII. **Absence of strict action against bank frauds of high magnitude**

- This is because of absence of a strong law against wilful defaulters and fraudsters

– **IMPACT Of High NPAs**

» **On Banking Sector**

- Decreasing income/Increasing losses for the banks
- Reduces effective internal source of increasing capital which is even under a lot of pressure on account of impeding BASEL-3 guidelines.
- Downgrading of ratings as asset quality deteriorates, this would make international operation and funding difficult.

» **Hinders Economic Growth**

- Accumulation of NPAs in the banking system, specifically in the PSBs, had adverse effects on credit disbursement. Reduction in credit available for market and individual customers led to slowing down of economy.
- The Rise in NPAs occurred with the deterioration of the balance sheet of non-financial firms, and this **twin balance sheet problem** contributed significantly to the deceleration of growth in late 2000s.

» **On Government**

- Increasing **fiscal burden** on government as it has to recapitalize these banks to ensure their proper functioning.

» **On Individuals/ Society**

- **Relatively expensive loans** and decreased interest on deposits.
  - This means that performing borrowers and depositors were effectively being taxed in order to subsidize the non-performing borrowers.
  - Only after demonetization, the interest rates went down because of the flux of cash with the banks
- Less budget/credit available for social welfare programs.
- Eventually its common man's money in the form of deposits which have been lend by banks and is put at risk in case the bank fails.

– **Balance Sheet Syndrome with Indian Characteristics:** High NPAs (TBS problem) have derailed growth in other countries. But huge NPAs have not had as huge an impact as in case of other countries. This is being considered 'Balance Sheet Syndrome with Indian Characteristics.'

- This is because the NPA's are concentrated in **public sector banks** which not only hold their own capital but are ultimately backed by the government who would eventually come to save these

banks in case situation gets out of hand. Therefore, creditors have retained confidence in the banking system and there has been no bank runs, no stress in the inter-bank market etc.
- Mid 2000s boom had created **enough infrastructure** (in India's severe supply constraint economy), that there was ample room for the economy to grow after the GFC.

- **4 Key steps in solving the NPA problem** (As suggested by Economic Survey of India 2015-16)
  - **4Rs, Recognition, Recapitalization, Resolution, Reform**
    - **Recognition**: Banks must value their assets as far as possible close to true value (recognition) as the RBI has been emphasizing
      - Asset Quality Review by RBI has done this and brought the real numbers forward.
    - **Recapitalization**: Once the true value of the assets is recognized, the capital position must be safeguarded via infusion of equity (recapitalization).
      - Bank recapitalization has been a regular feature of the Union Budget since 2016-17. Between FY17 and FY21, the centre has infused **about 3.31 lakh crore into banks**.
    - **Resolution**: The underlying stressed assets in the corporate sector must be sold or rehabilitated (resolution) as the government has been desiring.
      - **IBC** has played an important role in increasing recovery.
    - **Reform**: Future incentives for private sector and corporates must be set-right to avoid repetition of the problem.
      - Reform is one area where least progress has been made.
      - Governance structure of the banks have almost remained the same

- **Steps Taken:**
  1. **Know your customer (KYC)** norms have been strengthened
  2. **Early identification and reporting of stress** - Special Mention Account (As per revised framework for resolution of stressed assets - Feb 2018)
     - Lenders are required to identify incipient stress in loan accounts, immediately on default, by classifying assets as Special Mention Account (SMA) as per the following categories

SMA Subcategory	**Basis for classification -** principal or interest payment or any other amount wholly or partly overdue
SMA-0	1-30 days
SMA-1	31-60 days
SMA-2	61-90 days

     - This has to be reported to Central Repository of Information on Large Credit (CRILC) on all borrowers' entities having aggregate exposure of Rs 5 crore and above with them.
  3. **Asset Quality Review by RBI**
     - To deal with the cases of divergences in identification of NPAs or addition provisioning across banks at the central office level

  4. **Indradhanush Scheme**
     - Improving 7 different areas of banks (including capitalization)

5. **Insolvency and Bankruptcy Code (IBC-2016)**
    - To fast track insolvency resolution process and increase the % recovery. This was a more direct path to handle bad loan.
    - It allowed lenders to take defaulting borrowers to NCLT and trigger off bankruptcy proceedings against them.

6. **Fugitive Economic Offenders Act, 2018,** is also acting as a deterrent and may prevent future offenders from running to other countries.

7. **Project Sashakt** (July 2018)
    - **About Project Sashakt**
        - It is a five pronged strategy to resolve bad loans outline - SME resolution approach, bank led resolution approach, AMC/AIF led resolution approach, NCLT/IBC approach and asset trading platform
            1. **SME Resolution Approach (SRA):** Bad loans of upto 50 crore will be resolved at the bank level, with a deadline of **90 days**. For this approach, the committee has also suggested setting up of a steering committee by banks for formulating and validating the schemes, with a provisional for additional funds.
            2. **Bank led resolution approach:** For loans between 50-500 crore, banks will enter an **inter-creditor agreement**, authorizing the lead bank to implement a resolution plan in **180 days**, or refer the asset to NCLT. Here, an independent steering committee appointed by the Indian Banks Association (IBA) will validate the process. The resolution plan has to be approved by lenders holding at least 66% of the debt.
            3. **AMC/AIF led resolution approach:** For loans above 500 crore, the panel envisages one or more Independent Asset Management Company (AMC), supported by institutional funding through the Alternate Investment Fund (AIF).
                - The committee suggested that the bidding process should follow a market-led approach, inviting bids from AMCs, ARCs, and AIF.
                - Existing players, such as ARCIL and the national AMC, will be allowed to set the floor price for the bad assets while other players will be asked to either match the price or better it.
                - The AMC has to redeem security issued to banks by ARCs within 60 day
            4. **Asset trading platform** for performing and non-performing loans
            5. **NCLT/IBC approach**
                - If none of the above approaches work, NCLT will take over under the IBC provisions.

8. **Prompt Corrective Action (PCA) Framework**
    - **What is PCA?**
        - It is a framework under which banks with weak financial matrices are put under watch by RBI.

- The framework uses **three parameters** to measure the weakness of a bank:
    - **Capital Ratio**
    - **Asset Quality**
    - **Profitability**

- **RBI's revised PCA framework for banks applicable from 1st Jan 2022.**
    - The framework would apply on all banks operating in India, including foreign banks operating through branches or subsidiaries based on breach of risk thresholds of identified indicators.
    - **Three parameters** to measure the weakness of the bank: Capital, Asset Quality and Leverage Ratio.
    - **Indicators to be tracked** for capital, asset quality and leverage would be CRAR/Common Equity Tier-1 Ratio, Net NPA Ratio, and Tier 1 Leverage Ratio.
    - **Breach** of any risk threshold may result in invocation the PCA.
    - **Entry:** A bank will generally be placed under PCA framework based on the Audited Annual Financial Results and the ongoing Supervisory Assessment made by RBI.

PCA matrix – Parameters, indicators and risk thresholds

Parameter	**Indicator**	**Risk Threshold 1**	**Risk Threshold 2**	**Risk Threshold 3**
(1)	(2)	(3)	(4)	(5)
Capital (Breach of either CRAR or CET 1 ratio)	CRAR - Minimum regulatory prescription for Capital to Risk Assets Ratio + applicable Capital Conservation Buffer (CCB) **and/or** Regulatory Pre-Specified Trigger of Common Equity Tier 1 Ratio (CET 1 PST) + applicable Capital Conservation Buffer (CCB)	Upto 250 bps below the Indicator prescribed at column (2) Upto 162.50 bps below the Indicator prescribed at column (2)	More than 250 bps but not exceeding 400 bps below the Indicator prescribed at column (2) More than 162.50 bps below but not exceeding 312.50 bps below the Indicator prescribed at column (2)	In excess of 400 bps below the Indicator prescribed at column (2) In excess of 312.50 bps below the Indicator prescribed at column (2)
	Breach of either CRAR or CET 1 ratio to trigger PCA			
Asset Quality	Net Non-Performing Advances (NNPA) ratio	>=6.0% but <9.0%	>=9.0% but < 12.0%	>=12.0%
Leverage	Regulatory minimum Tier 1 Leverage Ratio	Upto 50 bps below the regulatory minimum	More than 50 bps but not exceeding 100 bps below the regulatory minimum	More than 100 bps below the regulatory minimum

- **RBI's corrective action plan based on risk threshold**
    - RBI can put **mandatory restrictions** on dividend distribution, branch expansion, and management compensation based on the risk threshold.
        - In an extreme situation, breach of third threshold, would identify bank as likely candidate for resolution through amalgamation, reconstruction or winding up.
    - Further there can be **discretional restrictions** on bank's lending limit, special audit etc.
    - RBI can supersede the bank's board, under the PCA.

- **Idea behind PCA:**
    - Handle problems before they attain crisis situation.
    - Essentially PCA helps RBI monitor key performance indicators of banks, and taking corrective measures, to restore financial health of a bank.

9. **UDAY Scheme** (for state power discoms)
    - As they were one of the largest NPA holders.

10. **Governance Reform in banks**
    - E.g., Separation of the post of CMD and Chairman

- **Impact: Current Situation:**
    - » Since 2015-16, RBI and the government have made dedicated efforts in terms of calibrated measures like strengthening the regulatory and supervisory framework, implementation of **4R's** approach of **Recognition, Resolution, Recapitalization,** and **Reforms** to clean and strengthen the balance sheet of the banking system. These continuous efforts have culminated in the enhancement of risk absorption capacity and a healthier banking system balance sheet in terms of asset quantity and quality over the years.
    - » **Indian Banks' NPA** has fallen to a **10-year low and is expected to improve further: RBI**
        - **Gross NPAs** of Indian Banks is **3.9%** as of March 2023.
        - **Net NPAs** had dropped to a ten year low of **1.3%** in Sep 2022.
    - » **Why decrease:**
        - Lower slippages and reduction in outstanding GNPAs through recoveries, upgrades, and write offs led to this decrease.

- **What more can be done:**
    - » **Governance Reform in Banks** and **exit of poorly performing banks.**
        - Financial sector is undergoing structural changes (fintech and other NBFCs) are challenging existing business models.
        - Governance reforms and cost reduction through innovation should be the key to survive in this environment and therefore it is important that inefficient banks should be wind up.
        - Banks have to come up with robust credit worthiness evaluation mechanism.
        - Process of consolidation of banking sector should continue.
    - » **Strengthening Insolvency and Bankruptcy Code** as and when loopholes emerge
        - Currently NCLT faces huge work load and hence its resources needs improvement.
    - » **Bring back developmental financial institutions.**
    - » **Robust and Transparent Secondary market** should be promoted to deal with bad loans.
        - For e.g., in USA, almost a trillion dollar of bad debt is handled every year through an active secondary market which includes ARCs.
        - A robust and transparent secondary market, unhindered by excessive regulation, is an essential element in the vital process of transferring risk from the banks to the capital markets.
    - » **Strengthening legal system** to deal with willful defaulters.
        - Currently, willful defaulters are mostly able to go scot free. This will inculcate discipline among the borrowers.

- **Conclusion**
    - » Though NPA issue has been resolved, but if the core issues of the banking sector like poor governance, political interference, etc are not resolved, the problem may re-emerge in future.

6. TOPICS FOR NEXT BOOKLET

2) NATIONAL ASSET RECONSTRUCTION COMPANY (BAD BANK)

3) VARIOUS TYPES OF BANKS AND FINANCIAL INSTITUTIONS

4) INSURANCE SECTOR

5) PENSION SECTOR

GS FOUNDATION FOR CSE 2024
ECONOMY-9
BANKING SECTOR – INSOLVENCY AND BANKRUPTCY CODE, BAD BANK, AND DEVELOPMETNAL FINANCIAL INSTITUTIONS

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2. DEVELOPMENTAL FINANCIAL INSTITUTION

- What is a **DFI** (Developmental Financial Institution) or **DFC** (Developmental Finance Company)?
  - Developmental Financial Institutions provide **long-term credit for capital-intensive investments spread over a long period and yielding low rates of return**, such as urban infrastructure, mining and heavy industry, and irrigation system.
  - The role of a Development Financial Institution (DFI) is to take cognizance of the gaps in institutions and markets in the country's financial sector and to act as a **gap filler**.

- **Objectives of DFI**:
  - **Economic Development** of the country via financing infrastructure project is the prime objective of the DFI.
  - They also provide **technical assistance** like Project Report, Viability Study, and Consultancy Services.
  - They provide credit enhancement for infrastructure and housing projects and also helps in improving debt flows towards infrastructure projects.

- **History of Development Banks in India**
  - **Industrial Finance Corporation of India** (IFCI), set up in 1949, was perhaps India's first developmental bank.
  - In 1955, the World Bank prompted the **Industrial Credit and Investment Corporation of India** (ICICI) - the parent of the largest private bank in India today - as a collaborative effort between the government with majority equity holding and India's leading industrialists with nominal equity ownership **to finance modern and relatively large private corporate enterprises**.
    - ICICI Bank limited was established in 1944 and in 2002 both were merged together making it the first universal bank of India.
  - In 1964, **IDBI** was set up as an apex body of all development finance institutions.

- **How were DFIs financed in India?**
  - In 1950s and 60s, the saving rate was low and the capital market was virtually absent. So, DFIs were mostly financed by:
    1. **Lines of credit from the Reserve Bank of India** (that is, some of its profits were channelled as long-term credit); and
    2. **Statutory Liquidity Ratio bonds**, into which commercial banks had to invest a proportion of their deposits.
  - In other words, by sleight of government hand, short-term bank deposits got transformed into long-term resources for development banks. The missing capital market was made up by an administrative fiat

- **However these DFIs didn't perform well:**

- They **faced very high** NPAs allegedly caused by politically motivated lending and inadequate professionalism in assessing the projects.
- Therefore, after 1991, following the Narsimhan Committee recommendations on financial sector reforms, **the DFIs were disbanded and got converted into commercial banks**.

- **Result of disbanding these institutions**
  - **Steep fall in long term credit** from a tenure of 10-15 years to five years. This has contributed to **NPA crisis** of Indian PSBs.
  - Further, the development of debt market has failed to take off.

- **In China**, these developmental banks - the Agricultural Development Bank of China, China Development Bank, and the Export-Import Bank of China - have been at the forefront of financing its industrial prowess.

- **Advantages of DFIs**
  - **Fill the gap in infra financing and long term financing:** The commercial banks have been reluctant to provide long term loans for infra projects especially after the huge NPA crisis
  - **Reducing future NPA burden on Banks**
  - **Utilize today's developmental capital and stock markets more efficiently** through specialized activities.

- Therefore, Finance Minister **Nirmala Sitharaman** while presenting the Union Budget 2021-22 stated that, India's Infrastructure needs long term financing and informed that India will set up a new **DFI** called the **National Bank for Financing Infrastructure and Development** (NABFID)

1) DETAILS ABOUT NATIONAL BANK FOR FINANCING INFRASTRUCTURE AND DEVELOPMENT (NBFID)

- NBFID Bill, 2021 was passed in Parliament in 2021.
- It was operationalized in Q1FY23.
- NBFID will be set up as a **corporate body with authorised share capital of one lakh crore rupees**.
  - Shares of NBFID may be held by: (i) central government, (ii) multilateral institutions, (iii) sovereign wealth funds, (iv) pension funds, (v) insurers, (vi) financial institutions, (vii) banks, and (viii) any other institution prescribed by the central government.
  - Initially, the central government will own 100% shares of the institution which may subsequently be reduced up to 26%.

- **Functions:**

- It will have both financial and developmental objectives.
- **Financial Objective** will be to directly or indirectly lend, invest, or attract investment for infrastructure projects located entirely or partly in India. Central government will prescribe the sectors to be covered under the infrastructure domain.
- **Developmental Objectives** include facilitating the development of the market for bonds, loans, and derivatives for infrastructure financing.
- **Functions of NBFID include**:
  - (i) extending loans and advances for infrastructure projects,
  - (ii) taking over or refinancing such existing loans,
  - (iii) attracting investment from private sector investors and institutional investors for infrastructure projects,
  - (iv) organising and facilitating foreign participation in infrastructure projects,
  - (v) facilitating negotiations with various government authorities for dispute resolution in the field of infrastructure financing, and
  - (vi) providing consultancy services in infrastructure financing

- **Sources of Funds**:
  - NBFID will raise money in the form of loans or otherwise both in Indian Rupee and Foreign Currency, or secure money by the issue and sale of various financial instruments including bonds and debentures.
  - It will borrow money from: (i) Central Government (ii) Reserve Bank of India (iii) Schedule Commercial Banks (iv) Mutual Funds, and multilateral institutions such as WB and ADB.

- **Management of NBFID**:
  - It will be governed by **Board of Directors**. The members of Board include:
    1. Chairperson appointed by the Central Government in consultation with RBI
    2. Managing Director
    3. Up to three deputy managing directors
    4. Two directors nominated by Central Government
    5. A few independent directors

- **Support from central government**:
  - **Government** will provide a grant of Rs 5,000 crores to NBFID.
  - It will also provide guarantee at a concessional rate of upto 0.1% for borrowing from multilateral institutions, sovereign wealth funds, and other foreign funds.
  - Upon request from NBFID, the government may guarantee the bonds, debentures, and loans issued by NBFID.

- **Other DFIs**:

» The Act also provides for any person to set up a DFI by applying to RBI. RBI may grant a license for DFI in consultation with the central government. RBI will also prescribe regulations for these DFIs.

– **How is NaBFID doing?**

» As of 2023, entire shareholding of the institutions held by Central Government, which has invested equity of Rs 20,000 crore and provided a grant of Rs 5,000 crores.

» **NaBFID** has raised Rs 10,000 crores via maiden issuance of listed bonds of 10 year duration at a coupon rate of 7.43%. It was oversubscribed by 4.7 times. (June 2023)

» In less than a year of operation, the institution has sanctioned **25,000 crore** rupees loan. The aim is to reach Rs 1 lakh crore in terms of sanctioned amount by FY24. (July 2024)

» It is also moving very cautiously with a **balanced portfolio** of completed projects (refinancing route), brownfield expansion and greenfield projects as a lopsided focus on green field carry high risks.

» It is also exploring a larger role in the infrastructure segment and not in just financing, with the objective of playing a catalysing role in developing infrastructure and the entire ecosystem. For e.g. it is looking at a project advisory role in railways and transportation infra projects that are stuck, or that haven't moved at required pace.

– **Conclusion**:

» **NaBFID** is working as a though leader and financier in the infra-financing space and is expected to deliver on its mandate of pushing infrastructure spending.

3. BAD BANK:

– **Example Questions**

i. "Bad banks can play a crucial role in solving India's NPA problem" Critically Analyze. [12.5 marks, 200 words]

ii. What is a Bad Bank? Discuss various advantages and limitations associated with setting up of a bad bank. [12.5 marks, 200 words

– **Need of Bad Bank**

▪ Various **available resolution mechanisms**, including Insolvency and Bankruptcy Code (IBC), SARFAESI Act, Debt Recovery Tribunals, etc. have proved to be useful to certain extent, however **a large stock of legacy NPAs are yet to be resolved.** In addition to this, while there are **28 ARCs existing in India**, due to limited capitalisation and low recoveries from existing portfolio, they are better placed for acquiring only smaller value loans.

▪ In order to **resolve the legacy NPAs and clean up the banking system**, the Union **budget 2021-22 announced,** *"The high level of provisioning by Public Sector Banks of their stressed assets calls for measures to clean up the bank books. **An Asset Reconstruction Company (ARC) Limited** and **Asset Management Company (AMC)** would be set up to consolidate and take over the existing stressed debt and then manage and dispose of the assets to Alternate Investment Funds and other potential investors for eventual value realization."* In line with this vision, two entities viz.

National Asset Reconstruction Company Limited (NARCL), and **India Debt Resolution Company Limited (IDRCL)** have been formed.

- **Understanding Bad Bank:**
  - A bad bank refers to a financial institution set up to buy the bad loans of another bank with significant NPAs and to resolve the stressed asset. This frees the original bank from the burden of resolving their bad loans.
  - **Advantages**
    - **Specialized and Efficient Recovery**: A bad bank specializes in managing the NPAs and would thus be more efficient in this field
      - It would be better focused on task of recovery and can have superior expertise in the area.
    - **Banks can focus on core business**
    - **Availability of fresh credit** will further boost economic growth in the count
  - **Challenges**
    - **Funding requirements**
    - Managing the sheer **size and diversity of the bad loans** acquired from multiple PSBs will be a tall order.
    - Government entity may not be able to pay specialists what it takes.
    - **Experience of Private asset reconstruction** companies haven't been very good in resolving stressed assets.
    - Bad banks will **not solve the existing governance issues** of the PSBs
    - **Moral Hazard:**
      - Former RBI Governor Raghuram Rajan says that bad bank will create a moral hazard for banks and would enable banks to continue reckless lending practices without focusing on reducing NPAs.

- **Understanding the two layered structure**
  - The bad bank's structure is two-layered with the **National Asset Reconstruction Company Limited (NARCL) operating as an ARC** and a separate asset management company called India Debt Management Agency (IDMA) restructuring and turning around bad loans.
  - NARCL was incorporated on 7th July 2021 and has received a certificate of registration from the RBI to commernce the business as an ARC in Oct 2021.
    - The NARCL is **51% owned by PSBs** and the remaining by private sector lenders.
      - **Canara bank** would be the sponsor of the NARCL and would be holding 12% equity in NARCL. Other public sector banks would pick up less than 10% each in the ARC.
    - The NARCL has an authorized capital of Rs 100 crore and the paid-up capital of Rs 74.6 crores.
      - This is going to **rise going forward** as NARCL is expected to have a capital base of Rs 6,000 - 7,000 crore eventually.
    - The **capital structure** of NARCL will have component of both equity and debt.
    - NARCL is expected to acquire stressed assets at net book value by offering 15% of it in upfront cash, and the rest (85%) in the form of security receipts (SRs).

    - The **government** will not have any direct equity contribution to NARCL. But it will guarantee the security receipts issued by NARCL, which will buy the bad loans from banks.
  - **Note:** The company has hired **P.M. Nair** - a stressed assets expert from the State Bank of India (SBI) - as the managing director.

» **IDRCL** was incorporated on 3rd Sep 2021 and will have a **min 51% ownership of private sector banks** and balance will be held by Public Sector banks.

» NARCL and IDCRL's relationship will be defined through a **debt management agreement** where in NARCL will aggregate and acquire the stressed assets and IDRCL, in turn, will provide stressed assets management and resolution services to NARCL on an exclusive basis. The **term of IDRCL** will be co-terminus with that of NARCL.

– **Resolution Mechanism**

» NARCL will acquire assets by making an offer to the lead bank and the lead bank with an offer in hand (of NARCL) will run a **'Swiss Challenge'** process wherein other interested ARCs / Bidders will be invited to better the anchor offer made by NARCL. Once NARCL is declared as a preferred bidder, NARCL shall initiate asset acquisition process and acquire the assets in the underlying Trusts.

- The company will pick up those assets that are **100% provided** for by the lenders.
- After acquiring the assets, IDRCL shall prepare and suggest the proposed restructuring / resolution plan, strategies, etc. for each Underlying Trust Assets. Post the approval of resolution from NARCL, IDRCL shall also assist in implementation of resolution. The assets acquired shall be resolved using existing resolution tools within the RBI framework for ARCs.

» Resolution mechanisms of this nature **typically require a backstop from Government** as it imparts credibility and provides for contingency buffers.

- **Globally**, bad banks have been set up with **Government participation in the form of equity** along with other regulatory dispensations, for instance, Danaharta Nasional Berhad (Danaharta) in Malaysia or Asset Resolution Ltd (UKAR) in UK.

- Therefore, taking the **precedence from international practices**, in India, the **government has provided a guarantee of up to ` 30,600 crore**, which will back Security Receipts (SRs) issued by NARCL. The government guarantee will be valid for 5 years. Guarantee available for these SRs may be invoked on completion of resolution or liquidation as the case may be to cover the shortfall between actual realization and face value of the asset. The guaranteed amount will be issued based on actual assets acquired by NARCL. This arrangement will not only safeguard the face value of Security Receipts but it will also take away the need for 100 per cent upfront capitalization of NARCL. The government will charge a guaranteed fee on the amount which it guarantees, which will increase annually to incentivize the early and timely resolution

– **E.g:**

- **In Jan 2023**, NARCL acquired its first stressed asset - Jaypee Infratech - from lenders. It acquired their exposure aggregating about Rs 9,200 crore at a 55% haircut.
  - **IDBI Bank**, the lead bank to the consortium of lenders with an exposure of Rs 3,750 crore, received Rs 253 crore (15% of Rs 1,687.5 crore recovery in cash) and Rs 1,435 crore (85% of the recovery) in the from of security.

– **Performance Analysis**:
  - The Bad bank had set a target to buy accounts of **Rs 50,000 crore**, it acquired **Rs 10,387 crore** loans from 3 accounts in FY23.

– **Why poor performance?**
  - **Primary issue plaguing NARCL's progress** is the **dual structure of NARCL and IDRCL**, which many within NARCL believe is not delivering the expected results.
    - Although IDRCL is engaged in the resolution of distressed assets, NARCL retain ultimate decision making authority, as it holds the ARC license from the RBI. This dual structure has led to **higher costs** and a **cumbersome structure,** contrary to initial expectations that private sector participation would expedite decision-making in the resolution process.
  - **NARCL's protracted due diligence process** and its **tendency to present offers that banks consider inadequate** have also contributed to the challenge faced by the initiative.
  - **Bid-Offer Spread** has remained a concern:
    - ARCs like NARCL typically discount the cost of capital at around 25%**,** given their expensive capital, while banks, which offload their NPA to ARCs, discount cash flows at a maximum of 12-13%. This difference in price expectation has deterred banks from selling their distressed assets, even when NARCL offers relatively higher prices compared to its peers.
  - **Public sector ARCs** like NARCL, subject to government audit and preferring safer options, may end up **incurring higher due diligence** costs by paying substantial fees to external consultants compared to private sector stressed asset firms.

– **Way Forward**:
  - **Merging of NARCL** and **IDRCL** can increase the effectiveness of NARCL. It will optimize the business opportunities and streamline operations, and potentially reduce cost.
  - **Implement recovery-linked incentive** for personnel at the bad bank could attract talent and increase efficiency.

4. INSOLVENCY AND BANKRUPTCY CODE (IBC), 2016

– **Basic Definitions**
  - **Insolvency** refers to a situation where individual, entity or a company is unable to meet its financial obligations (i.e., unable to pay off debts).
  - **Bankruptcy** is the legal declaration of one's inability to pay off debts. When bankruptcy is filed, two ways of resolving insolvency is available.
    1. **Reorganization:** debtor restructure their repayment plans to make them more easily met.
    2. **Liquidation:** Debtors assets are sold to pay the creditors.

- **Problems with India's Insolvency and Bankruptcy Process (Before IBC, 2016)/Need of IBC**
  - » **Delayed Process** (9 years, (1.7 years in OECD))
  - » **High Cost of Process** (9% of total asset cost, (5% in OECD)).
  - » **Poor Recovery** (25.7% (72% in OECD))
  - » **Archaic laws,** some more than 100 years old, governed the Insolvency and Bankruptcy procedures.
  - » **Different acts for different entities created confusions.**
    - The **RDDB act and the SARFAESI** act applied only to Indian Banks and specific NBFCs which deal with housing loans.
    - **SICA** (Sick Industrial Companies Act, 1985) applied to only Industrial companies which created a major problem as India is increasingly becoming a services-led economy.
    - **Joint Lenders Forum and Corporate Debt Restructuring** also apply to only regulated banks and NBFCs. They too don't address insolvency in systematic manner.
  - » **Creditors were relatively powerless** when faced with a default while promoters were, in the words of former RBI governor Raghuram Rajan, able to "insist on their divine right to stay in control".

- **Insolvency and Bankruptcy Code 2016 - passed by Parliament in May 2016**
  - » IBC 2016 is considered one of the landmark economic reform by the Modi Government. It is based on the recommendations of **the Bankruptcy Law Reform Committee** headed by **TK Viswanathan.**

  - » **Provisions:**
    - i. **Unified Framework: Applicable to both Individuals and companies**

    - ii. **Clear Coherent and Speedy Process**
      - Code lays down a clear, coherent and speedy process for early identification of financial distress and revival of the companies and limited liability entities if the underlying business is found to be viable.
      - **Corporate debtors (LLPs and companies):**
        - **Corporate Insolvency Resolution Process (CIRP)**:
          - Under this steps are taken for revival, selling the company to a suitable buyer, etc.
          - Resolution plan has to be approved by CoC (at least 66% of the creditors in CoC).
        - **Time Bound Resolution:** Insolvency resolution - Max (~~180 + 90 Days)~~ **330 days** (including the liquidation process) (after the Aug 2019 Amendment)
        - **Came into force** on 1st Dec 2016).

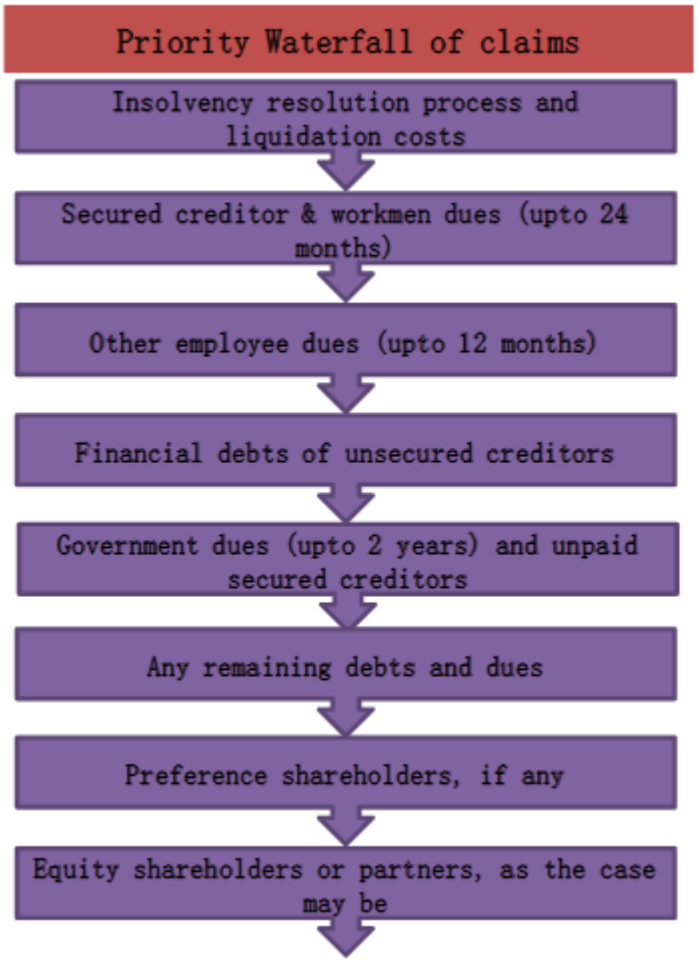
    - iii. It offers a paradigm shift from the existing **'Debtor in possession' to a 'Creditor in control' regime**.
    - iv. **Institutional Infrastructure for Insolvency and Bankruptcy Process under IBC**
      - **Insolvency and Bankruptcy Board of India ->** Insolvency regulator, oversees the functioning of insolvency intermediaries (IPs, IPAs, IUs)
      - **Insolvency Professionals and Insolvency Professional Agencies** -> private bodies -> specialized in helping sick companies -> license from IBBI required

- **Information Utilities**
  - Collate all information about debtors to prevent serial defaulters from misusing the system.
- **Adjudication** (Corporates: NCLT->NCLAT-SC; Individuals: DRT -> DRAT -> SC)

v. **Insolvency and Bankruptcy** fund
- For establishment and use by Insolvency and Bankruptcy Board of India and also for implementing various provisions of the act.

vi. **Provisions to address cross border insolvency** through bilateral agreements with other countries.

vii. **Protection of worker's interest**
- The code has provision to ensure that the money due to workers and employees from the provident fund, the pension fund and the gratuity fund shouldn't be included in the estate of the bankrupt company or individual.
- Further, worker's salaries for upto 24 months will get first priority in case of liquidation of assets of a company, ahead of secured creditors.
- It also enables workers to initiate the insolvency process and they will be first in line to get the proceeds of liquidations.



viii. **Disqualification of bankrupt from holding public office**
- Provisions that disqualify anyone declared bankrupt from holding public office, thereby ensuring that politicians and government officials cannot hold any public office if declared bankrupt.

– **Significance/Key Achievements of IBC:**

» IBC has created a **cohesive and comprehensive insolvency ecosystem**.

» It has **made it easy for creditors** to deal with default.

» It has **professionalized insolvency services** by creation of two professions namely: the insolvency profession and the valuation profession

» It has **fast tracked** the insolvency and bankruptcy process and has resulted into **higher recovery** and thus has benefitted all the creditors including banks. As per ESI 2021-22:
- In value terms **74%** of distressed assets were rescued.

- The average time for resolution (428 days) and liquidation (375 days) is a reduction over the pre-IBC times.

» IBC has also ensured fast track closing of businesses enhancing a key component in India's Ease of Doing Business.

» **IBC** has also led to **Behavioural change**.

- **Increased responsibility and accountability** have been ensured among borrowers. This has ensured that business entities are paying upfront before being declared insolvent.
- Further, in case of distress, thousands of debtors are resolving distress in the early stage of distress.

– **Concerns:**

» **Capacity of NCLT**: Large number of pending cases

– **Way Forward**

» Institutional capacity should be strengthened, specially of NCLTs and DRT

» Deal with delays and increase recovery.

» Bankruptcy board of India should quickly develop a robust way to select the most qualified IPs.

- It should be ensured that IPs are truly independent and are not influenced by promoters and key stakeholders in any unfair manner.

» Centralized framework for IUs so that all data is easily accessible.

» Finally, government should be ready to bring in changes as and when required to deal with issues that may emerge with time as has been done over the last 2 years.

– **Conclusions**

» IBC has changed the credit culture in the country. It has made the borrowers more responsible.

» This process can be made more effective by ensuring that the so-called pillars - insolvency professionals, information utilities, a strengthened adjudication mechanism and a regulator are institutionalized and function efficiently.

GS FOUNDATION FOR CSE 2024
ECONOMY-10
BANKING SECTOR –PPIRP, CROSS BORDER INSOLVENCY RESOLUTION, RURAL BANKS, PAYMENT BANKS AND SFBS

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2. PRE-PACKAGED INSOLVENCY RESOLUTION PROCESS (PPIRP) FOR CORPORATE MSMES

- Multiple ways of stress resolution are always good for economy.

- In April 2021, GoI amended the IBC Code, 2016 to introduced PPIRP for corporate MSME with defaults up to Rs 1 crore.
- **Key Features of PPIRP**
  - **Voluntary Initiation**: It is initiated voluntarily by the debtor. The debtor and creditor mutually work on a resolution plan and approach NCLT for its approval.
  - **Expedited Resolution**: Unlike CIRP, where 330 days are given, PPIRP is expected to be a faster process, with a maximum timeline of 120 days for the submission and approval of the pre-packaged plan.
  - It has rigour and discipline of the CIRP. At the same time, it is informal upto a point and formal thereafter.
  - **Minimal Disruption**: PPIRP minimizes disruptions to the debtor's business operations as negotiations are conducted before the formal insolvency process begins. The management of the affairs of the CD shall continue to vest in the Board of Directors/ partners of the CD and the resolution professional conducts the process under the guidance and oversight of the creditors.
  - **Creditor's involvement** in the resolution plan make it more likely to be feasible and acceptable by them. \
  - The **informality in the beginning** (pre-initiation phase) offers **flexibility** for the CD and its creditors to swiftly explore and negotiate the best way to resolve stress in the business.
  - The **Post-initiation stage drives value maximization** and bestows the resolution plan with statutory protection.

- **Advantages:**
  - Time efficient resolution
  - Early revival of stressed assets
  - Improved business continuity
  - Enhanced stakeholder involvement
  - Reduction in cost in insolvency resolution process
  - Preserve asset value: Early resolution can help preserve the value of the debtor's assets, preventing further deterioration and maximizing creditor's recovery

- **Performance Analysis**:
  - **Poor Start**: In two years of the program, only four cases have been admitted.
    - **Banks** are reluctant to get into an agreement with borrowers with no chance of full recovery.
      - If banks allow these promoters to escape with a haircut, there will be a flood of such requests, creating asset quality challenges.
    - There are no takers for this scheme as **banks prefer a one-time settlement (OTS**) in such cases and they are quicker to implement.
      - The scheme is similar to an OTS because the creditor and the bank have to agree to the plan, but the big difference is that in the PRIRP, we need a court approval that takes its own time. Therefore, for small outstanding loans, the OTS is much simpler than going to court.

- Further, small companies were **not well equipped** to approach banks with a clear plan, which was another reason for its failure.

3. CROSS BORDER INSOLVENCY (INTERNATIONAL INSOLVENCY) LAW IN INDIA

- **Example Questions**
  - "Inclusion of UNCITRAL Model Law provisions in Insolvency and Bankruptcy Code, 2016 will strengthen the Insolvency resolution norms in the country" Discuss [10 marks, 150 words]

- **Intro**
  - Cross border Insolvency mechanisms deals with financially distressed debtors who have assets or creditors in more than one country. Currently, the Cross Border Insolvency has no clear legal framework in India.

- **Key Cross border insolvency scenarios**
  - Creditor of an Indian debtor wishing to enforce their rights over the overseas assets of an Indian debtor.
  - Creditors of a foreign debtor wish to enforce their rights over the assets of foreign debtor in India.
  - Indian creditors to a foreign debtor, wish to enforce their rights over the assets of that foreign debtor in a foreign Jurisdiction.

- **Why cross border insolvency process is important?**
  - **Increasing global footprint of corporates**
  - **Improving Ease of Doing Business**
  - **Preventing the misuse of bankruptcy law**: It will further help India in dealing with cases like that of Nirav Modi who has filed for Bankruptcy in USA.

- **Key components of Cross border insolvency:**
  i. Which **law** is applicable in case of cross border insolvency
  ii. Who has the **jurisdiction** to administer the insolvency process.
  iii. How are judgments asserting control on assets **enforced**.

- **The UN Commission on International Trade Law (UNCITRAL) Model law**
  » This is a model law issued by UNCITRAL in 1997, to assist countries in regulating cross border insolvency. Over the years it has emerged as the most widely accepted legal framework to deal with cross-border insolvency issues.
  » It is based on the principle of **Modified Universalism** (as opposed to Territorialism and Universalism).
  » The law addresses the core issues of cross border insolvency cases with the help of **four main principles:**
    i. **Access**: It allows foreign professionals and creditors direct access to domestic courts and enables them to participate in and commence domestic insolvency proceedings against a debtor
    ii. **Recognition**: It allows **recognition of foreign proceedings** and enables courts to determine relief accordingly.

iii. **Cooperation**: It provides a framework for cooperation between insolvency professionals and court of countries.

iv. **Coordination**: It allows for coordination in the conduct of concurrent proceedings in different jurisdiction.

v. **Main Proceeding:** Principle for identifying where the insolvency proceeding (the main proceeding) should be initiated?

- The law sets out the **Centre of Main Interests (COMI)** in deciding where the main proceedings should be commenced.
    - The law doesn't define COMI, but it is generally presumed to be debtor's registered office or location of its assets and its significant operations.
- Further, the resolution professionals in this jurisdiction (where the main proceeding is initiated) are granted recognition and access in proceedings in other jurisdictions, where the insolvent entity may have assets (the non-main proceedings).

- **How many countries have adopted UNCITRAL?**
    - As of Oct 2023,**around** states have adopted the UNCITRAL Model Law (including USA, UK and Singapore). Some of them have set a reciprocity pre-condition.
- **Other Facts for Pre**
    - UNCITRAL, established in 1966, is a subsidiary body of the General Assembly of the UN.
    - It is mandated with harmonization and unification of the international trade law, as per the website.

– **Cross Border Insolvency in India**
  - » India has **not yet adopted** UNCITRAL Model Law. (as of Oct 2023)
  - » Earlier, Justice V. Balakrishna Eradi Committee in 2000 and N.L. Mitra Committee had recommended the adoption of the model law.
  - » **Under the current IBC, 2016**, two sections deal with cross border insolvency.
    - Section 234 of the code empowers government to sign treaties to enable the provisions of the code.
    - Section 235 provides for a 'letter of request' by the liquidator for action on the assets of the company situated in other country. However, a reciprocal arrangement must exist there.
  - » India has not yet initiated the bilateral treaty mechanism to deal with cross border insolvency provisions.

– **The Report of Insolvency Law Committee** (ILC) - chaired by Corporate Affairs Secretary **Injeti Srinivas**
  - » **Key Findings**
    - Section 234 and 235 of the IBC, don't provide a comprehensive framework on cross-border insolvency.
  - » **Key recommendations**
    - **Adoption of the UNCITRAL Model Law** as it provides a comprehensive framework to deal with cross border insolvency issues.
    - **Some changes to ensure consistency with IBC**
        - India's adoption of model law should only include corporate debtors and not individuals.

- **Incorporate Reciprocity Provision**
- **Foreign Creditors should be treated on par with domestic creditors**.
  - They will still be able to initiate, participate in and file claims in proceedings in India under IBC regardless of reciprocity.
- Centre should draw up a list of such indicative factors in subordinate legislation which can help while **ascertaining the COMI** (Centre of Main Interests)

» **Positives**
- The implementation of new recommendations will ensure better cooperation between domestic and international courts, a more transparent international insolvency resolution mechanism and better ease of doing business.
- It will benefit the resolution professionals by enhancing their ability to seek assistance in other jurisdiction.
- The reciprocity requirement will be essential to protect the interest of domestic parties.

» **Some Limitations of ILC recommendations**
- The **definition of establishment** is limited under the ILC's recommendations. It may exclude the internet based companies that essentially operate outside the traditional brick and mortal model.

» **Way forward**
- » Extensively draw lessons from global experience, especially while drawing the list of indicative factors to help **determine the COMI (Centre of Main Interest) and establishment**.
- » Careful, exhaustive mechanism to determine COMI to prevent misuse and forum shopping by various entities globally.
  - Any loophole in the system will be exploited by businesses to move into jurisdictions with very beneficial laws.

– **Conclusion**
- » The ILC report is a laudatory effort towards cross-border insolvency. It will be another step towards reforming the Insolvency process to make it more effective.
- » The responsibility is now with center and legislators to fine tune the recommendations and hasten its implementations.

4. DIFFERENT TYPES OF BANKS

1) REGIONAL RURAL BANKS (RRBS)

– **Example Questions**
- » Discuss the key role that Regional Rural Banks play in the development of rural sector? Why has government taken steps towards consolidation and amalgamation of the Regional Rural Banks? [12.5 marks, 200 words]

– **Background: Why RRBs were formed?**

- » Even after bank nationalization in 1969, there was a feeling that there were cultural issues which made it difficult for commercial banks, even under government ownership, to lend to farmers.
  - ▪ On the basis of recommendations of **Narsimhan Committee (1975)**, a Regional Rural Banks Act 1976 was passed to create regional rural banks to look after the banking needs of the rural and agricultural sector.
- » These banks act as an alternative to cooperative banks in providing financial inclusion in rural areas. RRBs combine the inclusiveness of cooperative banks with the professionalism of commercial banks.
- » They act as a decentralized solution for the skewed banking development that was happening across the country, with the south and west being well banked while the north-east, east and central regions suffered.

– **Ownership structure and other norms**(Remember for Prelims)

- » RRBs are owned by three entities with their respective shares as follows

Central Government	50%
State Government	15%
Sponsor Bank	35%

- » Every bank would be supported by "a Public Sector Bank".
- » The Sponsor banks are required to
  - ▪ Subscribe to the share capital of RRBs
  - ▪ Train their personnel
  - ▪ Provide managerial and financial assistance

– **Limitation in area of operation**

- » Each RRB operates within the geographical limit notified by the government. This may include one or more districts of the state.
- » **PSL Norms for RRB**
  - ▪ In 2015, the PSL targets for RRBs were increased to 75% from the existing 60%.

Categories	Targets
Total Priority Sector	75 per cent of total outstanding*
Agriculture	18 per cent of total outstanding
Small and Marginal Farmers	8 percent of total outstanding**
Micro Enterprises	7.5 per cent of total outstanding***
Weaker Sections	15 per cent of total outstanding

– **Key services provided by RRBs:**

- » Provide banking services in rural and semi-urban areas.
- » Providing loans to small and marginal farmers, craftsmen and artisans, MSMEs etc.
- » Carrying out government operations such as disbursing MGNREGA workers' wages and distributing pensions.
- » Providing para banking services like lockers, debit and credit cards, mobile banking, internet banking, and UPI services.

- **Regulation:**
  - RBI and NABARD are the main regulatory authority of the RRBs.

- **Key Challenges faced by Regional Rural Banks**:
  - **Cost of operations** of RRBs are much higher when compared to a scheduled commercial bank of similar size
  - **Losses**: These banks have limited mandate and thus many of the branches in rural areas don't have enough business.
  - **Less Technology Usage**: For e.g., not all RRBs provide net banking or mobile banking facilities.

- **Key Steps being taken:**
  - **Recapitalization of RRBs:**
    - In 2020 and again in 2021, through recapitalization helped these banks to improve their CRAR.
  - **Amalgamation of RRBs:**
    - In 2005, government initiated an amalgamation program which resulted into 43 RRBs in 2023 from 196 in 2005.
    - **Why?**
      - **Advantages** (reduces the overhead cost, improve operational viability, take advantage of economies of scale; increases capital available with the banks; Easy to regulate; Optimize the use of technology; higher productivity, improved financial inclusion etc.
      - **Criticism:**
        - Reduced number of banks -> takes banks away from customers.
    - **Note**: In July 2023, Ministry of Corporate Affairs exempted RRBs from the purview of CCI's merger control regime.
      - The exemption dispensation from the prior scrutiny and approval of Competition Commission of India (CCI) would be available for five years. It would pave the way for merger of RRBs without prior scrutiny and approval of Competition Commission of India (CCI), which has the mandate to examine whether merger and consolidation will lessen competition or affect consumer interest.
  - Government has also been encouraging RRBs to adopt technology and provide internet banking, phone banking and other online services to reduce the cost. RRBs have also been suggested to expand lending to MSMEs sector.
    - Sponsor banks have also been asked to create a roadmap for strengthening of RRBs.
    - This plan includes merging branches of these RRBs with sponsor banks once these branches reach a certain level of business.
  - **NABARD** is working on a roadmap for 22 RRBs which is expected to be implemented soon.

- **Plan to list RRBs to rise resources:**
  - Government has also **issued draft guidelines for listing of RRBs. (Oct 2022)**
  - This would allow them to raise resources by listing on stock exchange.
  - Basic criteria set in the guidelines are:
    - Net worth of Rs 300 crore during the previous three years.
    - Capital Adequacy of above the regulatory minimum level of 9% in each of the preceding three years.

- Track record of profitability - minimum profit of Rs 15 crore for at least 3 out of previous five years
- Besides, there shouldn't be any accumulated loss and the lender should have given return on equity of minimum 10% in three out of the preceding five years.

» As per the draft norms, the responsibility of identifying suitable lenders for issuing IPO has been left with the respective sponsor bank.

– **Way Forward:**

» Like scheduled commercial banks, RRBs need a common framework (something similar to Core Banking solution) so that they can provide better services, enhance user base and thus enhance overall profitability.

2) NICHE BANKING/ DIFFERENTIATED BANKING (PAYMENT BANKS AND SMALL FINANCIAL BANKS)

– **Intro:**

» Niche banks refer to those banks that cater to and serve the **needs of a certain demographic segment** of the population. Niche banks typically target a specific market or type of customer, and tailor a bank's advertising, product mix and operations to this target market's preferences.

» To promote financial inclusion in the country, RBI has in recent years launched two niche categories - Payment Banks and Small Financial Banks.

A) PAYMENT BANKS

» Payment banks are a new model of banks conceptualized by RBI (on recommendation of **Nachiket More Committee**) to increase financial inclusion. It focuses on **operating at smaller amounts without involving any credit risk**.

– **Regulation:** Payment Banks are registered as public limited company under the Companies Act, 2013, and licensed and governed under Banking Regulation Act, 1949.

– **Who is eligible:** A payments bank can be a mobile service provider, supermarket chain, non-banking finance company, corporate business correspondent, reality sector corporations and PSUs.

– **Main Features**

- **What they must do / necessary conditions**
  - **Minimum capital:** 100 crores
  - Maintain 75% deposit in government bonds
  - Maintain 25% deposit in other banks
  - Have 25% branches in Unbanked area

- Have atleast 26% investment by Indians
- Get listed if net worth crosses over 500 crores
- Be fully networked and technology driven
- **Cap on Deposit/ac:** 1,00,000.
- **Only current account and saving account.**
- Word **"Payment Bank"** in its name to differentiate it from other banks
- These banks should comply with the **corporate governance guidelines**, including 'Fit and Proper' criteria for directors as issued by RBI.
- Operating of the bank should be **fully networked** and **technology driven** from the beginning.
- Have to follow **CRR/SLR norms**.

- **What they can do / Optional**
  - Offer internet banking
  - Sell mutual funds, insurance schemes, pensions
  - Offer bill payment service for customers
  - Can provide locker and vault facilities
  - Have ATMS and business correspondent
  - Can function as BC of other banks

- **What they can't do**
  - **No Credit Lending i.e.** cannot Offer credit cards
  - Extend loans (so PSL not applicable)
  - Handle cross border remittances
  - Accept NRI deposits

- **Guidelines for Payment Bank's SFB license (March 2020)**
  - Payment Banks willing to convert into Small Financial Banks can apply for such license only after **5 years of operation**.

- **How would payment banks help in improving financial inclusion?**
  1. **Banking services to unserved groups:**
     - Banking services such as saving bank account, current account and payments/ remittance services to non-serviced groups such as **migrant workers, low income households, small businesse**s, other unorganized sector entities, by enabling technology driven environment
  2. **Extension of services in rural areas**
     - 25% of access points have to be in unbanked areas.

- Extension of services to rural areas, as use of technology such as mobile phones would be extensive.

3. Payment banks would **create infrastructure** to send/receive cash - including digital infrastructure
4. It will also increase the penetration of **insurance, mutual funds, pensions** etc.
5. It will help in **formalization of economy** by promoting the use of banks for day-to-day transactions
6. Promote development of **financial technology** sector to increase the efficiency of doing business with small amounts.

- **Skeptics**
  - **Feasibility:** Whether a bank which cannot lend and whose max deposit limit can be 1 Lakh per customer can have a future
  - **Regulation:** Whether RBI will be able to regulate these banks which will operate mainly with point of sale devices and through business correspondent.

B) INDIAN POST PAYMENT BANK (IPPB)

- IPPB is a payment bank owned by GoI and is operated under Department of Posts, Ministry of Communication. It's **first phase** was launched on 1st Sep 2018. The bank had started operating on pilot basis from Jan 2017, by opening two branches (Ranchi and Raipur).
- It is aimed at utilizing all of India's 1.5+ lakh post offices as access points and more 3 lakh postal service workers to provide house-to-house banking services.

- **Three different kinds of services provided by IPPB.**
  a. **Regular Services**
  b. **Basic Saving Accounts**
     - All features similar to regular services, but will allow only four cash withdrawals in a month.
  c. **Digital Saving Accounts**
     - Opened from the IPPB Mobile App available on android phones.

- **Other Key Features**
  a. **QR Cards + Biometric** (two-step verification process)
     - The IPPB has **done away with ATM Or Debit Cards** and will be using a QR card for both cash and cashless transactions. This QR card will work on biometric authentication and not on passwords or PINs.

b. **Third party services like loans and insurance**
   - IPPB has teamed up with financial services providers like PNB and Bajaj Allianz Life Insurance for third-party products like loans and insurance.
     - (Note: IPPB can't give loans directly as it is a payment bank)

c. **Options for having a deposit more than 1 Lakh rupee**
   - Deposits that exceed Rs 1 Lakh will be automatically converted into post office saving accounts.

– **Analysis: Advantages**

a. General advantages associated with payment banks

b. **Better reach of Postal network in rural areas**
   - 1.5 lakh post offices and around 4 lakh Grameen dak sevaks

c. **Door step services**
   - It is one of the most distinct features of IPPB making it more accessible.

d. **QR cards will be simpler to use**

e. **Increased digital and financial literacy**
   - Grameen Dak Sevaks will also be responsible for promoting financial and digital literacy.

f. **Fast-track welfare schemes**
   - Benefits of schemes such as PMFBY which provides assistance to farmers will be delivered faster now.

g. **More business for post offices**
   - Over the last few years, postal department has faced losses which can be reversed by expanding their role through payment banks.

h. **Break the infamous 'Liquidity preference'**
   - People in rural India have a habit of keeping money in cash or gold as they don't have other better options available.
   - IPPB has the potential to break this infamous 'liquidity preference' and revitalize the cycle of money and income, by making micro-savings a reality.

– **Analysis: Some Challenges**

a. **Financial:** Legacy casts a significant shadow over the success of IPPB. India post had a revenue deficit of more than 11K crore in 2016-17.

b. **Legacy Issues and high-cost business models**
   - Post offices business models have not been very effective so far
   - It's technology is inferior and archaic to private banks.

c. **Government Control** (since it is 100% owned by government) could lead to IPPB hindered by red-tapism, bureaucracy and corruption and could impede it from competing in a dynamic industry like banking.

d. **Training of human resource**
   - Banking and technology training needs to be provided to these dak sevaks.

e. **Connectivity**
   - Micro-ATM etc will only work when there is proper connectivity even in remotest corner. This is a concern for now.

f. **Charges** of Rs 25 for cash withdrawal/deposits and Rs 15 other digital transactions while availing door-step service is undesirable, both socially and commercially, and could be disadvantageous for the program.

– **Conclusion**
  - If we take steps deal with the above challenges, and provide services which are cost effective, efficient and easily available (connectivity), IPPB may turn out to be one of the biggest reforms in India's banking sector.

C) SMALL FINANCIAL BANKS (SFB)

- SFBs are niche banks with main function to perform **lending activities among unserved sections**.
  - SFBs were key recommendations of the committee on financial inclusion chaired by **Nachiket Mor**.
- **Objectives:** Increase **financial inclusion** by provision of saving vehicles to **under-served and unserved section** of population, supply of credit to small farmers, micro and small industries, unorganized sector entities.
- **Main Purpose:** Provide a whole suite of **basic banking** such as deposit and supply of credit, but in **limited area of operation**
- **Who is eligible to start a Small Bank?**
  - Resident individual with 10 years of experience in finance, NBFCs, microfinance companies, local area banks etc.
- **Who is not allowed?**
  - Large public sector enterprise and big industrial houses
- **Minimum Capital Requirement: 200 crore** (earlier - 100 crore - changed in Dec 2019)
- **CRAR: 15%**.

- The **promoters minimum initial contribution** to the paid-up equity capital of such small SFB shall at least by **40%** (can be brought down to **26%** within 12 years from the date of commencement of business of the bank).
    - **Shareholdings:** In these banks, entities other than promoters will not be permitted to have shareholding in excess of 10 percent.
- **Foreign Shareholding:** As per the current FDI policie.
- **Voting rights**: as per the existing guidelines for private banks
- These banks should comply with the **corporate governance guidelines**, including 'Fit and Proper' criteria for directors as issued by RBI.
- Operating of the bank should be **fully networked** and **technology driven** from the beginning.
- Both have to **follow CRR/SLR norms**.
- **What they must do?**
    - Have minimum capital of Rs **200 crore** (earlier 100 crore - changed in Dec 2019)
    - Extend **75% loans (ANBC) to priority sector**
    - Maintain **reserve requirements**
    - **50% of loan portfolio** should constitute **loans upto Rs 25 lakh**.
    - Have a **business correspondent network**
- **What they can do?**
    - Sell forex to customers
    - Sell mutual funds, insurance and pension
    - Can convert into a full-fledged bank
    - Expand across the country
- **What it can't do**
    - **Extend large loans**
        - The maximum loan size and investment limit exposure to a single and group would be restricted to 10% and 15% of its capital funds, respectively
    - **Float subsidiaries**
    - **Deal in sophisticated financial products**
- **Main challenges before SFBs**
    - Staying competitive with other commercial banks
    - Mobilizing deposits
        - It is one big issue, as most of these institutions were earlier into microfinance businesses (thus into lending) and don't expertise in collecting deposits.
            - Therefore, they are offering high interest rates from the beginning.
    - Human Resource
        - Attracting high quality banking talent cost a lot these days and this may create resentment among the existing MFI employees who have been with the organization for years.

- Technology requires hefty investment and greater understanding
- Demonetization has queered the pitch for the MFI turned SFBs as cash is the mainstay of their business model and it's not easy to leap into a cash less business model for small borrowers who work in the informal sector.

- **RBI releases final guidelines for on-tap licensing of SFBs (Dec 2020)**
  - On tap licensing will allow license to new SFBs throughout the year.
  - **Guidelines**
    - The minimum paid up voting equity capital or net worth requirement has been set at Rs 200 crore, up from 100 crore set earlier.
      - For Urban Cooperative Banks that intend to covert into SFB, initially the minimum paid up capital shall be 100 crore, which will have to be increased to 200 crore within five years from the date of commencement of business.
    - Investors, other than promoters will not be allowed to hold more than 10% share in SFB.
      - However, in case of NBFCs, Micro finance institutions, local area banks, where non-promoters hold more than 10 percent limit, RBI may consider giving 3 years time to dilute the stake.
    - SFBs will be given scheduled bank status immediately and will be allowed to open banking outlets from the date of commencement of operations.
    - RBI will appoint a Standing External Advisory Committee (SEAC) with a tenure of three years to process applications.
    - **The listing of** SFBS will be mandatory within three years after **it reaches a net worth of Rs 500 crore** for the first time.

- **Difference between Payment Bank and Small Finance Banks**

Point	**Payment Bank**	**Small Finance Banks**
Objective	Provide small saving accounts and payment / remittance services to migrant workers and low income households.	Financial inclusion and supply of credit to small business units and farmers through high technology and low cost operations.
Eligible Promoters	Individuals or professionals with necessary experience and eligibility, existing NBFCs, corporate banking correspondents, mobile companies, supermarket chains, real-estate co-ops and corporate entities	Resident individuals or professionals with 10 years of experience in banking and finance, companies and societies owned by residents, existing NBFCs, microfinance institutions and local area banks owned and controlled by residents.

Scope of Activities	• Accept deposit but the account balance should not exceed Rs. 1 Lakh (later updated to 2 lakhs) • Can issue ATM/Debit cards but cannot give loans or credit cards. • Atleast 25% in unbanked areas • FD/RD not allowed.	• Basic service of accepting deposits and lending • Can give loans. • No restriction on the area of operation • FD/RD allowed

- **Analysis**
    - While the older Local Area Banks and Narrow Banking concepts have failed, this might be a success because of sheer increase in technology in recent years.
    - Since all these banks will be entirely in private sector, it is the motivation of profit that will drive these new banks.
    - The success of the differentiated bank idea will herald a major change in the ownership pattern of banks with Public sector's dominant share getting whittled down.

GS FOUNDATION FOR CSE 2024
ECONOMY-11
FISCAL POLICY-BASICS

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2. PUBLIC FINANCE

– **Public finance** is the area of economics which deals with **resource mobilization and resource utilization to accomplish activities of the government** at all levels (Central, State and local bodies level).

– The objectives of the public finance are to manage public funds, mobilize resource for government activities, promote economic and social development, reduce inequalities, ensure price stability, manage the currency value in the international market, ensure long term sustainability (both economic and environmental) by controlling fiscal deficit and public debt.

1) GENERAL BUDGET

- Budget is the annual financial statement.
  - » **Article 112** of the Constitution of India requires central government to lay down annual financial statement in front of the Parliament.
  - » **Article 202** of the Constitution of India requires the same from state governments in front of their respective state legislatures.
- It is the **statement of account of the government**. It also reflects government's **vision** and highlights the overall government **policy**.
- **From 1921** to 2016-17, Railway Budget was presented separately from the general budget. But this practice was done away from 2017-18 general Budget, where Railway Budget was merged with general budget on the recommendations of the Bibek Debroy committee.
- **Budget contains** an account of **expected receipts and expenditure** of the government. It has three components:
  1. Actual figure for the previous year
  2. Budgeted and Revised figure for the current year
  3. **Estimates for the upcoming year**.

  - For e.g., if it is the Budget of 2023-24, it would be presented on 1st Feb 2023.
    - So, it would contain actual figures for FY 2021-22.
    - It would also contain budgeted and revised figure for FY 2022-23
    - An estimate for the FY 2023-24.

2) THE THREE FUNDS

- The estimated receipts and expenditures are made out of the three funds: Consolidated Fund of India, Public Accounts of India and Contingency Fund of India.

A) CONSOLIDATED FUND OF INDIA (ARTICLE 266(1)):

- **All revenues** received by the GoI, all **loans raised** by that government by the issue of treasury bills, loans or ways and means advances and **all moneys received by that Government in repayment of loans** shall form one consolidated fund which is entitled as "The Consolidated Fund of India".

- **All expenses incurred by the Government** including repayment of debts and loans given to state governments/ UTs is spent from this fund.

- **Note1:** Government needs Parliament's approval to withdraw money from thus fund.
- **Note2:** Each state has its own respective Consolidated Fund of State with similar provisions.
- **Note3:** The CAG audits these funds and reports the relevant legislatures on their management.

B) PUBLIC ACCOUNTS OF INDIA (ARTICLE 266(2)):

- All Public money received other than those included in Consolidated Fund of India are held in Public Accounts of India.
  - It mainly consists of money raised through small saving schemes, provident fund schemes etc.
  - The **government is just custodian of these**. It has to be repaid in future (either on maturity or when people demand it).

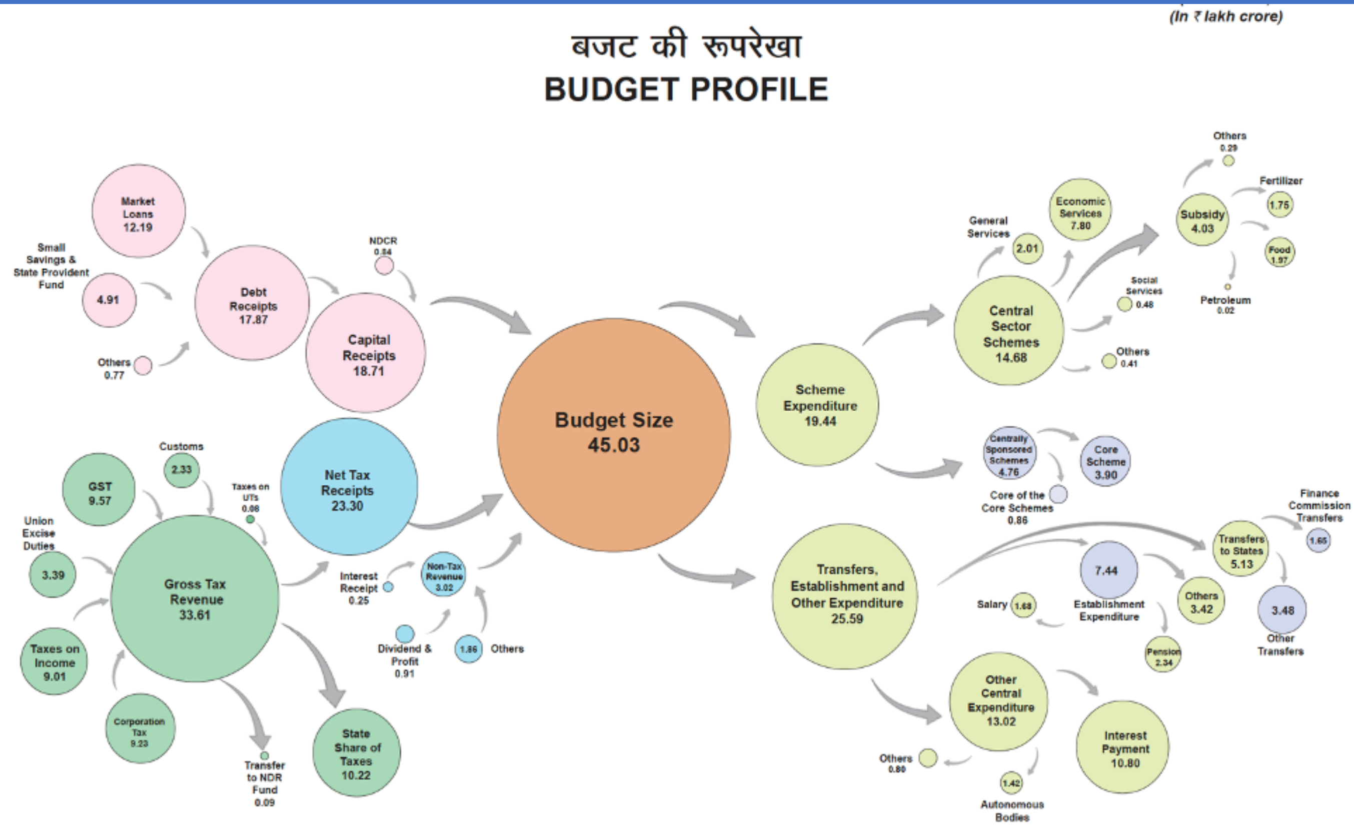
- This kind of debt or obligations raised by government is called **other liabilities**.
  - Please note: Public Accounts doesn't only contain other liabilities. It also has some other receipts too.

- **Note:** Expenditures from Public Account of India are not to be approved by the Indian Parliament. It is because of the returning nature of the fund.

C) CONTINGENCY FUND OF INDIA (ARTICLE 267):

- It is created to meet unforeseen expenditure. It is held at the disposal of the President of India. He/she can meet the expenditure and get the approval of the Parliament later.
- **Note**: Each state can have its own Contingency Fund established under Article 267(2).
- **Note**: CAG audits all expenditure from the contingency fund of India and Public Account of India as well as contingency fund and public account of each state.

3. BUDGET PROFILE 2023-24



4. UNDERSTANDING VARIOUS COMPONENTS OF THE BUDGET: RECEIPTS AND EXPENDITURE

1) RECEIPTS

- **Receipts** can be broadly divided into **Revenue Receipts** and **Capital Receipts**

A) REVENUE RECEIPTS ARE ONE-WAY TRANSACTIONS, AND THEY DON'T NEED TO BE PAID BACK.

- They include **Net Tax Receipts** and **Non-Tax Revenue**
  - **Tax Revenue (Gross Tax Revenue)** include the revenue generated by levy and collection of taxes by the Central government.
    - **Union Excise Duty**: Duties of excise on the following goods - (a) Petroleum Crude (b) High Speed diesel (C) motor spirit (petrol) (d) natural gas (e) aviation turbine fuel (f) tobacco and tobacco products
    - **GST**
    - **Custom Duties** (tax on export and import of commodities from and to the country
    - **Corporate Tax**
    - **Income Tax (Personal Income Tax)**

- **Taxes of Union Territories** (UT (except Delhi and Puducherry) are under direct administration of the Centre. So, their tax income is lumped and taken into account in Central Budget and accounted for under this head.
- **Other Taxes and Duties**: Tax income from other taxes like wealth tax, securities transaction tax are lumped together under this category.

- **Net Tax Receipt** is obtained by taking out State's Share of Taxes and Transfer to NDRF from the Gross Tax Receipts.
  - **National Disaster Relief Fund (NDRF):** It is financed by levy of cess on certain items, chargeable to excise and customs duty, and approved annually through finance bill.
    - Currently, a National Calamity Contingent Duty (NCCD) is levied to finance the NDRF and additional budgetary support is provided as and when necessary.

- **Non-Tax Revenue** include:
  - **Interest Receipts**: From the loans given to states and other government bodies.

  - **Dividend and Profit**: Profit is the dividend income from fully government owned enterprises. Dividends are income from the shares owned by government in private or semi-government enterprises.

  - **Other Non-Tax Receipts** include receipts from:
    - » Fiscal services
      a. Currency, coinage and mint i.e., profit from circulation of coins, is accounted under this head.

Details about Minting of Coins in India

- The GoI has the sole right to mint coins and design coins in various denominations. The responsibility of coinage vests with the GoI in terms of Coinage Act, 2011 as amended from time to time.
- GoI is the sole authority for minting of coins under the Coinage Act, 2011 as amended from time to time.
  - Coins are minted at four Government of India mints at Mumbai, Alipore (Kolkata), Saifabad (Hyderabad), Cherlapally (Hyderabad) and Noida (UP).
- Currently, coins in India are being issued in denominations of Rs 1 and above. They are called Rupee Coins.
- Coins can be minted and issued up to the denomination of Rs 1000 as per the Coinage Act, 2011.

- The coins are circulated through the RBI.
- Government also issues commemorative coins.

- The difference between the intrinsic value and face value is the profit for the government.
  - Intrinsic value -> Cost of production of the coin. It is the metal and other costs.
  - Face Value -> Value mentioned in the coin.

b. **Other Fiscal Services**:
   - These receipts are mainly related to contributions by RBI towards Extended Fund Facility (EFF) charges payable to the IMF, remunerations etc., received from IMF and Penalties realized against Economic offences.

» General Services (e.g., profits from Central Police, Public Services Commission etc.)
» Economic Services (i.e., receipt from various departments like Agriculture, transport, communication etc.),
» Social Services (departments like education, health etc.),
» **Grants in Aid** (from **foreign governments, multilateral bodies** etc.),
» Non-Tax Receipts from UTs (without legislature)
  - They are related to administrative services; sale of timber and forest produce mainly in A&N Islands; receipts from Chandigarh transport undertaking; Receipts from shipping, tourism, power etc.

B) CAPITAL RECEIPTS

– **They** result in **either reduction in government assets** (sale of shares, disinvestment) or **increase in some liability** (government borrowings). It can be divided into **Debt-Capital Receipts** and **Non-Debt Capital Receipts**

– **Debt Capital Receipts** include the fresh borrowings by government, along with other liabilities.
  - **Fresh Borrowing** can be **from within the country** (Internal) or **from outside the country** (external)
    - **Internal Loans** include **Market loans** through bonds, **Treasury Bills** issued to RBI & Banks, **Ways and Means Advances** by RBI etc.
      - **Market Loans**: Government of India's borrowing through **dated government securities** is called Market Loan. They are long term (more than 1 year) debt instruments. Generally, the tenure ranges from 5 years to 40 years. These **government securities** are sold through market auction. Since 2002-03, the Central government has been announcing half-yearly Indicative market calendars based on its core borrowing

requirements. These auctions are conducted by RBI's Public Debt Office (PDO), as debt manager to central government. The dated securities are **mostly fixed coupon securities**. The government also issued **Floating Rate Bonds** (FRBs) on which the coupon rate is reset semi-annually by adding a 'spread' to the base rate, determined through auction. Interest is paid semi-annually on both fixed and floating rate bonds.

- **Treasury Bills Issued to RBI and Banks**
  - These are the securities issued by Government Treasury. They are **short term** in nature and in this regard, they are different from market loans.
  - They are **not-interest bearing** (zero interest / zero coupons). They are thus called zero coupon bonds. They are **issued at discount rate**. (i.e., securities worth Rs 1,000 would be issued at an amount lower than Rs 1,000)
  - Treasury bills can be of different maturity. Till 1991-92, Treasury bills were only of 91 days maturity. This was also called ad-hoc treasury bills. To replace it, Ways and Means advance were introduced.
  - In 1998-99, 182-day treasury bills were introduced. It was soon replaced by 364-day T Bills. Again, 182-day treasury bills were introduced and later 14 days treasury bills were introduced in 1999-2000.

- **Other Internal Debt**:
  - Debt raised to meet the budget needs apart from the above methods is called other internal debt. They include:
    - **Funded Securities**:
      - Sometimes short-term treasury bills are converted as market loans (long-term loans) to defer the repayment. These are called funded securities. These were made non-marketable (i.e., it can't be sold to third party). Sometimes, portion of this security was made marketable.

    - **Other Special Securities Issued by RBI**:
      - Bonds issued by the government, to raise funds which were outside its annual borrowing program such as the oil bonds, fertilizer bonds etc. were classified as special securities. If these bonds were subscribed by RBI, they are accounted for in this head.

    - **Cash Management Bills (CMBs)**

- Cash Management Bills (CMBs) are short term bills issued by Central Government. The purpose of the mechanism is to enable government meet its short term needs.
- The bills are issued by RBI on behalf of the government.
- Thus, CMBs are short term money market instruments that help the government to meet its temporary cash flow mismatch. Key features:
    - **Maturity less than 91 days** (this is the key difference between treasury bills and CMBs)
    - **Generic characteristics of Treasury bills** - issued at discount rate and redeemed at face value at maturity.
    - They are eligible for SLR securities.
- CMBs were issued first on 12th May 2010.

- **Ways and Means Advances:**
    - As a banker to the government, RBI gives temporary loan facility to the Central and State governments. This facility is called Ways and Means Advances (WMA).
    - It was introduced in 1997 to meet mismatches in the receipts and payments of the government.

    - **How does it work?**
        - Government can get, immediate cash from RBI, if required. But it has to be **returned in 90 days**. Interest rate is charged at the **existing repo rate**.
        - If WMA exceeds 90 days, it would be treated as overdraft (interest rate is 2% points more than the repo rate)

    - **What is the WMA limit?**
        - The limits of WMA are decided by government and RBI mutually and revised periodically.

    - There are two types of Ways and Means advances - normal and special.
        - **Special WMA** or **Special Drawing Facility** is provided against collateral of the

government securities held by the state. After the state has exhausted the limit of SDF, it gets normal WMA. The interest rate for SDF is one percentage point less than the repo rate.

- **The number of loans under WMA** is based on three-year average of actual revenue and capital expenditure of the state.
- **Note:** Both WMA and Cash Management bills are used to meet the temporary mismatch in the cash flow of government.
- **Key difference between WMA and Cash Management Bills**:
  - **CMBs** are subscribed by others through auction like Treasury bills.
  - **WMA is a loan** given by RBI.

– **Market Stabilization Scheme**:
  - » It is not a pure fiscal/budgetary exercise, but a **fiscal cum monetary instrument**. It is a facility to control liquidity due to excess foreign exchange flow into the country.
  - » When a lot of foreign exchange flows into the country, there will be a matching rupee circulation in the economy. This would contribute to inflation.
  - » Under this scheme, Government issues securities through RBI and mops up the excess liquidity/money supply.
  - » The money collected is used by government for its need till its repayment.
  - » The amount of issue and the date of issue is decided by RBI in consultation with the Ministry of Finance, GoI.

– **Special Floating and Other Loans**
  - » Special floating loans are launched to raise money and their interest is subject to revision periodically, in accordance with some predefined variables.
  - » One such scheme was launched in 2001-02.

- **Securities against Small Savings**:
  - In 1999-2000, the GoI created a fund called National Small Savings Fund in the Public Accounts of India.

  - **Barring** State Provident funds, insurance and pension funds, trusts and endowments, and some small saving funds, collections of various small savings schemes like Post Office Savings Account, National Savings Time Deposits, National Savings Recurring Deposits, National Savings Monthly Income Scheme Account, Senior Citizens Saving Scheme, National Savings Certificate, Kisan Vikas Patra and Sukanya Samriddhi Account and Public Provident Fund are **deposited in NSSF**.

  - **Net collection** is invested in central and state government securities, and are invested in various public agencies like FCI, NHAI etc. These are called **Securities against Small Savings**.
    - Note: Net collection means deposit - withdrawals during the financial years.
    - The interest amount generated from these investments are used to pay interest for the subscribers of small saving schemes.
    - **Note:** Only the amount invested in central government securities are accounted under this head.
    - **Note:** The respective states and the public sector enterprises accounted for their borrowings

- **Compensation Bonds and Others**:
  - Bonds issued by government to affected persons by its policy decisions.
  - For e.g. - government abolished Zamindari system and to compensate for the loss of zamindars, the government issued bonds. These bonds were made to be encashed in the future and are of long-term nature.

- **Non-Negotiable, Non-Interest-bearing Securities issued to international financial institutions.**
  - These securities are issued to international financial institutions like WB, ADB. They are non-negotiable i.e., they can't be sold to others by security holder

and can be redeemed only form the issuing authority.

- **External Borrowings**: It includes money borrowed from outside the country from various sources and instruments. They are classified as multilateral and Bilateral loans:
  - **Multilateral Loans**: From IMF, WB etc. These are not borrowed against securities.
  - **Bilateral Loans**: Loans raised from foreign government and foreign government bodies directly.

- **Other Liabilities** are those money which are not directly borrowed but are available for government expenditure. It includes money deposited by people in custody of government such as for Provident Fund, NSSF, Small Saving Accounts etc.
  - Further, under this government may also use reserve funds of the Railways, Posts & Telegraph.

– **Non-Debt Capital Receipts**
  » These capital receipts don't create any liabilities.
  » They include **Recovery of Loans** and **Disinvestment of Government Shares**

2) EXPENDITURE

– The public expenditure can be classified as - **Revenue Expenditure** and **Capital Expenditure**:
1. **Revenue Expenditure**: Expenditure incurred to meet day-to-day and regular needs of government. This will not yield any profit/revenue in future. It is a one-way payment. It includes:
   » **Interest Payments**: Interest paid on borrowings and other liabilities and discounts on treasury bills constitute this category.
   » **Defence, Police**: - Expenditure of revenue nature towards law and order and defence.
   » **Subsidies**: On PDS, Fertilizers, fuel etc.
   » **Grants to States/UTs**: Though these grants are spent under capital expenditure by the receiving governments they come under this head as stipulated by Article 34(C) of the Audit code.
   » **Pensions and Salaries** of central government departments and those paid out of consolidated fund as charged expenditure.
   » **Economic Services**: Noncapital expenditure towards agriculture, industry, power, transport etc.
   » **Other General Services**: Non-capital expenditure towards education, health, broadcasting, etc. is included in this category.
   » **Social Services**: Non-capital expenditure towards education health etc.
   » **Postal Deficit**: Postal department is not able to generate enough revenue and is fulfilled by expenses of central government.
   » **Expenditure on UTs without legislations**

» **Grants to Foreign Governments**: Grants to countries like Nepal Bhutan etc. towards their developmental expenses; aids given to them during disaster etc.

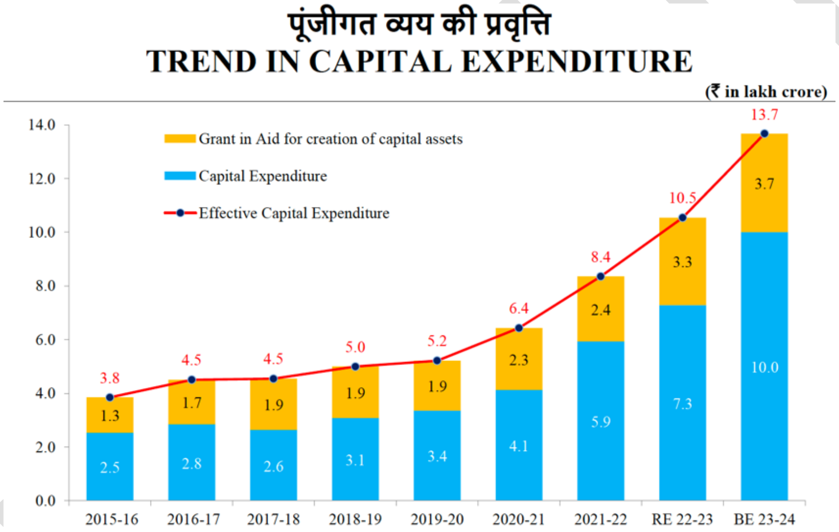
2. **Capital Expenditure**:
   » These expenses create **permanent assets or loans** which will yield periodical income. It is a two-way payment i.e., money spent can be recovered through periodical income and/or by disposal of the asset created.
   - It also **includes loans given to state governments and Uts**.

3) WHAT DOES ESI 2022-23 SAY ABOUT GOVERNMENT EXPENDITURE

Pragmatic Expenditure Policy of Reprioritization

Following the countercyclical fiscal policy, the government expenditure in FY21 rose to 17.7% of GDP higher than the previous five-year average of 12.8%. With revival of economic growth, this was brought down to 16.0% in FY22 and 15.3% in FY23 (BE).

After ensuring basic safety nets for the vulnerable, the emphasis of the government expenditure shifted to provide domestic capital expenditure. **Capital expenditure** rose in FY21. Later in FY22, FY23 and FY24 (BE), it has increased substantially.



Capex Led Growth to Bring Back Animal Spirits and Manage Debt Levels

– The government's thrust on capital expenditure, particularly in the infrastructure intensive sectors like roads and highways, railways, and housing and urban affairs, has longer term implications for growth.

– **Advantages of Higher Capital Expenditure:**
  - Strengthens aggregate demand.
  - Crowds in private spending
  - Enhances longer term supply chain productivity.

- Centre has also worked towards enhancing capex from state governments by providing long-term interest free loans and capex-linked additional borrowings.

Geopolitical Development stretched Revenue Expenditure Requirement

- **FY21** needed a lot of pandemic related support and hence revenue expenditure reached **15.6%** of the GDP. However, with winding up of pandemic related support, this was brought down to **13.5% (FY22:PA)**. This reduction was primarily due to reduction in subsidy expenditure which was brought from to **3.6% of GDP in FY21** to **1.9% in FY22**. This was further estimated to go down to **1.2% of GDP** in FY23 (BE).

- **But** the sudden outbreak of geopolitical conflict led to higher fuel, food and fertilizer prices requiring higher food and fertilizer subsidy.
    - **Therefore, government** sought an **additional Rs 80,000 crore for the expenditure** towards the food subsidy and additional allocation under PMGKAY and Rs 1.09 lakh crore for fertilizer subsidy required this year.

5. KEY TERMS TO UNDERSTAND

1) FISCAL DEFICIT; PRIMARY DEFICIT ETC.

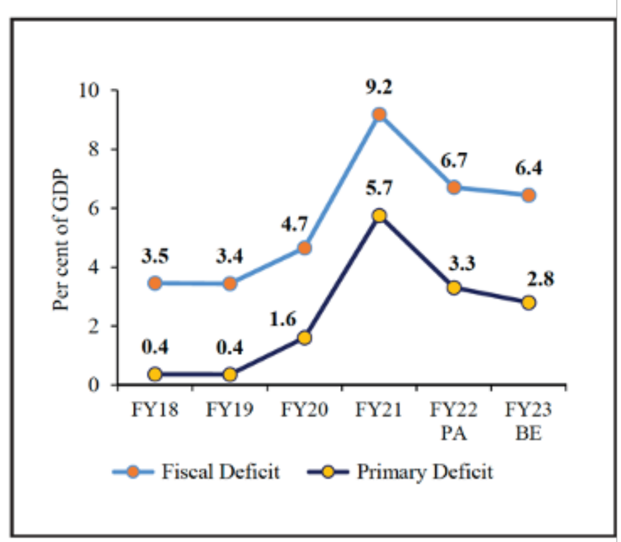
It is the difference between the Revenue Receipts plus Non-debt Capital Receipts (NDCR) and the total expenditure. It is **reflective of total borrowing requirements** of the government.

- **Fiscal Deficit**
  = Total Expenditure - Total Receipts other than borrowings
  = Revenue Expenditure + Capital Expenditure - (Revenue Receipt + Non-Debt Creating Capital Receipt)

- **Budget 2023-24: Key Fiscal Policy Targets**:
    i. **Fiscal Deficit (FY24: BE)**: 5.9
    ii. Targeted Fiscal Deficit to be below **4.5%** by 2025-26.

- **Implications of High fiscal deficit**:
    - **Inflationary Spiral**: Borrowing from RBI leads to increased money supply in economy which leads to higher inflation.
    - **Increased national debt**: This will impact future economic growth as a large part of the expenditure will go in paying interest for the debt rather than for capital investment.

Figure III.1: Trends in Union government deficits over the years- On the way to fiscal consolidation



Source: Union Budget documents, O/o CGA

- **Vicious Cycle of high Fiscal Deficit and Low GDP Growth**
- **Crowding out Effect**: This is the situation when high borrowing by the government (due to high fiscal deficit) leads to reduction in availability of funds for private investors. Accordingly overall investment in the economy reduces.
- **Erosion of government credibility**: High fiscal deficit (thus high debt of government) erodes credibility of the government in domestic as well as international money market. It may also lead to reduction in the 'Credit Rating' of the government (and the economy). Lower credit rating may lead to global investors withdrawing their investment from the domestic economy.

- **Therefore**, fiscal deficit shouldn't be allowed to go beyond manageable limits (about 3% of the GDP is considered manageable).
    - **High deficit** also signifies fiscal indiscipline. It points to a situation when GDP growth is low, and unemployment is high. The economy slips into stagnation and revival becomes difficult with FDI.

ii. **Revenue Deficit**: It refers to excess of revenue expenditure over revenue deficit.

iii. **Effective Revenue Deficit** is the difference between Revenue Deficit and Grants for Creation of Capital Assets.
- **The calculation of effective revenue deficit was introduced from 2010-11 budget.**

iv. **Primary Deficit** is measured as Fiscal Deficit less interest payments.
- **Primary Deficit** = Fiscal Deficit - Interest Payment

v. **Monetized Deficit**: It goes beyond the government's budgetary operations. It represents increase in the net RBI credit to the Union government which is the sum of increase in RBI's holding of government debt and any draw down by the government of its cash balance with RBI.

vi. **Fiscal Slippage**: If the actual fiscal deficit is more than what was expected it is called fiscal slippage.

2) BALANCED AND UNBALANCED BUDGET

i. **Balanced Budget**: A balanced budget is that budget in which government receipts are equal to government expenditure.
- **Merits:**
    - **Government is not indulging in wasteful expenditure.**
    - **It also ensures financial stability and signals fiscal discipline in the economy.**
- **Demerits:**
    - **During the 1930s Depression in the global economy, the demerits of balanced budget was understood:**

1. Balanced Budget **does not offer any solution to the problem of unemployment** especially when unemployment is due to reduction in aggregate demand.
2. Balanced budget is not conducive for growth in developing economies. For growth, more investment is needed, and some fiscal deficit should be acceptable. Moreover, developing countries have low capital output ratio, meaning investment will lead to much higher output and thus deficit should be acceptable to ensure investment which will have higher outputs in the economy.

ii. **Unbalanced Budget**:
- Here receipts and expenditure of government are not equal. It can be of two types:
  i. **Surplus Budget:** More receipt than expenditure i.e. government is not spending all the receipts.
     - **Need of Surplus Budget:** It is desired when economy is battling inflation and thus government tries to reduce the aggregate demand by either increase in revenue collection or decrease in government expenditure.
     - **Demerit of Surplus Budget**: Since surplus budget lowers the Aggregate Demand, it is not desired at the time of economic slowdown.

  ii. **Deficit Budget**: Here government expenditure are greater than government receipts.
     - **Keynes** and other modern economists stress significance of deficit budget, highlighting its merits.
     - **Merits**: Deficit budget contributes to economic growth when the loans are focused on increasing the capital investment in the economy. Deficit budget raises the level of Aggregate Demand in two ways:
       i. By way of high government expenditure.
       ii. By inducing greater expenditure (investment and consumption) by the people.
     - **Demerits**: Already discussed

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ECONOMY-12
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BUDGET, FISCAL DEFICIT, GOVERNMENT DEBT, FRBM ETC.

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2. TYPES OF BUDGETS

- Different kinds of budget follow different accounting principles to measure the results.

1. **Performance and Program Budgeting**:
   - In a performance budget, both the input of resources and the **output** of services are reflected in each unit of organization.
     - Performance of a program will be evaluated based on weather expected output was achieved or not.
     - So, it involves stage wise planning and standard fixation to assess performance of programs. It establishes a **correlation between physical (output) and financial (input) aspects** of each program and activity.

   - It was introduced in India in 1968 for four ministries on the recommendations of the 1st ARC. In 1975-76, it was introduced for all developmental departments.

   - **Advantages:**
     - Objective evaluation of performance
     - Employees can be kept motivated to achieve the outcome

2. **Outcome Budget**
   - The first outcome budget in India was introduced on Aug 25, 2005 by finance minister P. Chidambaram.

   - The outcome budget is a progress card on what various departments have done with the amount assigned in the previous budget.
     - It measures outcome of all government programs and weather money was spent for the purpose in was sanctioned.
     - Outcome refers to the **benefits that arise out of physical output f**rom the respective financial inputs.
       - For e.g. when roads are constructed, roads are the physical output. The rise in productivity of industries, transport sector etc. are the outcomes.

3. **Zero Based Budget (ZBB)**
   - In this system, all the schemes and programs are not included in every year's budget just because they already exist.
     - Here, **every scheme is reviewed critically and re-justified** as to why they have to be included in the coming budget.
     - It involves **consideration that there are no existing schemes/programs** and the budget has to be started from scratch/zero base.
     - So, it is called Zero based budget. The finance ministry has the plan to introduce it in future.
   - **Three essential principles of ZBB** (or three essential questions)
     - **Should we spend?**
     - **How much should we spend?**
     - **Where should we spend?**

- **Three essential features of ZBB:**
    1. **Conventional Aggregate approach is not applied.** In conventional approach every department prepares its own budget for many activities in aggregate from. Here, scrutinizing each and every activity is difficult.
        - » In **ZBB**, **every scheme/department needs to justify its existence** in the budget based on mathematical technique of econometrics i.e. cost benefit analysis.
        - » In simple terms, every scheme/activity by every department is scrutinized and once justification is validated, fund is allocated.
    2. ***Economy in public expenditure***, is a core principle followed here and budgetary allocations are cut to the extent it doesn't effect benefits of various service delivery to public.
    3. **Prioritizing of competing needs** is another special feature of ZBB. Different programs and given priority and the programs with least priority are allocated funds at the last. This may even lead to some very low priority schemes not getting any allocations.

- **Limitations of ZBB:**
    - » Services like 'Defence', 'Law and Order' etc. defy cost-benefit analysis i.e. no matter the cost, these services have to be mantained.
    - » Parliament can't scrutinize some expenditures like expenditures charged on the Consolidated Fund of India.
    - » ZBB is affected by biases of the scrutinizer as scrutiny is a subjective matter.
    - » It may give a lot of power to Finance Ministry as scrutinizer and weaken other ministries

- **Conclusion**:
    - » Despite some challenges, ZBB sounds a good step towards long term budgetary reform. It will promote both economy and efficiency in the budgetary process and functioning of the government.

- **Zero Based Budgeting in India**:
    - » ZBB was introduced for Department of Science and Technology in 1983. In 1986, it was adopted by the Indian government as a technique for systematic regulation of the expenditure budget. However, as of today, India has limited applications of ZBB.

3. MAJOR REFORMS IN INDIA'S UNION BUDGET OVER THE LAST FEW YEARS

– **Introduction**:
- » A transparent, comprehensive and realistic budgetary process enables better fiscal management.
- » To achieve efficiency in public spending, several reforms have been introduced in the Union Budget over the last few years:

– **Key Reforms:**

1. **Improved Fiscal Transparency and realistic revenue assumption in the budget**:
    - **It has been achieved by bringing below the line expenditures above the line and making revenue projections on realistic assumptions.**
        - For e.g. the extra-budgetary borrowings of the government were brought down from Rs 1.48 lakh crore in FY20 and Rs 1.21 lakh crore in FY21 to Rs 750 crore in FY22. No extra budgetary resources were estimated for FY23 in the budget.
    - **These measures demonstrated the government's commitment to sound fiscal management and provide an adequate buffer to deal with global challenge.**
2. **Discontinuation of Plan and non-Plan Classification**:
    - The Budget FY18 discontinued Plan and Non-Plan classification of government expenditure. It thus gave a greater emphasis to **revenue and capital classification** of Government expenditure.
    - Over the years, a broad understanding had developed that plan expenditure was good and non-plan expenditures were bad, resulting in skewed allocations in the Budget. The reform enabled effective planning and allocation of resources in the budget.

3. **Merger of Railway Budget with the Main Budget**:
    - It was done from FY18.
    - It gives a **holistic picture** of the government's financial position.
    - It also envisaged **facilitating multimodal transport planning** between highways, railways, and inland waterways, which has been strengthened in subsequent years with Gatishakti.
    - It has also enabled the Ministry of Finance to **ensure a coherent emphasis on capital expenditure** across sectors in recent years.

4. **Shifting the date of the Budget to 1st Feb**
    - This was done from the Budget FY18.
    - It paved the way for early completion of the budget cycle and enabled ministries to ensure better planning and execution of schemes from the beginning of the financial year.

- **Suggestions for further improvement** by **the Estimates Committee of Parliament** chaired by Mr. Girish Bhalachandra Bapat.
    1. **Incorporate the state wise allocation details** in the Union Budget documents to bring transparency in transfer funds to states.
        - Currently, the Union Budget at a Glance document provides an overview of the budget, including the allocation of major schemes by the central government. However, the funds allocated to different states don't reflect in this document.
        - But, people are interested in knowing the amount of money allocated to different states by the central government.

    2. **Increasing readability of Union Budget** documents: The Union Budget documents are very voluminous and common man and public representatives don’t have the time required go through it. Government should organize a briefing session for the MPs immediately after the presentation of the budget in Lok Sabha and highlight details from the budget documents.

3. **Regulating the use of interest income made by states** using central grants:
    - Grants transferred by central government to state remain in treasuries till they are transferred to implementing agencies. In the process they also earn interest on it. The Central government should identify the interest income made by various states and frame guidelines for utilization of funds earned by them.

4. **Underspending has to be dealt with**: Despite advancement of the budget cycle, as per the estimates committee there was underspending/under utilization of resources which occurred in around 100 departments in FY20 in the first six months. Steps need to be taken to ensure that union budget are optimally and fully utilized.

5. **Monitoring the implementation of Schemes**: Department of Economic Affairs (DEA) should develop a mechanism to track the progress of Ministries/Departments on implementation of projects/schemes, so that habitual defaulters who have not updated the progress can be identified while allocating the budget.

4. FISCAL CONSOLIDATION

- **Example Question:**
    - Discuss the key steps that needs to be taken in India to achieve fiscal consolidation [10 marks, 150 words]

- **Fiscal consolidation** refers to long term permanent strategies to reduce deficit by increase the revenue and reducing expenditure.

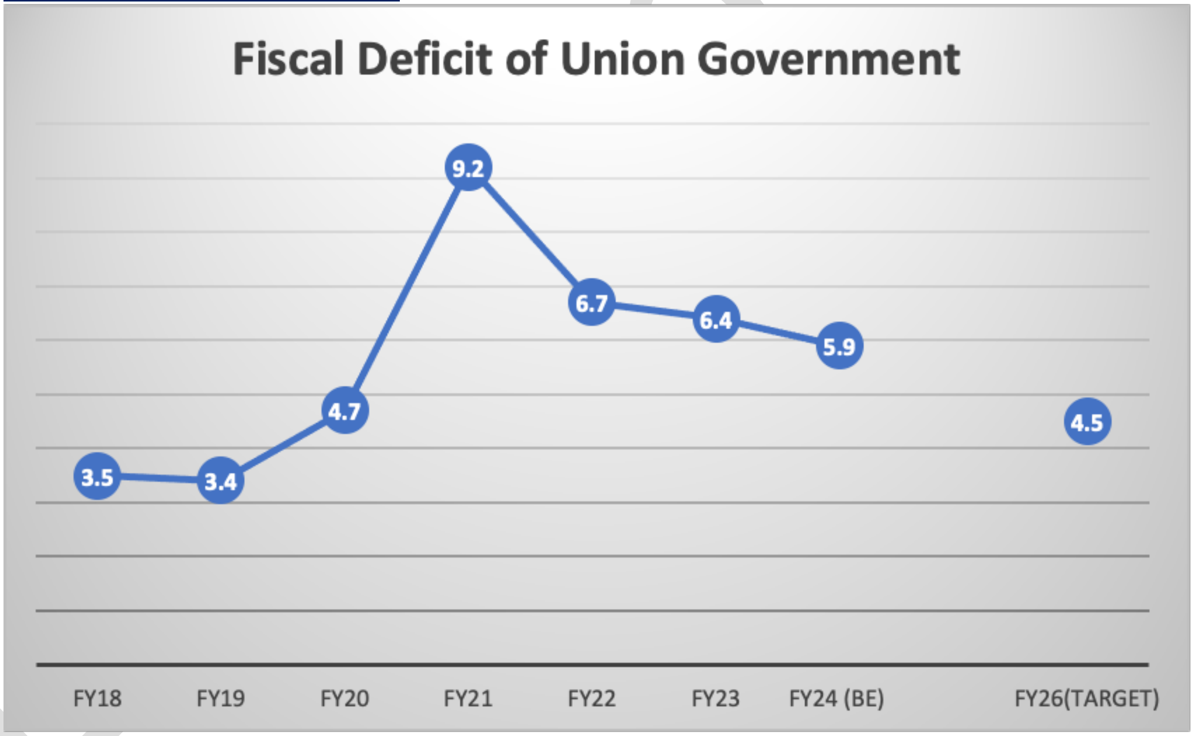
- **Why is Fiscal Consolidation** (i.e. reduction of fiscal deficit) **needed / Negative Impacts of High Fiscal Deficit**:
    - » **Inflationary Spiral**: Borrowing from RBI leads to increased money supply in economy which leads to higher inflation
    - » **Increased national debt**: This will impact future economic growth as a large part of the expenditure will go in paying interest for the debt rather than for capital investment.
    - » **Vicious Cycle of high Fiscal Deficit and Low GDP Growth**
    - » **Crowding out Effect**: This is the situation when high borrowing by the government (due to high fiscal deficit) leads to reduction in availability of funds for private investors. Accordingly overall investment in the economy reduces.
    - » **Erosion of government credibility**: High fiscal deficit (thus high debt of government) erodes credibility of the government in domestic as well as international money market. It may also lead to reduction in the 'Credit Rating' of the government (and the economy). Lower credit rating may lead to global investors withdrawing their investment from the domestic economy.
    - » **High Burden on Future Generation** as they are the ones who have to bear the brunt of higher interest rates.

- **Therefore**, fiscal deficit shouldn't be allowed to go beyond manageable limits (about 3% of the GDP is considered manageable).

- » **High deficit** also signifies fiscal indiscipline. It points to a situation when GDP growth is low and unemployment is high. The economy slips into stagnation and revival becomes difficult with FDI.

– **However**, some amount of fiscal deficit may be crucial for developing economies like India.
  - » Promote capital expenditure (fiscal deficit with high capex)
  - » Revitalize the business cycle (Counter-cycle fiscal policies)
  - » Promote crowding in investment (if better infrastructure is created -> fall in cost of production)
  - » Spending have higher fiscal multipliers during slowdown.

– **Thus, fiscal deficit may be ok, if following things are kept in mind:**
  - » Loan interest shouldn't become very high. Rate of growth of interest shouldn't be higher than the rate of growth of the GDP.
  - » Loans shouldn't be used to fund revenue deficit. It should go on **capital expenditure**.

– **Current Situation of India**:
  - » Structural reforms in FY20 (reduction in corporate taxes) and COVID-19 lockdowns in FY21 and FY22, diverted India from the track of fiscal consolidation.
  - » But, currently India is back on track with target of fiscal deficit to be **4.5% by FY26** and the current target of **5.9%** by FY24.
  - » 

– **Key steps that need to be taken**
  - » **Improving Tax System** (GST reforms, Direct Tax Reforms)
  - » **Reduce/Remove Perverse Subsidy** (e.g. Urea Subsidy; Electricity subsidy in agriculture; Electricity subsidy in urban areas; Subsidizing higher end travelling in Railways;)
    - **Replace these expenses** with better irrigation facilities; better marketing facilities etc.
  - » **Reduce Wasteful Expenditure** (delay in projects)
    - Timely project completion can reduce cost over run.

» **Rationalization of government schemes programs** (Central Sector Schemes/ Centrally Sponsored Programs)

» **Government exiting from nor core areas** in Public Sector Enterprise.

- Work on this front has been slow. Rather than dispensing with activities such as telecom to the private sector, the government continues to pour money into BSNL.

» **Avoid socialization of loss** (for e.g. taking of equity by Vodafone): Loss socialization is basically some type of government intervention either through bailouts or subsidies.

– **Conclusion**1:

» With these steps, India should be able to comfortably move towards the target of the fiscal deficit of 4.5% of the GDP by FY26 and further consolidation later.

– **Conclusion2:** (Accepting missed target of fiscal deficit)

» Economic Survey of India 2020-21 had concluded that in India, it is eventually growth which would create debt sustainability and not vice-versa. So, India should focus more on economic growth, even if fiscal deficit targets get missed for sometimes.

5. PUBLIC EXPENDITURE AND ITS KEY ROLE IN ECONOMY

– **What is public expenditure?**

» Expenses incurred by the public authorities - central, state and local self-government - are called public expenditure. In 19th century Europe, Public expenditure was believed to be wasteful. This conservative thinking died down in the twentieth century, especially after the second world war.

– **Why has public expenditure kept on increasing in recent years in India:**

1. **Increasing Population**: With increase in population of the country there is an expansion in the administrative activities of the government (like defence police and judiciary) which would lead to growth of public expenditure.
2. **Defence Expenditure**: As a country develops, it enhances its defence capabilities. In case of India, situation is more precarious and geographically India is located in a turbulent surrounding, thus needing to spend much more on defence.
3. **Welfare State:** Various socio-economic programs are undertaken by modern governments for the socio-economic uplift of the masses.
4. **Economic Development**: Modern government has a huge role in the growth of economy. Specially, in situations like COVID-19, government has to provide stimulus support. (e.g. various Atmanirbharta related initiative)

– **Freebie expenditure vs Fiscal Consolidation**

▪ Government may be giving a lot of subsidy/benefits which can be classified in following types:

i. **Subsidy/benefit for improving economy** (e.g. PLI schemes, MUDRA yojna etc.). It also included foregoing of tax expenditure to promote sectors which are affected by sudden changes (e.g. recent reduction in taxes on crude oil)

ii. **Subsidy for distributional efficiency** (e.g. subsidy like food subsidy, fertilizer subsidy, subsidy for insurance, subsidy for pension funds etc.)

iii. **Expenses to stabilize economy** (e.g. provisions to control inflation; spending on capital formation etc.)

iv. **For improving Current Account Deficit** (e.g. export promotion related subsidies)

- **Now, not all freebies/government expenditure can be done away with.**
  - Services like law and order, defence, judicial services etc. have to be available free of cost.
  - **Merit goods** like health, education, water supply etc. could be subsidized for vulnerable groups
  - **Public Utilities** like railways, public transport, electricity can be run on cost recovery basis.
  - **Commercial activities** like running of steel plants, manufacturing of capital goods etc. should either be given up by government and should be run on profit motive/basis.

6. MONETIZATION OF DEFICIT

- **Introduction**
  - The need for monetization of deficit was widely debated in the light of COVID-19 pandemic and need to provide stimulus to economy, in which both government's efforts and RBI's easing were found to be inadequate.

- **What is Monetization of Deficit?**
  - In simple terms, monetization of deficit means **printing more money i.e. RBI buys government securities from the primary market to fund the government's expenses**. It thus means increase in RBI credit to government.
  - **Note:** Monetization of deficit doesn't mean that government is getting free money, rather it is highly subsidized money.

- **Monetization of Deficit in India**
  - Till 1997, monetization of deficit was a **common practice in India** and RBI used to automatically monetize government's deficit through the issue of ad-hoc treasury bills.
    - But, through **agreements in 1994 and 1997 t**he funding through ad-hoc treasury bills was completely phased out. Later, **FRBM act** completely prohibited RBI from subscribing to the primary issuance of the government from 1st April 2006.
    - **Now**, RBI only buys government bonds in secondary market through open market operations. Here RBI is indirectly monetizing the deficit.

    - **Note:** FRBM Act has an escape clause which permits monetization of the deficit under special circumstances.

- **Advantages of the above decision to prohibit/phase out monetization of deficit** i.e. of prohibiting RBI from subscribing to the primary issuance of the government.
  - Since the government started borrowing in the open market, **interest rates went up** which **incentivised saving and thereby spurred investment** and growth
  - Also, the **interest rate that the government commanded** in the open market acted as a critical **market signal of fiscal sustainability**.
  - Importantly, the agreement shifted **control over money supply, and hence over inflation, from the government's fiscal policy to the RBI's monetary policy.**
  - The **India growth story** that unfolded in the years before the global financial crisis in 2008 when the economy clocked growth rates in the range of 9 per cent was at least in part a consequence of the high savings rate and low inflation which in turn were a consequence of this agreement

- **Advantages/ Need of Monetization during recessionary face**
    - **Fiscal Stimulus**
    - **Reducing cost of borrowing**

- **Limitations**
    - It triggers **inflation**. In long run, the increased money supply would definitely add to the inflationary pressure.
    - **Increased supply of Rupee** may also lead to **depreciation of the value of Rupee**. This makes imports expensive and exports cheap.
    - It gives rise to **unproductive spending**.
    - **Impacts credibility of government ->** portrays government as unable to meet its own financial needs.
    - Finally, it also **erodes RBI's control over monetary policy** (and thus its independence). If RBI agrees to monetize the deficit, it is effectively agreeing to subordinate monetary policy to the financing policy of the government.

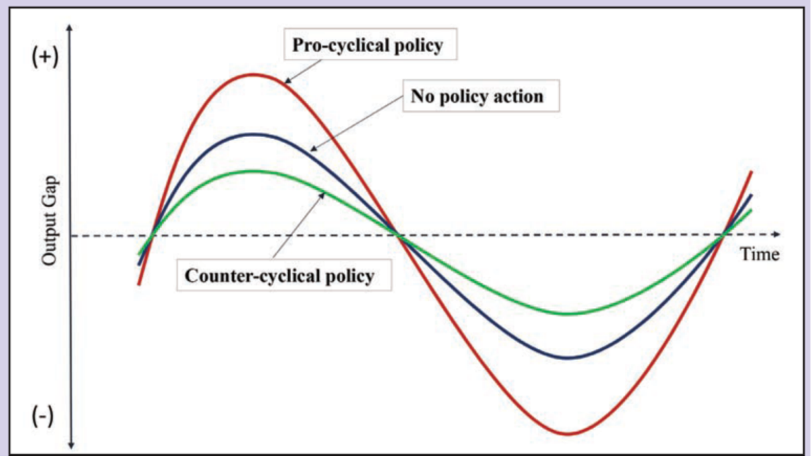
- **Conclusion**
    - Monetization of deficit is something that should be avoided in normal circumstances. Only in very extreme situations, government/RBI may resort to this.

7. COUNTERCYCLICAL FISCAL POLICY

- **What is Countercyclical Fiscal Policy?**
    - **During slow-down or recession**, government should allow slippage of fiscal target and reduce taxes and increase expenditure. This creates more demand and brings economic upswing.
    - **During Boom Period**, government should perform fiscal discipline, increase taxes and reduce government expenses. Otherwise, the growth would not be sustainable, high inflation may result and the amplification of boom can be disastrous in long run.

- **Pro Cyclic Fiscal Policy**
    - It is opposite of counter cyclic policy. During Boom, government may further increase the expenditure to allow further growth of the boom.

- **Why counter-Cyclic Fiscal Policy is crucial?**



- At the time of recession, **private consumption (C) reduces, and private investment (I) also go down.** In such scenario, **increasing government expenditure** – both consumption and expenditure – **will support GDP and minimize the output gap**. This happens primarily through the **following mechanism**:
    i. Increased government expenditure **cushions the contraction in output by contributing to the GDP growth** and offsetting the decline in consumption and investment.
    ii. During recession **spending multiplier is higher** which leads to boosting of private investment and consumption.
    iii. Higher spending by government **compensates for 'risk aversion' by private sector** and brings back 'animal spirits'.
    iv. It also **enhances expectation multiplier** by building confidence in tough times. Since government is able to exhibit their commitment to sound fiscal management, the *rational players in the economy would not expect the economy* to fluctuate as much and therefore private players will further increase the investments and reinforce this expectation multiplier.

- Numerous studies in economic literature have established the same conclusion both **theoretically as well as empirically**.

    Ozkan and McManus (2015) study the impact of fiscal policy on macroeconomic outcomes for 114 countries over 1950-2010. They found that a counter-cyclical fiscal policy stance with policy action against the cycle acts as a stabilizer by reducing output volatility and keeping growth on a steady path.

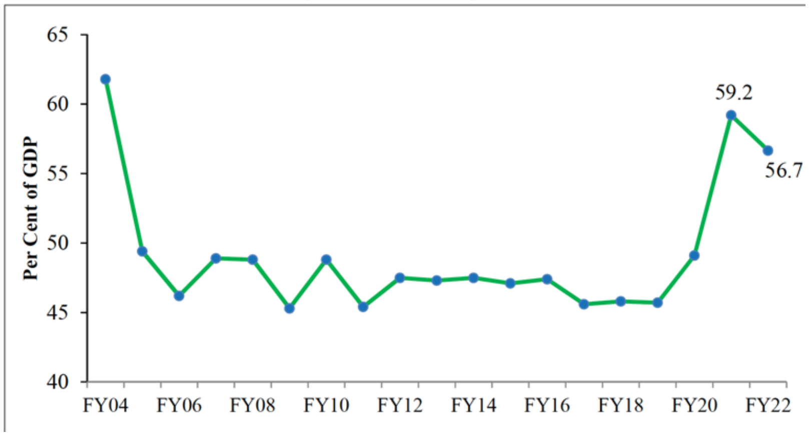
- **Conclusion: For India** too, in recessionary scenario of COVID-19, when the private consumption (which contributes to 54% of the GDP) was contracting, and private investment (which contributed to 29% of the GDP) was uncertain, the **relevance of counter-cyclical fiscal policies was paramount**.

8. GOVERNMENT DEBT

- The Covid-9 crisis has led to rise in government debt all over the world. IMF projected the **global government debt** at **91% of the GDP** in 2022, about 7.5% points above pre-pandemic levels. In Europe, even in FY23 government debt went up as government provided relief to households and small businesses from mounting energy bills.

- **India's Situation**: **Situation of Union Government**:

Figure III.14: Moderating Union Government's Debt-GDP ratio after the pandemic induced-spike



- In FY22 the total debt of Indian Government was **134.08 lakh crores** which includes:
  - **Public Debt** (121.21 lakh crore in FY22) of which:
    - **Internal Debt** (Rs 114 lakh crore in FY22): Borrowings using debt securities like dated securities treasury bills etc from domestic market.
    - **External Debt** (Rs 6.59 lakh crore in FY22): Borrowings from other governments (bilateral); multilateral agencies like WB, ADB, etc and FPI purchasing Governemnt securities.
  - **Public Accounts Liabilities** (11.8 lakh crores in FY22)
    - It includes National Small Savings Schemes.

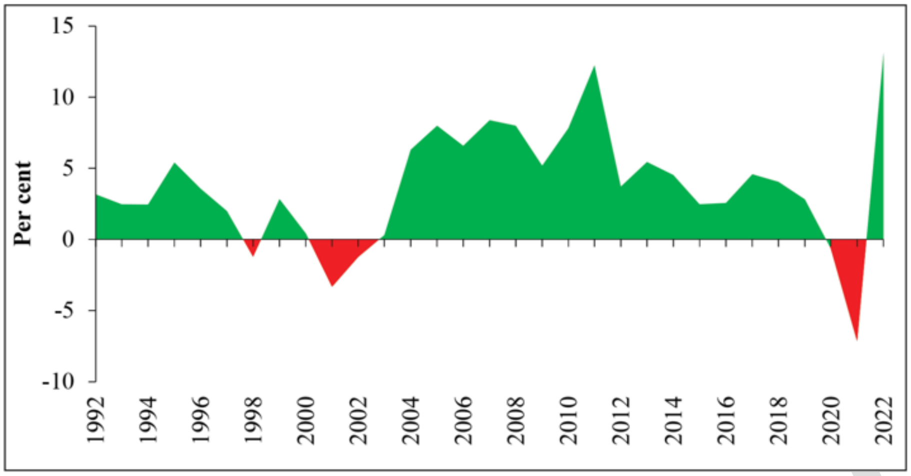
- **Extra Budgetary Liabilities** (1.39 lakh crores in FY22)
  - Extra Budgetary Liabilities are those financial liabilities that are raised by PSUs for which repayment of entire principal and interest is done from Government budget; Such borrowings are made by state-owned firms to fund government schemes but are not part of the official budget calculations.
  - They are excluded from fiscal deficit calculations, but at the same time, are added to the total debt of the government.

- **Note:** Share of external liability in public debt is **only 4.9%**. Thus, India's public debt profile is relative stable and is characterized by **low currency and interest rate risks.**
- Further, public debt in India is primarily contracted at **fixed interest rate**.

– **India's Situation: General** Government (Central + State): Debt to GDP Ratio
  - **Current Situation**
    - India's Public Debt to GDP ratio shot up from 75% in FY20 to **88.5%** in FY21.
    - Then it gradually reduced to **82.8% in FY23**.
  - **Future Estimate**
    - IMF says that the debt to GDP ratio may rise again in FY24 and FY25. After that it may start going down and reach 80.5% in FY29.
  - It clearly shows that Government debt is not going to return to pre-pandemic levels in medium term.

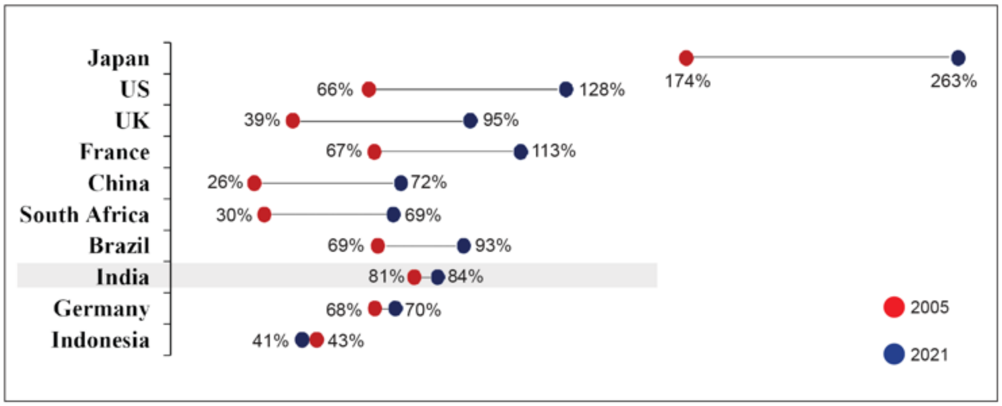
– **Sustainability of Government Debt**:
  - **A Positive Growth-Interest Differential Keeps the Government Debt sustainable.** In India, this differential has historically been positive.
  - **Increased capital expenditure** -> Higher growth -> Higher Revenue -> Sustainable fiscal path
    - The emphasis on capex led growth will enable India to keep the growth-interest differential positive.

Figure III.18: Growth-interest rate differential for India

» 

» In general, globally, between 2005-2021, there has been a substantial increase in debt to GDP ratio for most countries. But in case of India, the increase is **modest**. It has been possible due to resilient economic growth over the last fifteen years.

Figure III.19: Comparing General Government debt to GDP ratio in 2005 with 2021 across the countries

» 

Source: World Economic Outlook, October 2022.

- **High level of public debt is a cause of concern**:
  - » **High interest payment:** Interest payment constitute around 5% of India's GDP which is higher than the government expenditure on health and education put together. This crowds out government expenditure on infrastructure, human development etc.
  - » **Distortion of Financial Markets**: To keep the interest rates on government borrowings low, some financial repressions are imposed. For e.g. under SLR regime banks hold around 18% of NTDL in government securities. Similarly, RBI may intervene in the market through open market operations.
  - » **High level of debt also makes it difficult to calibrate counter-cyclical fiscal policy** and constraint the ability of government to respond to shocks.
  - » **Rating agencies keep the sovereign ratings low** when deficits and debt are high, and this increase the cost of external commercial borrowings.
  - » **Hampers Inter-Generational inequality**: Today's borrowing is taxing tomorrow.

- **Way Forward:**
  - » **Fiscal Consolidation** (already discussed with fiscal consolidation topic)

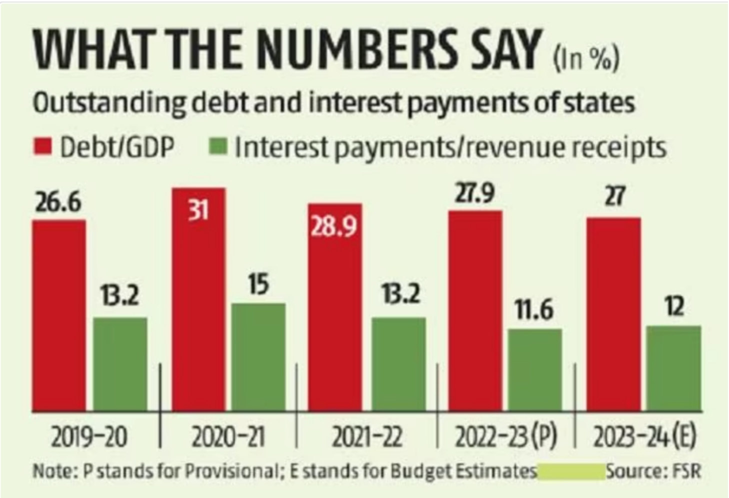
- » **At the state level**, guard against the return to the **old pension scheme** and indulge in large-scale giveaways for electoral reasons.
- » **Impose hard budgetary constraints** by enforcing **Fiscal Responsibility and Budget Management Rules** in allowing states to borrow.

9. OVERVIEW OF THE STATE GOVERNMENT FINANCES

1) FISCAL DEFICIT:

- In the pandemic year (FY21), the **Gross Fiscal Deficit (GFD) of the states** increased to **4.1% of GDP**. This was brought **down to 2.8%** in FY22 and FY23.
- This deficit is much lower than the budgeted estimate of 3.4% for FY23. **What are the reasons for swift** consolidation?
  - » **Decline in revenue expenditure.**
  - » **Increase in state's tax revenue** (led by GST collections)
- **For FY24,** States have budgeted a GFD-GDP ratio of **3.2%,** which is significantly lower than the indicative targe of 3.5% set by central government.

2) DEBT:

- After reaching a 15-year high of **31% of GDP** at the end of FY21, they came down to **27.9% of GDP** by the end of FY23.
- The **debt service burden** of the states, measured in terms of the **interest payment to revenue receipts ratio**, has also moderated during the period.
- **Are the above numbers good?**
  - No.
  - At 27.9%, it is higher than **the 20% limit recommended by the FRBM Review Committee (2018)** and warrants further consolidation.
    - 

3) ENHANCED LIMIT OF BORROWING FOR THE STATES AND INCENTIVES FOR REFORMS

- Since the outbreak of the pandemic, the Centre has kept the Net Borrowing Ceiling of the state government **above the Fiscal Responsibility Legislation (FRL) threshold**.

- It was fixed at **5% of GSDP in FY21, 4% of GSDP in FY22 and 3.5% of GSDP in FY23**. A part of the additional borrowing was **linked to reforms** encouraging the states to undertake them.
  - For instance, in FY21, a part of the additional borrowing ceiling was conditional on implementing the '**ONORC' System, EODB** reforms, **ULB/utility** reforms, and power sector reforms. This led to implementation of these reforms in many states.
  - Similarly, **in FY22** a part of additional borrowing was earmarked for **incremental capital expenditure** and 16 states accessed the additional borrowing upon meeting the capex target.

- In addition, the Fifteenth Finance Commission had recommended performance based additional borrowing space of **0.5% of GSDP** to the states in the power sector.
- **Note:** States had unutilized borrowing limits during the last three years.

- **Budget 2023-24**: States will be allowed a fiscal deficit of 3.5% of GSDP of which 0.5% will be tied to power sector reforms.

4) COOPERATIVE FISCAL FEDERALISM DRIVES A WELL-TARGETED FISCAL POLICY:

A) TRANSFER FROM CENTRE TO STATES:

- Transfer of funds to states comprises the Share of States in Union Taxes (41%) devolved to the states, Finance Commission Grants, Centrally Sponsored schemes, and other transfers.
- **Total transfer to states** has risen between FY19 and FY23.

B) SUPPORTING THROUGH GST COMPENSATION PAYMENTS DURING CRISIS:

- **GST Compensation to States Act, 2017**
  - » As per section 7 of the GST (Compensation to States) Act 2017, loss of revenue to the state on account of implementation of GST should be payable during the **transition period of five years**.
  - » States' tax revenue of FY16 was considered as the base year and 14% growth every year was assumed to measure the compensation to each state.
  - » **Generation of this extra revenue** was done through **GST Compensation Cess**. It is levied on luxury and sin goods.
    - ○ SUV Vehicles (more than 4 meters) are charged 50% of tax, of which GST rate is 28% and the compensation cess is 22%.
    - ○ Aerated drinks, Pan Masala, tobacco products are also covered under this cess.
    - ○ The collected compensation cess flows to the Consolidated Fund of India and then transferred to the Public Account of India, where a GST Compensation Cess Fund has been created.
- **End of GST compensation regime but continuation of Compensation Cess till March 2026:**

» But GST council has decided to **extend the time for levy of GST compensation cess** by nearly 4 years till 31st March 2026. This has been done to repay the loans taken in the last two fiscal years to make up for the shortfall in their revenue collection.

» Note: In order to meet the resource gap of states due to short release of compensation, the Centre has **borrowed and released Rs 1.1 lakh crore in 2020-21 and Rs 1.59 lakh crore in 2021-22** as back-to-back loans to meet a shortfall in cess collection.

C) CENTRE'S SUPPORT TOWARDS STATES' CAPITAL EXPENDITURE

– **Scheme for Special Assistance to States for Capital Expenditure**: Under this scheme the centre has provided 50-year interest free loans to state governments in last four years (FY21, FY22, FY23 and FY24)

» **Budget 2023-24 (FY24):** Budget presented in Feb 2023 announced to continue 50-year interest free loans to state governments from one more year to spur investment in infrastructure and to incentivize them for complementary policy actions, with a significantly advanced outlay of **Rs 1.3 lakh crore.** This amount includes an unconditional component and smaller components linked to specific reforms/initiatives.

Table III.8: Details of Scheme for Special Assistance to States for Capital Investment' for FY23

(₹ crore)

Component	Basis	Allocated	Approved	Released
1	Allocation proportional to the share of tax devolution for FY23	80000	68,592	31,571
II	PM Gati Shakti-related expenditure	5,000	1,458	1,458
III	PMGSY	4,000	1,616	1,616
IV	Incentive for digitisation	2,000		
V	Optical fiber cable		2,215	2,011
VI	Urban reforms	6,000		
VII	Disinvestment and monetisation	5,000		

Source: Department of Expenditure

» Note: During FY23, the allocation was 1.05 lakh crore.

» **Advantages of this mechanism**:
- Centre's loan is cheaper (then if state had borrowed at its own)
- Entire money goes in capital expenditure (If state had borrowed, it could have spent some money in revenue expenditure)

10. FRBM ACT

– **Background: Need to institutionalize a new fiscal discipline framework:**

» In 1980s, India saw a sharp deterioration in fiscal situation, which ultimately culminated in the balance of payment crisis of 1991. Within a decade of economic liberalization, the fiscal deficit and debt situation again seemed to head towards unsustainable level around 2000. At that time, a need to **institutionalize a new fiscal discipline framework**.

– **FRBM Act** was passed in 2003 and became effective from July 5, 2004. It enjoins government to conform to a pre-set fiscal target, and in the event of failure to do so, to explain the reasons for deviation.

- The **aims** of the act are to:
  - Introduce **transparency in India's fiscal management** systems.
  - Achieve **inter-generational equity** by ensuring equitable distribution of debt over the years.
  - Ensure **long term macro-economic stability** through fiscal stability

- **To promote transparency** in fiscal management, s**ection 3 of the act** provides that Union government will place **three more documents on fiscal policy** along with the budget:
  1. Macroeconomic framework Statement
  2. Medium Term Fiscal Policy Statement
  3. Fiscal Policy Strategy Statement

- Later, through an amendment a fourth statement, **Medium Term Expenditure Framework (MTEF)** needs to be presented.

- At the end of the second quarter, the finance minister would make a statement on the trend of fiscal indicators and corrective measures taken thereof.

- The Act requires the central government to progressively reduce outstanding debt, revenue deficit, and fiscal deficit.
  - The central government gives three year rolling targets for these indicators when it presents the Union Budget each year.

- It says that the **Central Government shall not borrow from the RBI** except by way of advances to meet temporary excess of cash disbursements over cash receipts.
  - Further, **RBI shall not subscribe to the primary issue of the Central government securities** from the year 2006-2007.

– **Originally, the following targets were set under the act and FRBM rules.**
  - Revenue Deficit -> 0 by 2007-08; Fiscal Deficit -> 3% by 2007-08.
  - **Total liabilities of** central government should **not rise by more than 9% a year**.
  - Union government will not give guarantee to loans raised by PSUs and state governments for more than **0.5%** of the GDP aggregate.

– **2008 Financial crisis and its aftermath**
  - Deadlines for the implementation of the targets in the act was initially postponed and subsequently suspended in 2009. In the next few years, the act was largely neglected.

– **NK Singh Committee to review FRBM Act (Report submitted in 2017): Key Recommendations:**
  - The committee said that **debt should be considered primary target**. It suggest Public Debt to GDP ratio as a medium term anchor for fiscal policy in India.
  - It also gave targets of (Fiscal Deficit, Revenue Deficit and debt) to be achieved by 2022-23.
  - Creation of a **Fiscal Council**: It is a proposed 3 member body which will have functions like preparing multi-year fiscal forecast; preparing fiscal sustainability analysis; providing

independent assessment of the central government's fiscal performance; and improving quality of data.

- **Escape Clause and Buoyance Clause**

– **In 2018, the FRBM Act was amended to specify three conditions upon which the escape clause can be invoked**.

- **First**, over-riding considerations of **national security, acts of war, and calamities of national proportion** and **collapse of agriculture severely affecting farm output and incomes**.
- Second, far-reaching **structural reforms in the economy** with unanticipated fiscal implications.
- Three, a **sharp decline in real output growth of at least 3 percentage points** below the average for the previous four quarters.
- The FRBM amendments also mentioned that the **deviation from the stipulated fiscal deficit target must not exceed 0.5 percentage** points in a year.
- **Note:** the term "escape clause" hasn't been used in the act. It was used by the FRBM review committee chaired by NK Singh.
- In Budget 2020-21, the finance minister Nirmala Sitharaman has used the escape clause provided under the act to relax the fiscal deficit target. It was done on the grounds of reduction in corporate tax (structural reform)
  - The fiscal deficit of FY19-20 was 3.8% (BE was 3.3%, therefore the 0.5% relaxation)

– **Recommendations of the 15th Finance Commission**

- The 15th Finance Commission for 2021-26 suggested a path for fiscal consolidation for the centre by reducing **fiscal deficit to 4%** of GDP and **outstanding debt liabilities** to 56.6% of the GDP by 2025-26**.**

– **Current Scenario:**

» Due to COVID-19 scenarios, the targets were against missed. Therefore, FRBM Act should have been amended to set new targets.

» But the revisions to the FRBM Act Medium Term Fiscal Policy Statement for 2021-22 and 2022-23 omitted the rolling targets for budget deficits.

  o Government wants a fiscal flexibility to respond to emerging contingencies till the pandemic induced uncertainties ease.

» However, government has said that it would pursue **a broad path of fiscal consolidation** reaching the target **of 4.5% of Fiscal Deficit by 2025-26**.

In Aug 2023, the Finance Ministry conveyed its inability to release **Medium Term Expenditure Framework (MTEF)**, mandated by FRBM Act, 2003. It said that since the presentation of Union Budget for FY24 in Feb, there hasn't been any significant and favourable change in global headwinds and associated risks. Therefore, the **medium-term projections are not feasible**. Further, effective management of exogenous shocks and global uncertainties **necessitated additional flexibility** for the Government in terms of expenditure management and fiscal consolidation.

– **Critical Analysis of FRBM Act**

- The act was passed to make the central government and finance minister accountable to parliament for fiscal discipline. However, **due to a lack of autonomous Fiscal Management Review Committee (as proposed originally)** the act more or less became like a Directive Principle of State Policy which is not enforceable by court. Its mandate was diluted and even today we find both revenue deficit and fiscal deficit targets regularly being missed.
- Some economists consider 3 percent target as arbitrary, and more suited to the west where the growth has tapered off.
- **Some suggestions for improvement**
  - The problem lies in the act itself. The FRBM rules can be simply amended by gazette notification. They lack transparency and adequate monitoring and compliance by the government.
  - **Some changes that would help are:**
    - **i.** Move the annual numerical targets from FRBM rules (which are framed and amended by central government at whim by gazette notification) to the FRBM act itself (so that atleast parliamentary approval is needed to make changes)
    - **ii.** Do away with the ambiguous concept of Effective Revenue Deficit which is nothing but a jugglery to rewrite revenue expenditure as capital expenditure.
    - **iii.** There is a need to institute an independent review and monitoring of implementation of the FRBM law.

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2. INTRODUCTION

- Tax is a **compulsory levy payable by an economic unit to the government without any corresponding entitlement** to receive a definite and direct quid pro quo from the government.

- **Tax Base:** Legal description of the **object with reference to which the tax is payable**. It may have time dimension like year, month etc.
  - E.g., base of the excise duty is production of commodities
  - Base of income tax is income of the individual

- **Tax Buoyancy** measures actual observed change in Tax Revenue relative to GDP
  - Tax Buoyancy = Proportionate change in the tax revenue / Proportionate change in GDP
  - Tax Buoyancy = %change in tax revenue / % change in GDP
  - Change in tax may be because of two reasons:
    1. Due to automatic increase
    2. Due to discretionary changes in tax rates or coverage or both

- **Tax Elasticity:**
  - It measures proportionate change in tax revenue without any discretionary change, relative to GDP.
  - E.g.
    - If tax rate has changed by 20%, (10% without discretion and 10% because of rate change) and If Change in GDP is 10%
      - Tax Buoyancy = 20/10 = 2
      - Tax Elasticity = 10/10 = 1

- **Classification of Taxation**: The taxation can be classified mainly into three types (1. Proportional Taxation 2. Progressive Taxation 3. Regressive Taxation)
  i. **Proportional Taxation:** Tax levied as a % of tax base irrespective of size of tax base, at a uniform rate is called as proportional tax.

  ii. **Progressive Taxation:** Tax rate increases with the increase in size of tax base.
    For e.g., under the **new tax regime**: Following are the interest rates:
    - Up to Rs 3 lakh - 0 per cent tax
    - Between Rs 3 and 6 lakh - 5 per cent tax
    - Between Rs 6 and 9 lakh - 10 per cent tax
    - Between Rs 9 lakh and Rs 12 lakh - 15 per cent tax
    - Between Rs 12 lakh and Rs 15 lakh - 20 per cent tax
    - Above Rs 15 lakh above - 30 per cent tax

  iii. **Regressive Taxes:** If the tax rate decrease with the increase in tax base it is called regressive tax. Here the % of tax rate decreases but the absolute amount of tax increases with increase in size of tax base but less than that of proportional and progressive taxation.

- **Impact of Tax**
  - Impact of tax is on its **first point of contact with the tax payers**. It is upon those who bear the first responsibility of paying it to authorities.

- E.g., Income tax -> income recipient
- Sales Tax -> seller

– **Incidence of Tax**
  - Incidence of tax is on its final resting place, i.e. those economic unit which finally bear the money burden of tax, and which are not able to pass it to others.

– **Different methods of taxation on goods**
  i. **Ad Valorem**: If tax is levied as % of the value of the goods regardless of number of units produced/sold/imported, then it is called ad valorem.

  ii. **Specific Duty:** If tax is levied at a flat rate per unit of goods.

3. TYPES OF TAXES

– There are two types of taxes namely.
  i. **Direct Tax**
  ii. **Indirect Tax**

1) DIRECT TAX

– **Impact and incidence lies on same point.** Those taxes for which burden for tax falls on the entity that is being taxed are knowns as direct taxes.

– Progressive in nature in India and all over the world and are highly elastic in nature.

– **E.g.**
  - **Income Tax:** Tax on personal income of the individuals, Hindu undivided families (HUFs), partnership firms etc.
  - **Corporate Tax:** It is levied on the company's profit income. There is not separate tax called corporate tax. It is also income tax. But the contribution of tax from corporate to the income tax is large. So, it is shown in separate head.
  - **Wealth Tax:** It is imposed on accumulated wealth or property of every individual, Hindu undivided family.
    - **Note:** It was **abolished** in the Union budget presented on 28th Feb 2015.
    - It has been replaced with **additional surcharge** on super rich with a taxable income of over 1 crore annually.
    - **Why was it abolished:** Although only a nominal amount of revenue is collected (844 crore in 2012-13), this levy creates a significant amount of compliance burden on the taxpayers as well as administrative burden on departments. Moreover, the assets which are specified for the levy of wealth Tax, being unproductive like jewellery, Luxury cars etc are difficult to be tracked.

- **Property Tax:** As per the income Tax Act of India, incomes from properties are regarded as one of the heads of income. Therefore, tax is levied on the income from property. These usually include buildings, flats, shops and land etc.

- **Securities Transaction Tax (STT)**
  - Introduced in 2004-05. It is tax imposed on transactions of securities in Stock Exchange.
  - Current STT ranges from 0.001 percent to 0.2 percent depending on the nature of transaction.

- **Commodities Transaction Tax (CTT)**
  - CTT is similar to STT, levied in India, on transactions done on the domestic commodity derivatives exchange.

  - First introduced in Budget 2008-09, but was withdrawn later as it was felt that it could have negative impact on India's nascent commodity derivative market.
  - This was that reintroduced in Budget 2013-14. But it has been done only for the **non-agriculture commodity** future at the **rate of 0.01%** (which is equivalent to the rate of equity futures)

  - **Aims/Advantages of CTT**: Discouraging **excessive speculation**, which is detrimental to the market and to bring parity between securities market and commodities market such that there is no tax/ regulatory arbitrage. The CTT also helps government in widening tax base.

  - **Other Updates**
    - **Finance Act, 2016** provided that transaction carried out in a recognized commodity exchange located in an international Financial Center, where the payment is carried out in terms of foreign currency, would be **exempt** from payment of CTT.

  - **Key recommendations**
    - A finance ministry official has called for reduction in CTT and STT as these tax rates were higher than international marketplaces such as Singapore and Hongkong.
    - Recent a NITI Aayog Committee has also recommended scrapping of commodities transaction tax on gold.

- **Minimum Alternate Tax** - see details separately.
- **Alternate Minimum Tax -** See details separately.

2) INDIRECT TAX

- If impact is on one point and incidence on some other point. It is called indirect tax.
  - These taxes are considered regressive in nature.

- But by imposing higher rate of taxes on luxury goods and lower rates of taxes on essential goods the progressiveness of indirect taxes is ensured to some extent.

- **GST** - Covered in detail separately.

- **Union Excise Duty**:
  - **Duties of Excise** on the following goods manufactured and produced in India:
    - Petroleum Crude; high Speed Diesel; Motor Spirit (commonly known as petrol); natural gas; aviation turbine fuel; and tobacco and tobacco products.
    - **Note:**
      - In addition to excise duty and customs duty levied, **National Calamity Contingent Duty (NCCD)** is levied on some of the specified tobacco products and on crude petroleum. It is credited to National Calamity Contingent Fund (NCCF) and National Disaster Relief Fund (NDRF).

- **Custom Duty:** Tax on import and export of commodities.
  - Note: Tax on export is levied very rarely. It is generally done in cases of domestic shortage of some agri goods.

- **Sales Tax/ VAT**:
  - It is a tax on sale of commodities. It is a state level sales tax. The tax is imposed on the percentage of value added. Hence, it is called VAT. **After introduction of GST** only few products like petrol and diesel are under VAT.

3) OTHER IMPORTANT ASPECTS

- **Cess:** It is a tax additionally levied as a percentage of existing tax amount for specific purpose. The tax amount collected should not be used for purposes other than the purposes for which it is meant for.
  - For e.g: **Education Cess**: It is an additional levy that is applied on basic tax liability by the government to generate additional revenue to fund primary, secondary and higher education. Apart from individuals, even corporations are required to pay this cess every year at rates determined during the annual budgets.

- **Surcharge:** A tax additionally levied as a percentage of existing tax amount, but **without any specific purpose**. It is levied if size of the tax base exceeds a certain threshold limit.
  - For e.g.: Surcharge on Income Tax of Individuals

Annual Income	Surcharge
Under 50 Lakh	Nil
Rs 50 Lakh to 1 crore	10%
Rs 1 crore to 2 crores	15%
Rs 2 crore to 5 crores	25%
Above Rs 5 crore	25% (From FY24)

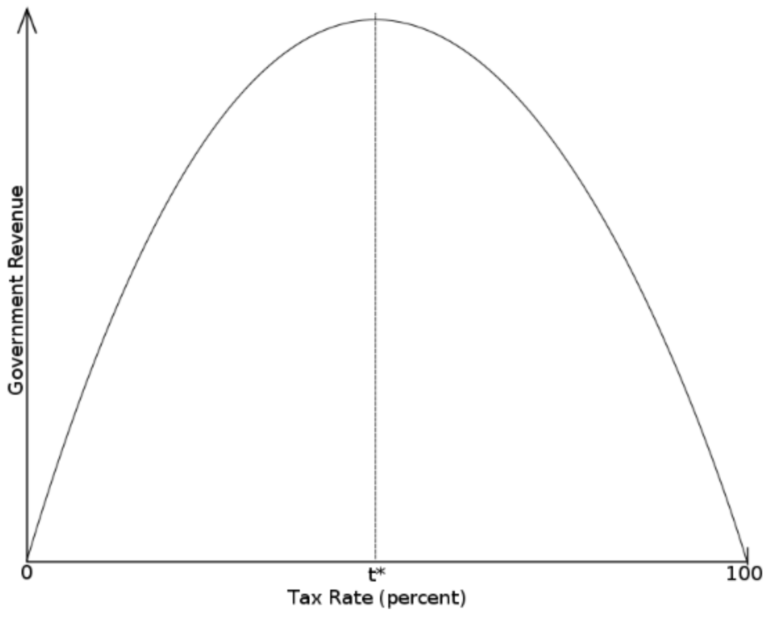
  - **Note:** On annual income above Rs 5 crore, surcharge of 37% was applicable. But from FY24, this has been reduced to 25%. This will ensure that maximum marginal rate of tax will be reduced from **42.74%** to 39%.

- **Countervailing Duty:** To encourage export, countries give subsidy to exporters. So, the cost of production for exporters comes down. Hence, exporters are able to export to other countries at a cheaper rate. It largely affects producers of the importing country. To counterbalance (countervail) this, importing countries impose duty on imported goods to raise the price of the subsidized product to offset the lower price. This is called countervailing duty.

- **Anti-Dumping Duty:**
  - **Dumping** means exporting goods to other country in large quantity at a cheaper rate. There are two types of dumping.
    - i. **Price dumping:** It means selling goods in foreign country at price lower than the price of home country.
    - ii. **Cost Dumping:** It means selling goods in foreign country at a price lower than cost of production. It is mainly aimed at wiping out domestic producer from the market. It is also called **predatory dumping**.
  - **Duties imposed on dumped goods is called Anti-dumping duty**.

4) LAFFER CURVE

- In economics, the Laffer curve is a representation of the r**elationship between rates of taxation and the resulting levels of government revenue**.
  - Proponent of Laffer curve claim that it illustrates the concept of taxable income elasticity - i.e., how taxable income will change in response to changes in the rate of taxation.
  - The Laffer curve postulates that no tax revenue will be raised at the extreme tax rates of 0% and 100% and that there must be at least one rate which maximizes government taxation revenue.



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2. DIRECT TAXES

1) INCREASING DIRECT TAX BASE

- **What is Direct Tax?**
  - Direct taxes are those taxes where impact and incidence lie on the same point (i.e. the burden for the tax falls on the entity that is being taxed). These taxes are generally progressive in nature and are highly elastic.
  - Because the direct taxes are **progressive**, they bring equity in society (which doesn't happen with indirect taxes). Therefore, the direct taxes need to be monitored carefully.

- **Direct Tax in FY23**:
  - India's **net direct tax collection** have **risen by 17.63%** in 2022-23 to touch **Rs 16.61 lakh crores**, as per the data released by Finance Ministry in April 2023.
    - It was 14.09 lakh crore in FY22 and 9.41 lakh crores in FY21.
  - **Corporate Tax** - **Rs 10.04 lakh crores** (51.1% of direct tax) and **Personal Income Tax** and Securities Transaction Tax accounted for **Rs 9.61 lakh crores (48.9%** of direct tax)

  - **Even for FY24**, situation seems to be good so far:
    - **Between April 2023** to **Aug 2023**, the direct tax collection has increased by **26.6%**.

- **Current Tax Base**:
  - Less than 6% of the population has filed ITR in FY23. Only **7.4 crore / 140 crore** population have filed ITR in FY23.

- **Why is it important to increase the Direct Tax Base?**
  - **Fiscal Consolidation** - More resources with government will be better for infrastructure and social projects. This will contribute to **economic growth** as well.
  - **Fights Inequality:** Indirect taxes are regressive, but direct taxes are progressive and thus promote equality. Direction taxes also avoid severe distortionary trend of indirect taxes.
  - **Educative Value**: Direct tax creates a civic sense among taxpayers. Because money is directly paid by citizens, they become **more vigilant** of where and how government is spending their money.
  - **Anti-Inflationary**: Direct Tax can be considered a good instrument of anti-inflationary fiscal policy.
  - **Reduce pressure on honest taxpayers.**

- **Key Reasons for recent increase in tax base**
  i. **Steps to make it difficult to avoid tax**:
    - **Bank accounts** linking with PAN and Aadhar.
    - **Introduction of new data sources** in the Statement of Financial Transaction (SFT), such as dividend, interest, details of shares etc has led to jump in reported information, with additional information of about 3 crore persons.
    - Expansion of the scope of TDS/TCS: Several new transactions were brought under the ambit of TDS and TCS.

ii. **Simplified process** through technology:
   - **Faceless assessment Scheme** is one of the biggest direct tax reforms in India based on key principle of Efficiency, Transparency and Accountability.
   - Simplified ITR filing process through a 1-page SAHAJ return process for individual income tax.
   - **Ease of getting refund**, majorly by small and medium taxpayers have also encouragement more filing of ITRs.

iii. Steps towards formalization of economy:
   - Initiatives like Pradhan Mantri Formalization of Micro Food Processing Enterprises (PMFME)

iv. Steps to expand digital payment system (Demonetization, UPI etc.)

vii. Streamlining of GST system
   - It has reduced the scope of evasion of direct taxes.

– **The above growth is still not good enough** and the tax base is very low (only 7.4 crore people filing FIR)

– **Key factors for low tax base**

i. **Complex Law**
   - **Income Tax Act 1961** isn't suitable for current scenarios. It has become very complex and has thus reduced compliance.
   - This **complicated structure** is difficult to understand for individuals/corporate sector. Plethora of exemptions and deductions, adding to litigation on these, needs to be removed.
   - **High compliance cost**

ii. **High Rates** are recipe for low tax compliance.
   - Personal income tax rates are very high leading to high rates of evasion.

iii. **Poor Tax Administration**
   - A lot of tax evaders go scot-free.
   - Income Tax department doesn't have resources to deal with small tax evaders
   - Corruption is rampant in income tax department
   - Complaints of harassment by tax officials.

iv. **Large Informal Sector**: This sector doesn't effectively get covered under tax regime.

v. **Agriculture-out of tax net** (sometimes non-agri income is also presented as agri-income)

– **Way Forward**
   - **Simplified Direct Tax Law -** A Direct Tax Code (DTC) has been envisaged for long now. It is high time it gets implemented.
   - **A direct tax council** on lines of GST Council
     - To periodically update the tax rates and other provisions
   - **Increasing Compliance**
     - Reducing tax rates for personal income tax as well
     - Simplifying tax filing (for e.g., recent proposal by CBDT to merge 6 ITR methods into 1 is a step in right direction)
     - Increased resources with income tax department to even prevent evasion from among small players.
   - **Focusing on Behavioural Change**

- » **Employ social norms** in encouraging the individuals to pay taxes. Countries like UK, Norway, Guatemala to name a few have successfully used the social pressure to increase the tax compliance.
- » CBDT campaigns can focus on salience of taxes in providing public goods.
- » **Incentivize honest taxpayers** - For e.g., by determining the amount of pension on the basis of individua's tax contribution.

- **Enhance use of new technologies like AI and ML to identify tax evaders** (e.g. Project Insight)
- **Bring Agriculture Income** under Tax regime.

– **Conclusion**
- Higher direct tax collection could lower the tax burden on the poor by creating fiscal space for reduction in GST rates.
- Therefore, it is important that government keeps working towards increasing the share of direct taxes in overall tax collection and increasing the tax base.

2) ONE NATION ONE RATION CARD

– **What is ITR?**
- » An Income Tax Return (ITR) is a form used to file information about income and tax to the Income tax Department.

– **Currently, How many kinds of ITR are there?**
- » Currently, there are seven categories of ITR forms, for different categories of taxpayers.
  - **ITR Form 1**, called **'Sahaj'** is for small and medium taxpayers. It can be filed by individuals who have an income upto Rs 50 lakh, with earnings from **salary, one house property/ other sources** (interest etc.)
  - **ITR-2** is filed by people with income from residential property
  - **ITR-3** is intended for people who have income as profits from businesses/ profession.
  - **ITR-4** (**Sugam**), like ITR-1, is a simple forms, and can be filed by individuals, Hindu Undivided Family and firms with total income upto Rs 50 lakh from b**usiness and profession**.
  - **ITR-5** and **ITR-6** are for limited liability partnerships (LLPs) and businesses
  - **ITR-7** is filed by Trusts and non-profit organizations

– **Changes proposed by CBDT:**
- All taxpayers (except trusts and non-profit organizations (ITR-7)), will be able to use a common ITR form, which will include a separate head for disclosure of income from virtual digital assets.
- **Sahaj** (ITR-1) and **Sugam** (ITR-4) will continue. This will give option to such taxpayers to file the return either in the existing form (ITR-1 or ITR-4), or the proposed common ITR, at their convenience.

– **Reasons:**
- **Simplifying ITR filing system** -> Ease of filing returns and Reduced time for filing the ITR
  - Taxpayers will not have to see the schedules that don't apply to them.
  - It intends the smart design schedule in a user friendly manner with a better arrangement, logical flow, and increased scope of pre-filling.

    - It will also facilitate **proper reconciliation** of third-party data available with the Income-Tax department vis-a-vis the data to be reported in the ITR to reduce compliance burden on tax payers.
  - Making the system in sync with International best practices

3) TAXING AGRICULTURE

- **Agriculture Income:**
  - **Agriculture Income** is **defined** under section 2(1A) of the Income Tax Act as:
    - i. Any rent or revenue from land situated in India and is used for agriculture purpose
    - ii. Any income derived from such land by agriculture operations including processing of agriculture produce so as to render it fit for the market or sale of such produce.
    - iii. Any income attributable to farm house subject to satisfaction of certain conditions specified in this regard in section 2(1A).

- Agriculture income earned by farmers in India is **exempt from Income tax**. It is provided under Section 10(1) of the Income Tax Act, 1961.

- The demand to tax agriculture income in India is not a new one. Several expert committees over the years have recommended taxing of farmers income. But, this demand has increased in recent years due to rising heterogeneity in farmer's profile.

- **Past Attempt at taxing agriculture income**
  - » **Taxation Enquiry Committee in 1924-25** recommended taxing of farmers.
  - » **DR BR Ambedkar** had also favored taxing agri-income based on the income of farmers. He criticized the land revenue system of British, but was of the view that income from agriculture must be taxed.
  - » **Wanchoo Committee of 1971 on Direct Taxes** also recommended that agriculture income should be done away with and be aggregated with other income liable to income tax as the provision was being used for evading tax.
  - » **KN Raj Committee** through its report in 1972 analyzed the feasibility of taxing agriculture **and recommended taxing of rich farmers**.
  - » **Kelkar task force report in 2002** estimated that 95% of the farmers were below the tax threshold. It also stated that **the exemption to agriculture income is a distortion to both horizontal and vertical equity** and encourages laundering of non-agriculture income as agriculture income.
  - » In Short, **almost all the commissions and agencies appointed or created by the government in the last 60 years have unanimously been of the view that agriculture income should be subjected to tax**.
  - » In **April 2022**, the Public Accounts Committee tabled a report in the Parliament on 'Assessments relating to Agriculture Income' in which the committee examined certain paragraphs of the CAG report which dealt with verification of documents for exemption, incorrect reflection of income tax etc.

- **Why agri-income should be taxed?**
  - » **Increasing Tax Base**: Rich and large farmers who has very large income should be brought under tax net.

- » It will help in **formalization of agri activities**.
- » E**nsuring better access to farmers of various government programs**: For e.g., bank loan officers on many occasion reject loan request because of no proper way to assess income of farmers.
- » **Avoiding Tax Evasion and Money Laundering**: A lot of people claim their non farm income as agri income and evade taxes on them.
  - There are lots of industrialists who are in service sector and are also farmers, owning more than a 100 hectares of land. The don't labor on the field and are thus inactive farmers. Their agriculture income also needs to get taxed.

– **Challenges of taxing agri-income:**
- » **Incomplete land records**: This will make it difficult to calculate agri-income
- » **Administrative preparedness** to implement agriculture income tax is missing. Revenue department of state government lacks expertise to collect agri-income.
- » **Administrative cost** (i.e. cost of collecting tax) may become higher than the revenue generated from it.

– **Criticism [Not Valid]**
- » Farmers are already under a lot of stress and there are lots of instances of farmer suicide
- » Average income of agriculture household is very low
- » Assessing incomes and filing ITRs will be challenging for farmers
- » It may also reduce the payment being made to agri-laborers.

– **Why opposition of agri-taxation is mis-guided**
- » **Only rich farmers would be taxed**: Even if we go as per the current income tax slabs, most of the farmers won't have income of more than Rs 5 lakhs and thus wouldn't need to pay any tax at all.
  - Further, farmers with about 2-3 hectares of land can be exempted from tax regime.
- » **Agricultural laborers** are already least paid workforce in India. And payments to laborers can be increased by ensuring proper coverage of MGNREGA and other such social security benefits.

– **Conclusion:**
- » Agricultural income tax should be imposed on rich and large farmers. But at the same time, there is a need to prepare for this first. This would happen through finalization of land records and making the revenue department to get an expertise in collecting agri-income tax.

4) DIRECT TAX CODE (DTC)

– **Intro:**
- ▫ The **basic structure of Income Tax Act, 1961 has remained same for the last 61 years.** It was drafted in an **era when India was closely controlled economy with quasi-socialist mindset**. It has **not changed much vis-a-vis the changes in the economic scenarios in the country**.
- ▫ The current direct tax structure in India is **very complicated**. For e.g., the 1961 act has 700+ sections.
- ▫ This makes compliance difficult for taxpayers and assessment difficult for tax authorities leading to litigations and counter litigations.
- ▫ The **Direct Tax Code** is envisaged as a single, simplified, uniform, economically effective and equitable mechanism which will deal with the above challenges.

- **What does DTC entail?**
    - So far various committees have suggested the following simplification in the direct tax structure:
        - **Single Code for Direct Taxes** -> All the direct taxes are sought to be brought under a single code and unified compliance procedures. It is going to be shorter, crispier and easy to understand.
        - **Doing away with cesses and Surcharge** which leads to confusions and complications and also affects federal distribution of taxes. (Akhilesh Ranjan)
        - **Reducing Litigations**
            - **Simplified, very transparent and unambiguous mechanisms** to reduce disputes and minimize litigations.
            - Introduction of **Negotiated Settlement**
                - it is envisaged as a mechanism to settle disputes through **negotiated settlement** between taxpayer and income tax officers (A collegium of commissioners). Here only tax and interest have to be given and no penalty has to be provided for. (Akhilesh Ranjan)
            - **A Litigation Management Unit** to manage the entire tax litigation process, right from deciding in which cases the appeals ought to be filed to devising the strategy to defend a case.
        - **Bringing predictability and Stability in tax regime** by including accepted international principles and best practices.
        - **Improving the Assessment Process** (Akhilesh Ranjan)
            - **Replacing the concept of Assessing Officer with Assessment Units**
            - **Faceless scrutiny** of cases picked through centrally and randomly allotted mechanism.
        - **Promote Ease of Doing Business** (Akhilesh Ranjan)
            - Common Tax Code for Domestic and Foreign companies (currently foreign companies pay different tax rate)
            - Reduce the tax burden on Corporate sector (reducing it to 25%)(already done)
            - Special provisions for startups
            - Doing away with dividend distribution tax - already done (Budget 2020-21)
            - Separate mechanism to deal with transfer pricing assessment. TP assessment will be carried out by separate functional unit.
                - This is also expected to reduce number of litigations in India.

- **Benefits of Direct Tax Code:** A clean direct tax code can help in achieving the following objectives:
    i. **Increased Tax Base** due to simplification due to DTC can contribute towards **reducing government's fiscal burden**. An effective, simpler and easy to comprehend tax system will widen the tax base. This will also **alter the Indian Social Contract** by increasing the number of people paying taxes.
    ii. **Economic Growth:** It will help make **Indian economy more competitive** through tax stability, minimal exemptions and the focus on allocative efficiency.
        - **E-Commerce and Start-ups** will get more clear tax mechanisms under DTC and thus will find it easy to do business in India.
    iii. **Opportunity for Lower Indirect Taxes or GST rates**
    iv. **Reduction in Litigations**

- **Arguments Against Building a Direct Tax Code/ Does India need a direct tax code?:** Some experts feel that in current scenario, odds against DTC are high:
  i. **New Law will consume precious time and money for all stakeholders**
     - Taxpayers, law authorities, tax advisors and the judiciary
  ii. **Income tax has been amended several times** to keep it in sync with the business requirements
     - For e.g. amendments has been done to counter Base Erosion and Profit Shifting.
  iii. **Stability of law is fundamental for any fiscal statute**
     - Upsetting settled jurisprudence on taxation could become a challenge.
  iv. Instead of new tax code, **fair and reasonable administration of existing tax laws** is the need of the hour.

5) REDUCTION IN CORPORATE INCOME TAX

- Corporate tax rates which used to be more than 50% in early 1990s was brought down to 30% by 2004-05 as per the recommendations of Shome Committee (2001) and Kelkar Committee (2002).

- But, even at the basic rate of 30% the effective corporate tax paid by Indian companies was around 35% which was on the higher side compared to its peers.

- **This high tax** rate led to low investments which reduced economic growth potential.

- **So**, through Taxation Laws (Amendment) Ordinance following changes were made in Sep 2019.
  » **Income Tax rate** of **22% (Effective 25% with surcharge and cess)** for all domestic companies (provided they don't claim deductions under the Income Tax Act)
    - The new rates are **applicable for those companies** which will not avail any exemption/incentives.

  - Domestic manufacturing companies set up on or after Oct 1, 2019, to pay tax at a **lower 15% rate** (effective 17%) if they forego other incentives.
    - Note: These companies must start manufacturing before April 1, 2023.

  » If a company applies for new rates than the same will be applicable in subsequent years.
  » Provisions related to Minimum Alternate Tax (MAT) will not be applicable for companies choosing new tax rates.

» **Minimum Alternate Tax** (MAT) has been reduced from 18.5% to **15%** for companies not choosing the new tax rates.

– **Positive Implications**
  - India's tax rates have become **on par with competing Asian peers**.
    - This will **increase the profitability** of the corporate players and thus will contribute in making India an **attractive destination for investment**.
  - It may also **increase the export competitivity** of Indian companies as now they will be able to price their products at lower prize for same profitability.
  - **Sectors like telecom sector**, which are facing high debt burden, can use the extra money to pay off the debt and thus will contribute **to better functioning** of India's banking system.
  - **Contribute to easy credit availability**
  - In long run, the **enhanced economic activities will increase the tax base** and thus may also **boost tax collection**.

– **Concerns**
  - **Revenue loss** and thus **increased fiscal deficit** in short runs
    - For e.g. recently, finance ministry announced that the government faced a revenue loss of more than 1 lakh crores in FY21.
  - **Hasn't kickstarted investment**: RBI has recently notes that the new tax regime **didn't kickstart the intended Investment Cycle**.
    - In an annual report for 2019-20, the RBI said that tax rate cut may have been used for debt servicing, building up cash, and other current assets.

– **Way Forward**
  - Reduced tax rates alone can't deal with the key challenges faced by Indian economy. It is a bold move but is only one of the **supply side reforms**. Other steps required are:
    - **Land and Labor Reforms** -> to further simplify the ease of doing business in the country.
    - **Banking reforms** -> to ensure easy credit for consumption and investment.
  - Further, the supply side reforms should be **complemented with demand side reforms**. Without increase demand, increasing supply will be of no use.
    - Here, there should be focus on **increasing income** of working and middle class. Here reforming **agricultural sector** would be crucial as it provides income and employment to more than 50% of the India's population.
    - Continuation of the reform process also calls **for Rationalizing Personal Income Tax Rates** in alignment with the new CIT rates.
  - Further, since there is going to be a **large slippage in fiscal deficit**, the central government would do well to enhance the efforts to garner **additional non-tax revenue as well as disinvestment proceeds** over and above the budget estimates.

– **Conclusion**
  - In long run, the corporate tax cut, can indeed boost economic activities. It's important that to fully utilize the potential of this cut other complementary steps such as reform in labor laws, strengthening of the banking sector also takes place.

6) GLOBAL CORPORATE MINIMUM TAX

- **Need:** The existence of **tax havens** - Many companies register on these tax havens and evade tax through various mechanisms like round tripping.
    - Big companies have an increasing tendency to shift income from tangible sources such as drug patents, software and royalties on intellectual property to these jurisdictions, allowing companies to avoid paying higher taxes in their traditional home countries.

- **In Oct 2021**, after negotiations at the OECD, more than 130 countries agreed to an outline of Global Minimum Tax Agreement.

- **Global Minimum Tax Agreement** is aimed:
    - » **Pillar-1:** Reallocate taxing rights on about $200 billion in profits from the companies to the countries where they do business (rather than just the home country)
        - **Implications**: US tech companies may have to pay more taxes to governments of developing countries.
    - » **Pillar-2**: It establishes the base, rate, and approach for global minimum corporate tax.

- Governments are now working on **implementation plan** and turning the agreement into law.

- **How will this work?**
    - **A global minimum tax** would apply to overseas profit of multinational firms with 750 million euros in sales globally.
        - Governments can still set whatever local corporate tax rate they want, but if companies pay lower rates in a particular country, **their home governments would "top up" their tax to th 15% minimum**, eliminating the advantage of shifting profits.

- **Advantages:**
    - » **Increase in global tax revenue** by about $**150 billion** in additional global tax revenue (OECD)
    - » **Economic Growth**: Economists expect that the deal will encourage multinationals to repatriate capital in their country of headquarters, giving boost to these economies.
    - » **End of Race to the Bottom**: This has made harder for government to shore up revenues.

- **Challenges**:
    - » **Legal sanction in all countries**: Agreement calls for countries to bring it in law in 2022 which has still not happened for many countries. For e.g. USA has not seen any ratifying plan any time soon.
    - » **High-income countries** have first choice at collecting additional "top up" taxes.
    - » **Low- and Middle-Income countries** may have to forgo existing and future digital service tax in exchange for a new formula based approach.
    - » **Tax Havens** may not agree and will try to stall the plan.
- **Criticism**:
    - » Without tax competition between governments, the world would be taxed a lot more than it is today, thus adversely affecting global economic growth.

- **Updates:**
  - In **Dec 2022**, Members of EU have agreed in principle to implement a minimum tax of 15% on big businesses in accordance with the pillar-2 of the global tax agreement framed by OECD.

7) 2% GLOBAL WEALTH TAX: TO CURB EVASION: SUGGESTED BY EU REPORT

- **Report**: European Union Tax Observatory has published the report titled '**Global Tax Evasion Report 2024**'.

- **Key Highlights:**
  - Tax Evasion is enabling billionaires to enjoy effective tax rates equivalent to 0% to 0.5% of their wealth.
    - The number of people affected by it would be miniscule, the tax rate of them (2%) "would still be very modest" given that the wealth of billionaires has grown at 7% a year annually since 1995.

- **Some past efforts** which have been beneficial:
  - **The Automatic exchange of bank information** - have been successful in reducing offshore tax evasion by a factor of 3 over the past 10 years.

- **Recommendations**: A global minimum tax on billionaires equal to 2% of their wealth.
  - **Expected Impact**: This would address evasion and "Generate nearly $250 billion from less than 3,000 individuals".

8) MAT AND AMT

A) MINIMUM ALTERNATE TAX (MAT)

- **Objective of MAT**
  - **Scenario:** At times it may happen that a taxpayer, being a company, may have generated income during the year, but by taking advantage of various provisions of Income-tax Law (like exemptions deductions and depreciations, etc.) it may have reduced its tax liability or may not have paid any tax at all.
    - **Due to increase in zero tax paying companies,** MAT was introduced by the Finance Act, 1987 with effect from assessment year 1988 - 89. Later on, it was withdrawn by the Finance Act, 1990 and then reintroduced by Finance Act (No. 2) 1996.
  - **Objective:** To bring into tax net "**zero tax companies**" which in spite of having earned substantial book profits and having paid handsome dividends, do not pay any tax due to various concessions and incentives provided under the Income-Tax Law.

- **Section 115JB of Income Tax Act, 1961:** Since the introduction of MAT, several changes have been introduced in the provisions of MAT and today it is levied on companies as per the provisions of section 115JB.

- **Basic Provisions of MAT**
  - As per the concept of MAT, the ***tax liability of a company will be higher of the following***

- **Normal Tax Liability:** Tax liability of the company computed as per the normal provisions of the income tax law, i.e., tax computed on the taxable income of the company by applying the tax rate applicable to the company. Tax computed in the above manner can be termed as Normal Tax Liability.
- **MAT:** Tax computed ~~@ 18.5%~~ (15% from AY 2020-21) (plus surcharge and cess as applicable) on **book profit**.

– **Applicability and Non Applicability of MAT**

» As per the section 115JB, every tax payer being a company is liable to pay MAT, *if the income tax (including surcharge and cess) payable on the total income, computed as per the provisions of the Income-tax Act in respect of any years is less than 18.5% of its book profit , + surcharge + education cess + Higher Education Cess*.

» **Every company**: Provisions of MAT are applicable to every company whether public or private and whether Indian or foreign.

- **Exceptions**
  - MAT shall not apply to any income accruing or arising to a company from **life insurance business** referred to in section 115B.2 -
  - MAT will not apply to a **shipping income liable to tonnage taxation**, i.e., tonnage taxation scheme as provided in section 115V to 115VZC.

B) ALTERNATE MINIMUM TAX (AMT)

– The provisions of MAT are applicable to a corporate taxpayer only. The provisions relating to AMT are applicable to non-corporate taxpayers in a modified pattern in the form of Alternate Minimum Tax. Thus, it can be said that MAT applies to companies and AMT applies to person other than companies.

– **Section 115JC and Section 115JF** contains provisions relating to AMT

– AMT tax rate is 18.5%.

9) CAPITAL GAINS TAX AND ANGEL TAX

- Next class

10) INSTITUTIONS DEALING WITH DIRECT TAXES IN INDIA

A) CENTRAL BOARD OF DIRECT TAXES (CBDT)

– It is a statutory authority functioning under the Central Board of Revenue Act, 1963. The officials of the board in their ex-officio capacity also function as a division of the ministry dealing with matters relating to levy and collection of direct taxes.

– CBDT Is a part of Department of Revenue in the Ministry of Finance. It provides input for policy and planning of direct taxes in India and is also responsible for administering of the direct taxes law through the IT department.

– **Composition**

- The CBDT consists of Chairman and following six members.
  1. Chairman
  2. Member (Income-tax)
  3. Member (legislative and computerization)

4. Member (Personnel and Vigilance)
5. Member (Investigation)
6. Member (Revenue)
7. Member (Audit and Judicial)

– The Chairperson of CBDT is the senior most IRS(IT) serving in the country.

GS FOUNDATION FOR CSE 2024
ECONOMY-15
FISCAL POLICY-5
TAXATION-3 – INDIRECT TAXES (GST)

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2. BASICS – UNDERSTANDING CASCADING EFFECT

3. PROBLEMS THAT EXISTED BEFORE GST SYSTEM WAS ENFORCED

- India had perennially marked the presence of one of the **most complicated indirect tax regimes**. This had been due to:
    - **Cascading Effect**: Tax over tax led to very high effective tax rates.
    - Divided powers between center and state to levy different taxes
    - Distinction between goods and services
    - Multiple tax rates and arbitrage on rates across the country (For e.g., different states had different sales tax rates) -> this led to different prices of same goods and services in different states -> fragmentation of India's market -> made doing business difficult
    - Multiplicity of assessments

- **The GST regime** has fixed the above issues and ensure reform aims at simplifying the indirect tax regimes.

4. GST

- **Introduction**
    - The GST is the most important indirect tax reform in recent years and it carried VAT to its logical conclusion. It was passed by Parliament in Aug 2016 through the 101st Constitutional Amendment Act and was rolled out from **1st July 2017**.

- **Key Features:**
    - It has subsumed several indirect taxes at central and state level and acts as one indirect tax for the whole nation on the supply of goods and services.
        - **Central taxes that GST has replaced**
            - **Excise Duties:** Central Excise Duty (except few fossil fuels and tobacco), Duties of Excise (medicinal and toilet preparation) and Additional duties of excise (goods of special importance)

- **Custom Duties: Additional duties of custom** (commonly known as Countervailing duty) and **Special additional duty** of custom (SAD)
- **Service Tax**
- **Cesses and surcharges** in so far as they relate to supply of goods and services.

▫ **State Taxes that GST has subsumed.**
  - State VAT(except few fossil fuels and tobacco), Central Sales Tax, Purchase Tax, Luxury Tax, Entry tax (all forms), Entertainment Tax (other than those levied by local bodies), Tax on advertisement, Tax on lotteries, betting and gambling, State Cesses and surcharges.

» **Avoids Cascading** of taxes through **input tax credit (ITC)** mechanism.

▫ **Understanding the concept of Input Tax Credit** and how it removes cascading effect:

Business:1 • Input Cost = 0 • Value Added = 100 • Sale Price = Rs 100 • GST (18% = 9% CGST, 9% SGST) = Rs 18 • Invoice = Rs 18	**Net Tax to Government** = Rs 18
Business:2 • Cost of Input = Rs 118 • Value Added = Rs 500 • **Input Tax Credit (GST Refund)** = Rs 18 • **Sale Price** = Rs 600 • **GST (18%) =** Rs 108 • **Invoice** = Rs 708	**Net Tax to Government** = 108 - 18 = 90 Rs 90

▫ Total tax that went to government = Rs 18 + Rs 90 (i.e. 18% of total value added (Rs 100 + Rs 500))

▫ Thus no cascading effect.

▫ Credits of input taxes paid at each stage is available in the subsequent stage of value addition. The final consumer thus bears only GST charged by the last dealer in the supply chain, with set-off benefits at all previous stages.

» It is applicable on **supply of goods and services** instead of earlier concept of tax on the manufacture or sale of goods or on provision of services. It is a **destination-based tax (Consumption based tax)**. Earlier indirect taxes were origin based.

▫ Note: At times GST is payable by the recipient of supply of goods and services or both instead of supplier of such goods and services. It is called "**reverse charge**".

» GST is a **dual tax** and centre and states are simultaneously levying it on a common base.

» An **integrated GST (IGST)** is levied on inter-state supply of goods and services.

▫ This is levied and collected by the centre so that the credit chain is not disrupted. Centre will then distribute IGST proceeds among the states.

  » The IGST would roughly be equal to CGST plus SGST.

- **Imports of goods or services** are deemed as supply of goods or services or both, in the course of inter-state trade or commerce and thus attract IGST.
    - Note: Basic custom duties which were levied on import of goods, continue to be levied in addition to IGST on imported goods.
    - **Earlier**, import of goods attracted Basic Customs Duty (BCD), Additional Customs Duty (ACD) and Special Additional Customs Duty (SAD).
        - Services attracted Service Tax or Research and Development cess in some instances.
    - **After GST Regime**
        - **Import of goods or services** are *deemed* **as supply of goods or services or both**, in the course of inter-state trade or commerce thus attracting IGST.
        - **Thus,**
            - **Import of Goods** attract BCD and IGST
            - **Import of Services** attract IGST

- **Exports** are zero-rated.
    - The GST paid in the entire value chain and the IGST paid at the border is refunded/credited back to the suppliers. So, effectively there is not tax on exports and hence we can say that exports are "zero rated" supplies.
    - Supplies to SEZs are also zero rated.

- **GST Council** is a federal Constitutional authority created to give recommendations on the rates of taxes on different goods and services. It is chaired by Union Finance Minister.
    - **Some exceptions:**
        - GST is applicable on all goods and services **except alcohol** for human consumption.
            - This is the only item mentioned as an exception, all other sectors/goods will be included under GST.
        - GST on **petroleum products** would be applicable from a date to be recommended by GST Council.
        - **Tobacco and Tobacco** products are subjected to GST. **In Addition**, the centre would continue to levy central excise duty.
        - **Electricity:** As per the notification dated 28th June 2017 - '**Transmission or distribution of electricity** by an electricity transmission or distribution utility' are taxable under GST@ '**NIL**'.
- **Cross Utilization of Credit**
    i. **Between CGST and SGST :** Credit of CGST paid on inputs may be used only for paying CGST on the output and the credit of SGST paid on inputs may be used only for paying SGST. In other words, the **two streams of input tax credit (ITC) cannot be cross utilized**, except in specified circumstances of inter-state supplies, for payment of IGST.
    ii. **Cross Utilization Between Goods and Services** would be **allowed**.

5. ADVANTAGES OF GST

i. **For Business and Industry->**

- » **Easy compliance** (online filing, single tax, less chance of harassment);
- » **Uniform tax rate** (common national market, easy expansion);
- » **Removal of cascading** (reduction of total tax payment); Increase competitiveness;
- » **gain for manufacturers and exporters**.

ii. **Advantages of Government (Center and State) ->**

i. **Easy administration** (Single Tax, end to end IT system);
ii. **Better control over leakage** (robust IT infra, simple tax structure -> easy compliance);
iii. **Improved tax base.**
iv. A more transparent basis for apply WTO's National Treatment Principle;
v. **Higher revenue efficiency** (less cost of administration);
vi. **Spur economic growth**;
vii. **Reduced corruption**;
viii. **Promote cooperative federalism** (In GST system center and states work together for the nation's benefit).

iii. For Consumers/citizens ->

- **Cheaper goods and services.**
- Higher revenue efficiency-More money with government -> More social initiatives;
- **Increased resource for resource consuming states** (as this is a destination-based tax).

6. SOME OTHER IMPORTANT FEATURES

1) THRESHOLD TURNOVER FOR APPLICABILITY OF GST

- **Initially**, threshold turnover for applicability of GST was Rs 20 lakh. For the special category states, it was Rs 10 lakh.
- **From 1st April 2019 for goods** the limit has been increased to Rs 40 lakhs for normal category states and Rs 20 lakh for Special category states.
  - » **For services**, there has been no change in limit (i.e. Rs 20 lakh and Rs 10 lack respectively)
  - » **However, the states were given choice** to opt for either the existing limits or the new limits. Some special category states also opted for the higher limit of Rs 40 lakhs for goods instead of Rs 20 lakhs.

2) COMPOSITION SCHEME / COMPOUNDING SCHEME

- **What is composition scheme?**
  - » It is an alternative method of tax levy under GST designed to simplify compliance and reduce costs for **small taxpayers**.
  - » The main feature of the scheme is that business or person who have decided to come under composition scheme can pay tax at a **flat percentage of turnover** every quarter, instead of paying tax at normal rate every month.
  - »
- **Who may opt for composition scheme?**

- » **Small manufacturers or traders** whose taxable business turnover is upto Rs 1.5 crore (Rs 75 lakh in case of NE-States),
- » A **service provider** whose taxable turnover is upto Rs 50 lakh.
- » **Exceptions:**
    - » Businesses with inter-state supply, manufacturers of ice cream, pan masala, and tobacco, and e-commerce players can't opt for composition scheme.

- **Rates:** 1% for manufacturers (0.5% CGST and 0.5% SGST), 5% for restaurants not serving alcohol and 6% for other service providers.
- **Note:** The tax is to be paid from taxpayers' own pocket without charging the customer. The words, "composition taxable person, not eligible to collect tax on supplies" should be mentioned at the top of every bill issued by the business.

3) GST COMPENSATION CESS ON SIN GOODS – DONE SEPARATELY IN DETAILS

7. CURRENT GST RATES ON VARIOUS ITEMS (AS OF JAN 2023)

- A four-tier tax structure has been decided by GST council (5, 12, 18 and 28%) (Nov 3, 2016)

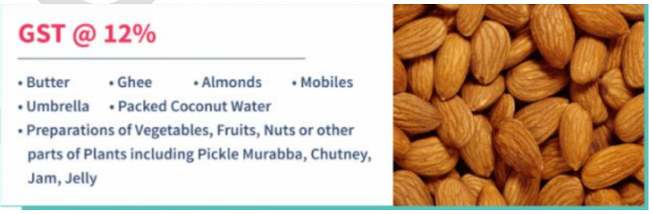
1. **0% (items of basic needs)**

Unpacked food grains, unbranded atta, unbranded maida, besan, Prasad, Kajal, Education services and health services.

2. **5% -** items of mass consumption which are used particularly by common people, green technologies (like Electric Vehicles)

Life saving drugs, Roasted Coffee Beans, Coffee (except instant) Mishti/Mithai (Indian sweets) etc.

3. **12%:**



Computers, mobiles, Processed food, umbrella etc.

4. **18%:** Pegged as standard rate - products for "lower middle class" and other products.

Soap, Corn flakes, Soup, Capital goods, Industrial intermediaries Toiletries etc.

5. **28%** - white goods, like non-luxury cars etc.
    - **28% + Cess : Luxury car, aerated drinks, pan masala and tobacco products.**

28%	Small cars (+1% or 3% cess)	High-end motorcycles (+15% cess)
28%	Consumer durables such as AC and fridge	Beedis are NOT included here
28%		Luxury & sin items like BMWs, cigarettes and aerated drinks (+15% cess)

6. **Note:** There are few lesser used GST Rates like 3% and 0.25%

- Lowest rates for essential items and highest for luxury and de-merit goods that would also attract an additional cess was decided.
- With a view to keeping inflation under check, essential items including food, which presently constitute roughly half of consumer inflation basket, will be taxed at zero rate.

1) 50TH MEETING OF GST COUNCIL (JULY 2023)

- **Marking the 50th Meeting**:
    - The Chairperson released a short video film titled '**GST Council-50 Steps towards a journey**'. The film depicts the journey of the GST council and has been made in Hindi, English and 11 other regional languages.
    - To mark the 50th meeting, the first set of a **Special Cover** and **Customized 'My Stamp'** were also presented to Chairperson and Members of the Council by the Chief Postmaster General, Delhi.

- **Key recommendation**:
    - Reduction in the rate of uncooked/unfried snack pallets, by whatever name called, to **5%**.
    - **GST rates on Services**:
        - GST exemption on satellite launch services supplied by ISRO, Antrix Corporation Limited and New Space India Limited (NSIL) may be extended to such services supplied by organizations in private sector also to encourage startups.
        - **Casino**, Horse Racing and **Online Gaming** to be taxed at the uniform rate of **28%**.

8. OTHER IMPORTANT ASPECTS

1) GST NETWORK (GSTN)

- **About GSTN**
    - GSTN is a not-for-profit company created under Section 8 of the Companies Act 2013. It provides the IT backbone of the GST system.

- ~~It is a private, not for profit company in which the central government and states and UTs together hold 49% (24.5% centre and 24.5% state. The rest 51% is owned by non-government financial institutions.~~

- It provides shared IT infrastructure and services to central and state governments, tax payers and other stakeholders.
  - It is a portal on which all tax assesses have to register.
- The **key objectives** of the GSTN are.
  - To provide a **standard and uniform interface to taxpayers**
  - Shared infrastructure and services to central and state/UT governments.

- GSTN has developed a state-of-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 state that include processing or returns, registrations, audits, assessments, appeals etc.
- There would be **no manual filing of returns**. All taxes can also be paid online. All miss-matched return will be autogenerated, and there would be no need for manual interventions.

- **Bringing 100% government ownership of GSTN**
  - Union Cabinet has approved increasing the government ownership in GSTN and change in the existing structure with transition plan (Sep 2018)
    - **51% equity of non-government institutions** in GSTN will be acquired equally by centre and states.
    - Now, Centre and State will have **50-50** ownership of GSTN.
    - **Board of the company** will also be restructured having 11 directors as follows:
      a. Three directors will be center's nominee.
      b. Three directors will be states' nominee
      c. Three independent directors who shall be nominated by the Board of directors.
      d. One chairman
      e. One chief executive officer.
  - **Why?**
    - GSTN has faced a number of issues (including crashes initially) which led to delays and difficulties in filing returns.

9. 6 YEARS OF GST – AN ANALYSIS

- **Positives:**
  - **Tax base has increased** (Update)
    - **Average monthly GST collections** has increased to **1.55 lakh crore** in 2022-23.
    - **Number of GST taxpayers** have increased from 70 lakh in FY18 to **1.4 crore** in FY23.
    - **Small businesses and informal sectors** initially faced some issues, but many of them jumped to the tax net to take advantage of ITC.
    - **GSTN,** as a common technology platform has simplified tax compliance. It provides a one stop solution where key business process registration, payment of duties and filing of returns are done online in a transparent manner.
    - **Action taken against tax evaders, including steps being taken by tax authorities**, has resulted in better compliance and helped push the growth in GST collection.

- **Facilitated free movement of goods and services** and **Increased efficiency of logistic supply chain**:
  - Earlier, check posts served as bottlenecks that not only involved a lot of waiting time but were also breeding spot for corruption - as tax varied from state to state, city to city and even local bodies.
- **Reduced Tax Burden**: Overall tax on many essential use items have come down. Further, with input tax credit the cascading has been reduced.
  - For e.g. reduction in food inflation is one of the key features of GST regime.
- **Push for Cooperative federalism:** GST Council has played a crucial role in forging a national consensus on key issues related to tax regime - rates, exemptions, business, processes, and movement of ITC.
- **System has evolved to simplify tax compliance for MSME sector**: Recently, threshold exemption limit was increased form 20 lakh to 40 lakh for goods and Quarterly Returns and Monthly Payments (QRMP) system was introduced.
- **Tax Evasion has reduced**:
  - E-Invoicing has become an integral part of doing business in India.
  - The GST number that can track every supply chain transaction has helped to address fraudulent claim.
  - **Coordination between CBIC and CBDT** has increased to ensure easy compliance.

- **Negatives/Limitations**
  - **Federal Issues**:
    - **Fiscal Autonomy reduces for states and ULBs** - states now have limited scope to raise their own revenue. **ULBs** are also much weaker and more dependent on state grants.
    - It **harms the producer state and reward the consumer state** in terms of revenues.
      - States like TN which have invested heavily in their manufacturing ecosystem are now facing revenue challenges. GST compensation period has also ended. **After the end of GST compensation,** fiscal strain is expected in state budget as the median growth rate of subsumed tax in many states are much lower than 14%.
  - **GST Council decides the increase or decrease of tax rates** . Earlier, these powers were only with Parliament/state legislatures.

- **Criticism of keeping some items out of GST Net.**
  - This goes against the principle of 'One nation one tax'. It also allows continuance of cascading.
  - Further, sectors like airline industry is not able to get credit for taxes paid of jet fuel.
  - Major black money generating sector such as real estate are out of the GST regime
- **Multiple Rates and Cess -> not a simple tax**

- **Advanced Economies like USA have also not moved onto GST path yet**: It is mostly due to their federal structure and federal autonomy.

- **Large businesses/units are reluctant to purchase from MSME sector** as they don't get ITC.
- **Delay in establishment of Appellate tribunal** related to GST is increasing the burden on Judiciary. Trapped GST refunds and numerous court cases are alarming.
  - **Update**: On Sep 15, 2023, Centre has notified setting up of 31 GST appellate tribunal benches across the country to ensure quick resolution of disputes related to GST.

- **Way Forward:**
  - **GST structure needs to be further simplified and rationalized**: This was recommended both by 15th Finance Commission and the Revenue Neutral Rate Report.
    - New structure should have lesser number of rates (preferably 2, but at max 3).
    - National Institute of Public Finance and Policy has also recommended a three rate framework of 8%, 15% and 30%.
  - **Petroleum products** should be brought under GST regime. This should be followed by inclusion of real estate and electricity sector.
  - **To increase the attractiveness of MSME sector** by large enterprises, amend the law to provide that all units buying from unregistered GST suppliers would have to pay duty on a reverse charge basis.
  - **Set up GST Appellate Tribunal** as soon as possible as dispute resolution remains a pain point.
  - Finally**, GST Council's working needs tweaking**.
    - During Vajpayee regime, Yashwant Sinha established a culture of consensual decision making on indirect taxes. He did this by requiring the Empowered Committee of State Finance Ministers to be headed by a finance minister from an opposition-run-state government, such as Asim Das Gupta from WB and Sushil Modi from Bihar. **This spirit can be translated in GST Council's functioning as well**.

10. GST ON GAMING SECTOR

- **Why in news?**
  - » GST Council, in its 50th meeting in July 2023 decided to **levy a uniform 28% tax on full face value for online gaming, casinos, and horse-racing**. (July 2023)

- **About Online Gaming Market**:
  - » The revenue of the Indian Mobile Gaming industry is expected to exceed $1.5 billion in 2022 and is estimated to **reach $5 billion** in 2025.
    - It grew at a rate of **38% CAGR** between 2017-20.

- **Details of GST Council's decision**:
  - » The GST council has recommended a uniform levy of 28% tax on the face value of chips purchased in the case of casinos, on the full value of bet placed with bookmaker/totalizer in the case of horse racing, and on the full value of the bets placed in case of online gaming.
  - » Government has now expected to bring amendment to the GST-related laws to include online gaming and horse racing in Schedule III as taxable actionable claims.

- **Significance**:
  - » Increase in tax base.
  - » The taxation aligns with the regulation of the MeitY.
  - » **Moral suasion** to stay away from betting and online gaming addiction.
  - » **Simplification and transparency** in the gaming sector.

- **Criticism**:

- Online gaming companies have said that this will be catastrophic for online gaming industry which have to compete with several international players.
- They also complaint that it will benefit **illegal gaming platform**s.
- **Nowhere in the world** is tax levied on the entire money that is pooled in online game. The levy of tax is always on the amount charged for the provisions of service and this can only be on the platform fee or service charge levied by any gaming company.
- **Negative impact on employment** in a sector which already employs more than 100,000 employees.

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CONSTITUTIONAL PROVISIONS ABOUT TAXES

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2. CONSTITUTIONAL PROVISIONS ABOUT TAXES

1) ALLOCATION OF TAXING POWERS BETWEEN CENTER AND STATES

i. **The Parliament has exclusive powers to levy taxes on 13 subjects enumerated in the Union List (82-91, 92A-92B, 96)**
   i. Taxes on Income, other than agriculture income (82)
   ii. Duties of Customs including export duties (83)
   iii. **After the 101st amendment**, it includes "**Duties of excise on the following goods manufactured or produced in India**, namely: (84)
      i. Petroleum crude
      ii. high speed diesel
      iii. motor spirit (petrol)
      iv. natural gas
      v. aviation turbine fuel
      vi. tobacco and tobacco products (Note: GST + Central Excise)
      - Thus, **petroleum products are now out of ambit of GST** and subject to Union Jurisdiction

Before 101st Constitutional Amendment Act	~~Duties of excise on tobacco and other goods except alcoholic liquors for human consumption and opium, Indian hemp and other narcotic drugs and narcotics, but including medicinal and toilet preparations containing alcohol~~

   iv. Corporate Income Tax (85)
   v. Taxes on Capital value of the assets (exclusive of agricultural land) of individuals and companies **(capital gain tax);** taxes on the capital of companies (86)
   vi. Estate Duty in respect of property other than agricultural land (87)
   vii. Duties in respect of succession to property other than agricultural land (88)
   viii. Terminal Taxes on goods and passengers, carried by railway, sea or air; taxes on railway fares and freights (89)
   ix. Taxes other than stamp duties on transactions in stock exchanges and future markets (90)
   x. Rates of Stamp duties in respect of bills of exchange, checks, promissory notes, bills of lading, letters of credit, policies of insurance, transfer of shares, debentures, proxies and receipts (91).

92 (Deleted now)	~~**92:** taxes on sale or purchase of newspapers and on advertisement published therein~~ (**Deleted** by 101st Constitutional amendment.

   xi. **92A:** Taxes on sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of **inter-state trade or commerce.**
   xii. **92B:** Taxes on consignment of goods in the course of interstate trade and commerce

92C: **Taxes on Services** (deleted by 101st Constitutional Amendment)

   xiii. Fees in respect of any of the matters in the Union List, but not including fees taken by any court.

ii. **The state legislature has exclusive power to levy taxes on subjects enumerated in the state list:**
   i. **45:** Land Revenue
   ii. **46:** Taxes on Agricultural Income
   iii. **47 and 48:** Succession and Estate duty on agricultural land

iv. **49:** Taxes on lands and buildings

v. **50:** Taxes on mineral rights subject to any limitations imposed by Parliament by law relating to mineral development

vi. **51:** Duties of excise on the following goods manufactured or produced in the State and countervailing duties at the same or lower rates on similar goods manufactured or produced elsewhere in India: -

   i. alcoholic liquors for human consumption.

   ii. opium, Indian hemp and other narcotic drugs and narcotics, but not including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry.

52: (DELETED BY 101st CONSTITUTIONAL AMENDMENT ACT)	Taxes on entry of goods into a local area for consumption, use or sale therein.

vii. **53**: Taxes on the consumption or sale of electricity.

viii. **54:** (Amended by 101st CAA): **Sales Tax**

Earlier:	In Entry 54, **Taxes on sale or purchase** of goods other than newspapers, subject to the provisions of Entry 92-A of List 1 has been replaced by ->
After Amendment	Taxes on the **sale of petroleum** crude, high speed diesel, moto spirit (commonly known as petrol) natural gas, aviation turbine fuel and **alcoholic liquor** for human consumption, but not including sale in the course of inter-state trade and commerce or sale in the course of international trade or commerce of such goods.

55 (deleted by 101st CAA)	Taxes on advertisements other than advertisements published in the newspapers and advertisements broadcast by radio or television.

ix. **56**: Taxes on goods and passengers carried by road or on inland waterways.

x. **57:** Taxes on vehicles, whether mechanically propelled or not, suitable for use on roads, including tramcars subject to the provisions of entry 35 of List III.

xi. **58**: Taxes on animals and boats.

xii. **59**: Tolls.

xiii. **60**: Taxes on professions, trades, callings and employments.

xiv. **61**: Capitation taxes.

xv. **62**: (Amended by 101st CAA)

Before 101st CAA	~~Entry 62 (taxes on luxuries, including entertainments, amusements, betting and gambling)~~ has been replaced by ->
After 101st CAA	Taxes on entertainment and amusements to the extent levied and collected by a Panchayat, or a Municipality, or a Regional Council or a district Council.

xvi. **63**: Rates of stamp duty in respect of documents other than those specified in the provisions of List I with regard to rates of stamp duty.

iii. **There are three area provided in concurrent list** where both center and state can levy taxes/fees/duties:

- Mechanically propelled vehicles including the principles on which taxes on such vehicles are to be levied.
- **Stamp duties** other than duties or fees collected by means of judicial stamps, but not including rates of stamp duties.
- Fees in respect of any of the matters in the concurrent list

- **However, please note that Article 246A gives concurrent powers to both Centre and the States to impose taxes on GST.**

iv. **Residuary Powers of Taxation:** The residuary power of taxation (i.e. the power to impose taxes not enumerated in any of the three lists) is vested in parliament. Under this provision, the parliament has imposed gift tax, wealth tax and expenditure tax.

2) DEVOLUTION OF TAX REVENUE

1. Devolution of tax means sharing of tax revenue of Centre with the States.
   - **Reason**: Most of the taxes which are capable of yielding more revenue are in the Union list apart from GST. The GST divided the tax jurisdiction of indirect taxes equally between the Centre and the state. However, **all put together, tax revenue of Centre is more than that of the states**. At the same time **socio economic expenditure to be incurred by the states are more** compared to the Centre. It leads to mismatch between own source of revenue and required expenditure. **To overcome this imbalance** the Constitution has mechanism for **Tax devolution from the Centre to the States and distribution of states' shares among all states**. They are, **finance Commission**, **GST Council** and the **Parliament**. These institutions and 80th and 101st Constitutional Amendment government the tax devolution mechanism.

2. The parliament also draws a distinction between the **power to levy** and **collect** a tax and the power to **appropriate the proceeds** of the tax so levied and collected.
   - E.g., the income tax is levied and collected by the centre, but its proceeds are distributed between the centre and the states

3. **Distribution of Tax Revenues** : 80th, 88th and 101st CAAs had induced major changes in the scheme of the distribution of tax revenues between Center and State. Before 80th amendment, **only few taxes were sharable between Center and States**. The taxes like corporation tax, custom duties etc. were not sharable.

3) 80TH AMENDMENT, 2000

- To give effect to the recommendation of 10th Finance Commission
  - **Alternative Scheme of Devolution:** Out of total income obtained from certain central taxes and duties 29% (41%, beginning April 2021, 15th Finance Commission) should go to states. This came into effect retrospectively from April 1, 1996.

- This amendment has brought several central taxes and duties like Corporation Tax and Customs Duties at par with Income Tax (taxes other than agricultural income) as far as the constitutionally mandated sharing with the states are concerned.

4) 88TH AMENDMENT OF 2003 (REPEALED BY 101ST CAA)

- ~~Added a new **article 268-A** dealing with service tax. It has added a new subject to the Union List - entry 92-C (taxes on services). Service tax is levied by the center but collected and appropriated by both the centre and the states.~~ **[repealed by 101st constitutional Amendment]**

5) 101ST CONSTITUTIONAL AMENDMENT ACT, 2016: MAIN PROVISIONS

i. **New Article 246A**
   - This article provides that both parliament and state legislatures shall have **concurrent powers** to make laws with respect to **goods and services tax (GST)**.
   - The parliament will retain exclusive power to legislate on goods and services tax in case of inter-state trade or commerce.

ii. **Amendment to Article 248: Residuary Powers of legislation**
   - The residuary power of Parliament under article 248 is now subject to article 246A.

iii. **Amendment to Article 249: Power of Parliament to legislate with respect to** *"good and services tax provided under article 246A or"* **matter in the state List in the national interest.**
   - Article 249 has been changed so that if 2/3rd majority resolution (2/3rd of present and voting) is passed by Rajya Sabha, the Parliament will have powers to make necessary laws with respect to GST in national interest.

iv. **Amendment to Article 250**
   - Article 250 has been changed so that parliament will have powers to make laws related to GST during emergency period.

v. **Article 268** has been changed so that excise duty on medicinal and toilet preparation will be omitted from the state list and will be subsumed by GST.

vi. **Article 268A** has been **repealed** so now service tax is subsumed in GST.

vii. **Article 269: Taxes levied and collected by the Union but assigned to the states.**
   It has been amended to make it subject to new article 269A

viii. **Article 269A** has been introduced **(Very important)**
   - (**1**) *GST on supplies in the course of inter-State trade or commerce shall be levied and collected by the Government of India and such tax shall be apportioned between the Union and the States in the manner as may be provided by Parliament by law on the recommendations of the Goods and Services Tax Council*

- Explanation- For the purpose of this clause, supply of goods, or of services, or both in the course of import into the territory of India shall be deemed to be supply of goods, or over services, or both in course of inter-state trade or commerce

ix. **Amendment to Article 270**

- It provides that GST collected by centre shall also be distributed between centre and state.

x. **Amendment to Article 271**

- The amendment puts restriction on the powers of Parliament to levy surcharge for on the GST.
  - In other words, it provides that **goods and services on which GST is levied shall not be subject to any surcharge under article 271**.

xi. **Article 279A has been introduced.**

- Provides for the constitution of a **GST council** by president within sixty days from this act coming into force.
- The GST council shall consist of the following members, namely;
  a. The Union Finance Minister (**Chairperson**)
  b. The Union Minister of State in charge of Revenue or Finance (Member)
  c. The Minister in charge of finance or taxation or any other nominated by each state government (and UT with legislative assemblies) (Members)

- *The Members of the Goods and Services Tax Council referred to in sub-clause (c) of clause (2) shall, as soon as may be, choose one amongst themselves to be the **Vice-Chairperson of the Council** for such period as they may decide.*

- **GST council shall make recommendations on:**
  a. The taxes, cesses and surcharges levied by the Union, the states and the local bodies which may be subsumed in the goods and services tax.
  b. The goods and services that may be subjected to, or exempted from the GST.
  c. Model GST Laws, principles of levy, apportionment of goods and services tax levied on supplies in the course of inter-state trade or commerce under article 269A and the principles that govern the place of supply.
  d. The **threshold limit** of turnover below which goods and services may be exempted from GST.
  e. The **rates including floor rates** with bands of GST.
  f. Any special rate or rates for specified period, to raise additional resourced during a natural calamity or disaster.
  g. **Special Provisions** with respect to states of Arunachal Pradesh, Assam, J&K, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim, Tripura, Himachal Pradesh and Uttarakhand.
  h. Any other matter related to GST as the council may decide.

- The GST council shall recommend the date on which the GST be levied on petroleum crude, High speed diesel, motor spirit (commonly known as petrol), natural gas and aviation turbine fuel.

- **Quorum**: one half of the members
- **Procedure**: The GST council shall determine the procedure in the performance of its functions

- **Majority Decision (not less than 3/4th of the weighted votes of the members present and voting)**

- Vote of central government shall have a weight of one-third of the total votes cast.
- The votes of state government taken together shall have a weight of two-thirds of the total votes cast.

6) CURRENT SCENARIO OF THE POWER TO LEVY TAX, COLLECT TAX AND APPROPRIATION OF TAXES

i. **Article 268: Taxes Levied by Center but Collected and Appropriated by the States**
   - Stamp duties on bills of exchange, checks, promissory notes, policies of insurance, transfer of shares and others.
   - ~~Excise duties on medicinal and toilet preparations containing alcohol and narcotics~~ **[101st amendment subsumed it under GST]**.
   - The proceeds of above duties levied within any state do not form part of the Consolidated Fund of India but are assigned to the state.

ii. ~~**Article 268A: Taxes Levied by center but collected and appropriated by both center and states**~~ **[by 101st amendment Service tax has been subsumed under GST]**
   - The principles of their collection and appropriation is formulated by the Parliament.

iii. **Article 269: Taxes levied and collected by Center but assigned to states**:

   (1): Taxes on the sale or purchase of goods and taxes on the consignment of goods [**except as provided in article 269A**] shall be levied and collected by the Government of India but shall be assigned and shall be deemed to have been assigned to the states on or after 1st of April, 1996 in the manner provided in clause (2)

   (2): The net proceeds of these taxes don't form part of Consolidated fund of India. They are assigned to the concerned states in accordance with the principles laid down by the parliament.

iv. **Article 269A (introduced by 101st constitutional amendment Act)**
   - **Article 269A: Levy and Collection of Goods and Services Tax in course of inter-state trade or commerce**.
   - (**1**) ***GST*** *on supplies in the course of* ***inter-State trade or commerce*** *shall be levied and collected by the Government of India and such tax shall be apportioned between the Union and the States in the manner as may be provided by Parliament by law on the recommendations of the Goods and Services Tax Council*
     - Explanation- For the purpose of this clause, supply of goods, or of services, or both in the course of import into the territory of India shall be deemed to by supply of goods, or over services, or both in course of inter-state trade or commerce

v. **Article 270: Taxes levied and collected by the center but distributed between center and the states.**
   - (**1**) This category includes all taxes and duties referred to in the Union List **except the following**
     1. Duties and taxes covered under **268, 269, 269A.**
     2. **Surcharge on taxes and duties** referred to in Article 271; and
     3. Any cess levied for specified purposes.

- (**1A**) The tax levied and collected by Union under GST shall also be distributed between the union and the states.

- (**1B**) The manner of distribution of the net proceeds of these taxes and duties is prescribed by the President on the recommendation of the Finance Commission.

vi. **Article 271: Surcharge on certain Taxes and Duties for Purposes of Center**

- The parliament can at any time levy the surcharges on taxes and duties referred to in **Article 269 and 270**.
    - The proceeds of such surcharges go to the Center Exclusively. In other words, the states have no share in these surcharges.
- **Surcharge can't be levied on taxes under article 246A** (GST)

GS FOUNDATION FOR CSE 2024
ECONOMY-17
EXTERNAL SECTOR-1
BALANCE OF PAYMENT: FOREX, EXCHANGE RATE, INTERNATIONALIZATION OF RUPEE ETC.

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2. BASICS OF EXTERNAL SECTOR

- **External sector** deals with import and export of goods and services, and financial capital between nations.
  - » The sector in which domestic economy has an advantage over other countries, goods and services of these sector are **exported**.
  - » The sector in which the domestic economy has a disadvantage over other countries, goods and services of these sectors are **imported**.

- **Balance of Payments** (BOP)
  - » BOP, also known as the **Balance of International Payments**, is a statement of all transactions between entities in one country and rest of the world over a defined period of time such as a quarter or a year.
  - » **Note**: Balance of payment thus summarizes all transactions that a country's individuals, companies, and government bodies complete with individuals, companies and government bodies outside the country.

1) BALANCE OF PAYMENT IN ONE TABLE

A. Current Account: (A.1 + A.2)		
	A.1: Merchandize Trade Balance	
		A.1(a): Merchandize Exports
		A.1(b): Merchandize Imports
	A.2: Invisibles	
		A.2(a): Services
		A.2(b): Transfers
		A.2(C): Income
B. Capital Account: B1+B2+B3+B4+B5		
	B.1) Foreign Investment	
		B.1.a) Foreign Direct Investment (FDI)
		B.1.b) Foreign Portfolio Investment (FPI)
	B.2) Loans	
		B.2.a) External Assistance
		B.2.b) Commercial Borrowings (MT & LT)
		B.2.c) Short term Credit to India
	B.3) Banking Capital	

	B.4) Rupee Debt Service	
	B.5) Other Capital Flow	
C. Errors and Omissions		
D. Overall, Balance (A + B + C)		
E. Reserve Change	**-(A + B +C)** **(-) indicates increase and (+) indicates decrease**	Explaination -> **Positive Balance of payment** would lead to increase in a nation's net foreign asset. And **Negative Balance of Payment** would mean decrease in a nation's net foreign asset.

- **Real Life Example** (see below table from ESI 2021-22)

Year / Item (Net)	2019-20				2020-21				2021-22 (P)	
(US$ Billion)	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
A. Current Account	**-15.0**	**-7.6**	**-2.6**	**0.6**	**19.1**	**15.3**	**-2.2**	**-8.2**	**6.5**	**-9.6**
A 1 Merchandise Trade Balance	**-46.8**	**-39.6**	**-36.0**	**-35.0**	**-11.0**	**-14.8**	**-34.6**	**-41.7**	**-30.7**	**-44.4**
A 1 a Merchandise Exports	82.7	80.0	81.2	76.5	52.2	75.6	77.2	91.3	97.4	104.8
A 1b Merchandise Imports	129.5	119.6	117.3	111.6	63.2	90.4	111.8	133.0	128.2	149.3
A 2. Invisibles	**31.8**	**32.1**	**33.4**	**35.6**	**30.0**	**30.1**	**32.4**	**33.6**	**37.2**	**34.8**
A 2.a) Services	20.1	20.9	21.9	22.0	20.8	21.1	23.2	23.5	25.8	25.6
A 2.b) Transfers	18.0	20.0	18.9	18.4	17.0	18.4	19.3	18.8	18.9	18.9
A 2.c) Income	-6.3	-8.8	-7.4	-4.8	-7.7	-9.4	-10.1	-8.7	-7.5	-9.7
B) Capital Account	**28.6**	**13.6**	**23.6**	**17.4**	**1.4**	**15.9**	**34.1**	**12.3**	**25.5**	**40.1**
B.1) Foreign Investment	18.8	9.8	17.6	-1.8	0.1	31.4	38.6	10.0	12.1	13.3
B.1.a) Foreign Direct Investment	14.0	7.3	9.7	12.0	-0.5	24.4	17.4	2.7	11.7	9.5
B.1.b Foreign Portfolio Investment	4.8	2.5	7.8	-13.7	0.6	7.0	21.2	7.3	0.4	3.9
B.2) Loans	**9.6**	**3.1**	**3.1**	**9.9**	**2.8**	**-3.9**	**0.3**	**7.7**	**2.8**	**7.6**
B.2.a) External Assistance	1.5	0.4	1.3	0.6	4.1	1.9	1.2	4.0	0.3	1.1
B.2.b) Commercial Borrowings (MT & LT)	6.1	3.3	3.2	10.3	-1.2	-4.0	-1.1	6.1	0.6	4.1
B.2.c) Short Term Credit to India	2.0	-0.6	-1.4	-1.0	-0.2	-1.8	0.2	-2.3	1.9	2.4
B.3) Banking Capital	**3.4**	**-1.8**	**-2.3**	**-4.6**	**2.2**	**-11.3**	**-7.6**	**-4.4**	**4.1**	**0.4**
B.4) Rupee Debt Service	**-0.1**	**0.0**	**0.0**	**0.0**	**-0.1**	**0.0**	**0.0**	**0.0**	**-0.1**	**0.0**
B.5) Other Capital	**-3.1**	**2.5**	**5.2**	**13.8**	**-3.7**	**-0.3**	**2.8**	**-1.0**	**6.6**	**18.8**
C) Errors and Omissions	**0.4**	**-0.9**	**0.6**	**0.9**	**-0.6**	**0.4**	**0.6**	**-0.7**	**-0.2**	**0.7**
D) Overall Balance	**14.0**	**5.1**	**21.6**	**18.8**	**19.8**	**31.6**	**32.5**	**3.4**	**31.9**	**31.2**
E) Foreign Exchange Reserves (Increase - / Decrease +)	**-14.0**	**-5.1**	**-21.6**	**-18.8**	**-19.8**	**-31.6**	**-32.5**	**-3.4**	**-31.9**	**-31.2**

A) CURRENT ACCOUNT

- Current account records a nation's net trade in goods and services, its net earnings on cross border investments, and its net transfer payments over a defined period.

- Current Account (like revenue receipt and revenue expenditure) transactions are single time and one way transaction. It means that the transaction (like receipt of payment) happens once and transaction ends there. There is no future liability/asset created.
  - » For e.g., when Tata Motors export a car and receives money for that, the transaction comes to an end with respect to this car being exported.

TRADE BALANCE:

- **Export**:
  - » It includes export of merchandize goods to other countries and receipts against it.
  - » Please note that, while considering trade balance, export/import of services are not considered.

- **Import**:
  - » It includes import of merchandize goods from other countries and payments for it.

- **Trade Balance** is the difference between exports receipt and import payments.
  - » In case the trade balance is positive, it is called trade surplus or favorable trade balance.
  - » In case the trade balance is negative, it is called trade deficit or unfavorable trade balance.

INVISIBLES (NET)

- The invisible (net) is that part of balance of trade that refers to services and other products that **doesn't result in transfer of physical assets**.
- **Invisibles** may include **Services, Income and transfer payments.**

SERVICES

I) Travel
II) Transportation
III) Insurance
IV) Government not included elsewhere (GNIE)
V) Miscellaneous Services
   a. It encompasses communication service, construction services, financial services, software services, news agency services, royalties copyright and license fees and business services.

INCOME (I.E. INVESTMENT INCOME)

- This income may be from financial assets, labour and property.
- These transactions are in the form of interest, dividend, profit for servicing capital transactions.
- **Interest Payment** represent servicing of debt liabilities. E.g. interest earned (paid) from bank loans to foreign country.
- **Dividend or profit** represent servicing of non-debt (FDI, FPI) liabilities.
- **Compensation** of employees are also included in "income" category.

TRANSFERS

- They represent one sided transaction i.e. transaction that don't have quid-pro-quo, such as grants, gifts, migrants transfers by way of remittances for family maintenance, repatriation of savings, and transfer of financial and real resources linked to change in resident status of migrants.
- They may be private or official.
- E.g.
    - Grants, donations and other assistance received by government from bilateral and multilateral institutions.

CURRENT ACCOUNT BALANCE = TRADE BALANCE + NET INVISIBLES

- **Positive (+)** Current Account (Current Account Surplus) means that the country is a net exporter of goods and services.
- **Negative (-)** Current Account (Current Account Deficit) means that the country is a net importer of goods and services.

- For e.g.
    - » **USA** had the world's largest Current Account Deficit in 2020 at US$ 616 billion.
    - » **China** had the world's largest Current Account Surplus in 2020 at US$ 274 billion.

B) CAPITAL ACCOUNT

- Capital account transactions are two-way transactions. It means **paid money can be recovered through periodical income** and/or by **disposal of the asset created**. Similarly, the loan has to be repaid periodically and has to be settled finally by paying the full amount.

- It includes: **Loans, Banking Capital, Investments (FPIs, FDIs),**

LOANS

External Assistance (official bilateral and multilateral loans), **External Commercial Borrowing** and **Short-term debt**.

- » **External Assistance (net)** means transaction of official (government) bilateral and multilateral loans.
- » **External Commercial Borrowings (ECBs)**:

    It means loan transaction by commercial enterprises.
    - » It includes commercial loans in the form of bank loans, buyers' credit, suppliers' credit, securitized instruments availed from non-resident lenders with a **minimum average maturity of three years**.
    - » **ECB** can be raised only for specific purposes, such as the import of capital goods, implementation of new projects, etc. These restrictions are called **end use restrictions**.

> **Extra Gyan:**
>
> **Buyers Credit** and **suppliers' credit** are called trade credits. Depending on the source of finance, such trade credits are classified as suppliers' Credit or Buyers' Credit.
>
> - **Supplier's Credit** relates to credit for imports into India extended by the overseas supplier.

- **Buyers' credit** refers to loans for repayment of imports into India arranged by the importer from a bank or financial institution outside India.

- Note: Both these credits are for the purpose of import and loan availed by importer.
  - In supplier's credit only two parties namely exporter and importer are involved.
  - In Buyer's credit, a third party namely a bank or financial institution comes into the picture to finance import.

Securitized instruments refer to debt securities like bonds, debentures and preference shares which are not fully or compulsorily convertible.

Bonds and Debentures are debt instruments i.e. means the owner of debt/debentures are creditors to the company and doesn't have any ownership.

Bonds are generally secured by a collateral.
Debentures is a debt security issued by a corporation or government entity that is not secured by an asset. Debentures have higher seniority for liquidation repayment than preferred shares.

Preference Shares are equity instruments known for giving owners preferential rights in the event of dividend payments or liquidation by the underlying company.

» **ECB** also covers **Foreign Currency Convertible Bonds** (FCCB) and **Foreign Currency Exchangeable bonds** (FCEB).

» FCCB and FCEB are both types of bonds issued by companies in foreign currency i.e. principal and interest in respect of these bonds are payable in foreign currency.

» **FCCB:** It provides bondholder with the option to convert the bonds into a predetermined number of shares of the issuing company's stocks at a specified conversion price during or end of bond's maturity.

» If the equity conversion option is used, the bondholder becomes a shareholder of the company, giving them ownership in the form of equity. Conversion Ratio determines the number of shares to be allotted upon conversion, which is usually determined based on a formulae or fixed ratio. FCCBs typically pay regular interest to bondholders until conversion or maturity, similar to conversion bonds.

» **FCEB**: They are exchangeable into equity shares of another company called the offered company. The word 'Exchangeable' refers to the facility to convert bonds of one company into equity shares of another company.

» Its other features are similar to FCCB. The key difference lies in the type of equity ownership that results from the exercise: direct ownership of the issuing company's shares in the case of FCCBs and ownership of shares in a different company for FCEBs.

» **Short term Debt**: These are trade credits for a maturity less than three years.

BANKING CAPITAL

- It comprises of three components: Foreign assets of Commercial Banks, Foreign Liabilities and Others.
- **Foreign assets of commercial banks**. It consists of:
  - Foreign Currency holdings
  - Rupee overdrafts to non-residents

- **Foreign liabilities** of commercial banks. It consists of:
  - **Non-Resident Deposits**:
    - The deposits received from non-resident Indians comes under this head. At present there are three types of NRI deposit schemes. They are:
      i. **Foreign Currency Non-Resident (Banks) FCNR (B)**: These deposits are held in the following foreign currencies - US Dollar, Pound Sterling, Euro, Japanese Yen, Australian Dollar and Canadian Dollar; only term deposits of **1-3 years of maturity** are allowed. The interest rates are pegged to LIBOR/ SWAP rate.
        - **Note:** LIBOR (London Interbank Offered Rate) is a benchmark interest rate at which major global banks lend to one another in the international interbank for short-term loans.

      ii. **Non-Resident External Rupee Account NR (E) A**: These deposits are held in Indian rupees. **Term deposits with maturity of one to three** years as well as **saving deposits are allowed u**nder the scheme. Its interest rate is also pegged to the LIBOR/SWAP rate.

      iii. **Non-Resident Ordinary Rupee Account:**
        - It is the account held by Indians ordinarily living abroad.
        - An Indian who was an Indian resident but migrated abroad can shift this account to this category. It is held in Indian rupees.
        - It can be opened in **current, saving, recurring or fixed deposit accounts**.

  - **Liabilities other than non-resident deposits,** which comprise of **rupee and foreign currency liabilities** to nonresident banks and official and semiofficial institutions.

- **Others**
  - "Others" under banking capital include transactions in **balances of foreign central banks and international institutions** like the IBRD, IDA, ADB, IFC, IFAD etc. mantained with deposit

account departments (DAD) of RBI as well as transactions in balances held abroad by the embassies of India in London and Tokyo.

FOREIGN INVESTMENT (FDI AND FPI)

OTHER CAPITAL FLOWS

These include **delayed export receipt**s, **leads and lags in export receipts** (the difference between custom data and banking channel data), funds held abroad, and other capital transactions not included elsewhere such as flows arising from cross-border financial derivatives and commodity hedging transactions, and **sale of intangible assets** such as patents, copyrights, trademarks etc.

CAPITAL ACCOUNT BALANCE:

- **Loans** (External Assistance + External Commercial Borrowing (net) + Short term debt (net)**) + Banking Capital** (net) + Foreign Investment (net) + Other outflows (net)
    - **Capital Account Surplus** -> If Capital Account Balance is positive.
    - **Capital Account Deficit** -> If Capital Account Balance is negative.

C) ERRORS AND OMISSIONS

- It includes the differences between debit and credit entries of all transactions.
- Capital Account balance is calculated with and without errors and omissions.

D) OVERALL BALANCE/ BALANCE OF PAYMENTS

- **Balance of Payment =** Current Account Balance + Capital Account Balance
- If the BoP is positive -> it would lead to increase in foreign exchange reserve and vice-versa.

3. FOREX RESERVES

1) COMPOSITION OF INDIA'S FOREX RESERVES

- India's foreign exchange reserves comprise of four components:
    1. **Foreign currency assets (US$, Euro, Pound, and Yen)**: It is expressed in US Dollar or Indian rupee terms.
        - It also includes foreign currency deposits held by RBI with foreign central banks, the BIS and non-resident deposit taking institutions as well as deposit agreements with IMF Trust Accounts that are readily available to meet a BoP financing needs.

- Securities issued by non-residents and financial derivatives having underlying foreign currency assets also form part of foreign currency assets.

2. **Gold reserves of RBI**: The RBI has gold stocks as a backup to issue currency and to meet unexpected balance of payment problems.

3. **Reserve Tranche**:
   - It consists of India's quota (member subscription fee) to IMF and lending to the General Resource of IMF.
     - Note: The General Resource Account is the pool of member countries' quota payment.

4. **Special Drawing Rights** (SDR) holdings of the government
   - The IMF member countries are entitled to get a loan from IMF's SDR Account. This loan amount is upto 200% of the member's quota with the IMF. It is also known as **Paper Gold**.
     - In this arrangement IMF doesn't lend directly. It is the member countries, who are in a strong position, lend their SDR holdings to member countries who are in problems for balance of payment.

2) WHO MANAGES FOREX RESERVES?

- **RBI Act and Foreign Exchange Management Act, 1999** set up the legal provisions for governing the foreign exchange reserves.
- **The RBI** functions as the custodian and manager of forex reserves and operates within the overall policy framework agreed upon with the Centre. It allocates the dollars for specific purposes.
  - For e.g., under the Liberalized Remittances Scheme, individuals are allowed to remit up to $2,50,000 every year.
- The Central bank uses its forex kitty for orderly movement of the rupee. It sells the dollar when the rupee weakens and buys dollar when the rupee strengthens.

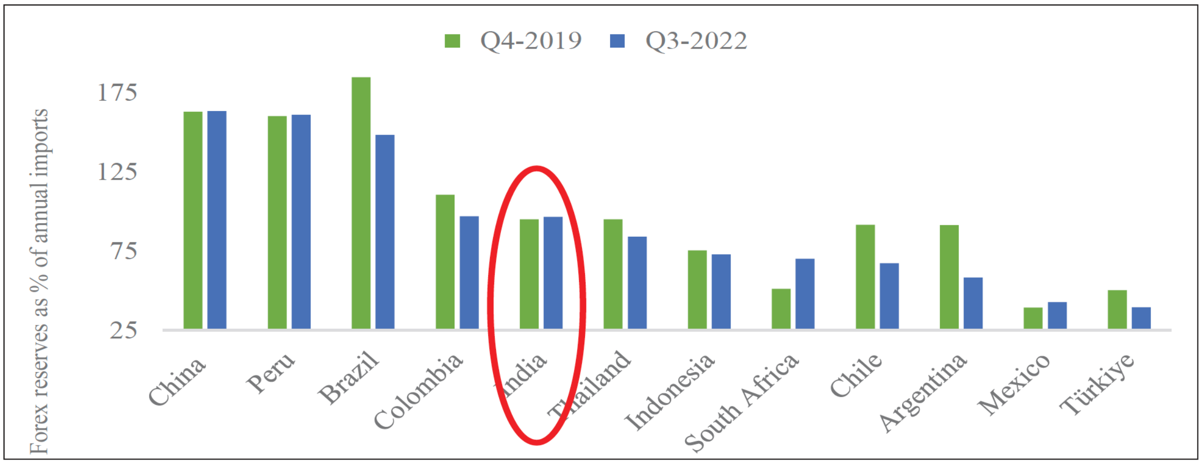
3) SIGNIFICANCE OF FOREX RESERVES

- It acts a **cushion against domestic currency volatility** once the global exchange rate start rising.
- It increases the **confidence in the monetary and exchange rate policies** of the government.
- During **balance of Payment crisis** foreign exchange reserve come to the rescue of any country so as to absorb the distress related to such crisis.
- Strong forex reserves also helps a country to **adopt more aggressive countercyclical measures** and emerge from a short-lived recession.
- It also **adds to the comfort of market participants** that domestic currency is backed by external assets and hence it also helps the equity markets of the country, because due to strong reserves many people from foreign countries are willing to invest in the country.

4) OTHER ASPECTS RELATED TO FOREX RESERVES

- **However, holding too much foreign exchange reserves is also not advisable -> (Opportunity Cost)**
- **How much Foreign Reserve do we have?**
  - India's forex reserve at $602 billion as of Aug 2023: RBI
    - **Foreign Currency Assets** (FCAs): $534.40 billion
    - **Gold Reserves**: $44.34 billion
    - **SDR**: $18.32 billion
  - **Note:** India's foreign reserve had **peaked in Sep 2021** at $642.45 billion.
  - **Note:** The **import coverage of foreign currency reserves** has declined since the pre-pandemic levels in most emerging market economies; however, that of India has increased from 95% in Q4 2019 to 96.5% in Q3 2022.

Figure XI.15 Adequacy of India's Forex Reserves (as a percentage of Annual Imports): A Cross-country perspective



Source: IMF (forex reserves) and WTO (for imports data)

- **How did India's foreign exchange reserves increase till Sep 2021**?
  - Generally, the current account surpluses result in a building of reserves, as the central bank mops up all the excess foreign currency flowing into the country. **But, India is an outlier**. From 2011 to 2021, there was **only one year i.e. 2020 when India had run a surplus**. India accumulated forex reserves despite having aggregate deficit of $400 billion during 11 years.
  - The reserve was built through **import of capital**.
  - **Another source** of reserve accretion or depletion: **Valuation Effect**. Foreign exchange reserves are held in the form of dollars as well as non-dollars currencies and gold, whose value is, in turn, influenced by movements in exchange rates and gold prices. A depreciation of US$ or higher gold prices cause valuation gains.

SOURCES OF INCREASE IN INDIA'S FOREIGN EXCHANGE RESERVES
(IN BILLION US DOLLARS)

		1990-91 TO 1997-98	1998-99 TO 2005-06	2006-07 TO 2013-14	2014-15 TO 2021-22
1	Trade Balance (1a - 1b)	-72.469	-165.135	-1051.316	-1176.895
	(a) Exports	207.273	472.412	1857.615	2555.150
	(b) Imports	279.742	637.547	2908.931	3732.045
2	Net invisibles	37.527	165.189	713.252	967.989
3	Current Account Balance (1+2)	-34.942	0.054	-338.064	-208.907
4	Capital Flows*	57.887	117.133	479.750	544.290
5	Overall Balance (3+4)	22.945	117.187	141.686	335.383
6	Valuation Effect	2.460	5.068	10.915	-32.297
7	Rise in Reserves (5+6)	25.405	122.255	152.601	303.086

*Including from International Monetary Fund.
Source: Reserve Bank of India.

- **Why the recent drop in the reserves?**
  - **Largely due to steps taken by the Reserve Bank of India to support the rupee**.
  - Increasing trade deficits (and Current Account Deficits)
  - Capital outflow (FIIs have pulled out) [given the rising global interest rates and bond yields on the back of monetary policy tightening by the US Fed and other major central banks.

- **Some Recent Steps by RBI:**
  - In July 2022, RBI has announced a series of measures including relaxation in:
    i. **Foreign investment in debt**:
      - **FPIs in government securities and corporate debt** made till 31st Oct 2022, will be exempted from this short-term limit. These will not be reckoned for the short-term limit of one year till maturity or sale of such investments.

    ii. **External Commercial Borrowings**
      - Increase the limit under automatic route for ECBs from $750 million or its equivalent per financial year to $1.5 billion.

    iii. NRI Deposits:
      - RBI has allowed banks temporarily to raise Fresh Foreign Currency Non-Resident Bank i.e., (FCNR (B)) and Non-Resident External (NRE) deposits without reference to the current regulations on interest rates. This relaxation is available till 31st Oct 2022.
      - From July 30, 2022, incremental FCNR(B) and NRE deposits with reference base date of 1st July 2022, will be exempt from the maintenance of CRR and SLR.

- **Conclusion:**
  - With reserve bank of India showing **willingness to use reserves to defend the rupee** - ensuring "orderly evolution" of the exchange rate with "zero tolerance for volatile and bumpy

movements" - a further drawdown of foreign exchange reserve is possible. The forex reserve were, after all, accumulated as a buffer against currency volatility, external shocks and sudden stop in capital flows. As RBI Governor Shaktinath Das has recently put it, "***You buy an umbrella to use it when it rains***".

4. EXCHANGE RATE

1) BASICS OF EXCHANGE RATE

- 'Exchange rate is the price of a nation's currency in terms of another currency'. Thus, an exchange rate has two components, the domestic currency and a foreign currency and can be quoted either directly or indirectly.
    1. **Direct Quotation**
        - The price of a **unit of foreign currency** is expressed in terms of domestic currency.
            - For e.g., in India's context: 1$ = 80 Rs.
    2. **Indirect Quotation**
        - The price of a **unit of domestic currency** is expressed in terms of the foreign currency.
            1. For instance, 1Rs = 0.0125%

- Generally, exchange rate is **quoted in value against US dollar**. However, exchange rates can also be quoted against another nations currency.

- **Floating vs Fixed Exchange Rate**
    - A floating exchange rate is where a currency rate is determined by market forces. This is generally followed by most major economies.
    - **Fixed Exchange Rate**: In this case, the exchange rate is fixed or peg their currencies to a widely accepted currency like the US dollar.
        - This is done to reduce volatility or better manage trade relations. For e.g. Most GCC countries including Saudi Arabia fixes its currency Riyal to US$ because its main export is oil, which is priced in US$.

- **Depreciation or Appreciation of Exchange Rate**
    - **Depreciation:** Increase in the direct exchange rate (i.e., fall in the external value of domestic currency because of more demand for foreign currency or less supply of foreign currency or more supply of domestic currency or less Demand of Domestic currency).
        - For e.g., rupee depreciation would mean rupee falling from 1$ = 50 rupee to 1$ = 52 rupee.
    - **Appreciation:** Decrease in the direct exchange rate (due to more demand or less supply of home currency; or less demand or more supply of foreign currency).
        - For e.g. Rupee appreciation would mean Rupee appreciating from 1$ = 50 Rupees to 1$ = 48 rupees.

- **Devaluation**
  - Reduction in the external value of home currency is called Devaluation.
    - This is done to increase export and is usually resorted to correct the deficit in the balance of payment.
    - How?

- **Revaluation**
  - Increase in the external value of home currency is called revaluation.
  - It is usually resorted to correct the surplus in the balance of payment. This reduces deficit for other countries. This is very rarely done.

- **Note:**
  - Depreciation and Appreciation takes place automatically due to movement in the demand and supply of currencies in the market (i.e. by market forces). If dollar demand exceeds supply, the rupee depreciates with respect to it and vice versa.
  - Devaluation and revaluation are done voluntarily either by the government or monetary authority.

- **Relation between Inflation and Exchange Rate**
  - Class Discussion

2) EFFECTIVE EXCHANGE RATE INDICES OF INDIAN RUPEES

- EER is a summary indicator of **movements of home currency against a basket of currencies** of trading partners.

- EERs serve as a gauge for assessing the **fair value of currency**, the external competitiveness of an economy and even serve as guideposts for setting monetary and financial conditions.

- **The Nominal Effective Exchange Rate (NEER)** is an index of the weighted average of bilateral exchange rates of home currency vis-a-vis currencies of trading partners, with weights derived from their shares in the trade basket of the home currency.

- A **Real Effective Exchange Rate (REER)** is the NEER adjusted by relative prices and costs, typically captured in inflation differentials between the home economy and trading partners.

- **RBI** is responsible for compilation and dissemination of NEER and REER Indices of the Indian rupee (both trade and export oriented).

- **Key Changes made 2021:**
  - **Base year** was moved from 2004-05 to **2015-16** for NEER/REER indices.

  - **Coverage of NEER/REER basket** has been expanded from **36 to 40 currencies** (8 new additions and 4 removals)
    - The selections is based on **two criterias**:

i. **Trading partners with extremely high and volatile inflation** are excluded as their currencies tend to experience rapid nominal declines which undermines the stability of NEER/REER indices.

ii. Data on inflation and exchange rates of trading partners should be available on a regular basis.

- The new basket represents **88% of India's total trade** as compared to 84% in the case of older 36 currency basket.

- **Note:** To **calculate trade weights**, geometric means of India's trade (exports plus imports) with trading partners during the preceding three years are computed and then normalized to 100. While the Euro area retains its top position in the trade basket, the US assigned the highest weight in the export basket in 2015-16.

Table 1: New 40-Currency NEER/REER Basket – Normalised Weights

(Per cent)

Country/Area	2015-16		2020-21 (P)	
	Trade-based Weight	Export-based Weight	Trade-based Weight	Export-based Weight
1. Euro Area	11.4	14.0	11.6	14.7
2. China	10.0	5.0	12.0	5.6
3. UAE	9.4	12.4	7.8	10.4
4. US	9.1	14.7	11.6	18.4
5. Saudi Arabia	6.4	4.1	4.4	2.1
6. Switzerland	3.7	0.5	2.7	0.4
7. Hong Kong	2.9	4.8	3.9	4.6
8. Indonesia	2.9	1.8	2.8	1.6
9. Singapore	2.8	4.4	3.2	3.7
10. Iraq	2.7	0.4	3.2	0.6
11. Korea	2.5	1.6	2.9	1.7
12. Kuwait	2.5	0.4	1.3	0.5
13. Japan	2.5	2.3	2.3	1.7
14. Qatar	2.4	0.3	1.5	0.5
15. Nigeria	2.3	1.0	1.8	1.0
16. UK	2.2	3.5	2.2	3.3
17. Malaysia	2.2	1.8	2.2	2.2
18. Iran	2.1	1.5	1.4	1.1
19. Australia	2.0	0.9	2.2	1.2
20. South Africa	1.8	1.9	1.5	1.4
21. Brazil	1.5	2.2	1.1	1.3
22. Thailand	1.3	1.4	1.6	1.5
23. Vietnam	1.1	1.9	1.8	2.3
24. Bangladesh	0.9	2.2	1.3	3.1
25. Taiwan	0.9	0.9	0.9	0.8
26. Angola	0.9	0.2	0.6	0.1
27. Russia	0.9	0.8	1.3	0.9
28. Turkey	0.9	1.7	1.0	1.9
29. Mexico	0.9	0.8	1.2	1.3
30. Israel	0.9	1.3	0.7	1.3
31. Sri Lanka	0.8	1.9	0.7	1.6
32. Canada	0.8	0.8	0.9	1.0
33. Egypt	0.7	1.1	0.6	0.9
34. Oman	0.7	1.0	0.8	0.8
35. Nepal	0.6	1.4	1.1	2.6
36. Kenya	0.6	1.5	0.3	0.7
37. Tanzania	0.5	1.0	0.4	0.6
38. Chile	0.5	0.2	0.3	0.3
39. Ukraine	0.4	0.2	0.4	0.1
40. Ghana	0.2	0.3	0.5	0.2
Total	100.0	100.0	100.0	100.0
Memo Items:				
AE Currencies	41.7	49.7	45.0	52.6
EMDE Currencies	58.3	50.3	55.0	47.4

AE: Advanced economies. EMDE: Emerging market and developing economies. P: Provisional.
Source: RBI staff calculations.

- The **methodology of computing** NEER/REER indices:
    - The NEER is calculated as the geometric weighted average of bilateral exchange rates of the home currency in terms of trading partner currencies.

Specifically the NEER can be calculated as follows:	$$NEER = \prod_{i=1}^{n} \left(\frac{e}{e_i}\right)^{w_i} \quad (1)$$
REER, which is NEER adjusted by weighted average ratio of the domestic price to foreign prices, is calculated as:	$$REER = \prod_{i=1}^{n} \left[\left(\frac{e}{e_i}\right)\left(\frac{P}{P_i}\right)\right]^{w_i} \quad (2)$$
'e' represents the exchange rate of rupee against the IMF's SDR 'e_i' is the exchange rate of the foreign currency 'i' against the IMF's SDR.	A rise in e or (e/e_i) represents an appreciation of the rupee relative to currency 'i' and vice versa. '*P*' and '*P*i' represent price indices of the home economy and the trading partner 'i', respectively. '*wi*' denotes trade-/export-based weight assigned to foreign currency/trading partner 'i', while '*n*' is the number of currencies (other than home currency) included in NEER/REER basket

3) DEPRECIATION AND ASSOCIATED ISSUES

- **Why does depreciation take place?**
    - **Core Reason - Demand supply gap of foreign currency (US$)**
        - **Increasing Current Account Deficit** (More imports, less exports).
        - **Monetary and Interest rate hikes by the US Fed**
            - This makes US treasury investment more attractive and leads to **FII's moving funds from emerging economies back to US**.
    - **Other traditional factors affecting India's exchange rates**
        - Mounting External Debt
        - Tightening global liquidity
    - Further, since India is an emerging market, **inflation rate** here would be higher when compared to developed countries and there will be a long term depreciation.

- **Why the recent depreciation in rupee?**
    - Since March 2022, **the US Federal Reserve has been raising its benchmark interest rate** causing investors seeking higher returns to pull capital away from emerging markets such as India and back into the USA. This puts pressure on emerging market economies.
    - India's Current Account Deficit is expected to hit a 10-year high of 3.3% of GDP in the current financial year.

» Consistently high domestic inflation

- **Negative Impacts**
    1. **Decline in forex reserves**

    2. **Negatively impacts Current Account Deficit -> Vicious Cycle**

    3. **Pulling out of Foreign Portfolio Investments**

    4. **Inflation: Increased prices of imported products**
        - Further, increases the cost of crude oil import.
    5. **Negatively impacts business' taking loans from abroad**
        - With banks already not willing to lend because of increasing NPAs depreciating rupee makes it difficult for business' to borrow from abroad.
    6. **Difficulty in financing external debt**
    7. **Increase in RBI's monetary policy rates**
        - Thus impacting economic growth negatively
    8. **Challenges for students studying or wanting to study abroad**

- **Positives of declining rupee**
    » Depreciation helps in **increasing exports** as exports become cheaper for importing foreign country.
        - Therefore, some sectors like IT, Pharma, hospitality can actually benefit from depreciating rupee.
        - This may help in chipping away of trade deficit imbalance.
    » **Tourism and hospitality** sector may get a boost
    » **Remittances tend to increase** during the depreciating phase

- **Sectoral Impact**
    1. **Export based industry would benefit**
        - Depreciation acts as booster for IT and Pharma sector which are export based. Further hospitality sectors such as tourism, hotel etc can benefit as foreign tourists would now find in cheaper to visit India.
    2. **Problems for Oil Marketing Companies**
        - Rise in crude oi prices and depreciation of rupee is a double jeopardy for oil marketing companies. The lack of pricing power during major elections further exacerbate the problems for OMCs.
    3. **Auto sector**
        - Companies having high export shares will benefit from this depreciation.
        - On the other hand, operating procedure margins of vehicle manufacturers such as Maruti Suzuki which import most of their components and focus on domestic market are going to face problems.
    4. **Aviation sector will be hit**
        - Increasing cost of Crude oil (thus Aviation Turbine Fuel)
        - The big capacity additions on the anvil will also face problems.

- **Steps taken by Government.**

- Steps to fight trade deficit [see Trade Deficit Topics]
- Steps to attract investments [See currency depreciation topic]

- **Conclusion**
  - Most of the reasons for depreciation in rupee are not due to development internal to India and thus the problem is not India specific.
  - Further, though a depreciating rupee may be beneficial for a few sectors, but it doesn't bode well for the country's macro-economic stability, unless export growth increases.
  - In long run, India should focus on decreasing its energy dependency, expanding its manufacturing sector to reduce current account deficit, and to make India less vulnerable to these external factors.
    - We will need to remove policy barriers that are impeding the growth of export oriented sectors.
  - And finally, there is a need of reform in the monetary policy framework of RBI to reduce the continuous inflationary pressure on rupee.

5. INTERNATIONALIZATION OF RUPEE

- **What is Internationalization of Rupee?**
  - Internationalization is a process that involves increasing the use of the rupee in cross-border transactions. It involves promoting the rupee for import and export trades, and then other current account transactions, followed by its use in capital account transactions.
  - It will also require:
    - F**ull capital account convertibility** (currently India allows only full current account convertibility, capital account convertibility is limited).
    - **Availability in sufficient quantities**
    - **Opening up of currency settlement and a strong swap and forex market**.

- **Advantages of Internationalization of Rupee**:
  - **Reduces exchange rate risks**, while curtailing the demand for US dollar.
    - **Reduces risk to economy** due to sudden withdrawal of capital from market
  - **Reduces the need of forex war chest** to meet the external vulnerabilities.
  - **Lower cost of capital** due to better access to international financial markets.
  - **Promotes ease of doing business** but also improves the chances for Indian businesses to grow globally.
    - **Bargaining power of Indian businesses** will increase, adding weight to Indian economy and enhancing India's global stature and respect.
  - **Reduced transaction costs**: They will not have to incur exchange rate fees.
  - **Geopolitical Significance**: US-dollar dominated global currency system can become limitations for the economy if India's relations with US and Europe becomes tense in future. In that scenario, business in domestic currency can be a savior.

- **Internationalization of currency is closely linked with a nation's economic progress**.
    - Currently, the US $, the Euro, the Japanese Yen and the pound sterling are the leading reserve currencies in the world. China's efforts to make its currency renminbi (yuan) a reserve currency has met with only limited successes so far.
    - US$ is said to enjoy a 'exorbitant privilege', which refers to the innumerable benefits that accrue to the US on account of all other countries of the world using the US$ as their currency in most of their international transactions, among global currencies.
    - **Factors behind US$ being the most common currency of reserve and exchange:**
        - **Size of US Economy** (largest in the world)
        - **Reach of its trade and financial market**
        - **Depth and liquidity** of the US financial market
        - History of macro-economic stability
        - Currency convertibility
        - Lack of viable alternative.
    - **Is there are challenger to US dominance?**
        - The obvious challenger to US dominance is the Chinese Renminbi. However, it ability to rival the US dollar will depend on future policies in both the US and China and the ability of Chinese economy and its financial system to demonstrate long term resilience, integrity, transparency, openness and stability.

- **China's Experience**:
    - Before 2004, RMB couldn't be used outside China.
        - By 2007, the **"Dim Sum" bond** and offshore RMDB bond market had been created.
    - **Post 2008**, China pursued a phased approach:
        - **First**, it allowed use of RMB outside China for Current account transactions and for select investment transactions (FDI, outward direct investment) etc.
        - **By 2009**, it had signed currency swap agreements (i.e., an exchange of an equivalent amount of money, but in different currencies) with countries like Brazil, UK etc.
        - Then, **Central banks, offshore clearing banks and offshore participating banks** were allowed to invest excess RMB in debt securities.
        - **Sanghai Free Trade Zone** was launched in 2013, to allow free trading between non-resident onshore and offshore accounts.
    - **In this way**, overtime RMB was internationalized, with reserve currency status increasingly enabled. For e.g. in Q2, 2022, the RMB's share of international reserves had reached around 2.88%.

- **Steps Taken towards Internationalization of Rupee:**
    - **Liberalization of Capital Account**: Over the years, government has relaxed FII and FDI norms, facilitating greater cross-border investment and trade.
    - Enabling of **ECB in rupee**.

- **Currency Swap Agreements** with several countries, which allow for the exchange of rupee and foreign currency between the central banks of the two countries.
- RBI allowed banks from 18 countries to open **Special Vostro Rupee Accounts** (SVRAs) for settling payments in Indian Rupees.
- RBI constituted Inter-departmental group (IDG) headed by RBI Executive Director **Radha Shyam Ratho** to frame roadmap for the Internationalization of Indian Rupee has submitted its report.
- During PM Modi's visit to UAE in July 2023, Reserve Bank of India (RBI) signed two MoUs with Central Bank of UAE. One of the MoU focuses on establishing a framework to promote the use of local currencies from cross-border transactions, the other was for linking payment systems.

- **Challenges in achieving internationalization:**
  - **Little traction for international trade in rupee**:
    - The daily average share of Rupee in the global foreign exchange market hovers around 1.6%, while India's share of global goods trade is around 2%.
      - For e.g. Russia reportedly preferred Yuan or Dirham as a medium of transaction for Indian imports of oil, rather than rupee.
  - **Large Trade Deficit**: It would make acceptance of Rupee in global economy would be limited due to its depreciation problem.
  - **Lack of Liquidity**: For now, Indian rupee is not as liquid as other major global currencies and thus it may be difficult to buy and sell large amounts of rupees.
  - **Underdeveloped Financial Markets**: India's financial market are still relatively under-developed when compared to major economies, which can limit the range of products and services available to international investors.
  - **IDG has also highlighted following limitations that may arise due to internationalization of Rupee:**
    - **Exchange rate volatility in rupee's exchange rate** will increase in initial stages of internationalization
    - **Triffin Dilemma**: Obligation of a country to supply its currency to meet the global demand may come in conflict with its domestic monetary policies.
    - **Accentuation of external shock** may take place due to open channel of flow of funds into and out of the country and from one currency to another.
  - However, the IDG itself said that the advantages of internationalization far outweigh the above limitations. Moreover, the internationalization of rupee will be a long drawn process and would enable timely redressal of these challenges.

- **Recommendations given by RBI's Inter-Departmental Group:**
  - **Short term measures:**
    - » Adoption of Standardized approach for examining the proposals on bilateral and multilateral trade arrangements for invoicing, settlement, and payment in the rupee and local currencies.

- » Encouraging the opening of the rupee accounts for non-residents both in India, and outside India.
- » Incentivizing exporters to use Indian currency for trade settlements.
- » Integrating payment systems to provide seamless cross border transactions.
- » Strengthening the financial markets by fostering a global 24X5 rupee market
- » Recalibration of FPI regime.

- **Medium Term Measures (2-5 years targets)**
  - » Synchronizing tax regimes of India and other financial centres.
    - A review of taxes on masala bonds
  - » Allowing banking services in the rupee outside the country
    - Allowing international use of RTGS for cross border trade
  - » Inclusion of Indian government bonds in global bond indices

- **Long Term**
  - » Measures to have rupee included in the IMF's SDR.

- **Other steps that can be taken:**
  - » **Focus on increasing exports** - As India increases exports and accepts money in rupee, it will lead to more acceptance of rupee internationally.
  - » **Rupee should be made fully convertible** - letting financial investments move freely between India and abroad.
  - » **Deeper and more liquid rupee bond market -** This will allow foreign investors and Indian trade partners to have more investment options in rupees, enabling its international use.
  - » **Additional Currency Swap Agreements** (as with SL) would further allow India to settle trade and investment transactions in rupees, without resorting to a reserve currency like dollar.
  - » **Tax incentives to foreign businesses** to utilize rupees in operations in India would also help.
  - » **Currency Management Stability:** RBI and Finance Ministry has to ensure currency management stability through consistent and predictable issuance/retrieval of notes and coins).
  - » **Improvement in general macro-economic parameters -** The Tarapore Committee's recommendations must be pursued including a push to reduce fiscal deficits lower than 3.5%, a reduction in gross inflation rate to 3%-5% and a reduction in gross banking NPAs to less than 5%.

- **Conclusion:**
  - » As the Indian economy grows in size, as its trade linkages with other countries grow stronger, more space will be created for using the rupee in international transactions.

GS FOUNDATION FOR CSE 2024
ECONOMY-18
EXTERNAL SECTOR-2
EXPORT SITUATION; FOREIGN TRADE POLICY, FOREIGN INVESTMENTS (FDIS AND FPIS)

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2. EXPORT SECTOR

- **Current Situation**:

		2022-23 (USD Billion)	**2021-22** (USD Billion)
Merchandize	**Exports**	447.46	422
	Imports	714.24	613.05
Services	**Exports**	322.72	254.53
	Imports	177.94	147.01
Overall Trade (Merchandize + Services)	**Exports**	770.18	676.53
	Imports	892.18	760.06
	Trade Balance	-122.00	-83.53

- **Why does India face such huge trade Deficit**:
  - **Huge Dependency on Fossil fuel imports**
  - **Underperformance in Exports** (India's global export share is only 1.8%, China has 13% share).
    - » Manufacturing sector not well developed.
    - » Less diversification in export basket (10 principle exports account for 78% of total merchandize exports)
  - **Less focus on scientific research and development**
    - » This hinders complex and unique exports.
  - **High cost of logistics** -> Reduces cost competitiveness of Indian products.
  - **Not able to utilize its demographic dividend** due to poor skill levels in the country.

- **Some steps taken to promote exports** and reduce import dependency
  - **Various Schemes** to promote exports.
    - A. **Remission of Duties and Taxes** on Exported Products (RoDTEP) Scheme.
    - B. **Export Promotion in Capital Goods Scheme**
  - **Steps to improve infrastructure.**
    - National Logistic Policy
  - **Focus on Manufacturing sector** - Atmanirbhar Bharat; Various **PLI Schemes**
  - **Increased focus on renewable Energy**

- **Way Forward**:
  - » Focus on growth of manufacturing sector (Initiatives like Atmanirbhar Bharat, Performance linked incentive if effectively implemented will go a long way forward in dealing with these challenges.
  - » **Reduce fuel dependency**: Focus on renewable, biofuels, energy conservation etc.
  - » **Promote ease of doing Business in India**:
    - To attract more investment and production within the country

- Land reforms and labor reforms are two most important focus areas.
- **Diversify export basket** and **focus on value added exports**
  - For e.g. rather than raw agri products, processed food items can serve more value.
- **Fast track free Trade** negotiations with EU, Britain etc.
- **Continued focus on Service sector** like IT.
  - It will be crucial that India's IT sector focuses on emerging technologies, like AI, Machine Learning, ChatGPT etc. so that they will be able to provide next generation services which will be required in future.

3. FOREIGN TRADE POLICY, 2023

- **Example Questions:**
  - What are the key objectives of India's Foreign Trade Policy, 2023? Highlight some of the challenges to the implementation of this policy. Suggest measures to make this policy more effective in boosting India's exports [15 marks, 250 words]

- **Introduction**:
  - Foreign Trade Policy (FTP) refers to a set of guidelines, regulations and measures formulated by a government to govern its international trade.
  - India's new FTP i.e. **Foreign Trade Policy, 2023** has come into force from 1st April 2023.

- This policy is based on continuity of time tested schemes **facilitating exports** as well as a document which is **nimble and responsive** to the requirements of trade.

- **The Key Approach** to the policy is based on these **4 pillars**:
  1. **Incentive to Remission**
  2. **Export Promotion** through collaboration - Exporters, States, Districts, Indian Missions
  3. **Ease of Doing Business, reduction in transaction cost and e-initiatives**.
  4. **Emerging Areas** - E-commerce, Developing Districts as export Hubs and **streamlining SCOMET Policy**.
     - **Note: SCOMET stands for Special, Chemicals Organisms, Materials, Equipment, and Technologies (SCOMET) policy.**

- **Key Aims and Objectives of India's FTP, 2023 are**:
  - Boost India's **exports to USD 2 trillion by 2030**.
  - Strengthen India's **export competitiveness**
  - **Diversify export basket**, **expand** export markets and **promote sustainable exports**.
  - Focus on promoting exports from small and medium enterprises (SMEs). For this policy envisages support in the form of access to finance and markets.
  - Provide for several **incentives for exporters**, including duty drawback, export promotion capital goods (EPCG) scheme, and interest subvention schemes.
  - **Encourage collaboration** between exporters, states, and districts to promote exports.
  - **Simplify and streamline the process** of exporting goods and services:

- **Focus on emerging areas of export**, such as e-commerce, green technology, and defence and aerospace. These are the areas where India has a competitive advantage, and the policy aims to help businesses take advantage of these opportunities.

- **The Policy aims to boost India's exports through** a number of **measures:**
  - **Process Re-engineering and Automation** (technology enablement) for facilitating exporters.
  - **Expanding the scope of Town of Export Excellence (TEE)** by including Faridabad, Mirzapur, Moradabad and Varanasi in the existing list of 39 towns listed as Towns of Export Excellence (TEE).
  - **Promoting Exports from districts** by building partnerships with state government and taking forward the **District as Export Hubs initiative** to promote exports at the district level.
  - A **robust export control system** in India would provide **access of dual use High end goods and technologies** to Indian exporters while facilitating exports of controlled items/technologies under **SCOMET** (Special Chemicals, Organisms, Materials, Equipment, and Technologies) from India.
  - **Facilitating E-Commerce Exports** through establishment of e-commerce hubs and other related elements.
    - The consignment wise cap on E-commerce exports through courier has been raised from Rs 5 Lakh to Rs 10 lakh.
    - A comprehensive e-commerce policy addressing export/import ecosystem is planned to be brough soon.
  - **Export Promotion of Capital Goods (EPCG) Scheme** has been rationalized.
    - Prime Minister Mega Integrated Textile Region and Apparel Parks (**PM MITRA) scheme** has been added as an additional scheme eligible to claim benefits under CSP(Common Service Provider) Scheme of Export Promotion capital Goods Scheme(EPCG)
    - **Battery Electric Vehicles (BEV) of all type**s, Vertical Farming equipment, Wastewater Treatment and Recycling, Rainwater harvesting system and Rainwater Filters, and Green Hydrogen are added to Green Technology products – will now be **eligible for reduced Export Obligation requirement under EPCG Scheme.**
  - **Introduction of provisions for merchanting trade**.
    - **Note:** Merchanting trade involves **shipment of goods from one foreign country to another foreign country without touching Indian ports, involving an Indian intermediary**.
  - **Amnesty Scheme** to provide relief to exporters who have been unable to meet their obligations under EPCG and Advance Authorization schemes. This will reduce litigations and foster trust based relationship.

- **Challenges:**

- » **Global Economic Uncertainty:** The global economy is facing a number of challenges, including the COVID-19 pandemic, the Russia-Ukraine war, and rising inflation. These challenges could impact India's exports, as they could lead to **lower demand for Indian goods and service**.
- » **Competition** from other emerging economies: Countries like China, Vietnam etc are also competing to increase its export base and may become a hurdle in India's achievement of its export targets
- » **Domestic challenges** such as infrastructure bottleneck, regulatory hurdles, lack of skilled workforce and high cost of logistics may also become a hindrance to India's exports.

- **Way Forward:**
  - **Increased government support** to exporters in the form of access to finance and market.
  - **Improvement in infrastructure** such as roads, railways, airways etc for easier and faster export of goods and services.
  - **Streamlined regulations** related to customs and taxation.
  - **Increased investment in R&D** for development of innovative products and services fulfilling the global demands.
  - **Promoting Brand India** in global market. This will attract foreign buyers and increase demand for Indian goods and services.
- **Conclusion1:**
  - Overall, the Foreign Trade Policy 2023 is a comprehensive and ambitious document that has the potential to boost India's exports and promote economic growth. Though, it faces some challenges, but with strong political will, and collaboration with various stakeholders, these challenges could be overcome.
- **Conclusion2:**
  - The new FTP is a shift from an incentive based approach and creates an enabling ecosystem for exporters, which is a move in line with India's vision of becoming 'Atmanirbhar' (self reliant).

4. FOREIGN INVESTMENT (FDI AND FPI)

1) FOREIGN DIRECT INVESTMENT (FDI)

- Foreign Direct Investment (FDI) is the **investment through capital instruments** by a person who is a resident outside India:
  - A. In an unlisted Indian company
  - B. In 10% or more of the post issue paid-up equity capital on a fully diluted basis of a listed Indian company
    - » (If the investment comes below 10% subsequently the FDI shall be continued to be classified as FDI. It will not be reclassified as FPI), i.e., **once an FDI, always an FDI**.

- **Key Facts about India's FDI Policy (Remember for Preliminary Exams)**

» **Eligible Investors**
- **A non-resident entity can invest in India, subject to FDI policy**, except in those sectors/activities which are prohibited.
- However, a citizen/entity from Bangladesh can only invest under the Government Route.
- Further, a citizen/entity from Pakistan can invest, only under government route, in sectors/activities other than defence, space, atomic energy, and prohibited sectors for foreign investment.

» **Prohibited Sectors**
- FDI is prohibited in:
  i. Lottery business including Government/private lottery, online lotteries, etc.
  ii. Gambling and betting including Casinos.
  iii. Chit Funds
  iv. Nidhi Company
  v. Trading in Transferable Development Rights
  vi. Real Estate Businesses and Construction of Farmhouses
     - 'Real Estate Businesses' shall not include development of township, construction of residential/commercial premises, roads or bridges and Real Estate Investment Trust (REITs) registered and regulated by SEBI.
  vii. Manufacturing of Cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes.
  viii. Activities/sectors not open to private investment e.g. Atomic Energy, Railway Operations (other than permitted activities)

A) FDI SITUATION IN INDIA (CURRENTLY)

- **FY23**: $70.97 billion
- **Top Source Countries** (FY23)
  - Singapore ($17.2 billion); Mauritius ($6.13 billion); the US ($6 billion), the UAE ($3.35 billion), the Netherlands ($2.5 billion).
  - Other important source countries include Japan, UK, Cyprus, Cayman Islands, and Germany.
- **Top Five Sectors** to receive FDI
  - **Computer Software ($9.4 billion)**; (Dip from last year)
  - **Service Sector** ($8.7 billion) (Rise from last year)
  - **Trading, Telecommunication, pharma and Chemicals** have also recorded growth in FDI inflow.
- **Statewise FDI reception**:
  - **Maharashtra** received the highest inflows of $14.8 billion during the last fiscal year (though the inflow are down when compared to $15.44 billion) of last year.
  - **Karnataka, Delhi, TN, Haryana, Telangana** and WB also saw a dip in FDI inflow.
  - **Gujarat** saw an increase in FDI to **$4.71 billion** (against $2.7 billion in FY22).
  - **Rajasthan** also saw a positive growth.

- **Why decline in FY23** and **what are FDI threats for future:**
  » Escalation in **geopolitical** stress
  » Enhanced volatility in global financial systems
  » Sharp Price corrections in global stock market

- » High magnitude of El-Nino
- » Frail Global Demand

B) WHY HAS INDIA EMERGED AS AN ATTRACTIVE DESTINATION OF FDI

- **Liberalization of investment restrictions**
  - In India FDI upto 100% is allowed in non-critical sectors through the automatic route, not requiring clearance from the Ministry of Home Affairs (MHA).
  - Even in strategic sectors like Defence, government has allowed FDI of upto 74% through automatic route and 100% through government route.
  - Consultation activities with representation of different sectors
- **Make in India**, **Atmanirbhar Bharat, PLI** Schemes, **PM GatiShakti** etc.
- **Reforms in Indirect and Direct taxes:**
  - Corporate tax for most companies have been reduced to 25% and for new companies in manufacturing, it has been reduced to 15%
  - GST system has been streamlined, leading to simple tax regime.
- **Increased public capex expenditure** - It is also crowding in private and foreign investment.
- Strengthening of **India's footing in global supply chains**
- **Elimination of Regulatory barriers**
- **Improved Ease of Doing Business**
- **Improved International Relations**

C) NEED OF FDI IN INDIA

- **Lack of Domestic Resources:**
  - » Neither the government, nor the private sector in India has enough resources to fulfill India's infrastructure and industrial needs. For e.g. infrastructure sector alone needs more than 1 trillion dollars over the next few years. COVID-19 crisis has further deteriorated the situation.
- **Diffusion of new Technology:**
  - » FDI, along with it brings in new technology which is very important for the growth and advancement of India.
- **Virtuous Cycle of Investment:**
  - » High FDI in any country gives confidence to other investors and creates a virtuous circle of more investments. So, increasing FDI will also increase private investments which has gone stagnant over the years.
- **Other advantages associated with FDI**
  - » **Economic Growth:** More Investment leads to more growth which in turn leads to higher incomes, more employment etc.
  - » **Improved performance of governments at state level:** Increases competition among states to attract FDI -> promotes good/efficient business practices among the states
  - » **Provides opportunity to government to focus more on social sector**

D) MAIN PROBLEMS THAT ARE RESTRICTING FDI INFLOWS IN THE COUNTRY

- **Complex and rigid Labour Laws**
- **Significant Delay in Land Acquisition** due to slow environmental clearance and difficult Land Acquisition Act.
- **Bureaucratic Red Tapism and Corruption** still dissuades foreign investors from investing in the country

- **Regulatory framework also needs simplification** as it is still too complex for many investors.
- **Regulatory Certainty** is something the investors crave the most.
    - Frequent rule changes, including retrospective changes worry the investors.

E) PROBLEMS ASSOCIATED WITH INCREASED FDI DEPENDENCY

1. **Volatile Investments:** Unreliable in the long term
    - FDI tend to switch to countries where there is more profit, cheap labor and cheap land.
2. **Diffusion of technology is limited :**
    - It is in the interest of foreign firm to withhold profitable technology. Thus generally diffusion of new technology is very less.
    - Moreover, in a developing country like India, where the state of both physical and human capital is not yet on a par with advanced countries, the diffusion also becomes difficult.
3. **Job Creation Not very effective due to FDI ->** FDI is mostly coming in service sector or capital intensive sector.
    - Despite the central government's push to boost manufacturing sector through 'Make in India' and various PLI initiatives, FDI's continue to chase bets in the services sector.
        - For e.g. in FY23, the highest FDI came in sectors like IT, Services etc.
    - Further, the bulk of FDI in manufacturing is not greenfield.

4. **Regional inequities are perpetuated** -> Most FDI come in already industrialized regions.
    - For e.g. Maharashtra, Karnataka, Gujarat and Delhi - collectively accounted for 83% of the FDI between Oct 2019 and March 2022. .
    - This further leads to metro - non metro divide and inequitable distribution of opportunities throughout the country.

F) WAY FORWARD & CONCLUSION

- **Promote Ease of Doing Business in Manufacturing sector**:
    - » Fast track the implementation of labor reforms
    - » Last mile infrastructure issue has to improve.

- **Deal with problems faced by foreign players in setting up large capacities (large factories)**

- **Focus on other impending downside risks** like
    - » Carbon Border Adjustment Mechanism (CBAM), for which carbon content reporting is mandatory from 1st oct 2023.
    - » Polarization risks arising out of the prevailing geopolitical situation reflected in the possible adoption of trade-restrictive measures.

- **Conclusion:**
    - While India has achieved a healthy growth in FDI, to sustain it we need to ensure sound trade policy, inclusive development, implementation of labor codes etc.

2) FOREIGN PORTFOLIO INVESTMENT (FPI)

- **Example Question:**
  - » What is Foreign Portfolio investment? How does it contribute in economic development of a country? Is India becoming immune to volatility associated with FPIs? Give reasons [15 marks, 250 words]

- **Introduction**
  - » Foreign Portfolio Investment (FPI) is any investment made by a person resident outside India in capital instruments where such investment is
    - ▫ Less than 10 percent of the post issue paid-up equity capital on a fully diluted basis of a listed Indian company or

Gyan	**Fully diluted basis** means the total number of shares that would be outstanding if all possible sources of conversion are exercised. For e.g. if the company had issued 100 shares as on today. However, there are debentures that are yet to be converted into shares. If it happens say the total number of shares may go up to 1500. The 10% calculation is to be made against 1500 which is called total number of shares on fully diluted basis.

    - ▫ Less than 10 percent of the paid-up value of each series of capital instruments of a listed Indian company
  - » **Note:**
    - ▫ FPI reflect capital gain but doesn't lead to lasting interest in the company.
    - ▫ FPI includes investment in stocks, bonds (government or corporate), infrastructure securities etc.
  - » Since FPI is easily withdrawable/cashable, it is also called **hot money** and is considered less stable when compared to FDI.

- **Type of FPIs:** In India, FPIs include Foreign Institutional Investment (FII) and Qualified Foreign Investment (QFI).
  1. **Foreign Institutional Investment**
     - It involves foreign institutional investors going for FPI.
     - **Only institutional investors** like investment companies, investment funds etc are allowed to invest in Indian stock market directly. These investors have to get a license from SEBI.

  2. **Qualified Foreign Investment (QFI)**
     - The concept of QFI was introduced in 2000, which allowed individual foreign investor to invest in Indian stock market **without a sub-account** in FII.
     - However, they have to open a Demat account and Trade Account with the depository participant in India.
     - A QFI can be individual, group or an association.
     - QFI should satisfy following conditions.
       i. QFI should be resident in a foreign country that is compliant with the standards of Financial Action Task Force.
       ii. QFI must be a signatory to International Organization of Securities Commission's Multilateral Memorandum of Understanding (MMoU).

- **Note: According to Regulations by SEBI**
    1. **Investments in unlisted companies** are treated as **FDI.**
        - FPIs are not allowed to invest in unlisted shares and investment in unlisted entities will be treated as FDI.
    2. Any equity which is less than or equal to 10% of capital in a company is portfolio investment. While investment above 10% of capital in a company will be counted as Foreign Direct Investment.
    3. **Investment by a FPI** cannot exceed 10% of the paid up capital of the Indian company.
    4. **All FPI** taken together can't acquire more than 24 percent of the paid-up capital of an Indian Company.
    5. **Investment by NRIs** will not be considered FPI.

- **Advantages of FPI**
    1. **For investor**
        - **Portfolio diversification**
        - **Easy access to international credit**
            - If investor holds FPI they can access credit in the foreign country. Ability to get credit on favorable terms and quickly can determine the business expansion opportunities for the investor.
        - **More Liquid and thus less risky**

    2. **For Domestic Economy**
        - **More capital to country's capital market** will lead to more development of capital market thereby resulting in more capital flowing into the real economy thereby leading to overall development of the country.
        - **Diverse Investment, large scale investments**
            - FIIs are big and hence they have the capacity to make large scale investment.
        - **Strengthening of domestic currency**

- **Limitations of FPI**
    1. **For Investors**
        - **Lack of control** over business
    2. **For domestic country**
        - Easy liquidity of investments comes with **vulnerability for economy**.
            - E.g. East Asia crisis of late 1990s.
        - Sudden withdrawal also leads to beating up of the domestic currency.
        - **Chances of round tripping of funds**
            - Sometimes, round tripped capital is re-invested in the Indian Stock markets using the FPI route.

- **Situation in FY23**:
    - As per annual report of SEBI released in Aug 2023, **FPIs pulled out Rs 37,632 crore** from Indian equities during FY23. This is a decline in outflow of **73.1%** as compared to FY22.
        - **Why the recent outflow**:
            - **Rise in Inflation worldwide** led to tightening of monetary policies among all major economies.

        - **Global uncertainty** due to geopolitics of Europe have also led to withdrawals.
        - **COVID-19** resurgence in China has also added to negative sentiments

- **But**, the **stock markets haven't fallen much** and are trading near its highest ever.
    - This is because DII flows are compensating the FII outflows. They invested a **total of Rs 2.55 lakh crore** during the fiscal year.
        - DIIs now own a record 15% of the BSE-500 shares, just 3.3% points below the share of FPIs, which has now declined to nine-year lows.
        - This highlights India's economic resilience and attractiveness to local investors.

- **In conclusion**, India's economy continues to recover and expand. With supportive regulatory measures from SEBI and other market regulations, India's financial markets are poised for a promising future, attracting both domestic and international investments.

GS FOUNDATION FOR CSE 2024
ECONOMY-19
EMPLOYMENT – BASIC TERMS TO UNDERSTAND

1. TABLE OF CONTENTS

2. EMPLOYMENT AND UNEMPLOYMENT ESTIMATES

- **Who measures employment and unemployment situation in the country**:
  - » **National Sample Survey Organization (NSSO)**, under Ministry of Statistics and Program Implementation is responsible for conduct of large-scale surveys in diverse fields on All India basis. It conducts employment and unemployment surveys along with Consumption Expenditure survey.

- As per the NSSO, concepts and definition of employment and unemployment are as follows:
  - » **Employment Indicators**: The key employment indicators are Labour Force Participation Rate, Worker Population Ratio, Proportion Unemployment and Unemployment Rate. Definition of these indicators are as follows:
    1. **Labour Force Participation Rate (LFPR):**
       - **LFPR =** (No of unemployed persons + Number of employed persons)/ Total Population

       Or LFPR = Number of persons in Labor Force / Total Population

    2. **Worker Population Ratio (WPR)** is defined as:
       - **WPR =** Number of Employed persons / Total Population

    3. **Proportion Unemployed (PU)** = Number of Unemployed Persons / Total Population

    4. **Unemployment Rate (UR)** = Number of unemployed persons / Labor Force
       - **Or UR =** Number of unemployed person / (No of Employed Persons + No of unemployed persons)

  - » These indicators are determined on the basis of **activity status** of a person. The activity status is based on whether a person is engaged in any **economic activity** of not.

  - **What is economic activity**?
    - If an activity results in **production of goods and services that adds value to national production** (National Income), it can be considered an economic activity. If not, it is not considered an economic activity.

    - Economic activities are further divided into **Market activities** and **non-market activities**.

    - **Market Activities** are those activities which involve **remuneration** in the from of wage or profit to those who perform the economic activity. (E.g. production of goods and services for the market by both private players and government). The government services done without price and purely for the welfare of the people also constitute market activities.

    - **Non-Market Activities**: Activities which don't involve remuneration and are **done for own consumption** are called non-market activities.

- E.g. Production of primary commodities for own consumption; Construction house with own labor or construction of common facilities like road, wells for community etc.

  - **Note**: Illegal activities like smuggling are also considered as economic activity. But, as a convention, activities like prostitution and begging are not considered as economic activities.

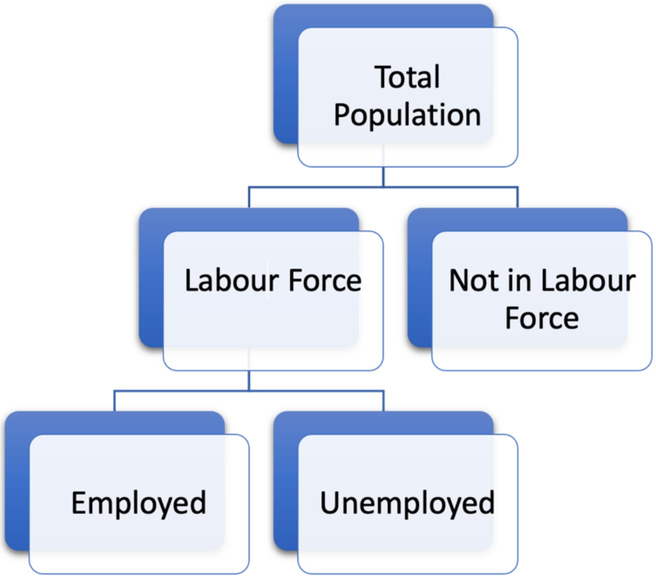
  - **Note**: Any person working **without compensation voluntarily** is considered unemployed. A laborer who is **forced to work without compensation** is considered employed.

– **Broad Activity Status**:
  - It is the activity situation in which a person is found during the reference period, which concerns the person's participation in economic and non-economic activities.
  - A person can be found in any of the following three statuses:
    i. **Working** or being engaged in any economic activity (work)
    ii. **Not working but seeking:** Not working or not being engaged in any economic activity and either m**aking tangible efforts to seek 'work'** or being available for work if the work is available.
    iii. **Neither working nor seeking work**, i.e. not engaged in any economic activity (work) and also not available for work.
  - i) & ii) together are called labor force.

  - Person in category i) ae called employed. They are termed as workforce.

  - Person in category ii) are called unemployed.

  - Person in category iii) are called not in the labour force.



– **Different Approaches for determining activity status**:
  – Activity status is determined with reference to three types of reference periods:

- They are:
    - One year
    - One week and
    - Each day of the reference week

- Based on these reference periods, three different measures of activity status are arrived at:
    - **The activity status**, determined on the basis of the reference period of **one year** is known as the **usual activity status/usual principal activity status**.
    - The activity status, determined on the basis of a reference period of **one week** is known as the **current weekly status** (CWS) of the person
    - The activity status, determined on the basis of each day of the reference week is known as the **current daily status (CDS) of the person**.

- These activity statuses help to classify the persons into categories of employed, unemployed, and not in labor force. It is **categorization**. It also helps to measure the extent of employment and unemployment of persons. It is a measure of **intensity**.
    - In the **Categorization** we measure number of persons employed or unemployed or not in labor force, say 30 million persons/year are employed.
    - In the **intensity measurement**, the **extent of employment and unemployment** is measured. It is measured in person days or person years, say 20-million-person days of employment.

– **Summary: Various Activity Status and Their Measures**

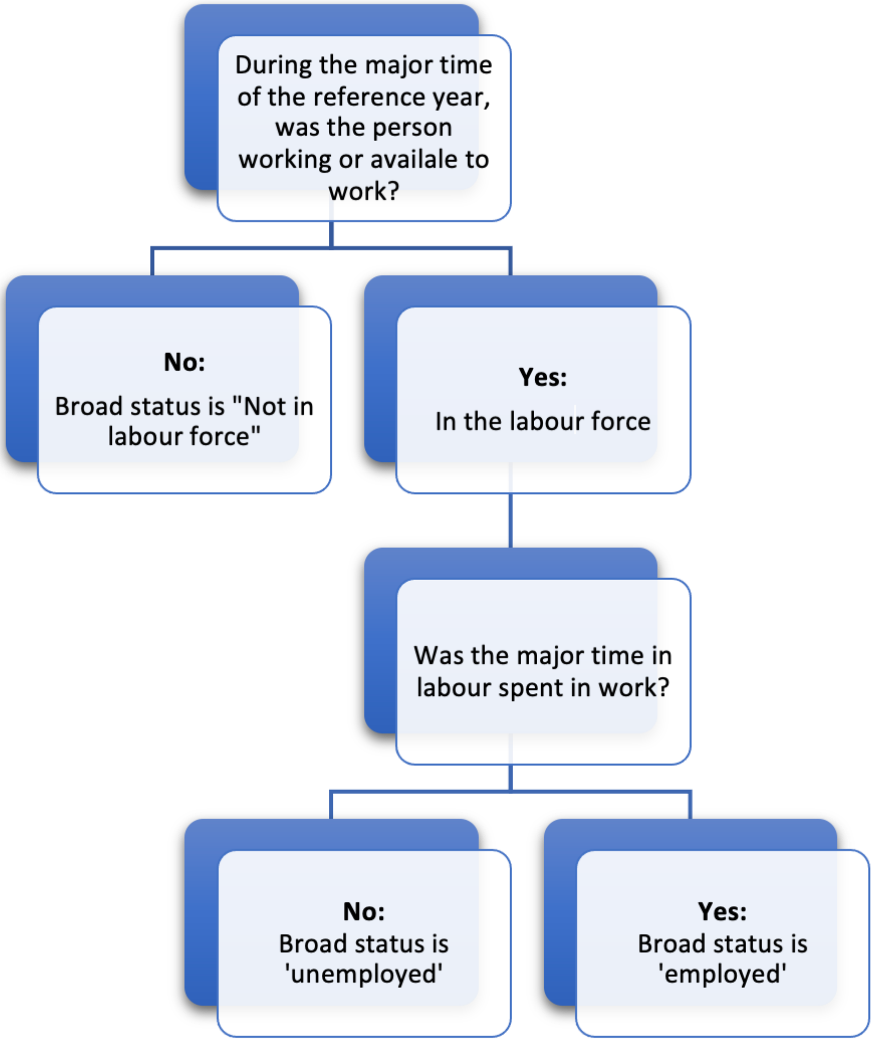
Reference Period	**Activity Status**	**Unit of Measurement**	**Measure**
One Year	Usual Activity Status	No. of persons	Categorization
One Week	Current Weekly Status (CWS)	No. of persons	Categorization
Each Day of the reference Week	Current Daily Status (CDS)	No. of person days	Intensity

– So, current daily status (CDS) is considered to be a comprehensive measure of unemployment, as it captures **chronic unemployment**, as well as **under employment** on a daily basis.

– At times a person may fall into more than one category of broad activity i.e., employed, unemployed and not in labor force.

- For e.g. If a person has worked only for half day -> he falls into the category of employed for half day and unemployed for remaining half day. To avoid overlap, **major time criteria and priority criteria are used**.

– **Usual Activity Status**:
  » It relates to activity status of a person **during the reference period of 365 days** preceding the date of survey. This activity status on which a person spent relatively long time **(major time criterion)** during the 365 days preceding the date of survey is considered ***usual activity status***, of the person.



– **Subsidiary Status**:
  » A person is considered employed in subsidiary status if he has '**worked a minimum of 30 days in the last 365 days**'.
    ▪ The 30 days of working need not be continuous.
      • A person may be engaged in both principal activity status as well as subsidiary status.
        • E.g. self-employed for a major part of the year and worked as an employee in a company for 30 days.

  » **E.g. of classification of Principal and Subsidiary Status**:

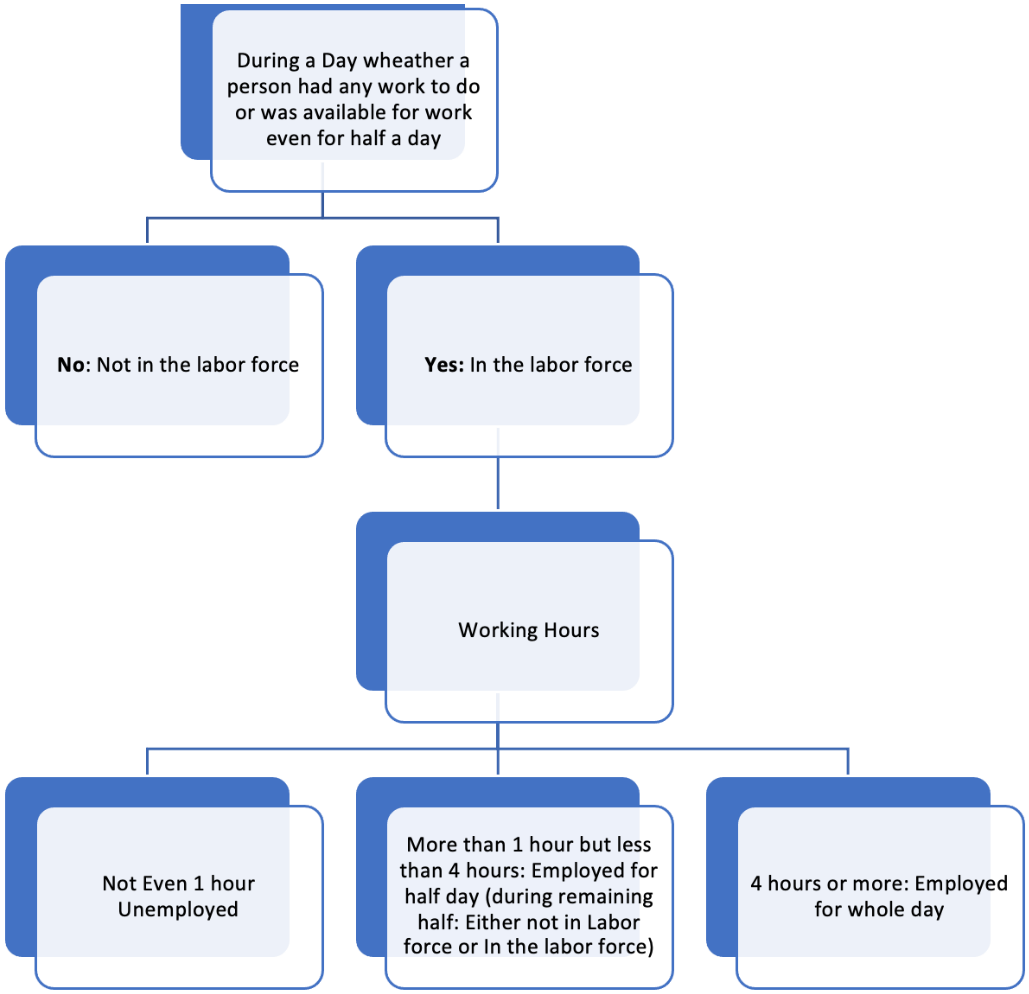
Number of months or equivalent days					
In labour force			Not in Labour Force	Usual principal activity status	Subsidiary Status
Person	**Employed**	**Unemployed**			
A	5	4	3	Employed	
B	4	5	3	Unemployed	Employed in subsidiary status (ss)
C	1	0	11	Not in labour force	Employed in subsidiary status (ss)

- **Current Weekly Status:**
  - » It refers to activity status of a person during the reference period of seven days preceding the date of survey. It is decided on the basis of a **certain priority cum major time criterion**.
    - According to the **priority criterion**, the status of 'working' gets priority over the status of 'not working but seeking or available for work', which in turn gets priority over the status of 'neither working nor available for work.'

Status: Working/Employed	A person is considered working (or employed) if she, while pursuing any economic activity, **had worked for at least one hour on at least one day during the seven days** preceding the date of survey.
Status: 'Seeking or available for work (i.e. Employed')	If during the reference week no economic activity was pursued by the person, but she made efforts to get work or had been available for work any time during the reference week though not actively seeking work in the belief that no work was available.
Status: "Not in Labour force"	Person who neither worked nor was available for work any time during the reference week, is considered to be engaged in non-economic activities (or not in labor force)

  - » Having decided the broad current weekly activity status of a person on the basis of 'priority' criterion, t**he detailed currently weekly activity status** is again decided on the basis of **'major time' criterion if a person is pursuing multiple economic activity**.

- **Current Daily Activity Status**:
  - » The current daily activity status relates to the activity status of a person during each day of the reference period of seven days preceding the date of survey.
  - » It sees each day into two halves or in full and record activity status for each half separately. It is more suitable for unorganized sector where the availability of work/employment varies each day.



3. STATUS OF EMPLOYMENT IN INDIA (ESI 2022-23)

- Employment situation in India can be studied in two different ways.
  i. **Supply Side of the Labour:**
     - Household surveys such as Periodic Labour Force Survey (PLFS) conducted by MoSPI.

  ii. **Demand Side of the Labour**
     - Enterprise or establishment surveys - such as Annual Survey of Industries (ASI) by MoSPI, Quarterly Employment Survey (QES) by Labour Bureau etc.

- These two methods together present a complete view of the labour market.

- **ESI 2022-23** highlights a broad-based improvement in the Employment Situation both in the supply side and demand side data.
  » **Unemployment rates** have fallen from 5.8% in 2018-19 to 4.2% in 2020-21, and there is a noticeable rise in rural FLFPR from **19.7% in 2018-19** to 27.7% in 2020-21.

  » Recent urban unemployment data shows progress beyond pre-pandemic levels as the unemployment rate declined from **8.3% in July-Sep 2019** to **7.9%** in July - Sep 2022.

» The **net EPFO payroll** is steadily moving upward, with the majority share coming from the youth.
» **As per QES** data, employment in major sectors has **increased by 10 lakhs over the year** 2021-22.
» **As per ASI 2019-20 data**, employment in the organized manufacturing sector has also been rising over the years.

– **Supply Side of Employment:**
  - **Annual Periodic Labour Force Survey:**
    - As per **usual status,** the labour force participation rate (LFPR), Worker Population Ratio (WPR), and Unemployment Rate (UR) in **PLFS 2020-21** have **improved for both males and females in both rural and urban areas**.

TableVI.4: Employment trends as per usual status
(principal status + subsidiary status) for persons of all ages

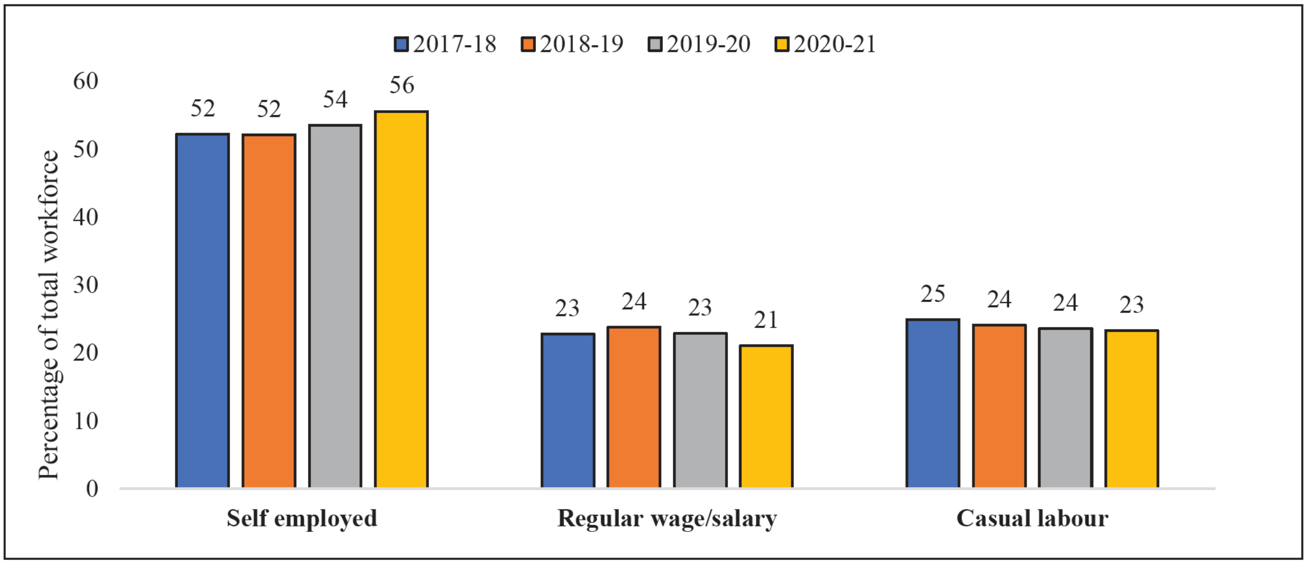
(per cent)

		Rural			Urban			Rural + Urban		
		2018-19	2019-20	2020-21	2018-19	2019-20	2020-21	2018-19	2019-20	2020-21
Male	LFPR	55.1	56.3	57.1	56.7	57.8	58.4	55.6	56.8	57.5
	WPR	52.1	53.8	54.9	52.7	54.1	54.9	52.3	53.9	54.9
	UR	5.6	4.5	3.9	7.1	6.4	6.1	6.0	5.1	4.5
Female	LFPR	19.7	24.7	27.7	16.1	18.5	18.6	18.6	22.8	25.1
	WPR	19.0	24.0	27.1	14.5	16.8	17	17.6	21.8	24.2
	UR	3.5	2.6	2.1	9.9	8.9	8.6	5.2	4.2	3.5
Person	LFPR	37.7	40.8	42.7	36.9	38.6	38.9	37.5	40.1	41.6
	WPR	35.8	39.2	41.3	34.1	35.9	36.3	35.3	38.2	39.8
	UR	5.0	4.0	3.3	7.7	7.0	6.7	5.8	4.8	4.2

Source: Annual PLFS 2017-18 to 2020-21, MoSPI

– **Share of Self Employed is increasing**.

Figure VI.3: Trends in broad employment status *(Persons, rural+urban)*



Source: Annual PLFS, MoSPI

– **Female Labour Force Participation Rate**
  - » **Measurement issue in Female Labor Force Participation Rate (FLFPR)**
    - ○ **Three key Issues:**
      i. **Use of Overly broad categories clubbing productive work** (collection of firewood, poultry farming etc.) with **domestic duties**

      ii. **No recovery questions in the PLFS questionnaire:** The survey design relies mainly on a single question for measuring the labor force status of individual, which eliminates the scope to rectify any error in self-reporting, considering the large rural population and literacy levels. This is contrary to ILO recommendations which provides for recovery question. ILO recommends using multiple probing or recovery questions.

      iii. **Measurement of "work" alongside "Employment"**: There is a need to broaden the horizon of measuring work, which constitutes the whole universe of productive activities alongside employment.
        - According to latest ILO standards, limiting productive work to labor force participation is narrow and only measures work as a market product. It doesn't include value of women's unpaid domestic work, which can be expenditure saving work such as collecting firewood, cooking, tutoring children etc.
        - **Thus,** a wholesome measurement of "work" may require improved quantification through redesigned surveys.

  - » It may be noted that 75% of rural female workers are employed in the agriculture sector. This implies a need to upskill and create employment for women in agriculture related sectors such as food processing. Here, **SHGs can pay a crucial role**.
  - » **Role of SHGs in Women's Empowerment** (Covered in GS1 - Women Organization)

- **Demand Side Employment**
  - » The **Quarterly Employment Survey (QES)**, conducted by Labour Bureau, covers establishments with ten or more workers in **nine major sectors** viz. manufacturing, construction, trade, transport, education, health, accommodation, & restaurants, IT/BPPs, and financial services.
    - ○ Note: These nine sectors account for around 83% of the total employment in establishments with ten or more workers.
  - » **So**, far results of four rounds of QES have been released covering four quarters of FY22.

Figure VI.6: Estimated Number of Workers according to QES *(in FY22 , in lakh)*

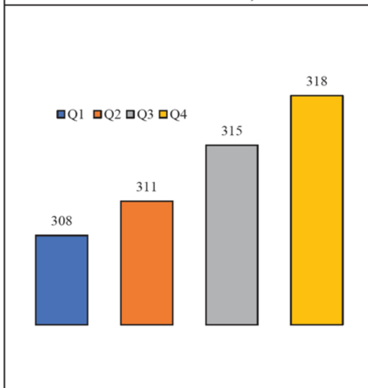
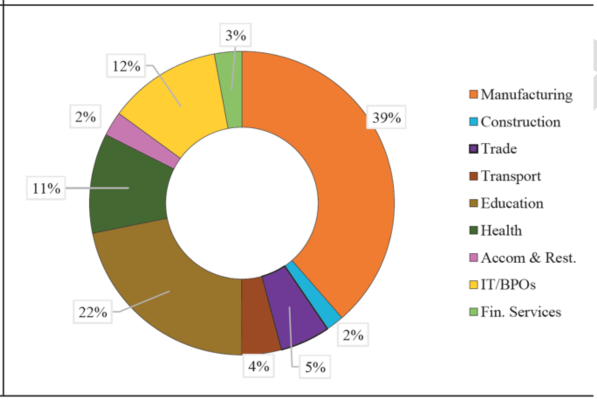


Figure VI.7: Sector-wise share of total employment according to QES *(in Q4 FY22; in percentage)*



Source: QES Reports, Labour Bureau

- **Annual Survey of Industries (ASI) 2019-20**
  - » The ASI conducted by MoSPI, is an important source of industrial statistics of the registered organized manufacturing sector of the economy.
  - » It covers all factories registered under Sections 2m(i) and 2m(ii) of the Factories Act, 1948, i.e., those factories employing ten or more workers using power; and those employing twenty or more workers without using power.
  - » **Key Findings:**
    - ▪ As per ASI FY20, employment in the organized manufacturing sector has maintained a steady upward trend over time, with the employment per factory increasing gradually.
    - ▪ **In terms of share of employment** (total persons engaged), the food products industry (11.1%) remained the largest employer, followed by wearing apparel (7.6%), basic metal (7.3%) etc.

- **Formal Employment**
  - » The organized sector job market conditions measured by payroll for Employees' Provident Fund Organization (EPFO) and ESIC reveal the benefits of the government initiatives towards improvement in the labor market.

- **Demand for Work Under MGNREGS**
  - » The number of persons demanding work under MGNREGs was seen to be trending around pre-pandemic levels from July to Nov 2022. This could be attributed to the normalization of economy due to strong agricultural growth and a swift recovery from COVID induced slowdown, culminating in better employment opportunities.

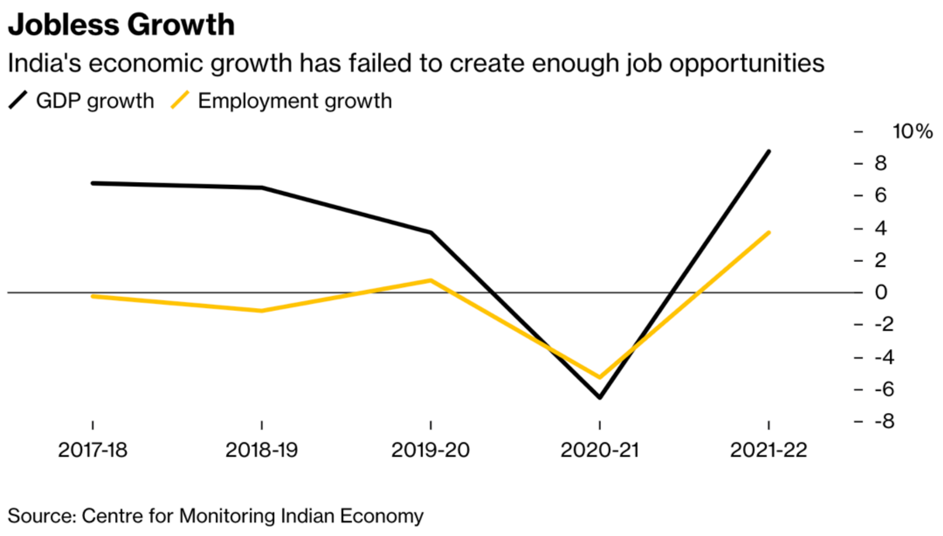
GS FOUNDATION FOR CSE 2024
ECONOMY-20
EMPLOYMENT-2 VARIOUS ISSUES

1. TABLE OF CONTENTS

2. JOBLESS GROWTH

- **Example Questions**
  - » The nature of economic growth in India in recent times is often described as a jobless growth. Do you agree with this view? Give arguments in favor of your answer. [12.5 marks, 200 words][CSM 2015]
  - » Discuss the key causes and consequences of 'Jobless growth' in India [10 marks, 150 words]

- **Introduction**
  - » **Jobless growth** refers to a phenomenon when **high economic growth rate coincides with low growth in employment opportunities** i.e. the high economic growth is not creating sufficient employment opportunities.
  - » In the 1970s and 80s, when India's GDP growth was 3-4%, employment growth was around 2%. But since the 1990s, our GDP growth rate has accelerated to 7%, but employment growth has slowed to 1% or less.
  - » **Economic Survey 2016-17** reports that **annual employment growth in India was only 0.5% during the year 2004-12, while labour force grew by 2.9%**.
  - » **According to (Centre for Monitoring Indian Economy) (CMIE)** India's unemployment rate is hovering around 7-8%. It was around 5%, five years ago.
    - **Moreover, the workforce shrank** as millions of people dejected over weak job prospects pulled out, a situation that was exacerbated by COVID-19 lockdown.
    - The labor force participation rate (meaning people who are working or looking for work) - has dropped to just 40% of the 900 million Indians of legal age, from 46% six years ago.



  - » **Work is also getting more precarious** with many jobs getting created in Gig economy without any job security.
  - » **The proportion of Indians employed in agriculture sector** had been falling for decades, but this process flattened some years ago and was reversed by covid crisis.
    - A big section of these are actually under-employed.

- **Unfortunately, the reality of jobless growth is not reflected in official statistics on unemployment**.
  - The latest number is 4.2% on usual status basis in 2020-21.

- **Negative Impact of Jobless Growth**
  - **High Unemployment** -> Poverty; Poor Education; Poor health -> overall losss for the country.
  - **Women are worst affected**: Between 2010 and 2020, the number of working women in India dropped from **26% to 19%** : World Bank
  - **Waste of demographic dividend** and chance of escaping the middle income trap.
  - **Big reforms become difficult**: For e.g. the recent attempt to reform agri marketing; protests against Agnipath schemes.
  - All this **will hamper economic growth in future**.

- **Reasons for Jobless Growth**
  - **Growth driven by Service Sector and capital intensive manufacturing sector:**
    - The main contributor to India's stellar growth performance over the last 2 decades have been financial, retail and business services including IT and IT Enabled Services. These sectors are **less labor intensive and are highly productive.**
    - Further these sectors have very small employment base and thus growth in the sector leads to very less addition of new jobs.
    - Moreover, a very small percentage of India's population can meet the skill and education requirements of the sector.
  - **FDI is mostly coming to brown field sector** not leading to many new job creations.
  - **Agriculture sector** has been struggling and taking people away from it
    - Since it employs very high % of India's population, the stress in the sector creates vulnerable employment situation.
  - **MSME sectors are facing a number of** challenges
    - MSME sectors have four times the labor intensity and **employ 40% of the workforce** of the country and represent about 45% of India's manufacturing output and 40% of India's total exports and thus have a lot of potential to create jobs.
    - But they are limited by a number of challenges such as poor access to credit, erosion of state protection over the years, increasing competition from bigger corporates.
  - **Legacy issues of:**
    - Poor Infrastructure
    - **Rigid Labor laws** have disincentivized employers from creating new jobs and moved them to capital intensive system of production.
    - **Poor Skill level** of the workforce reduces their employability
      - Schools see shortage of teachers; Healthcare sector has shortage of nurses and technicians.
  - **Rising Automation** is affecting the job market negatively.
    - It includes increased agri-mechanization which is taking jobs away from this labor intensive sector.

- **Key initiatives by Government:**
  - **Boosting Manufacturing Sector**: Production Linked Incentive Schemes (PLIS) for various sectors including electronics manufacturing, food processing etc.

- **Atmanirbhar Bharat and Make in India** initiatives are focused on improving manufacturing in the country
- **Skill Development** related initiatives
- **Entrepreneurship related initiatives:**
  - Pradhan Mantri **MUDRA** Yojna
- **Skilling:**
  - **Pradhan Mantri Kaushal Vikas Yojna**: It is a flagship program of Ministry of Skill Development and Entrepreneurship (MSDE).
- **Ease of Doing Business and relaxation of FDI norms**

– **What are the steps that are required to ensure growth with employment?**
  - **Understanding the reasons for jobless growth**
    - We have very limited understanding of the exact reasons for jobs not getting created and a huge amount of detailed on-the-ground research is required to study the issue properly.
  - **National Employment Policy**
    - Once the ground research gives us the proper understanding of the jobless growth, the government should formulate a national employment policy which comprehensively deals with the problems which are negatively impacting employment generation in India.
  - **Producing Periodic and Reliable Data on Employment**
    - Employment policy can further evolve with periodic and reliable data on employment. India needs to develop a mechanism for the same. The last time India carried out a focused and comprehensive estimation of the employment situation nationwide was in 2012 through the 68th round of NSSO. We need to come up with these numbers more regularly to better guide our policy framework.
  - **Improving business sentiments (Ease of Doing Business)**
    - Due to difficult business doing environment in India, companies tend to shift abroad. This will need to change.
    - The focus should be on kick-starting investment cycle, incentivize job creation by giving infrastructure a push, finding a way to lower interest rates and thus improving ease of doing business.
  - **Promote Manufacturing Sector**: Global factors are moving in favor of India, where the global economy is looking for an alternative to China.
    - **Promote Labor intensive sectors** like apparels, electronics etc to generate more employment.
    - **Promote MSME sector**
      - Arresting the lacklustre global demand and weak exports, and diversifying the exports basket are the dire needs of the MSME sector.
  - **Implement all the provisions of new labor codes**.
  - **More Focus on Skill Development** to ensure industry ready workforce.
    - Peasants who want to move from primary to secondary sector need a huge skill boost
    - Major gaps in skills are in automobile sector, construction sector, textile sector, retail etc.
    - Industries can also contribute here. Apart from beefing up there inhouse training mechanisms, the industry focuses on tie ups with educational/training institutes, and refurbishing curriculum, content, teaching/training methodologies etc.

- **Food Processing industries** can play an important role in providing employment in rural India where youth is moving away from agriculture.
- **Entrepreneurial sector needs to be promoted**
    - For e.g. by further expanding the Mudra Scheme.
    - This will increase opportunities both in rural India (e.g. food processing) and urban India (Zomato, Flipkart etc)

3. GIG ECONOMY

- **Example Questions**
    - Discuss the key promises and perils of increasing gig economy and gig workforce in India [10 marks, 150 words]

- **About Gig Economy:**
    - **A gig economy** is a free market system in which temporary positions are common and organizations hire independent workers for short term commitments. The term "gig" is a slang word for job that lasts a specified period of time.

- **Gig workers** can be classified into platform and non-platform workers.
    - Platform workers are those whose work is based on online software apps or digital platforms, while non-platform gig workers are generally casual wage workers, working part time or full time.

- **Factors behind rise in Gig Economy:**
    - **A rapidly expanding Startup ecosystem:** Startups, including some celebrated unicorns like Ola, Uber, Zomato, and Swiggy, have emerged as a major driver of the gig economy in India. They hire contractual freelancers in both skilled and unskilled jobs to reduce cost.
    - **The unconventional work approach of millennials, Gen Y & Gen Z:**
    - **COVID-19 Pandemic** led to many people losing their fixed jobs
    - **Fast clipped emergence of free lance platforms**
    - **Various other advantages** (see details below)

- **Advantages of Gig Economy/ Bright Side of Gig Economy**
    - **For Employees:**
        - **Employment opportunities**: As per NITI aayog, more than 75 lakh workers are engaged in gig economy in 2020-21, and this is expected to go to 23.5 million by 2029-30.
        - **Independence and flexibility** offered by the gig economy to choose projects and work hours has attracted millions of people to join the gig workforce.
        - **Additional income:** To impoverished population (particularly the jobless, women, and students)

    - **For Enterprise:**
        - **An efficient and speedy go-to-market solution** that allows them to **offload core business functions on demand** while **removing hurdles** like fixed costs, long recruitment cycles, and other compliance.
        - It **improves productivity** by reducing idle and unproductive time.

- It also offers **agility to enterprises**, making it easy to scale up or down to meet business requirements.

» **For Consumers**
- Cost effective, high quality services (for e.g. Urban Company, Ola, Zomato etc.)

» **Benefit for overall economy:**
- Increased labor force participation and contributes to reduction in unemployment.
- Skilled work force such as make-up artists can find business without setting up a physical shop.

– **Key Highlights of NITI Aayog's Report: 'India's Booming Gig and Platform Economy'**
- **Size of workforce**: In 2020-21, the gig workers constituted 2.6% **(7.5 million)** of the non-agricultural workforce and by 2030 they would constitute **6.7% (23.5 million)** of non-agricultural workforce.
- **Skill Levels**: As per the report, around 31% workers are in low skilled jobs; 47% of the gig work is in medium skilled jobs, and 22% work is in high skilled jobs.
- **Female Labour Force Participation** in India has **remained low** (between 16% - 23%) in last few years. Similarly, **Person with disabilities**, who constitute 2.11 to 10% of India's population, have a labour force participation rate of 36%.
  - **Why?** -> **Structural barriers** such as less access to education and skilling opportunities.

– **Other key issues faced by workers in Gig Economy:** While platform companies have created avenues of employment, it has often been marred by:

» **Contractual (non-permanent) work**:
- **No Social Security:** They don't have benefits like paid sick and casual leaves, travel and housing allowances, and provident fund saving among others.

» **Poor Service Conditions:**
- **Low wages**, Opaque payment calculations, increasing commission deductions etc.
- Lack of possibility of upward mobility within an organization
- Gig economy can **bring loneliness**. It would be especially true for designers, copywriters etc. working on their laptops from home.

» Unequal gender participation.

» The labor codes are vague about social protection for unorganized workers.
- The new **Code on Social Security** of 2020 replaced all existing laws on the subject. Gig workers find a place as unorganized sector workers in this code but the actual security cover remains **vague**.

– **Other Concerns:**

» **Traditional players** like (non-app based taxi service providers) are not able to survive in this cut-throat competition environment.

– **Key Recommendations of NITI Aayog**

- » **'Platform India Initiative'** - on the lines of Startup India Initiative: This should be built on the pillars of accelerating platformisation by simplification and handholding, funding support and incentives, skill development, and social financial inclusion.
- » **Skill Development** for platform jobs: Platform led models need to be created for skilling purposes.
- » **Social Inclusion**: Niti Aayog has recommended fiscal incentives, like tax rebates or start-up grants, for companies with about 1/3rd of their workforce as women or people with disabilities.
  - **Business should have Higher share of female managers and supervisors** in the organization to ensure that communication to workers doesn't perpetuate gender stereotypes.
- » **Extending Social Security for gig and platform workers:** Extend social security measures such as income support, paid sick leave, insurance and pension plans to people working for platform economies like Swiggy, Zomato, Ola and Uber.
  - Such plans and policies may be uniquely designed by a firm, in partnership with insurance companies, or could be designed and offered in collaboration with the government, as envisaged under the Code on Social Security, 2020.
- » **Self employed individuals** - selling regional and rural cuisine, street food etc., may also be **linked to platforms** so that they can sell their produce to wider markets in towns and cities.
- » **RAISE Approach for operationalizing the Code on Social Security (CoSS), 2020**:
  - **Recognize** the varied nature of work to design equitable schemes.
  - **Allow** augmentation of social security through innovative financing mechanism
  - **Incorporate**, while designing schemes, the specific platforms, factoring the impact on job creation, platform businesses and workers
  - **Support** workers to subscribe to government schemes and welfare programs through widespread awareness campaigns
  - **Ensure** benefits are readily accessible to workers.

– **Conclusion:**
- » Long term solution lies in creation of more better paying, secure jobs. But, at the same time there is need to ensure minimum wages, and social protection for gig and other organized workers who constitute the bulk of Indian workforce.

4. LABOR LAW REFORMS

– **Example Questions**
- » "Success of 'Make in India' program depends on the success of 'Skill India' program and radical labor reforms." Discuss with logical arguments [12.5 marks, 200 words, Mains 2015]
- » Discuss the key provisions of the four labor codes enacted recently. Have these codes mantained a balance between promoting ease of doing business and protecting rights of workers [15 marks, 250 words]
- » Labor law reforms will contribute towards formalization, investment and job creation in India's economy. But to achieve full potential of Indian economy it should be complemented with skill development, development of infrastructure, and stable law and order. Discuss [15 marks, 250 words]

– **Introduction**

- Labor laws, rules, regulations and the institutional framework dealing with them are among the biggest hindrances which is preventing India from achieving its full economic growth potential.

- **Key issues with labor laws (before the coming up of 4 codes)/ Need of the four codes:**
  - **RIGID Laws**
    - E.g. **Industrial Disputes Act, 1947**
      - The act mandated companies employing more than 100 employees to seek prior permission of the government for firing workers.
      - The act also restricted companies from exiting or downsizing quickly - a company needs to seek permission form government 3 months in advance.
    - Similarly, **the Contract labor Act of 1970** does not allow contract workers for work of perennial nature.

  - **Multiplicity of laws** -> **Expensive Compliance**
    - Before the four codes, there were 44 Central labor laws and more than 100 state specific laws.
  - **Many labor laws were old, outdated and irrelevant in present context**
  - **Ambiguous definitions between different laws**
    - For e.g. the older laws defined 'worker' and 'wages' in 17 different ways. These ambiguities and confusions discouraged a small entrepreneur.
  - The complex system had promoted **Inspector Raj** which had led to harassment of businesses.

- **Negative Impact of the above difficulties:**
  - **Hindered Ease of Doing Business -> Hindered Investment in labor intensive sector-> Restricted growth and development**
    - These problems also hamper initiative like Make in India.
  - **MSMEs** prefer to remain tiny (less than 20 workers) in order to stay away from the burden of compliance demands.
  - **Hampered Formalization of jobs** as with more full-time employees comes more compliance burden.
    - This is a major **factor in Urban Poverty** -> Most of the workers involved in contractual/informal works and thus are kept away from social benefits and various other protections.
  - **Reduced in-hand salaries of workers.**
    - About 40% of the payments are deducted under various social sector initiatives like EPFO, Insurance etc.
  - Led to **increasing litigations and complicated case laws.**
  - **Occupational Safety** remains a huge issue in India with several industrial accidents taking place every year.

- **Steps Taken**
  - **Codification of 29 laws into 4 codes:**
    - Against the background of above challenges, and after the recommendations of Second National Labour Commission (2002), and several other reports, Union Government

unified 29 statutes and **passed four codes** on **wages, safety (and health), industrial relations and social security**.

- The Code on Wages was passed in Parliament in Aug 2019, and other three in Sep 2020.

– **Summary of the 4 codes:**

1) CODE ON WAGES, 2019

- It **universalizes minimum wage** for all employees in both organized and unorganized sectors.
- It also **amalgamates the definition of wages** across all the legislations.
- There is a provision for **review of minimum wage every five years** and guarantee of timely payment of wages to all workers.

2) CODE ON SOCIAL SECURITY, 2020

- It aims to **extend social security to all employees and workers** both in the organized and unorganized sector including Gig Workers and platform workers.
  - **Increased coverage of ESIC:**
    - The coverage of ESIC have been extended **pan-India** as against the notified districts/areas.
    - ESIC coverage on **voluntary basis for establishments having less than 10 employee**s has been introduced. Further, ESIC can also be made applicable to establishment with less than 10 employees if the workers are involved in hazardous or life threatening activities.
  - Envisages a **Social Security Fund** (SSF) for formulating schemes for welfare of the unorganized workers, gig workers and platform workers.
  - At the time of retrenchment, worker would be provided 15 days' wages for re-skilling.
  - Benefits of pension scheme (EPFO) to all workers of organized, unorganized and self-employed sectors.
  - Requirement of minimum service has been removed for payment of **gratuity** in case of fixed term employees.

3) CODE ON INDUSTRIAL RELATIONS, 2020

- It streamlines laws related to trade unions, employment conditions for industries, and a comprehensive handling of industrial disputes.
- It provides for **recognition of trade union(s) by employers**, a labour right that eluded workers for seven decades.
- The code also **introduces new conditions for carrying out a legal strike**.
  - For e.g. the code says that no person employed in an industrial establishment shall go on strike without a 60-day notice and during the pendency of proceedings before a Tribunal or a National Industrial Tribunal.
- **A Labour Tribunal** with vibrant mechanism for speedy disposal of cases would be institutionalized - Faster adjudication would lead to faster justice and improved Ease of Doing Business

- **Greater flexibility to employers:**
  - **More flexibility of hiring and firing: Increase in threshold** relating to layoff and entrenchment in industrial establishments having 300 workers from 100 workers or more at present.

4) OCCUPATIONAL SAFETY, HEALTH AND WORKING CONDITIONS CODE

- It aims to ensure that employees across all sectors are treated equally and have safe working conditions.
- **Anomalies of the Inter-State Migrant Workers Act, 1979** have been comprehensively addressed in the code.
  - Earlier, only workers appointed by contractor were recognized as Inter-State Migrant Workers. However, under the new provisions of the Code, workers can be Aatmanirbhar as they can now register themselves as Inter-State Migrant Workers on the National Portal. By this provision, the workers would get a legal identity which would enable them to get benefits of all social security schemes.
  - **National database** would be created for the Inter-State Migrant workers.
- **Providing appointment letters** to the workers has been made mandatory.
- **Mandatory, free annual health checkup of the workers** has been provided by the employers.
- **Women Empowerment:**
  - Right to women workers to work in all types of establishments.
  - Women have been given right to work at night with their consent. Employer would also ensure adequate arrangements to provide safety and facilities to women workers at night.
- It allows **employers** to stay compliant with **fewer registration formalities and promotes ease of doing businesses in India**. It will be applicable to every organization that employs more than 10 employees.

- **Other key advantages:**
  - The new laws are in tune with the changing labour market trends and, at the same time, accommodate the minimum wage requirement and welfare needs of the unorganised sector workers, including the self-employed and migrant workers, within the legislation framework.
  - The Labour Codes have been aligned with the present economic scenario and technological advancements along with reduction in multiplicity of definitions and authorities.
  - The Codes also ease compliance mechanism aiming to promote ease of doing business/setting up of enterprises and catalyse creation of employment opportunities while ensuring safety, health and social security of every worker.
  - **Use of technology**, such as, web-based Inspection has been introduced in order to ensure transparency and accountability in enforcement.
  - **Decriminalisation** of minor offences has also been provided in the Labour Codes

5) LIMITATIONS/CRITICISM OF THE NEW CODES AND WAY FORWARD

- **Watering down of labor rights for workers in small establishments** having less than 300 workers.
  - There are no specific provisions for social security of employees in small startups, MSME or workers in small establishments having less than 300 workers.

- Self-employed workers, home based workers, and other vulnerable groups in rural areas are not covered under social security benefits.
- **Charity and NGOs are not covered** and people working in them have no social protection.
- **Invisible Labor -** like household work, childcare and looking after elderly hasn't been covered.
- **Implementation hasn't started**.

- **Why implementation has been delayed so much:**
  - Rules made under the Codes have been entrusted to Central Government, State Government and at appropriate level.
    - There is a **requirement for pre-publication of Rules in their official Gazettes** for public consultation.
    - As of **13 December 2022**, 31 States also have prepublished the draft rules under the Code on Wages, 28 States under Industrial Relations Code, 28 States under Code on Social Security, and 26 States under Occupational Safety Health and Working Conditions Code.
  - **The SP Mukherjee Committee**, which is working on the issue of minimum wages, is yet to complete its task. Setting a national wage is important in the implementation of the Code on Wages.
  - The Central Trade Unions (CTUs) have held three general strikes against the codes so far alleging that the codes will take away whatever little social and economic security is left in the employment sector.

- **Way Forward:**
  - **Increased Social Security Coverage**: State governments should enact legislation for the social security coverage of unorganized sector workers and small business employees.
  - **Employment Information Service** - an online portal - should be created and popularized among masses to get to know various employment opportunities available throughout the country.
  - **Bring in Futuristic Provisions in the Codes**: The 4 codes are solving many problems which have emerged in the past. But, we also need to give it a futuristic approach to deal with scenarios when AI, ML, bioengineering etc. may hamper rights of workers.
  - **Skill Development and Vocation Training system needs to strengthen**: This would make Indian workforce market ready. During these initiatives, workers should also be made aware of various rights of workers.
  - **Other reforms:** Flexible labour laws will have several positive impacts, but it isn't a magic wand to solve all labour and employment related issues. Broader reforms in the field of infrastructure, law and order and skills and education will be crucial in reforming the entire system.

GS FOUNDATION FOR CSE 2024
ECONOMY-21 EMPLOYMENT-3
(TYPES OF UNEMPLOYMENT, MSME SECTOR)

1. TABLE OF CONTENTS

2. TYPES OF UNEMPLOYMENT

- Unemployment refers to situation where individuals who are willing and able to work are unable to find suitable employment. There are **several types of unemployment** that can occur in an economy:

  i. **Structural Unemployment**: It occurs due to mismatch between the skills and qualifications of workers and the available job opportunities. This may happen when there is **fundamental change in the structure of the industry or economy** which renders certain kinds of skill set obsolete or low in demand.
     - Some structural changes which may cause this unemployment include - rapidly growing population, fall in the rate of capital formation, technological change etc.
     - This kind of unemployment is of long term in nature. It takes a longer time to correct unless some precautionary measures were taken.
     - E.g. High population of young working age population and not availability of enough entry level jobs has led to a type of structural unemployment.

  ii. **Frictional Unemployment:** When individuals are moving between jobs (including the period when she is searching for another job after leaving the existing one), they may remain unemployed for some times. This is called frictional unemployment.
     - It is typically of short-term nature and is part of job search process.
     - It may also occur due to technological advancements or shift in demand for certain skills.

  iii. **Cyclical Unemployment**: Economy goes through a face of boom (high rate of growth) and depression (low or negative rate of growth). During the phase of depression, aggregate demand is very less which leads to decline in production and thus decline in available job. This unemployment which is caused by cyclical nature of economic growth is **called Cyclical Unemployment**.
     - For e.g. the loss of jobs after the 2008 financial crisis will come in this category.

  iv. **Seasonal Unemployment**: When work is available in some part of the year and not available in the other part, it is seasonal unemployment. For e.g. agriculture is a seasonal occupation. During off-season, often the farm workers are out of job.

  v. **Technological Unemployment**: It occurs when advancement in technology leads to loss of jobs or the replacement of human labor with machines.

  vi. **Disguised Unemployment:** This occurs when the number of workers engaged in a job is much more than actually required to accomplish it. If some of them are withdrawn from the job, the total production will not fall.
     - This type of unemployment is rampant in Indian Agriculture because of joint family system (entire family will work) and lack of job opportunities outside agriculture sector.

  vii. **Underemployment**: Underutilization of available manpower both in terms of time and skill is called underemployment. So, a situation where individuals are working in jobs below their skill level, qualifications, or desired hours of work is called underemployment.
     - It leads to lower income, reduced job satisfaction and wastage of human resource.

viii. **Educated Unemployment / Open Unemployment**: When a person who is educated/trained/skilled and is seeking employment <u>fails to obtain a job suited to her qualification</u>, it is called <u>educated/open unemployment</u>.

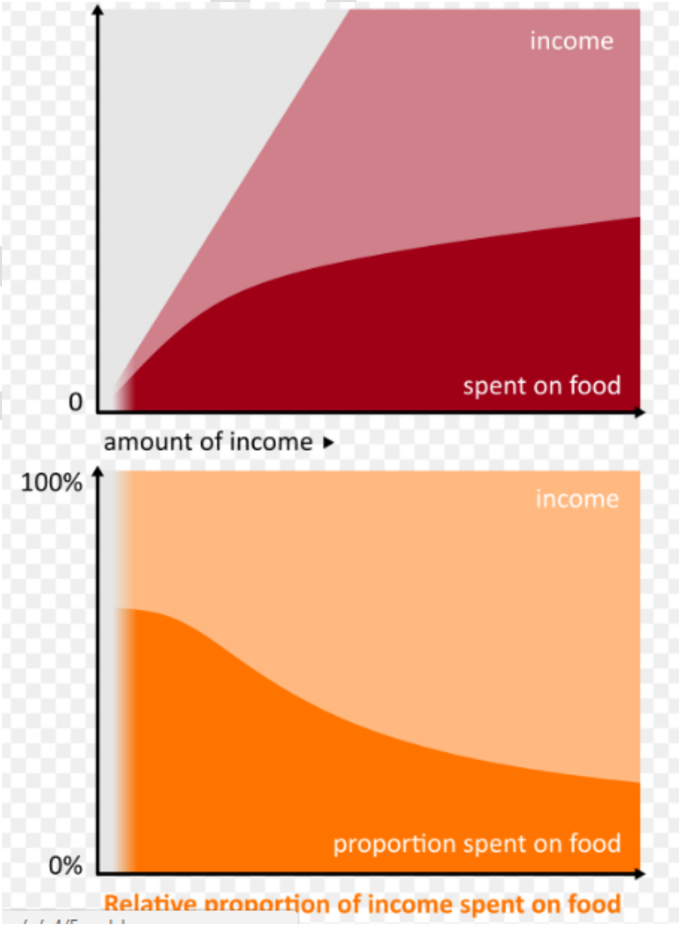
ix. **Voluntary Unemployment**:

- People who are <u>neither seeking employment nor are available for employment</u> even though <u>adequate work/employment is available</u> are called <u>voluntary unemployed</u>. These people are <u>**not in labour force**</u>.

1) RELATED TERMS

A) ENGEL'S LAW

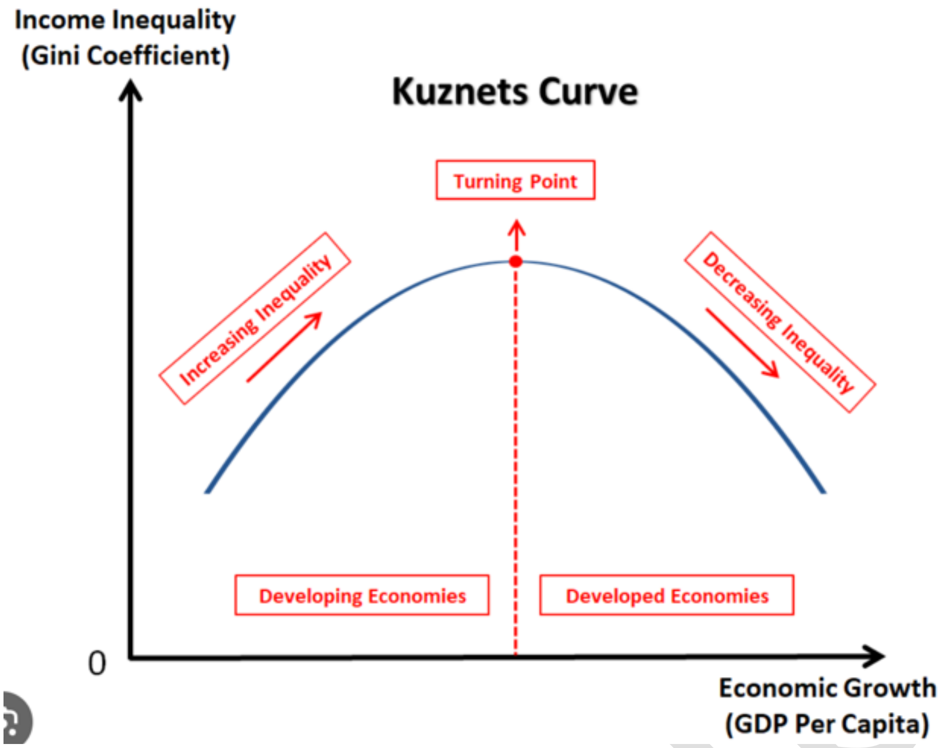
– It is an economic theory introduced in 1857 by Ernst Engel, a German statistician, which states that <u>the percentage of income spent on food decreases as income rises</u>. In other words, <u>the income elasticity of demand of food</u> is **between 0 and 1**.



B) KUZNET'S CURVE

The Kuznets curve expresses a hypothesis advanced by economist Simon Kuznets in the 1950s and 1960s. As per this hypothesis, <u>as an economy develops, **market forces first increase and then decrease economic inequality**</u>. It appeared to be consistent with experience at the time it was proposed.

However, in the USA and other developed countries, the inequality has risen, which invalidates the hypothesis.



3. MSME SECTOR

- **Example Questions**
  - **i.** Why is MSME sector the worst hit by COVID-19 lockdown? Discuss the key initiatives launched under the Atmanirbhar Bharat Abhiyan to revive MSME sector. [10 marks, 150 words]
  - **ii.** "Job creation in India suffers from policies that foster dwarfs, i.e. small firms that never grow, instead of infant firms that have the potential to grow and become giants rapidly" Discuss [250 words, 15 marks]
  - **iii.** "Micro Small and Medium Enterprise (MSME) sector acts as a key catalyst in India's economic growth". Elaborate in light of the recent efforts taken to promote MSME sector. [250 words, 15 marks]
  - iv. What are the key challenges faced by MSME sector in India? How will the recent announcement of redefining micro small and medium enterprises on the basis of annual turnover solve some of these problems? [200 words, 12.5 marks]

- **Introduction**
  - » MSMEs are considered **pillar of economic growth/ engine of growth** in both developed and developing countries of the world. They have played a prominent role in the economic development of India too.
  - » There are more than 6.34 crore MSMEs in India and around 50% of them are situated in rural areas.
  - » The revision of the **definitions of MSMEs** brought in w.e.f. 1st July 2020 as part of the AtmaNirbhar Bharat Package introduced a **composite criterion of investment and annual turnover** - and **identical limits for manufacturing and service sector**.

Micro	Investment [in Plant and Machinery or Equipment] doesn't exceed Rs 1 crore and turnover doesn't exceed Rs 5 crore.
Small	Investment doesn't exceed Rs 10 crore and turnover doesn't exceed Rs 50 crore
Medium	Investment doesn't exceed Rs 50 crore and turnover doesn't exceed Rs 250 crore.

  - ▪ **Note**: In the older definition, only investment criteria was used and separate parameters were there for Manufacturing sector and service sector.

- **Significance of the change**
  - » The change in definition will facilitate expansion and growth of these enterprises.
    - ○ The **resulting economies of scale** can enhance productivity without MSMEs losing out on several government incentives including market support, export promotion, preferential procurement in the public sector, and incentives through various government initiatives (MSE-CDP, PMEGP, SFURTI).
  - » This change will also **align MSMEs with GST regime** and would prove to be a good tool to assess the contribution of the MSMEs to GDP. It will also **avoid unnecessary inspections** and enable authorities to verify claims of businesses using GST network sales data

- » **Same criteria for both** manufacturing and Service SME will simplify the classification.

- **Importance of MSME sector for India's economy**
  - » **Economic**:
    - Share of MSME in the country's **GVA** is approx. **33.08 percent** (current price, 2019-20 (as per ESI 2021-22)).
    - It **employs** around **11 crore people** in India.
      - High Labor to capital ratio
      - It provides maximum opportunities for self-employment and wage employment outside the agri-sector.
    - **Manufacturing** -> 40% of the total manufacturing output.
    - **Exports**: Around **50% of the** total manufacturing exports
  - » **Curtailing Regional Disparity**
    - Geographical distribution of MSME's are more even.

- **Potential for growth in this sector**
  - » In countries like Singapore, France, Germany, Taiwan, South Africa etc, MSME contributes more than 50% in GDP and more than 50% in total employment too.
  - » With India's large labour pool of engineering talent and high skill labour at competitive costs, India has the potential to become a significant player in MSME sector, especially in auto industry.

- **Problems faced by MSME Sector**

  i. **Poor access to Institutional Credit** - UK Sinha committee (expert committee on MSME) singles out access to finance as the **foremost constraint** hindering the growth of MSME sectors.
    - » **Banks are often unwilling to lend to MSMEs and charge higher interest form them.**

  ii. **COVID-19 Pandemic** had hit MSMEs the most as they **didn't have the deep pockets** to sustain the lock down which the country went through.
    - » **Lack of deep pockets -> More than 95% of India's MSMEs are micro enterprises and they have found it difficult to survive after not being in business for 1 or 2 months.**
    - » **Most in Unorganized sector -> unregistered -> difficult to access government benefits.**
    - » **Difficulties in finding labour force after opening up of the economy.**

  iii. **Delayed Payments**
    - » Many MSMEs take part in supply chain as a supplier of intermediate goods and services to large firms including PSUs, resulting in low bargaining powers. Delayed payments significantly hamper MSMEs ability to repay loans and make wage payments.

  iv. **Poor state of infrastructure and Logistics**
    - » **Our MSMEs still work with older technologies**
    - » **New advanced technologies are generally too expensive for them.**
    - » **Poor state of logistic sector in India makes our MSMEs less competitive.**

  v. **Lack of skilled workforce**

- » Since most of MSME are in informal/unorganized sector, they mostly hire contract labourers who don't have any regular training.

vi. **Lack of proper market linkages**
- » Attracting the buyers to sell the products is one of the biggest challenges because a MSME doesn't have a credible brand name and at times it has to face big rivals in their product segment who have a natural benefit of their scale of operations

vii. **Excessive Regulation**
- » For e.g.: Local entrepreneurs still have to go through 12 procedures to start a business in Mumbai, the business hub of the country

viii. **Policy Changes, Complicated labor laws, changing taxation policy** are also creating hindrance to the sector.
- » GST, though supposed to simplify tax structure, had become a problem for MSMEs in the initial phase.
- » Demonetization had also badly impacted MSMEs as most of them worked in informal sector.

– **Initiatives of Government of India to promote/help MSMEs**

» The importance and contribution of the MSME sector to the economic growth and prosperity is well established. Towards this, government has taken a number of steps:

1. **Initiatives under Atmanirbhar Bharat Abhiyan**
   - **Emergency Credit Liquidity Guarantee Scheme (ECLGS)** (extended till March 2023)
   - **New Definition of MSMEs**
   - **Rs 20,000 crore of** subordinate debt to stressed MSMEs.

2. **Raising and Accelerating MSME Performance Scheme (RAMP)** in July 2022:
   - **Ministry:** Ministry of MSME
   - It is a **World Bank** supported **Central Sector Scheme**. It is aimed at **strengthening institutions and governance at the Centre and State**, **improving Centre-State linkages and partnership** and **improving access of MSMEs to market and credit**, **technology upgradation and addressing issues of delayed payments and greening of MSMEs**.
   - **Duration:** it will be implemented over a **period of five years**.
   - **Outlay**: The total outlay of the scheme is Rs 6,062.45 crores or USD 808 million, out of which Rs 3750 crore or USD 500 million would be a loan from the World Bank and the remaining Rs 2312.45 crore or USD 308 Million would be funded by GoI.

3. **MSME Cluster development program of Ministry of MSME**
   - » MSME is running two cluster development programs
     i. Micro and Small Enterprises - Cluster Development Program (MSE-CDP)
     ii. Scheme for upgradation of rural and traditional industries (**SFURTI**)

» **Advantages of such cluster programs**

- Quicker dissemination of info allows easy sharing of knowledge and best practices.
- Better cost effectiveness due to distribution of common cost
- Focuses on holistic development covering infra, common facility, testing, technology, & skill upgradation, marketing and export promotion.
- Weaves the fabric of networking, cooperation and togetherness in the industry

4. Other Past steps for Easy Credit Availability

» **Interest Subvention Scheme for MSME Sector**

- The scheme was launched in 2018 and provides a 2% interest subvention to GST Registered MSME sector.

» **MUDRA** initiative focuses on collateral free loans of upto Rs 10 lakh for non-farm sector.

» MSME sector brought **under PSL** by RBI from July 2016. From 2018, foreign banks also have to follow the PSL norms.

- Banks should **advance 7.5% of their loans to MSME** under PSL guidelines.

5. Steps to increase production by MSME and demand of MSME products

» **Reservation of items to be manufactured by MSME** sector -> provided in the Industries (development and regulation) Act, 1951.

» **Purchase Preference Policy: All CPSUs/Central Government Departments are required to procure 25% of their annual procurement** from MSMEs (including **4%** from MSEs owned by SC/ST and **3%** from MSEs owned by women entrepreneurs) and there is a sub-target of 20% for procurement of MSMEs owned by SC/STs under the Procurement Policy launched in 2012.

1. **MSME SAMBANDH Portal** - To monitor the implementation of the public procurement from MSEs by Central PSUs.

» **Price Preference Policy:** For selected items a price preference of 15% premium over the lowest quotation of the large scale unit is provided to MSME.

» **Benefits in tendering:** MSMEs are provided benefits such as exemption from payment of security deposit etc.

» **Marketing Assistance Scheme:** Provides assistance to MSMEs for the following activities: Organization of exhibitions abroad, co-sponsoring of exhibitions organized by other organizations, organizing buyer seller meets etc.

6. Other Initiatives to Increase Ease of Doing Business for MSMEs

i. **Udyam Registration (UR) Portal** (became operational in July 2020)

- It provides faceless, fully online, paperless, and transparent **MSME registration process** fully integrated with Income Tax and GSTIN system.

It is also integrated with government e-market place to make end to end MSME registration paperless.

- In 2021, government has included Retail and wholesale trade as MSMEs. They are allowed to be registered on Udyam registration portal. But the benefits to them is restricted to PSL only.
- **Progress:**
  - As of 7th Jan 2022, the portal has a total registration count of **1.32 crores**.

ii. **MSME SAMADHAN PORTAL**

- It was set up under the Micro, Small and Medium Enterprise Development (MSMED) Act to **monitor the outstanding dues to the MSME sector**.
  - MSMEs can directly register their cases relating to delayed payments by Central ministries/departments/CPSEs/Statements governments.
- As of 7th Jan 2022, the portal has received a total of 1.3 lakh applications.

iii. **TReDS** (Trade Receivable Discounting System) **Platform** for facilitating the discounting of trade receivable of MSMEs through multiple financiers.

- TReDS is an institutional mechanism for financing of trade receivables of MSMEs from corporate buyers through two or more financiers.
- There are 3 direct participants involved in the activities of TReDS viz.
  - MSME Sellers
  - Corporate Buyers
  - Financiers
- TReDS provides a platform to bring these participants together for facilitating, uploading, accepting, discounting, trading and settlement of the invoices / bills of MSMEs.

iv. **The CHAMPIONS portal** (www.champion.gov.in):

- It is a grievance redressal portal for MSMEs launched by Ministry of MSME in June 2020.
  - It is an ICT based technology system for making the smaller units big by helping and handholding them. A network of control rooms is created in a Hub & Spoke Model where hub is situated in the Ministry of MSME.
- As of Jan 2023, more than 56K grievances have been received and more than 98% of them have been resolved.
- The portal continues to improve through initiatives such **as localization of the** portal in 11 regional languages **and introduction of chatbot**.

v. **GST Composition Scheme** (turnover limit 1.5 crore (75 lakh in case of NE States)

vi. **Budget 2020-21: Easing Compliance burden**
   - In order to reduce the compliance burden on small retailers, traders and the MSME sector, **the auditing threshold has been raised by 5-times from INR 1 Cr in turnover to INR 5 Cr**. This would be applicable only to those **MSMEs that transact less than 5% in cash**.

viii. **Zero Defect Zero Effect** (ZED) Scheme to rate and handhold MSMEs to delivery top quality products using clean technology.

7. **Pre-Packaged Insolvency Resolution**:

– **Steps that further needs to be taken**

i. **Identify, Formalize and Spread awareness about government initiatives**: Identification of informal units in the sector and enabling the reach of policy intervention is significant.

ii. **Promote Digitization and Widen the use of Fintech Services**
   - Mandating the payments to MSME by UPIs can reduce the delays in payments
   - Fintech services (for e.g. Capital float) use technology to evaluate the financial capabilities of an MSME and provide collateral loans to them. It can thus deal with the financial woes of the MSMEs.

iii. **Provide more incentives for technology upgradation of MSME sector** specially for new and emerging technologies like Industry 4.0.

iv. **Mandatory procurement requirement should be extended to State PSUs also**. Right now, only CPSUs have mandatory procurement requirement from MSMEs.

v. **Increase the limit for collateral free loans to 20 lakh** from the current 10 Lakh limit (under MUDRA)

vi. **Re-structure initiatives like Skill India** to fulfill the human resource requirements of MSMEs

vii. **Act proactively within international laws to deal with dumping from countries like China**.

viii. **Ending the bane of dwarfs**
   - **Bring a sunset clause for benefits enjoyed by MSME**
     - I.e. an MSME should be able to enjoy certain benefits only for some period let's say 10 years. This will contribute towards ending the bane of dwarfism which limits job creation and productivity.
     - It will also help direct more funds towards new MSMEs thus promoting entrepreneurship, innovation and fast job creation.
   - **Prioritize PSL for infant (new MSMEs)**
   - **Reform labor laws** to incentivize expansion.

ix. **Work towards Sustainability of MSMEs ->** Government should try to mobilize international climate finance for the purpose of MSME.

– **Conclusion:**

» Necessity is the mother of invention. The Pandemic has certainly created the need for innovative policies to rescue the ailing MSME sector.

4. BANE OF DWARFISM IN MSME

- **Current Situation: Bane of Dwarfs**
  - ESI has defined dwarfs as firms that never grew beyond their small size. They are both small (< 100 employees) and older than 10 years and have continued to be stunted in their growth despite surviving for more than 10 years.
  - **Key facts about Dwarfs and small firms based on Annual Survey of Industries (ASI) for the year 2016-17:**
    - **Dwarfs make up more than 50% of the firms in organized manufacturing by number** -> their share of employment is only 14%, Net Value added is only 7.6%.
    - And, the **firms that are able to grow over time to become large are the biggest contributors to employment and productivity** in the economy.
  - **The above data dispels the common notion that small firms generate the most employment**. Small firms may generate higher number of new employments, however, they destroy as many jobs.
  - **As compared to the small firms**, it is the young firms that contribute significantly to employment and value added.

- **In India, with age the firm's size hasn't grown to the extent in other countries**
  - For e.g. According to ESI's analysis , the **average employment** level for 40-year old enterprise when compared to when enterprise was newly set is:
    - 7 times in USA
    - 1.4 times in India
    - 2 times in Mexico
  - Similar is the story for productivity (4 times in USA, 1.6 times in India 1.7 times in Mexico)
  - **Thus, both employment creation and productivity doesn't grow adequately as firms age in India**.

- **The Role of Government Policies in Fostering Dwarfism**
  - In India, the government policies create a **'perverse' incentive** for firms to remain small. If the firms grow beyond the thresholds that these policies employ, then they will be unable to obtain the said benefits. And since the economies of scale stem primarily from firm size, these firms are unable to enjoy such benefits and therefore remain unproductive.

Table 1. Size based Limitations posed by Key Labour Legislations

S.No.	Labour Acts	Applicability to Establishments
1	Industrial Disputes Act,1947, Chapter V relating to strikes, lockouts, retrenchment, layoff	Employing 100 or more workers
2	Trade Union Act, 2001-Registration of trade unions	Membership of 10 per cent or 100 workmen whichever is less
3	Industrial Employment (Standing Orders) Act, 1946	100 or more workmen
4	Factories Act,1948	10 or more workers with power and 20 or more workers without power
5	Contract Labour (Regulation & Abolition) Act, 1970	20 or more workers engaged as contract labour
6	The Minimum Wages Act, 1948	Employment in the schedule having more than 1000 workers in the State
7	Employees' State Insurance Act,1948 - ESI Scheme	10 or more workers and employees monthly wage does not exceed ₹21000
8	Employees' Provident Fund & Miscellaneous Provisions Act, 1952	20 or more workers

Source: Compiled from Ministry of Labour and Employment

  - **Impact of Labor Regulation**

- The regulations exempt smaller firms from complying. Given the compliance cost, a large majority of firms would prefer to be below the threshold of 100 employees.

- **ESI's analysis also shows that Flexible States** (states which provided flexibility/reforms in Labor laws) **create a more conducive environment for growth of industry and employment generation.**
- Studies have found that on average, plants in labour-intensive industries that have transited towards more flexible labor markets, such as UP and Gujarat are **25.4% more productive** than their counterparts in states like WB or Chhattisgarh that continue to have Labor rigidities.

– **Impact of Small Scale Reservation**
  - The policies which promote small firms irrespective of their age include:

Scheme	Objective
Priority Sector Lending	Direct and indirect finance at subsidized interest rates shall include all loans given to micro and small enterprises, irrespective of their age.
Credit Guarantee Fund Scheme	This scheme makes available collateral-free credit to the micro and small enterprises, irrespective of their age.
Purchase Preference Policy	A group of items (Group IV) are reserved for exclusive purchase from small scale units, irrespective of their age. Group V items are to be purchased from MSMEs, irrespective of their age, up to 75 per cent of the requirement.
Price Preference Policy	For selected items that are produced by both small scale and large scale units, price preference is provided to small firms, irrespective of their age. This price preference amounts to a 15 per cent premium over the lowest quotation of the large-scale units.
Benefits in tendering	MSMEs, irrespective of their age, can avail benefits such as availability of tender sets free of cost, exemption from payment of earnest money deposit, exemption from payment of security deposit.
Raw Material Assistance Scheme of National Small Industries Corporation (NSIC)	This scheme aims to help MSMEs, irrespective of their age, with financing the purchase of raw material (both indigenous and imported).
Marketing Assistance Scheme	Provides assistance to MSMEs, irrespective of their age, for the following activities: organization of exhibitions abroad, co-sponsoring of exhibitions organized by other organizations, organizing buyer-seller meets, intensive campaigns and marketing promotion activities.
GST Composition scheme	Scheme allows MSME firms, irrespective of their age, to pay GST at a flat rate. The turnover limit for businesses availing of the GST composition scheme is set at ₹1.5 crore.
Exemption under Central Excise law	Small scale units below a turnover of ₹4 crore, irrespective of their age, manufacturing good specified in SSI are eligible for exemption.

– **Because of above policies, India has created a number of dwarfs and they are consuming most of the resources that could possibly be given to infant firms**. These dwarfs contribute less to creation of jobs and economic growth as compared to infants.

– **Way Forward**

- MSMEs that grow not only create greater profits for their promoters but also contribute to job creation and productivity in economy. Our policies must therefore focus on enabling MSMEs to grow by unshackling them. Further there is a need of recalibration of policy towards supporting infant firms.
- **Prioritize PSL lending towards 'start ups' and 'infants'** in high employment elastic sectors.
    - This will ensure direct credit flow to sectors that can create the most jobs in the economy.
- **Sunset clause for the incentives**: Intensive should be available to firm only for 5-7 years thus ensuring most funds goes to start ups and infants.
- **Focus on High employment elastic sector**:
- **Focus on Service Sector with high spill over effect such as tourism**

GS FOUNDATION FOR CSE 2024
ECONOMY-22
INCLUSIVE GROWTH

1. TABLE OF CONTENTS

2. SYLLABUS

Inclusive growth and issues arising from it

3. PYQS

1. Is Inclusive growth possible under Market economy? State the significance of financial inclusion in achieving the economic growth in India [CSE Mains 2022, 15 marks, 250 words]

2. Explain intra-generational and inter-generational issues of equity from the perspective of inclusive growth and sustainable development [CSE Mains 2020, 10 marks, 150 words]

3. It is agreed that the strategy of inclusive growth is intended to meet the objectives of inclusiveness and sustainability together. Comment on this statement [CSE Mains 2019, 15 marks, 250 words]

4. What are the salient features of 'inclusive growth'? Has India been experiencing such a growth process? Analyze and suggest measures for inclusive growth. (2017)

5. Comment on the challenges for inclusive growth which include careless and useless manpower in the Indian context. Suggest measures to be taken for facing these challenges. (2016)

6. Capitalism has guided the world economy to unprecedented prosperity. However, it often encourages shortsightedness and contributes to wide disparities between the rich and the poor. In this light, would it be correct to believe and adopt capitalism driving inclusive growth in India? Discuss. (2014)

4. INCLUSIVE GROWTH

1) BASICS

- **Introduction**:
  - » Inclusive growth is the growth where opportunities are created for all. Here, all members of a society participate in and contribute to the growth process equally, regardless of their individual circumstances.

- **Characteristics of Inclusive Growth**: **Inclusive development can be characterized by 5 inter-related characteristics, viz.**

  - » **Participation,** i.e., people are able to participate fully in social and economic life and have greater say over their future. It means people are able to access and participate in the decision making of the government, in the market as workers, consumers and business owners and in society as responsible citizens.

  - » **Equity,** which signifies ample opportunities and equal access to all segments of society especially the poor or socially disadvantaged groups to take advantage of these opportunities for upward mobility. It ensures equality in access to public goods, services and infrastructure, such as public transport, education, health, clean water and air.

- **Growth,** such that an economy which increasingly produce enough goods and services to enable broad gains, well-being and greater opportunity and also a society which allow unhindered access to such goods and services.

- **Sustainability,** that means economic and social wealth is **sustained over time without hampering inter-generational well-being**. Inclusive economies preserve and restore nature's ability to produce the ecosystem, goods and services that contribute to human well-being, with decision-making incorporating the long-term costs and benefits.

- **Stability,** where individuals, communities, business and governments have a sufficient degree of confidence in the future and an increased ability to predict the outcome of their decisions.

2) NEED OF INCLUSIVE GROWTH

- **Fights inequality and ensures sustainability** of the growth process:
    - In the absence of inclusive growth unemployment and poverty are pretty commonplace in the country.
- **Efficient use of human and physical resources**: When development is inclusive, human resource is able to get education, health services, skill development etc. which allows for its efficient utilization. Similarly, when regional growth is equitable, resources from all parts of the country contributes fully towards the growth and development of the country.
- **Increases growth potential**: When every section of the society benefits from economic growth, in general the aggregate demand increases leading to overall economic growth.
- **Promotes social cohesion**: When economic growth benefits only some people, social tensions and violence increase. When the growth is inclusive, there is a tendency towards social inclusion.
- **Protects Human Rights** as it not only leads to reduction in poverty but also promotes equality.

3) VARIOUS DIMENSIONS OF INCLUSIVE GROWTH

- **Economic Dimensions:**
    - **Sustainable and Equitable growt**h are crucial for achieving inclusive growth. It is a type of growth which is **broad based and provides poor and low income household with both the capacity and opportunities** to benefit from economic growth.

    - **Enabling Factors:**
        - **Employment intensive growth**: Inclusive growth will employ the labor force in the poor and vulnerable groups of the population.

    - **Financial Inclusion**:
        - This ensures financial services to vulnerable groups. It increases the scope of self-employment and reduces the chance of exploitation by money lenders.

    - **Quality of Infrastructure**: Inadequate infrastructure raised the cost of doing business and discouraged domestic and foreign investment. IG ensures that basic infrastructure such as transportation, energy and communication etc are well distributed even for marginalized groups and rural areas.

- » **Entrepreneurship and Skill Development**:
  - In the absence of proper skilling of workforce, economic growth suffers (as investors prefer to invest in places where skilled workforce are available) and employability also goes down.

- » **Agriculture and Rural economy** are at the core of inclusive growth. This is because in developing countries like India still around 50% of the population are dependent on the sector.
  - Some things which can contribute here are yield improvement technologies, food processing industries etc.
  - **Rural infrastructure** ca specifically contribute to inclusive growth. For e.g.: feeder roads allow the supply of perishable foods to high-value urban markets.

- **Technological Dimensions**:
  - » Technology can cultivate greater inclusion by creating new ways of working, **support educational attainment** at all levels and enable faster, **more effective retraining, thereby accelerating the adoption of innovations.** All this can help lift more people out of poverty, narrow the gender gap, and increase the overall participation in the global labour force, nurturing a stronger and more sustainable economy.

  - » With the advancement of technologies, several traditional jobs tend to become obsolete.
    - For e.g. the recent development of Generative AI potentially threatens the several traditional white-collar jobs.
    - Therefore, for inclusive growth, its crucial that there is focus on technological advancement in every section of the population.
  - » Further, technology can play a crucial role in improving other aspects of economic growth like advanced manufacturing sector, improvement in agriculture, increasing access to health and education and overall governance which will benefit vulnerable sector.

- **Social Dimension**:
  - » This dimension focuses on **empowering marginalized sections of the population** including the low-income households and other disadvantaged groups.
  - » **Health and Education** are also key component of this social dimension. Inclusive growth ensures that everyone has access to quality education and healthcare services which promotes overall well-being.
  - » **Gender Equality** is another key component of inclusive growth. It promotes equal opportunities and rights for all genders in different spheres of life including education, employment, political representation etc.
  - » **Social security net** for vulnerable groups like elderly, disabled, unemployed etc also enhances inclusive growth.

- **Inclusive Governance**:
  - » This dimension focuses on **removal of institutional and policy barriers** that constraint economic growth. It focuses on empowerment by **ensuring access** to productive assets, capacities, and resources that will enable every person to participate in the growth process.

» This dimension will also focus upon '**political dimension**' which focuses upon broadening citizen participation in the political processes.

- **Environmental Sustainability**:
  » This is crucial for inter-generational equity. It focuses on resource use efficiency, pollution control and reducing carbon footprint.
    ▪ For e.g. in the absence of sustainability, we will be leaving behind depleted water resources, degraded land and exploited mines for our next generation, hampering inter-generational equity.

4) BRIGHT SPOTS IN INDIA'S INCLUSIVE GROWTH

- **Economic Growth**:
  » It is almost impossible to ensure economic mobility and equitable distribution of resources without complementing the same with an increase in the overall size of the economy. Hence, **economic development and inclusivity through access to resources go hand in hand**.
    ▪ With an average growth rate of 5.5% over the past decade, India has already become the fastest growing economy in the world and is set to double its current annual GDP of close to USD 3.5 trillion to USD 7 trillion by 2027 and to **USD 10 trillion by 2030**.

- **Poverty Reduction**:
  » Between 2011 and 2019, the country is estimated to have halved the share of the population living in extreme poverty - below $2.15 per person per day (2017 PPP) (**World Bank Poverty and Inequality Portal and Macro Poverty Outlook, Spring 2023**).

- **Financial Inclusion** has seen various successes.
  » **Jam Trinity** (Jan Dhan Yojna, Aadhar, Mobile) has been very crucial in ensuring financial inclusion for people.
  » Adoption of Business correspondents model has increased the penetration of banking sector in the country.
  » Pradhan Mantri Suraksha Bima Yojna has led to increase in insurance cover
  » Atal Pension Yojna has contributed to increase in coverage of old age benefits.

- **Entrepreneurship**:
  » With **more than 100 unicorns** valued at US$ 332.7 billion, India has the third-largest unicorn base in the world.
  » Initiatives **like Startup India, Standup India** and **MUDRA** have contributed to entrepreneurship environment in the country.

- **Special Focus on Vulnerable Groups**:
  ▪ **To promote entrepreneurship amongst women** various programs like Stree Shakti Package, Standup India Scheme, Udyogini Scheme, Women Entrepreneurship Platform etc. have been launched.
  ▪ **Special focus on SCs/STs** have been there through initiatives like PM Van Dhan Yojna, Pradhan Mantri Jan Jatiya Vikas Mission, National Scheduled Castes, Finance and Development Corporation (NSFDC)

- **Skill Development** has got special focus in the last 10 years:
    - **Pradhan Mantri Kaushal Vikas Yojna** (PMKVY)
    - **Pradhan Mantri Kaushal Kendras**

- **Inclusive regional development:**
    i. **Transformation of 'Aspirational Districts' Program**
    ii. **UDAN** (Regional connectivity Scheme)

- **Technological Advancements**:
    - Though India's gross expenditure on R&D (GERD) remains low at 0.66% of the GDP, it is targeted to reach 2% in future.
    - As per Global Innovation Index, India is ranked 40th out of 132 overall in terms of innovation and ranks amongst the top 15 nation in IT and ICT and R&D Intensive countries.

- **Increased focus on health and Healthcare infrastructure**:
    - As per the MoH&FW, India's doctor-patient ratio currently stands at 1:834 which is better than the WHO's prescribed norm of one doctor per 1,000 people.
    - Initiatives like Ayushman Bharat are further leading to improvement in the health situation in the country.

- **Penetration of Education is improving**:
    - » In **Times Higher Education (THE) Impact Rankings 2022**, India has been featured as the 4th most-represented nation with 64 universities.
    - » UNESCO's **Education for All Global Monitoring Report** ranks India at 32nd position out of 78 countries on **Education Rankings by Country 2023**.

- **Poverty Reduction**:

    - » The incidence of poverty in the country dropped from 55.1% in 2005-06 to 16.4% in 2019-21, as per the latest **Multidimensional Poverty Index (MPI)**.
    - » Indian poverty using the new poverty line of $2.15 per day, 10 per cent of Indians were poor in 2019, down from 22.5 per cent in 2011, according to a **new global poverty line** adopted from September 2022 by the World Bank.

    - » This was possible because of various efforts like MGNREGA, Deen Dayal Yojana - National Urban Livelihood Mission, National Rural Livelihood Mission, Pradhan Mantri Garib Kalyan Yojna, Pradhan Mantri Shram Yogi Maan-Dhan Yojna etc.

- **India is also a leader in sustainable development**:

    - » India has submitted a more ambitious NDC with commitment to reduce **Emissions Intensity** of its GDP by **45% by 2030**, from 2005 levels and achieve about 50% cumulative electric power installed capacity from non-fossil fuel-based energy resourced by 2030.

- India is also leading initiatives like International Solar Alliance, Mission LIFE (Lifestyle for environment) to ensure sustainable development.

5) ROADBLOCKS TO INCLUSIVE GROWTH OF INDIA

- **Economic Factors:**
  - **Jobless Growth**: While India has grown economically at a respectable rate, the economic growth has been dominated by service sector and capital intensive manufacturing sector. This has prevented the advantages of economic growth to penetrate to the weaker section of the society.

- **Poor Infrastructure**: It hampers inclusive development by limiting opportunities in remote regions and in less developed part of the country.

- **Slow pace of reforms in agriculture sector** and **rural development**:
  - Agriculture sector suffers from several challenges like fragmented landholding; absence of land leasing reforms; huge dependency on monsoon; poor market reforms; excess use of chemicals etc. This hampers agri-productivity and agri-sustainability.
  - This has led to a lot of disguise unemployment in agricultural sector.

- **Lack of Financial inclusion**: Though the number of bank accounts have increased in recent years due to PMJDY coming into force. Still, financial services such as insurance, loans, investments etc is being availed by very small number of citizens.
  - Further, as per the Financial Inclusion Survey: financial exclusion measured in terms of bank branch density, ATM density, bank credit to GDP and bank deposits to GDP in India is quite low as compared with most of developing countries in the world.

- **Poor Skill Situation**:
  - Despite all the efforts, as per the Global Skill Gap Report, Indian workforce **reported the highest skill gap after Brazil**.
  - **Periodic Labor Force Survey** shows that 84.4% of the people surveyed during 2020-21 didn't receive vocational and technical training.
  - **India Skill Report 2021** found that only about 45.9% of young people would be considered employable.

- **Social Factors:**
  - **Steep Social Hierarchies** like casteism:
    - The semi-feudal character of our ruling class and its iron grip on the states
    - The stronghold of rigid customs and cultural prejudice especially in our middle class
  - **Gender based discrimination** which persist in various forms hampers the benefit of economic growth from reaching women.
  - **Educational Disparities**: Disparities in access to quality education, particularly in rural areas contribute to lack of skills and opportunities.
  - **Absence of quality health facilities** leads to poor health outcomes leading to hampering of overall productivity and economic well being.

- **Governance Issues**:

- » **Corruption** and lack of accountability in both public and private sectors hampers the effectiveness of policies and programs.
- » **Complex & Rigid regulatory frameworks** hinder business growth, particularly in small enterprise.

- **Political Factors:**
  - Deep influence of dynastic loyalties and caste and communal identities on our electoral politics

- **Geographical Factors**:
  - Regional disparities have led to some regions of India remaining underdeveloped and thus hampering the economic growth in the country.

- **Environmental Factors**: Increasing pollution and climate change tend to impact vulnerable section more.
  - For e.g. very high level of air pollution in cities like Delhi impact people from labour class who have to do physical labour on open areas.
  - Similarly, climate change caused heat waves, sea level rise etc impact the weaker section more.

6) VARIOUS REPORTS RAISING CONCERNS

1. **Oxfam India's report** - "Survival of the Richest: The India Supplement" reveals that the top 1% in India owns more than 40.5% of total wealth in 2021 while the bottom 50% of the population (700 million) has around 3% of the total wealth.
2. **Inclusive Development Index (IDI)**:
   - The index is compiled by the **World Economic Forum (WEF)** and measures the extent of inclusive development in the country. It has three pillars: Growth and Development; Inclusion; and Inter Generational Equity.
   - In the 2018 reports, **India was ranked 62/74 emerging economies**. India's poor performance was primarily due to slow employment growth; high levels of poverty; and poor inter-generational equity.

7) WAY FORWARD

1. **Promote Efficient and Sustainable Economic Growth**:
   - Increasing productive employment is one of the principal ways of promoting inclusive economic growth.
   - **Infrastructure** needs special focus particularly in rural areas.
   - **Agricultural reforms** should induce modernization of agri-sector
   - **Skill development** initiatives need to be intensified to increased the % of skilled workforce in the country.
   - **Labor reforms** need to be implemented quickly to increase growth but at the same time India needs to **increase minimum wages towards living wages** and also promote transparency on pay ratio.

2. **Social Inclusion**:

- Promoting social inclusion requires interventions in three areas: **education, health, and other social services** such as water and sanitation to expand human capacities especially for disadvantaged.
    1. Oxfam suggests that India needs to invest more in making quality essential services like Universal education and healthcare available to everyone and **fund this by implementing highly progressive taxation**.
- **Gender Budgeting and Gender sensitive** growth is crucial to ensure that around half of India's population gets equal opportunities compared to the other half.
- **Affirmative action** needs to be continued to ensure that historically marginalized groups get equal opportunities.
- **Provide for Social Safety Net**:
    1. To address the extreme deprivation of the disadvantaged.
    2. It may take the form of labor market policies - Social insurance programs focusing on health, disability etc.
- **End the financial secrecy** that shelters trillions hidden in tax havens.

3. **Ensure a level Political Playing Field**: Political empowerment of weaker sections can be crucial to pressurize political representatives to work for every section of the society.
4. **Create Partnerships**: Government needs to partner with various stakeholders including private sector, NGOs in their vision of moving towards inclusive growth.
    - They can contribute through participation in allocation of resources for rural development; vigilance in the misuse of the funds to promote corruption and promote accountability and transparency, and by providing access to public services in remote areas.
    - For e.g. civil society can be supported to monitor public finance so that they can hold governments accountable for delivery of free quality services.

GS FOUNDATION FOR CSE 2024
ECONOMY-23
INCLUSIVE GROWTH-2
(VARIOUS SCHEMES)

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2. FINANCIAL INCLUSION RELATED INITIATIVES

1) FINANCIAL INCLUSION

- **What is financial inclusion?**
  - Financial inclusion is defined as the process of **ensuring access to adequate financial services (Banking, Credit, Investment, Insurance)** in a cost effective and timely manner for vulnerable and low-income groups.

- **Advantages: Need of Financial Inclusion**
  - **Increased Economic output -> Economic Growth:** Having a bank account ensures that savings of individual are turned into investments which is good for economy.
    - Easy access to loans for farmers and small businesses is also crucial for economic growth.
  - **Social Benefit**: Insurance, Savings, Investments are crucial for difficult situation for every section of the society.
  - **Reducing Inequalities:** Income inequality falls more rapidly in areas that have more developed financial intermediaries. This in a way also promotes social harmony and reduces the chances of terrorism and Maoism.
  - **Efficiency in implementation of government schemes:**
    - Banking services to everyone can ensure DBT and associated benefits.
  - **Protects low-income households** from money lenders (loans) and Ponzi schemes (savings).
  - **Promoting gender equality** and **women empowerment**.

- **Key steps taken so far to promote financial inclusion.**
  - **Nationalization of Banks** in 1969 and 1980 was **Region-focused** on ensuring that the banking services reach rural areas.
  - **Promotion of alternatives** Rural Banks, Cooperatives, etc. have also contributed to Financial inclusion.
  - **Lead Bank Scheme** - RBI assigns a district to a particular bank. The bank is responsible for promoting banking services and financial literacy in that district.
  - **Pradhan Mantri Jan Dhan Yojana (PMJDY)**, under which 43 crore accounts have been opened by Aug 2021.
  - **Niche Banking:** Setting up of Small Financial Banks and Payments Banks.
    - Launch of India Post Payment Bank in Sep 2018 is particularly significant in bridging the gap in last mile connectivity.
  - **Priority Sector Lending** initiative of RBI
  - **Various saving schemes under post office**
  - **Various Insurance and Pension initiatives**

- Schemes such as the **Pradhan Mantri Suraksha Bima Yojana** to provide accidental death or disability cover and **Atal Pension Yojana** to provide pension cover to subscribing bank account holders.

2) PRADHAN MANTRI JAN DHAN YOJNA (PMJDY)

- **Why in news?**
  - PMJDY completes 9 years of successful implementation (Aug 2023)
  - Nearly 18% bank accounts or roughly 8.1 crore bank accounts are inoperative: Government (Aug 2022)

- **Example Questions**
  - "Beyond enabling account ownership and the use of financial services, the PMJDY also facilitated financial inclusion for a variety of demographics" Elaborate [10 marks, 150 words]
  - Discuss the key challenges faced by PMJDY in achieving meaningful financial inclusion [10 marks, 150 words]

- **Important Quote**
  - **"***Mahatma Gandhi worked towards removing social untouchability. If we want to get rid of poverty, we have to first get rid of financial untouchability. We have to connect every person with the financial system***" PM Narendra Modi**

- **Introduction**
  - Financial inclusion is a crucial component of inclusive growth. But, even in the year 2014, more than 40% of the households in the country didn't have a bank account. In the absence of an account, they mostly depended on local money lenders for credit purposes at very high interest rates. Further, a very small percentage of bank loans used to go to rural area.
  - To remedy these problems, PM Modi announced PMJDY in his independence day speech on 15th Aug 2014 and the scheme was launched on 28th Aug 2014.

- **Objectives:**
  - Ensure access of **financial products & services** at an affordable cost.
  - Use of technology to lower cost and widen reach.

- The scheme is aimed at providing key financial inclusion services like banking facilities, financial literacy, insurance cover etc. to all the ~~**households**~~ **(adult individuals)** in the country. Further, the government also envisaged channeling all government benefits (Central, state and local government) to the beneficiary's accounts and promoting government's DBT initiative.

- **Eligibility**
  - Any person who is Indian citizen above the age of 10 and does not have a bank account can open an account with zero balance. It also provides for a relaxed KYC norm.

- **Basic Tenets of the scheme**
  - Banking the Unbanked
  - Securing the Unsecured
  - Funding the Unfunded

- **Six Pillars of PMJDY (National Mission on Financial Inclusion)**
    i. **Banking Service in every 5 kilo meters**
        » The country has been divided into a number of Sub Service Areas (SSA), each with 1000-1500 households. One banking outlet (branch or BC) have been established within a distance of five km from every SSA.
    ii. **Account for each ~~family~~ Individual**
        » Bank account for each adult individual with **accident insurance** of Rs ~~1,00,000~~ **2,00,000** for Rupay debit card holders and **overdraft** facility of Rs ~~5,000~~, **Rs 10,000**.
    iii. **Financial Literacy**
        » The scheme also focuses on expansion of financial literacy programs to promote saving, use of ATMs, getting ready for credit, availing insurance and pensions, using basic mobile phones for banking.
    iv. **Credit Guarantee Funds** to cover potential defaults in overdrafts.
    v. **Micro Insurance:**
        » Accidental insurance cover on RuPay cards holders has been increased from Rs 1 Lakh to Rs 2 Lakh for PMJDY accounts opened from 28.8.2018.
    vi. **Pension Transfers:** Pension payments under the Swavalamban Yojana scheme for workers in the unorganized sector is being paid through bank accounts.

- **Other Features**
    » Zero balance accounts etc.

- **Achievements so far:**
    i. **Near Universal Banking Coverage** with more than 50 crore accounts by Aug 2023 have ensured that almost all Indian households are withing the formal banking sector.
        ▪ The cumulative deposit in these accounts surpass Rs 2 lakh crores.
        ▪ Further, around 1.26 lakh Bank Mitras are providing branchless banking services in the sub-service areas.
        ▪ This has led to higher savings for the poor, reducing rural inflation, starting self-employment initiatives, better accidental insurance and promote cashless transactions
    ii. **Empowering the weaker sections**:
        ▪ PMJDY has led to attenuation of socio-economic hurdles. Women, low income individuals, rural residents and less educated enjoy greater account ownership under PMJDY.
            • For e.g.: As of Aug 2023, 55.5% of the account belong to women, and 67% have been opened in Rural/ Semi-Urban areas.

    iii. **DBT Schemes more successful now:**
    iv. With bank accounts government can also provide **access to cheaper credit**.
    v. **Increased coverage of accidental insurance**:
        ▪ Around 34 crore RuPay cards have been issued to these accounts without charge, which also provide Rs 2 lakh accident insurance cover.
    vi. **International organizations have lauded the initiatives as revolutionary one**

- **Key changes made in Sep 2018 (Jan Dhan 2.0)**
  i. **Open Ended Scheme ->** the scheme will now run indefinitely.
  ii. **Higher Insurance Cover**
     - Accident insurance cover for the Rupay card holder has been raised to Rs 2 Lakh (from Rs 1 lakh earlier)
  iii. **Higher Overdraft facility (OD)**
     - Increased to Rs 10,000 (from earlier Rs 5,000)
  iv. **Revision of age range for availing the OD facility**
     - 18-65 (from earlier 18-60 years)

- **Barriers which remain in financial inclusion**
  » **Access to insurance, pension services, micro-credit etc.** to vulnerable groups is still negligible.
     - Access to ATM, overdraft etc also remain poor.
  » **Inadequate infrastructure** (in parts of rural hinterland, far flung areas in Himalayan and north-eastern region). Poor tele and internet connectivity in rural hinterland.
  » **Financial Literacy** is still poor and hasn't increased much since the launch of the PMJDY.
  » **socio-cultural barriers**
     Hold of informal credit (moneylenders) hasn't decreased and the percentage of poor people getting formal loans haven't increased much.
- **Banking correspondents were underutilized** for regular services.
  » It is because of low and irregular commissions per transactions.

- **Way forward: Steps that can be taken to further improve the scheme.**
  » **Enhancing other aspects of financial inclusion**:
     - Endeavor to ensure coverage of PMJDY account holders under micro-insurance scheme.
        - Government has already announced that eligible PMJDY accountholders will be sought to be covered under PMJJBY and PMSBY. Banks have already been communicated about the same.
  » **Infrastructure enhancement** especially in low-income states. This can promote digital payments through RuPay debit cards.
  » Improving access to **PMJDY account holders** to Micro-Credit and micro-investment such as flexi-recurring deposit.
  » **Increased focus on financial literacy and awareness** about the benefit of the Jan Dhan account can contribute heavily towards achieving the objectives of the program.
  » **Measure targets based on transactions** rather than based on number of banks accounts
     - Number of deposits, withdrawals, loans etc from Jan Dhan accounts should be a measure of success or failure of the scheme.
  » **Ironing out kinks in the Banking Correspondents model** by ensuring better commission

- **Conclusion**
  » The above analysis clearly indicates that PMJDY has had extraordinary impact on financial inclusion of people but there are still lots of opportunities for course corrections.
  » These course corrections can help ensure that gains of PMJDY are more sustainable and leads to meaningful financial inclusion.

3) JAN DHAN DARSHAK APP (JDD APP)

- JDD App is a mobile application which provides a citizen centric platform for locating banking touch points such as bank branches, ATMs, Banking Correspondents (BCs), Indian Post Payment Banks etc. in the country. Over 13 lakh banking touchpoints have been mapped on the JDD App.
- The facilities under Jan Dhan Darshak App could be availed as per the need and convenience of common people. The web version of this application could be accessed at the link http://findmybank.gov.in.
- This app is also being **used for identification of villages which are yet to covered by banking** outlets within 5 km radius. These identified villages are allocated to various banks by concerned SLBCs for opening of banking outlets. The efforts have resulted in a significant decrease in number of uncovered villages.

3. MGNREGA

- **Introduction**
  - » Mahatma Gandhi National Rural Employment Guarantee Act 2005 is a statutory **job guarantee** scheme for rural India.
  - » It's an initiative by **MoRD**, which was launched in 2006. It is **aimed** at:
    - ○ Enhancing the **livelihood security of people in rural areas** by **legally guaranteeing 100 days of wage-employment** in a financial year to adult members of any household willing to do **unskilled manual work** related to public work at the **statutory minimum wage.**
    - ○ Creating **durable assets** (such as roads, canals, ponds, wells)
  - » The scheme also helps in protecting environment, empowering rural women, reducing rural urban migration, and fostering social equity, among others.

- **Other Key Features**
  - » **Demand Driven Program**: Workers are provided work when they demand it and not when the government wants it.
  - » Employment is to be provided **within 5 km** of an applicant's residence.
  - » If work is not provided within 15 days of applying, applicants are eligible for an **unemployment allowance.**
  - » **1/3rd** of the stipulated workforce should be women.
  - » **Social audit** of the work done by Gram Sabha.

- **Steps taken to improve the functioning.**
  - i. **Management Information System** - digitization of all process in MGNREGA - available in public domain - promotes transparency.
  - ii. **Mandatory expenditure on agriculture and allied sector:**
    - ○ As per the provision of the Act, the District Programme Coordinator is required to ensure that at least **60 per cent of the works to be taken up in a district** in terms of cost shall be **for the creation of productive assets directly linked to agriculture and allied activities** through development of land, water, and trees.
  - iii. **Training and Skill Development of Workers:**

- **Training of MGNREGA workers** under initiatives like **Bare Foot Technicians (BFT)** to move than up the skilling ladder.
- **Similarly**, project "**UNNATI" focuses** on **upgrading the skill base of MGNREGA workers**.

iv. **Other technology to Reduce Corruption and improve transparency:**
- **DBT through E-Payments** are used for payment of wages which is ensured fast payment and reduced siphoning of resources.
- **Geo-Tagging of assets** to reduce corruption
  - Rolled out in 2017 and more than 5.2 crore assets (Jan 2023) have been geo-tagged and made available in public domain.
- **National Mobile Monitoring Software (NMMS)** App was launched in 2021 which permits taking real time attendance of workers in MGNREGA worksites with a geo-tagged photograph.
  - It is a big step toward step towards bringing transparency and proper monitoring of the schemes and will help in increasing oversight of the program.
- **According to a SOP** recently (Aug 2023) issued by MoRD, **drones** will be used for monitoring of MGNREGA work. It will be used in four types of monitoring: Surveying the ongoing works, inspecting the completed works, impact assessment, and special inspections in case of complains.

v. **Regular verification of Job Cards (JC)** to weed out the bogus and duplicate JCs

vi. **Efforts to cover all landless households:**
- As per the SECC 2011 ,there are 5.5 crore households in India which fall in the landless category. Government is taking measures to get all these households a Job Card and thus employment under MGNREGA.

- **Performance of the Scheme:**

i. **Positives/Achievements**
- **Various Government Reports** have indicated that MGNREGA has led to:
  - » **Reduction in Poverty:** The program reduced poverty by 32 percent and prevented 14 million people from falling into poverty.
  - » **Raised Income level:** Although it fails to add to the number of days that Individual work , it attracted individuals who were previously employed in less productive work, thereby raising their income.
  - » **Relief during distress situations**
    - **During COVID-19 crisis** it had emerged as a mechanism to ensure jobs for migrants returning back home and
    - It serves as an important source of income during distress situations such as drought, famine etc. Additional employment opportunities are made available in these circumstances.
  - » **Upliftment of weaker sections** like women, SCs and STs through creation of livelihood opportunities.
    - Increase in women's control over resources: MGNREGs scheme may be the first opportunity for many women to earn cash income resulting in substantial increase in women's control over resources- including cash in hand and likelihood of having a bank account
    - The % of SC workers in MGNREGA has been around 20% and ST workers around 17%.

- » **Impact on Education of Children**: Higher level of educational attainment for children: MGNREGS households were likely to obtain higher level of educational attainment and were less likely to be working.
- » **Rise in financial inclusion**: during this period, there has been a general increase in financial inclusion, reliance on moneylender has gone down and accessing of formal credit grew.
- » **Development of Rural Assets**
  - Irrigation canals and roads have augmented rural infrastructure.
- » **Mitigation of climate change** - through water conservation, drought prevention, reforestation and flood control activities.

- **International praises**
  - » In World Development Report 2014, the world Bank termed it a "stellar example of rural development"

ii. Shortcomings/Limitations in implementation

- **Factors which adversely affect the implementation of MGNREGA**
  - **Funds constrains.**
    - Parliamentary Standing Committee has also raised concerns about slashing of the budget for MGNREGS. In the FY 2023-24, the allocations for MGNREGS has been drastically slashed to Rs 60,000 crores for this financial year from a Rs 73,000 crore budgetary estimates for 2022-23.
      - This allocation is much lower than World Bank recommendations of Rs 1.7% for the optimal functioning of the program.
  - **Disparity of wages across state and Wages less the minimum wages in many states:**
    - Parliamentary committee in a report in 2023 has highlighted that daily wage rates ranged from Rs 204 to Rs 331 in different states and UTs.
    - According to the new wage rate notified for FY2023-24, the lowest wage is in Chattisgarh and MP at Rs 221, while the highest is in Haryana at Rs 357.
  - **Delays in wage payment sometimes discourages work under MGNREGA. It also increases the chance of corruption.**

  - **Institutional Shortcomings:**
    - **PRIs suffer from challenges like inadequate administrative and technical expertise:**
      - This adversely affects proper planning, approval, monitoring and social audit of the scheme.
      - Inadequate technical staff to help unskilled workforce.

    - **Non-Appointment of Ombudsmen:**
      - Under the act, there should be an ombudsperson for each district who will receive grievances, conduct enquiries, and pass awards.
      - Standing committee in 2022 noted that out of 715 possible appointments, so far **only 263 ombudsmen have been appointed**

which shows poor coordination between central and nodal agencies.

- **Quality of Assets** which are getting created have turned out to be of incomplete or of poor quality, requiring repairs every year.

- **Cases of corruption / lack of transparency**
  - **Social audit hasn't been very effective** because of lack of cooperation from government officials. Further, non-compliance with transparency and accountability provisions and poor maintenance of records are impacting the implementation of the mega scheme.
  - **Fabrication of jobs cards** and associated corruption.

- **Inadequate coverage of person with disabilities and women in many states** is impacting inclusive aspect of the scheme

- **Some Issues specific to women:**
  - Lack of child care facilities and basic amenities at the site like clean drinking water, sanitation facilities impact health and safety of women.
  - Lack of awareness about the process and entitlements available under the scheme.

- **Steps that need to be taken**
  i. **More Funds:** MGNREGA has the potential to change the face of rural India and hence more funds should be allocated for the scheme.
  ii. **Minimum wage:** MGNREGA wages should be linked with Minimum wages act (Now The Code on Wages) and no state should be allowed to pay less than the statutory amount.
     - Parliamentary Standing Committee has recommended that government should explore the possibility of making the wages paid under the scheme uniform across the country.
     - Wages should also be linked with CPI-R rather than CPI-AL which is an outdated index.
     -
  iii. **Capacity Building of PRIs** by empaneling institutions that can be training institutions for MGNREGA.
     - **More technical human resource** needs to be provided at rural level to improve the quality of the assets which are getting created.
     - **Better Planning** for **durable infrastructure** creation.
  iv. **Appoint Ombudsperson** in all districts on high priority to ensure simple and effective grievance redressal.
  v. **Monitoring** of the projects needs to improve.
     - **Strengthening Social Audit: CAG should develop mechanism in consultation with other stakeholders to handhold Gram Sabhas to ensure regular social audits of all projects under MGNREGA.**
     - **Civil Society can also monitor the Information Management system to ensure that the program is properly implemented.**
  vi. **Promoting the use of Adhaar based biometric verification** to prevent fake job cards etc.
  vii. **Improved facilities at workplace** specially for women laborers. (E.g. Clean Sanitation facilities, childcare facilities etc.)

- **Conclusion**
    - » Since, MGNREGA has proved its socio-economic advantages for rural areas, the program should be continued in full throttle. But, at the same time it is important that the work being done under it is producing something concrete & sustainable and that there is a transparent grievance redressal mechanism for the unskilled work force which has worked under MGNREGA or is seeking work under MGNREGA.

4. TRANSFORMATION OF ASPIRATIONAL DISTRICT PROGRAM

- **Introduction**
    - Transformation of Aspirational Districts program (under the aegis of NITI Aayog) was launched in Jan 2018, with an aim to **quickly and effectively transform some of the most under-developed districts** in the country. This would improve **standard of living of citizens** and ensure **inclusive growth** of all in the burgeoning economy.

    - NITI Aayog has **identified 117** most backward districts from 28 states/UTs, at least one from each state, in a transparent manner using a composite index of key data sets.

- **Need of developing these districts**: Inclusive growth; improve overall national performance; Internal security -> fight LWE

- The program focuses on **practical and measurable social progress outcomes, in six main themes**:
    - Health and Nutrition (30%)
    - Education (30%)
    - Agriculture and Water Resource (20%)
    - Financial Inclusion (5%)
    - Skill Development (5%)
    - Basic Infrastructure (10%)

- **Core Strategies of Transformation of Aspirational District Program (**Convergence, Collaboration and Competition)
    - **Convergence** of central and state schemes
    - **Collaboration** of central, state and district level officers
    - **Competition** among the districts driven by a "mass movement" or a Jan Andolan.
        - Under this program, NITI Aayog releases **Delta Ranking** that ranks districts based on monthly improvement achieved in the six focus areas**.** This Delta ranking is provided on the programme's **Champions of Change Dashboard**.

- **Other Kye Strategies:**
    - **States -** act as driver of the scheme in that particular state.
    - The program is **driven by mass movement**.
    - **Focus on low hanging fruits** for immediate improvement
        - With states as the main drivers, this program focuses on the strength of each district, identifying low-hanging fruits for immediate improvement, measure progress, and rank districts.

- **Availability of real time data** -> better monitoring
- **Public Private Partnerships**
  - For e.g. in March 2018, NITI Aayog signed on a statement of interest with Piramal foundation which will work with government authorities to improve the identified indicators by strengthening the existing public systems, especially in health, education and nutrition sectors.

- **Institutional Framework (remember for Pre)**
  - **NITI Aayog anchors the program** with support from central ministries and the state governments.
    - NITI Aayog is steering the program in 30 districts, various central ministries oversee 50 districts besides the Ministry of Home Affairs focuses on 35 LWE affected districts.
  - Officers at the level of Joint Secretary/Additional Secretary have been nominated to become the '**Central Prabhari Officers' of each district.**
  - States have appointed 'State Nodal and Prabhari Officers'.
  - An Empowered Committee under the convenorship of the CEO, NITI Aayog will help in the convergence of various government schemes and streamlining efforts. They will also be responsible for necessary policy adjustments.

- **NITI Aayog** has developed a broad template for the formulation of district plans. Since different districts have different opportunities and challenges, they have been advised to customize the template.

- **Achievements of the Program:**
  - **Many ADs** have surpassed the average state values in several indicators under the health and nutrition theme monitored under the program.
  - **All districts** have made significant progress across different indicators for instance, under health and nutrition, 46 districts have improved up by 45%.
  - **ADs** have performed better than non-AD districts in financial inclusion (Bank accounts, insurance, MUDRA loans etc.)
  - **Several ADs** have reported saturation in the basic infrastructure indicators like the percentage of households with electricity connections: percentage of habitations with access to all weather roads and PMGSY.

1) THE ADP AS TEMPLATE FOR GOOD GOVERNANCE – MISSION UTKARSH AND 'ASPIRATIONAL BLOCKS PROGRAM'

- Two programs have been along the line of ADP design – **"Mission Utkarsh"** and **"Aspirational Block Program"**

A) MISSION UTKARSH

- Launched in Jan 2022
- Under this, 15 central ministries having an interface with the public, have identified their low performing 10-15 districts.
  - Following, the ADP templates, ministries have launched **actions to bring these districts at part with an average district in the state** in **one year** and **close to all-India average in another** (i.e. 2 years)

B) ASPIRATIONAL BLOCKS PROGRAM

- The program was launched in Jan 2023 and is aimed at improving the performance of blocks lagging on various developmental parameters.
    - It was launched during the 2nd National Conference of Chief Secretaries, which was held on January 5-7.
- The **Central government and states have come together** to use the ADP template to identify backward blocks and use similar data monitoring and competition-based programs to improve the most under developed blocks in the country.
- In order the further strengthen this initiative, **500 most backward blocks** across states and UTs have been identified for **rapid development**.

5. SKILL DEVELOPMENT: EQUIPPING THE WORKFORCE WITH EMPLOYABLE SKILLS AND KNOWLEDGE IN MISSION MODE

- Skill Development aims to remove disconnect between demand and supply of skilled manpower, building vocational and technical training framework, skill upgradation, and building of new skills, and innovative thinking not only for existing jobs but also for the jobs of the future.
- For this, **Ministry of Skill Development and Entrepreneurship (MSDE)** was created in 2014 and **Skill India Mission** was launched in 2015.
- With the new ministry, efforts to improve and streamline the skilling ecosystem were ramped up and the government launched the **National Skill Development Mission** as well as **National Policy on Skill Development and Entrepreneurship**.
- **Under the NEP also**, there was a special focus on vocational education and skill development. This integration of vocational education and skill development with general education is considered an important reform in India's education system.
- **PLFS** shows that vocational/technical training among youth (age 15-29 years) and the working population (age 15-59 years) have improved in FY21 over FY19. This improvement is there for both males and females as well as in both urban and rural areas.

1) SKILL INDIA MISSION

- It focuses on **skilling, re-skilling and up-skilling** through short term and long-term training programs. Under this mission, the government through more than 20 central ministries and departments, is implementing various skill development schemes across the country. These Include:

2) VARIOUS SKILL DEVELOPMENT INITIATIVES UNDER DIFFERENT MINISTRIES

C) DEEN DAYAL UPDHYAYA GRAMEEN KAUSHAL VIKAS YOJANA (DDU-GKY)

- **Ministry: MoRD**

- It is a market-led, placement linked skill development program for rural poor youth under NRLM.

- **Approach of DDU-GKY**

- State government as the main player - S**ingle State Project (SSP) to Annual Action Plans (AAP**)
- **Special scheme in collaboration with MoDONER** for skilling projects specific to the needs, requirements, and the special characteristics of States in the northeast
- Enhancing the Capacity of Project Implementing Agencies (PIAs)
- Consent and State share is mandatory.

- **Special Components of DDU-GKY**
  - **Focus on Socially disadvantaged groups:** 50% of the funds would be earmarked for SCs and STs, 15% to minorities, and 3% for PwDs.
    - **1/3rd** of the person covered should be women.

D) RURAL SELF-EMPLOYMENT TRAINING INSTITUTES (RSETI)

- RSETI is an initiative by **MoRD** to have **dedicated infrastructure in each distric**t of the country to impart training and skill upgradation of rural youth geared towards entrepreneurship development.

- This program is a three-way partnership between **MoRD, State Governments,** and **Sponsor Banks**.

  - The banks are mandated to open at least one RSETI in their lead districts to provide training to rural youth to take up self-employment/ entrepreneurship ventures.
  - RSETI program runs with an **approach of short-term training & long-term handholding of entrepreneurs**.
    - **Eligibility for training:** Rural poor youth between the age group of 18-45 years are eligible to join the training.
    - **Entrepreneurial Skills:** The RSETIs have become established as pioneers in capturing the aspirations of the rural poor youth and turning them into profitable entrepreneurs by training them in the domain and entrepreneurial skills.

- **Key outcomes:**
  - Women form around 66% of total trained candidates.
  - About 26.28 lakh candidates have been trained since inception and about 18.7 lakh have been successfully settled.

E) DEEN DAYAL ANTYODAYA YOJANA – NATIONAL URBAN LIVELIHOOD MISSION (DAY-NULM)

- National Urban Livelihood Mission (NULM) was launched by the **Ministry of Housing and Urban Poverty Alleviation (MHUPA)**, Government of India in Sep 2013 by replacing Swarna Jayanti Shahari Rozgar Yojana.

- **DAY-NULM**, under the aegis of MoHUA, has focused on **equipping the urban poor women with adequate skills and opportunities,** and to enable them to promote **sustainable micro-enterprise**.

- **Main Features**
  i. **Coverage**: To be implemented in all district's headquarters (irrespective of population) and other towns with population of 1 Lakh.
  ii. **Target Population**: Urban poor including urban homeless

iii. **Sharing of Funding**: Center: State: 75: 25 , for North Eastern and Special Category States (Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim, Tripura, Jammu and Kashmir, Himachal Pradesh and Uttarakhand) : this ratio will be 90 : 10

- **Guiding Principles**
  i. The core belief is that the poor are entrepreneurial and have innate desire to come out of poverty.

F) PRADHAN MANTRI KAUSHAL VIKAS YOJANA (PMKVY)

- **PMKVY** was launched in 2015 and is being implemented under Skill India Mission.
- It is a flagship outcome-based skill training scheme for **recognition** and **standardization of skills**.
- It has **two components:**
  - » **Short-term Training (STT)**
  - » **Recognition of Prior Learning (RPL)**

- It works through empanelled training centers, training providers (TCs/TPs) throughout the country.
- **Cost**: Ministry bears all the cost of training.

- **Progress so far:**
  - » **Third phase** of PMKVY is being implemented throughout the country since Jan 2021.
  - » **Under PMKVY 2.0: Between 2017 - 2023** (Jan 2023) about **1.1 crore persons have trained**: 83% certified and about 21.4 lakh placed.
  - » **Under PMKVY 3.0**, during FY21 to FY23 around 7.4 lakh persons have been trained, 66% certified and 41,437 placed.
  - » PMKVY also provided training **to Shramik (migrant laborers)** affected by COVID-19. This covered 116 districts of 6 states, viz Assam, Bihar, Madhya Pradesh, Odisha, Rajasthan, and Uttar Pradesh. Around 1.3 lakh workers were trained by Oct 2023

G) JAN SHIKSHAN SANSHTHAN

- **By MSDE**
- **Scheme for support to Jan Shikshan Sansthan (NGO's) for Skill Development**
  - » The scheme provides for a lump sum annual grant for NGOs for skill training to non-literate, neo-literates, persons with rudimentary level of education and school dropouts up to class XII in the age group of 15-45 years.
  - » **Priority groups** are women, SC, ST, and other backward sections of society.

- **Progress So Far (Jan 2023)**
  - » From FY20 to FY23, 16.0 lakh beneficiaries have been trained of which 28.4% are from urban areas and 69.0% are from rural areas and 2.7% are from tribal areas. Notably, 81% of trainees are women.

H) NATIONAL APPRENTICESHIP PROMOTION SCHEME

- It provides **financial support to industrial establishments** undertaking apprenticeship programs under the Apprentices Act, 1961.

- **Implementing authority**
    - The scheme is implemented by Director General of Training under the Ministry of Skill development.

- **Progress as of Jan 2023**
    - Since the launch of the scheme in 2016, as on Dec 2022, **21.4 lakh apprentices** have been engaged by Industries.

I) CRAFTSMAN TRAINING SCHEME

- It provides long term training in 149 trades through 14,938 Industrial Training Institutes (ITIs) across the country.
    - Since 2015, 91.7 lakh students have been trained by Oct 22.

J) CRAFT INSTRUCTOR TRAINING SCHEME

- Comprehensive training both in skills and training methodology is imparted to the instructor trainees to make them conversant with the methodology of teaching and techniques of transferring hands-on skills, to train skilled manpower for the industry.
- During FY22, a total of **8,847** trainees have been trained in various **National Skills Training Institutes** and **Institute of Training Trainers**.

K) SKILL INDIAN INTERNATIONAL NETWORK

- With an aim to make India a Skill Capital of the World and improve mobility of Skilled manpower the **National Skill Development Corporation (NSDC) International** has been set up, which aims to create a network of institutions across India.
- This network of institutions will be called as **Skill India International (SII) Network**. It shall be created through the empanelment of state-of-the-art government and private institutions.

- **MSDE has also signed MoUs with 11 countries** Australia, Belarus, China, Denmark, France, Germany, Japan, Qatar, Switzerland, UAE, and the United Kingdom in the field of skill development and vocational education training.

- NSDC has also signed **18 B2B MoUs** with countries like Australia, Canada, Germany, Japan, Malaysia, Kingdom of Saudi Arabia, UAE, etc

L) SKILLS ACQUISITION AND KNOWLEDGE AWARENESS FOR LIVELIHOOD PROMOTION (SANKALP) SCHEME

- **Details**
    - It is a World Bank loan assisted program of MSDE with three key result areas (RAs), namely:
        1. Institutional Strengthening at Central, State and District Level.
        2. Quality Assurance of Skill development programs; and
        3. Inclusion of Marginalized population in skill development programs

- The scheme was launched in **Jan 2018** and has a **six-year implementation period** till **March 2023**.

- **Key Outcomes**
  - Under the National Component and State Component of SANKALP, **64 & 700 projects** respectively have been taken up in the areas of Skill and Entrepreneurship development and strengthening of Monitoring.
  - **724 District Skill committees** (DSCs) have been constituted, which are mandated to plan, manage, and monitor skilling activities at the district level.

6. SOCIAL PROTECTION FOR RAINY DAYS

- Economic growth can lift citizens out of the low-income trap, but for ensuring that they are no longer vulnerable to crisis situation, various social protection has to be provided to them. It may be for health, old age, unemployment, disability etc.
- In FY2023 government continued to run various social protection programs. Some important ones are:

A) PRADHAN MANTRI VAYA VANDANA YOJANA (PMVVY)

- It's a **pension scheme announced by GoI** for **senior citizens aged 60 years and above**.
  - **Initially** elderlies could invest upto Rs 15 Lakhs and @8% get upto Rs 10,000 per month pension, but the provisions have now been modified.

- **Modifications in 2020**
  - **Varying investment rate** - depending on the Financial Year (FY) in which the investment is made. The maximum interest rate is capped at **7.75%** at any point.
    - » The government will declare the PMVVY interest rate at the start of each FY.
  - The **maximum investment** is restricted to **Rs 15 lakh** per senior citizen and maximum monthly pension in PMVVY is Rs 9,250 per person.
    - » So, if both husband and spouse invest, the maximum monthly pension can be **Rs 18,500** in the family for an investment of Rs 30 Lakh.

- **Other benefits**
  - Exemptions from GST
  - Loans about 75% of the purchase price shall be allowed after 3 years
  - Allows **premature exit** for the treatment of critical/terminal illness of self or spouse. In this situation, 98% of the purchase price will be refunded.

B) PRADHAN MANTRI JEEVAN JYOTI BIMA YOJANA (PMJJY)

- Ministry: **Department of Financial Services, Ministry Of Finance**
- It is one year life insurance scheme renewable from year-to-year.
- Coverage for **death due to any reason** and is available to people in the age group of 18 to 50 years (life cover up to age 55)having a savings bank account who give their consent to join and enable auto-debit.

- Life cover of Rs. 2 lakhs is available for a one year period stretching from 1st June to 31st May at a premium of **Rs.436/-per annum** per member.
- Assurance will be terminated under:
    a. On attaining age 55 years (age near birth day) subject to annual renewal up to that date (entry, however, will not be possible beyond the age of 50 years).
    b. Closure of account with the Bank or insufficiency of balance to keep the insurance in force.
    c. A person can join PMJJBY with one Insurance company with one bank account only.
- It is offered / administered through LIC and other Indian private Life Insurance companies. For enrolment banks have tied up with insurance companies. Participating Bank is the Master policy holder.

C) PRADHAN MANTRI SURAKSHA BIMA YOJANA (PMSBY)

- Ministry: **Department of Financial Services, Ministry Of Finance**
- A large proportion of the population have no accidental insurance cover
- PMJJBY is aimed at covering the uncovered population at an highly affordable premium of just Rs. **20** per year.
- Age group: 18 - 70 years
- Available to people with a savings bank account who give their consent to join and enable auto-debit on or before 31st May for the coverage period 1st June to 31st May on an annual renewal basis.
- Risk coverage available will be Rs. 2 lakh for accidental death and permanent total disability and Rs. 1 lakh for permanent partial disabilities.
- It is offered by Public Sector General Insurance Companies or any other General Insurance Company who are willing to offer the product on similar terms with necessary approvals and tie up with banks for this purpose.
- Participating Bank will be the Master policy holder
- **Progress:** As on 11th Jan 2023, 32.1 crore persons have been enrolled cumulatively and 1,10,298 claims have been paid under PMSBY.

D) PRADHAN MANTRI SHRAM YOGI MANDHAN YOJANA (PM-SYMDY)

- **Ministry:** Ministry of Labour and Employment
- Launched in March 2019, the PM-SYMDY is a **voluntary and contributory pensio**n scheme for providing a monthly **minimum assured pension of `3,000** upon attaining the age of 60 years.
    - Provision for **matching contribution** by the GoI: Contribution towards the Pradhan Mantri Shram Yogi Maan-dhan scheme is made by the subscriber and the central government on a 50:50 basis.
- The **workers in the age group of 18 to 40 years** having a monthly income of `15,000 or less and not a member of EPFO/ ESIC/ NPS (Govt. funded) can join the scheme.
- As of 2 November 2022, over **49.1 lakh beneficiaries** have been enrolled under the Scheme.

E) PM STREET VENDOR'S ATMANIRBHAR NIDHI SCHEME (PM SVANIDHI)

- **Ministry: Ministry of Housing and Urban Affairs (**MoHUA)
- **Need:** Street vendors had lost their livelihood due to COVID-19 crisis
- MoHUA is implementing the PM SVANIDHI Scheme since June 01, 2020, in which street vendors vending on or before 24th March, 2020 in urban, semi urban or peri-urban areas will be provided with **affordable working capital loan** to resume their livelihoods.

- A loan of **maximum 10,000 rupees** can be available which will be repayable in monthly instalments in a tenure of one year.
    - » On **timely/early repayment**, an interest subsidy @7% per annum will be credited to the bank account of the beneficiaries through Direct Benefit Transfer on quarterly basis.
    - » On early repayment, no penalty would be imposed.
    - » Further, **beneficiaries are also eligible for second tranche of loan** upto Rs 20,000 with 18 months tenure after timely repayment of the first tranche.

- The scheme also promotes digital transactions through cash-back incentives upto an amount of Rs 1,200 per annum.
- The vendors can fulfil their aspiration of climbing up the economic ladder by availing the facility of enhanced credit limit on timely/ early repayment of loan.
- **Note:** The scheme is available for beneficiaries belonging to those states/Uts which have notified Rules and Scheme under the Street Vendors (Protection of Livelihood and Regulation of Street Vending).

F) PM MUDRA YOJANA (PMMY)

- **Introduction**
    - » PMMY is an initiative by the **Union Ministry of Finance** to 'fund the unfunded'. It is aimed at using **micro-finance as an economic development tool** that helps to provide **income generating opportunities to the people at the bottom of the pyramid**, targeting small manufacturing units, shopkeepers, fruits and vegetable vendors, truck and taxi operators, food service units, repair shops, machine operators, artisan and food processors.
    - » PMMY's objective is to **refinance the collateral free loans** given by lenders to small borrowers through MUDRA Ltd.
        - ▪ The collateral free loans are provided through public sector, regional, rural, State and urban cooperative banks to **non-farm income generating enterprises** (Non-Corporate Small Business Segment (NCSBS) comprising of proprietorship or partnership firms) in manufacturing, trading and services whose credit needs are **below Rs.10 lakh**.
        - ▪ The scheme gives **priority to Dalits, Tribals, Backward Classes and Women**.
        - ▪ Note: These loans are not subsidized loans.
    - » The scheme was launched in **April 2015** and the allocation for the scheme has increased in every financial year.

- PMMY can be availed under three categories:
    - » **Shishu**, which will cover loans up to Rs. 50,000;
    - » **Kishor** for loans above Rs. 50,000 and up to Rs. 5 lakh;
    - » **Tarun** for loans above Rs. 5 lakh and up to Rs. 10 lakh

- **Micro Units Development and Refinance Agency Ltd (MUDRA Ltd)**
    - » MUDRA is wholly owned subsidiary of Small Industries Development bank of India (**SIDBI**).
    - » It is responsible for **developing and refinancing all Micro-enterprises sector** by supporting the finance Institutions which are in the business of lending to micro / small business entities engaged in manufacturing, trading and service activities.
    - » It partners with Banks, MFIs and other lending institutions at state level / regional level.

» **Responsibilities under PMMY:** MUDRA will provide refinance support, monitor the PMMY data by managing the web portal, facilitate offering guarantees for loans granted under PMMY and take up other activities assigned to it from time to time.

- **Progress so far (Jan 2023)**
  » **More than 38.4 crore loans,** amounting to Rs 21.4 lakh crores, have been sanctioned since the launch of the scheme.
    - Out of this, more than 8.2 crore loans amounting to Rs 6.8 lakh crore have been extended to new entrepreneurs/ accounts which is approx. 21% of total loans extended under the scheme.
    - About 69% loans have been sanctioned to women entrepreneurs.

7. DEVELOPMENT OF INDIA'S ASPIRING RURAL ECONOMY

- **The percentage** of the population living in India's rural areas was as high as around **80%** in the 1960s and remained over **70%** till 2017.

- **Present Population in Rural Areas**: Currently, around 65% of India's population lives in rural areas and around 47% of the population is dependent on agriculture as livelihood.

- **Therefore,** for inclusive development of the country, it's crucial to focus on rural areas.

- **Various measures** have been taken to enhance quality of life in rural areas:

Multifaceted initiatives to improve the ecosystem of quality of life

- The **NFHS Data** for 2019-21 illustrates a significant improvement vis-à-vis 2015-16 in an array of indicators concerning the quality of rural lives, including, inter alia, access to electricity, presence of improved drinking water sources, coverage under health insurance schemes etc.

- **Some Important Schemes:**

- **DEENDAYAL ANTYODAYA YOJANA: NATIONAL RURAL LIVELIHOOD MISSION (DAY-NRLM)**

  - **Ministry:** MoRD

  - NRLM was launched in MoRD in June 2011 as a restructured version of Swarna Jayanti Gram Swarozgar Yojana.

    » It aims to enable **economically weak households** to access gainful **self-employment** and **skilled wage employment** opportunities resulting in sustainable and diversified livelihood options for them.

    » It is one of the world's largest initiative to improve the livelihoods of poor.

    » It was renamed to **Deendayal Antyodaya Yojana (DAY-NRLM)** in Nov 2015.

    » The mission seeks to achieve its objective through **investing in four core components**:

      i. **Social Mobilization and Promotion and strengthening** of self-managed and financially sustainable community institutions of the rural poor women.

      ii. **Financial Inclusion**

      iii. **Sustainable Livelihood**

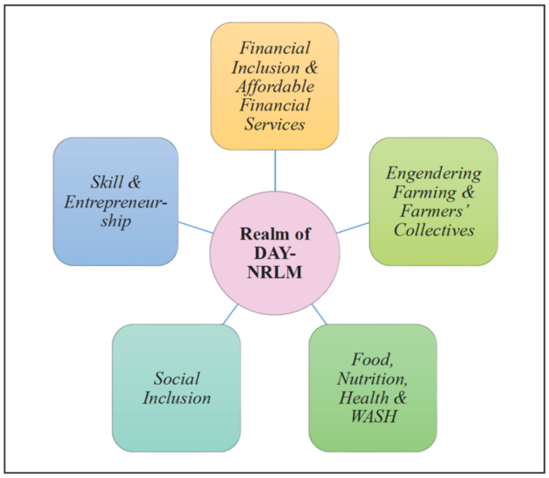
      iv. **Social Inclusion**, Social Development, and access to entitlements through convergence.

    » The **cornerstone of the Mission** is its '***Community-driven'*** approach which has provided a huge platform in the form of community institutions for women empowerment.

    » **Rural women are at the core** of the program which is extensively focused on their socio-economic empowerment by way of building their capacities, providing financial support, and training in order to enable them to undertake livelihoods activities and become financially independent.

      ▪ Nearly 4 lakh SHG members have been trained as Community Resource Persons (CRPs) (viz. Pashu Sakhi, Krishi Sakhi, Bank Sakhi, BimaSakhi, PoshanSakhi etc.) help in the implementation of the Mission at the ground level

Components of DAY-NRLM



  - The mission currently has its footprint across 6,880 blocks in **723 districts** across all states and UTs (except Delhi and Chandigarh) under its implementation strategy. It has mobilized total 8.7 crore women from poor and vulnerable communities into 81 lakh SHGs.

3) DDU-GKY:

- Already done with skill development topic

4) RURAL HOUSING: PRADHAN MANTRI AWAAS YOJNA – GRAMIN (PMAY-G)

- **Ministry:** Ministry of Rural Development (MoRD)
  - » **Centrally Sponsored** Scheme: (60:40 - Centre: State)
- **PMAY-G** was launched in Nov 2016 with the aim of providing **3 crore pucca houses** with basic amenities to all eligible houseless households living in Kutcha or dilapidated houses in rural areas by **2022 (2024)**.
- Under this scheme, financial assistance is provided for construction of pucca house to all houseless and for upgradation for households living in kutcha or dilapidated houses.

- It is being implemented in rural areas across the country except Delhi and Chandigarh.

- **Targeting**:
  - » To ensure that assistance is targeted at those who are genuinely deprived, and that the selection is objective and verifiable, PMAY-G selects beneficiaries using **housing deprivation parameters in the SECC, 2011 data** which is to be verified by the Gram Sabhas.
  - » Under the scheme, landless beneficiaries are accorded the highest priority in the allotment of houses.

- **Progress:**
  - » A total of 2.7 crore houses have been sanctioned and 2.1 crore houses have been completed by 6 January 2023 under the Scheme. Against the total target of completion of 52.8 lakh houses in FY23, 32.4 lakh houses have been completed

- **Through convergence** with other Government Schemes, the PMAY-G also addresses basic needs such as the construction of the toilet, piped drinking water, electricity connection, LPG Gas connection, and 90/95 person-days of unskilled labor from MGNREGA.

5) DRINKING WATER AND SANITATION

- **JJM** was launched in 2019 to provide **functional household tap connection (FHTC)** to every household by 2024

- **Need:**
  - » **Water inequality is a major concern in India. 81% of households** in India are without tap connection (14.6 cr /17.87 cr)
  - » Safe drinking water together with a comprehensive sanitation program is important for reducing the disease burden of the poor.

- **Details**
    - **JJM** restructures and subsumes the National Rural Drinking Water Program (running since 2009). The scheme is also known as **Har Ghar Nal Se Jal (HGNSJ)**.

- **The Broader Objectives of JJM are:**
    - » To provide **Functional Household Tap Connections (FHTC) to every rural household by 2024** with a service level of 55 litres per capita per day (lpcd).
    - » To **prioritize provision of FHTCs in quality affected areas**, desert areas, drought prone areas and Sansad Adarsh Gram Yojna villages.
    - » To provide functional tap connection to **Schools, Anganwadi centres, GP buildings**, Health centres, wellness centres and community buildings
    - » To **monitor functionality** of tap connections.
    - » To **promote and ensure voluntary ownership a**mong local community by way of contribution in cash, kind and/ or labour and voluntary labour (shramdaan)
    - » To **assist in ensuring sustainability of water supply system**, i.e. water source, water supply infrastructure, and funds for regular O&M
    - » To **empower and develop human resource** in the sector such that the demands of construction, plumbing, electrical, water quality management, water treatment, catchment protection, O&M, etc. are taken care of in short and long term
    - » To **bring awareness** on various aspects and significance of safe drinking water and involvement of stakeholders in manner that make water everyone's business

- A **dedicated fund** called '***Rashtriya Jal Jeevan Kosh***' has been set up by Ministry of Jal Shakti to **mobilse and accept contributions** received from other sources such as Corporate Social Responsibility to fund JJM.

- **Cost:** The total project is estimated to cost **Rs 3.60 lakh crore**.
    - **Center: State:** 50: 50 (90:10 for NE and Himalayan States and 100% for UTs)

- **Implementations**
    - JJM is implemented by the Department of Drinking Water and Sanitation (DDWS) under the recently formed MJS.

6) MISSION AMRIT SAROVAR

- **Ministry:** Ministry of Rural Development (MoRD)
- Mission Amrit Sarovar was launched on National Panchayati Raj Day on 24 April 2022 with the objective to **conserve water for the future**.
- The Mission is aimed at **developing and rejuvenating 75 water bodies in each district** of the country during this Amrit Varsh, 75th Years of Independence.

- So far, against the **initial target of 50,000 Amrit Sarovar**, a total of more than 93,291 Amrit Sarovar sites have been identified and works have commenced on more than 54,047 sites. Out of these commenced works, a total of more than 27,071 Amrit Sarovars have been constructed so far.

- **The impact of this initiative has been**
    - » About 32 crore cubic meters of water holding capacity has been enhanced.
    - » Water Users' groups have been associated with each Amrit Sarovar inter-alia improving the livelihoods base of the local community.
    - » Participation of freedom fighters, Martyr's families, Padma Awardees, and other eldest citizens of the local areas helped in **community participation at a large scale**, promoting social harmony and patriotism, and making this mission a mass movement.
    - » People's participation has been seen in this mission in a form of "**Shram -Daan**".
    - » This will result in the creation of a total carbon sequestration potential of 1,04,818 tonnes of carbon per year

7) JALDOOT APP

- **Ministry: MoRD**
- MoRD has developed 'JALDOOT App' which will be used across the country to capture water levels of selected well.
    - » It will enable Gram Rojgar Sahayak (GRS) to measure the water level of selected wells twice a year (pre-Monsoon post-Monsoon).

In every village adequate number of measurment locations (2-3) have to be taken.

8) SWACHH BHARAT MISSION (GRAMEEN)

- Swachh Bharat Mission (Grameen) (SBM(G)) was launched on 2nd Oct 2014 to ensure cleanliness in India and make Indian Open Defecation Free (ODF).

- Having **achieved the ODF status in all villages in the country** as of 2nd Oct 2019, **phase-II of SBM (G)** is now being implemented during FY21 **and** FY25, with the focus to sustain the ODF status of villages and covering all the villages with Solid and Liquid Waste management i.e. **to convert the villages from ODF to ODF Plus**.
- **Progress:**
    - ▫ More than 1.2 lakh villages have been declared ODF plus till 10th Nov 2022.
    - ▫ **Andaman & Nicobar Islands** has declared all its villages as ODF Plus, thus becoming the first ***Swachh, Sujal Pradesh***.

9) PRADHAN MANTRI UJWALLA YOJANA (PMUY)

- **Nodal Ministry:** Ministry of Petroleum and Natural Gas which is implementing this scheme (this ministry is perhaps implementing a welfare scheme for the first time)
- **Key Provisions PMUY** (later called PMUY 1.0)
    - The **PMUY** was originally launched in May 2016 as a flagship scheme to make **clean cooking fuel such as LPG available to rural and deprived households** which were otherwise using traditional cooking fuels such as firewood, coal, dung cakes etc.

- Initially it aimed to provide **5 crore free cooking (LPG) connections** to BPL families in 3 years (i.e. by 2018). Later, the target was revived to **8 crore free LPG cylinders/connections by 2020**.
- The scheme provided a **financial support of Rs 16,00 for each LPG connection** to the BPL families. In Feb 2018, to increase the coverage, government expanded to coverage for all SC/ST households, beneficiaries of PMAY (G), Antyodaya Anna Yojana, Forest Dwellers, most backward classes, tea and ex-tea garden tribes, people residing in island and rivers etc. in addition to SECC data.
- The connection was provided in the name of women of the households.

- **Tagline of the Scheme:** Swatch Indhan, Behtar Jeevan.
- **Outcome:**
  - The release of 9.5 crore LPG connections under the scheme has also helped in increasing the LPG coverage from 62% on 1st May 2016 to 99.8% on 1st April 2021.

- **PMUY Phase 2** (PMUY 2.0) (or Ujjwala 2.0)
  - Launched in Aug 2021.
  - In the Union Budget for FY 2021-22, provision for an additional one crore LPG connection under the PMUY scheme was announced.
    - These additional PMUY connections aim to provide deposit free LPG connections to those low-income families who couldn't by covered under the earlier phase of PMUY.
  - **Other than deposit free LPG connections,** Ujjwala 2.0 will provide **first refill and hotplate free of cost to beneficiaries**.
  - Further the enrollment process will require minimum paperwork.
    - Here, migrants will not be required to submit ration cards or address proof. A **self-declaration** for both 'family declaration' and as a 'proof of address' will suffice.
  - **Progress:** Under Ujjwala 2.0, **1.6 crore connections** have been released until 24 Nov 2022

10) PRADHAN MANTRI GRAM SADAK YOJANA (PMGSY)

- PMGSY was launched in the year 2000, as a centrally sponsored program by Ministry of Rural Development (**MoRD**).

- The primary **objective** of the programme was to provide
  - **Connectivity by way of all-weather roads** to unconnected habitations of designated population size of more than 500 in plain areas and 250 in north-east, hill, tribal and desert areas as per the census 2001.
  - **Upgradation of selected roads** to provide full farm to market connectivity.

- **Funding**
  - Initially, it **was fully funded by central government**.
  - **But lately,** since the 14th Finance Commission's recommendation for more devolution of tax pool to states, it is funded by both center and state government **in 60:40 ratio** (90: 10 in some north eastern and hilly states)

- **Connecting left wing affected areas Scheme:**

- To improve rural road connectivity in the left wing extremism affected districts from security angle , the Cabinet had in 2016 approved the centrally-sponsored "**Road Connectivity Project for Left Wing Extremism (LWE) Affected Areas**" scheme.
- The Project was implemented as a **vertical under PMGSY** to provide connectivity with necessary culverts and cross-drainage structures of 44 worst affected LWE districts and adjoining districts, critical from security and communication point of view.
- **Development of Major District Roads (MDRs):** PMGSY guidelines don't permit construction/upgradation of MDRs. However, keeping special circumstances of LWE area in view, MDRs were also taken up under the scheme as a special dispensation.
- The National Highways and State Highways would be excluded from the project.
- **States covered**
    - Orissa, Jharkhand, Bihar, Chhattisgarh, MP, Telangana and Maharashtra

- **Targets**
    - PMGSY Phase 1: Habitation (250+) covered by March 2019.
    - PMGSY Phase 2 (Habitation 100+) and LWE blocks covered by March 2020.
    - Phase 3 focuses on sustainable maintenance of the roads.
        - Phase 3 was launched in July 2019
        - It is aimed at **consolidation of 1 lakh 25 thousand Kms** through routes and major rural links that connect habitations to GrAMs, Higher Secondary Schools, and Hospitals.
- **Progress:**
    - Since its inception, a total of 1,84,984 roads measuring 8,01,838 km and 10,383 Long Span Bridges (LSBs) have been sanctioned under all the interventions/ verticals of PMGSY.

11) ELECTRICITY RELATED SCHEMES

A) SAUBHAGYA – PRADHAN MANTRI SAHAJ BIJLI HAR GHAR YOJANA

- **Ministry: Ministry of Power**
- **Introduction:**
    - The government launched PM Saubhagya in **2017** with the objective to achieve **universal household electrification** by providing **electricity connections to all willing un-electrified households in rural areas** and **all willing poor households in urban areas** in the country by March 2019.

- With this it also wanted to improve environment, public health, education and connectivity with the help of last mile power connections across India.

- **Main provisions**
    - **Free or small Fee:** The electricity connection will be free for people identified by SECC, 2011 and will be given at 500 Rs, payable in 10 instalments in the bill for others.
    - **Solar Photo Voltaic based stand-alone system For unelectrified households in remote and inaccessible** areas.
    - **Rural Electrification Corp** was the **nodal agency** for the scheme throughout the country while public institutions and panchayats were authorized to collect application forms, distribute bills, and collect payments in consultation with Panchayati raj institutions and urban local bodies.

- **Funding mechanism**
    - The scheme will be funded by Central grants (60%), Bank Loans (30%), and States (10%).

- The scheme complements DDUGJY which was launched in 2015, under which 100% of the 18,000 villages have been electrified.

- **Progress So Far**
    - **The Saubhagya scheme** has **successfully completed at the close of March 2022**

M) DEENDAYAL UPADHYAYA GRAM JYOTI YOJANA (DDUGJY)

- The scheme, launched in July 2015, draws its inspiration from similar pioneering scheme implemented by the government of Gujarat.

- This scheme **aims** at providing **round the clock power to rural households** and **adequate power to agriculture consumers**.

- The earlier scheme for rural electrification viz. Rajeev Gandhi Grameen Vidyutikaran Yojana (RGGVY) has been subsumed in the new schemes as its rural electrification component.

- **3 Components**
    1. **Feeder separation** (rural households and agriculture)
    2. Strengthening of **sub-transmission and distribution** network including **metering** at all levels (input points, feeders and distribution transformers);
    3. Micro grid and off grid distribution network and **Rural electrification** - already sanctioned projects under RGGVY to be completed.

The scheme extends financial assistance for capital expenditure by distribution companies (discoms) for strengthening and augmenting distribution infrastructure, including rural metering.

8. EDUCATION RELATED INITIATIVES

1) SCHOOL EDUCATION: ENROLMENT AND DROPOUT

- In FY22, a total of 26.5 crore children were enrolled in schools.

- The **enrolment** increased across all levels - Primary, Upper Primary, Secondary and Higher Secondary except for pre-primary levels.
    - At the pre-primary level, enrolment reduced from 1.1 crore in FY21 to 1.0 crore in FY22.

- **School Drop-out** rates at all levels have witnessed a **steady decline** in recent years. The decline is for both girls and boys.

- Total drop out (in %) was 1.5% at Primary levels, 3.0% at Upper Primary Levels, and 12.6% at secondary levels.
- The schemes such as Samagra Shiksha, RTE Act, improvement in school infrastructure and facilities, residential hostel buildings, availability of teachers, regular training of teachers, free textbooks, uniforms for children, Kasturba Gandhi Balika Vidyalaya and the PM POSHAN Scheme play an important role in enhancing enrolment and retention of children in schools

2) IMPORTANT SCHEMES FOR SCHOOL EDUCATION LAUNCHED IN FY23

A) PM SCHOOL FOR RISING INDIA (PM SRI)

- It is a Centrally Sponsored Scheme (CSS) launched on 7 September 2022.
- These schools will be equipped with **modern infrastructure and showcase the implementation of the NEP** and emerge as **exemplary schools** over a period, while offering leadership to other schools in the neighbourhood.
- Under the scheme, there is a provision for setting up more than 1**4,500 PM SHRI Schools, over the period FY23 to FY27** by strengthening the existing schools from those managed by Central Government/State/UT Government/local bodies.
- These schools will be equipped with modern infrastructure including labs, smart classrooms, libraries, sports equipment, art room etc. which is inclusive and accessible.
- They shall also be **developed as green schools** with water conservation, waste recycling, energy-efficient infrastructure and integration of organic lifestyle in curriculum.
- More than 20 lakh students are expected to be direct beneficiaries of the scheme

B) THE NATIONAL CURRICULUM FRAMEWORK (NCF) FOR FOUNDATION STAGE:

- It has been launched as the new 5+3+3+4 curriculum structure which integrates early childhood care and education for all children of ages 3 to 8.
- As articulated in NEP 2020, the NCF uses ‘play,’ at the core of the conceptual, operational, and transactional approaches to curriculum organisation, pedagogy, time and content organisation, and the overall experience of the child. It will deal with the role of teachers as well as parents and communities in enabling and enhancing the developmental outcomes that are sought during this stage

C) PILOT PROJECT OF BALVATIKA:

- With a focus on developing cognitive, affective, and psychomotor abilities and also early literacy and numeracy for students in the age groups of 3+, 4+ and 5+ years, Project Balvatika, i.e.,‘Preparatory Class’, was lauched in October 2022 in **49 Kendriya Vidyalayas**.

D) TOY BASED PEDAGOGY:

- A handbook for Toy-based pedagogy has been designed to promote the **integration of indigenous toys and their pedagogy into the curriculum of school education,** early childhood care and education and teacher education.
- This will help teachers select or create age-appropriate toys to explain various concepts to students

E) SCREENING TOOLS (MOBILE APPS) FOR SPECIFIC LEARNING DISABILITIES:

- **PRASHAST**, a **Disability Screening mobile app,** has been launched, covering 21 disabilities, including the benchmark disabilities as per the Rights of Persons with Disabilities Act 2016.
- PRASHAST App will help in screening disability conditions at the school level and will generate the school wise report, for further sharing with the authorities for initiating the certification process, as per guidelines of Samagra Shiksha

F) NATIONAL CREDIT FRAMEWORK (NCRF):

- Taking the vision of the new NEP, the **NCrF is an umbrella framework** for skilling, re-skilling, up-skilling, accreditation and evaluation, seamlessly **integrating the credits earned through school education, higher education, and vocational and skill education by encompassing the National Higher Education Qualification Framework (NHEQF), National Skills Qualification Framework (NSQF) and National School Education Qualification Framework (NSEQF)**.
- This would be a game changer by opening numerous options for further progression of students and inter-mingling of school and higher education with vocational education and experiential learning, thus mainstreaming skilling and vocational education. The Framework has been **released for public consultations on 19 October 2022**.

G) STRENGTHENING TEACHING-LEARNING AND RESULTS FOR STATES (STARS)

- STARS Project is being implemented as a CSS in six states namely Himachal Pradesh, Madhya Pradesh, Rajasthan, Maharashtra, Odisha and Kerala over a period of 5 years i.e., till FY25, partly funded by a loan from the World Bank. The objective of the Scheme is to **improve the quality and governance of school education** in the selected states

H) VIDYANJALI (A SCHOOL VOLUNTEER INITIATIVE):

- With the aim of strengthening schools and improving the quality of school education through **community, Corporate Social Responsibility (CSR) and private sector involvement** across the country, the Government has initiated Vidyanjali (a school volunteer management program).
- The Vidyanjali portal (https://vidyanjali.education.gov.in/en) enables community and volunteers/organisations to interact and connect directly with the Government and Government aided schools of their choice and share their knowledge and skills and/or contribute in the form of assets/material/equipment to meet the requirement of the schools.
- As of **20 January 2023**, 3,95,177 schools have been onboarded and 1,14,674 volunteers have registered on the Vidyanjali portal.

I) SAMAGRA SHIKSHA SCHEME: INTEGRATED SCHEME FOR SCHOOL EDUCATION (LAUNCHED IN 2018)

- It is an overarching program for the school education sector extending from pre-school to class 12. It focuses on the broader goal of improving school effectiveness measured in terms of equal opportunities for schooling and equitable learning outcomes.

- It subsumed erstwhile three Centrally Sponsored Schemes of Sarva Shiksha Abhiyan (SSA), Rashtriya Madhyamik Shiksha Abhiyan (RMSA) and Teacher Education.
- **It focuses on:**
    - **Administrative Reforms -** Single and unified administrative structure to harmonized implementation
    - **Quality Education**
    - **Digital Education**
    - **Strengthening of Schools**
    - **Girl Education**
    - **Inclusion**
    - **Skill Development**
    - **Physical Education**
    - **Regional Balance**

- **The Samagra Shiksha Scheme** has been aligned with the recommendations of the NEP 2020 and extended from FY22 and FY26.
    - Under the **ICT component of the Scheme,** there is a **provision to impart computer literacy and computer-enabled learning to children**, by developing and deploying curriculum-based interactive multimedia, digital books, virtual labs etc. across the country.
        - It supports the establishment of smart classrooms, and ICT labs in schools, including support for hardware, educational software, and e-content for teaching.
        - It envisages covering all Government/Government-aided schools with classes VI to XII. Till November 2022 (since inception), ICT labs have been approved in 1,20,614 schools and smart classrooms in 82,120 schools across the country.

2) HIGHER EDUCATION

- Indian higher education system is the laboratory of change for one of the largest young populations in the world, with more than 27 per cent of India's population in 15-29 years age bracket.

- Current Situation:
    - The **infrastructure** for higher education has been enhanced overtime.
        - Number of Medical colleges in the country have been increased from 387 in 2014 to 684 in 2022 and the number of MBBS seats have increased from 51,348 to 96,077.
        - **Number of IITs** have increased to 23 and IIMs have increased to 20 in 2022.
        - There are 1,113 universities in the country in 2022 (which was 723 in 2014)
    - The **total enrolment** in higher education has increased to nearly 4.1 crore in FY21 from 3.9 crore in FY20.
        - Female enrolment has also increased to 2.0 crore in FY 21.

3) NITIATIVES FOR HIGHER EDUCATION IN FY23

A)RESEARCH AND DEVELOPMENT CELL (RDC) IN HIGHER EDUCATIONAL INSTITUTIONS (HEIS)

- **The University Grants Commission (UGC)** launched an initiative to establish an RDC in HEIs with the mandate for promoting quality research that contributes meaningfully towards the goal of a self-reliant India, aligned with the provisions of NEP 2020.

- The RDC would **help create a research ecosystem** for reliable, impactful, and sustained research output.

- The **Guidelines for the same were issued in March 2022** providing for:
    - the creation of a conducive environment for enhanced research productivity;
    - encouraging collaboration across industry, Government,c ommunity-based organisations, and agencies at the local, national, and international levels and
    - facilitating greater access to research through mobilisation of resources and funding.

B) GUIDELINES FOR PURSUING TWO ACADEMIC PROGRAMS SIMULTANEOUSLY

- The UGC, in April 2022, issued Guidelines to allow the students to pursue two academic programmes simultaneously keeping in view the objectives envisaged in NEP 2020, viz. providing flexible curricular structures to enable creative combinations of disciplines for study, that would offer multiple entry and exit points, thus, removing currently prevalent rigid boundaries and create new possibilities for life-long learning through critical and interdisciplinary thinking.
- The Guidelines provide that a student can pursue two full-time academic programmes in physical mode or pursue two academic programmes, one in full-time physical mode and another in Open and Distance Learning (ODL)/Online mode; or up to two ODL/Online programmes simultaneously.
- These will be governed by Regulations notified by the UGC.

C) INTEREST SUBSIDY ON EDUCATION LOANS:

- Under the Central Scheme on Interest Subsidy (CSIS), launched in 2009, full interest subsidy is provided during the moratorium period (course period plus one year) on education loan taken by students from economically weaker sections (EWS) having parental income less than `4.5 lakh per annum for professional study in India.
- The scheme provides Education loans without any collateral or third-party guarantee

D) AKHIL BHARTIYA SHIKSHA SAMAGAM

- A three-day Akhil Bharatiya Shiksha Samagam was organised at Varanasi on 7-9 July 2022 by the Ministry of Education in association with the UGC and Banaras Hindu University.
- The event **brought together over 300 Vice Chancellors and Directors from public and private universitie**s, educationists, policymakers, as also industry representatives to deliberate on **how the implementation of NEP 2020 can be taken further across the country** after successful implementation of several initiatives in the last two years.
- The Summit provided a platform for thought-provoking discussions that helped articulate the roadmap and implementation strategies, foster knowledge exchange, build networks through interdisciplinary deliberations, and discuss challenges being faced by educational institutions and articulate solutions.

9. QUALITY AND AFFORDABLE HEALTH FOR ALL

- **Under the National Health Mission** (NHM) the Government has made concerted efforts to engage with all relevant sectors and stakeholders to move in the direction of achieving universal health coverage and delivering quality healthcare services to all at affordable costs.

- **Major initiatives from 2014 – 2022** in the health sector:

Major initiatives from 2014 to 2022 for better overall health

2014
- Mission Indradhanush
- Rashtriya Kishor Swasthya Karyakram
- Swachh Bharat Abhiyan

2015-16
- Free Drugs and Diagnostic Service
- Maternity Benefits Act - 6 months paid maternity leave
- Pradhan Mantri Ujjawala Yojana
- Pradhan Mantri National Dialysis Programme

2017
- National Health Policy
- Mental Healthcare Act
- National Strategic Plan for TB Elimination
- HIV and AIDS (Prevention & Control) Act

2018
- Ayushman Bharat - Health and Wellness Centres
- Ayushman Bharat – PM Jan Aarogya Yojana
- POSHAN Abhiyaan
- Anemia Mukt Bharat Strategy

2019-20
- Surakshit Matritva Aashwasan (SUMAN)
- e-Sanjeevani OPD
- Social Awareness and Actions to Neutralize Pneumonia Successfully (SAANS)

2021
- COVID-19 Vaccination Programme
- XV-Finance Commission – Health Sector Grants to Local Bodies
- Ayushman Bharat Digital Mission
- Ayushman Bharat – Health Infrastructure Mission
- Medical Termination of Pregnancy (Amendment) Act, 2021

2022
- Pradhan Mantri TB Mukt Bharat Abhiyaan to end TB by 2025
- National List of Essential Medicines Revision
- National Tele Mental Health Programme (Tele MANAS)

1) HEALTH SITUATION OF MOTHER AND CHILD

- With concerted efforts made under the Reproductive, Maternal, New-born, Child, Adolescent Health Plus Nutrition (**RMNCAH+N**) strategy, India has made considerable progress in health in improving the health status of both mothers and Children.

- As per the **Sample Registration Survey (SRS) data**, India has successfully achieved the major milestones to bring Maternal Mortality Ratio (MMR) to below 100 per lakh live births by 2020 [laid down in the National Health Policy, 2017]

- **Eight states** have already achieved the 2030 SDG targets to reduce MMR to less than 70 per lakh live births by 2030. These include Kerala (19), Maharashtra (33), Telangana (43), Andhra Pradesh (45), Tamil Nadu (54), Jharkhand (56),

Table VI.18: Trends in Mortality indicators

	2014	2016	2018	2020
Maternal Mortality Ratio (per lakh live births)	167 (2011-13)	130 (2014-16)	113 (2016-18)	97 (2018-20)
Infant Mortality Rate (per 1000 live births)	39	34	32	28
Neonatal Mortality Rate (per 1000 live births)	26	24	23	20
Under 5 Mortality Rate (per 1000 live births)	45	39	36	32
Early Neonatal Mortality Rate – 0- 7 days (per 1000 live births)	20	18	18	15

Source: Sample Registration System

Gujarat (57), and Karnataka (69).

- **Under five mortality and neonatal mortality** have also declined in the country.

2) HEALTH EXPENDITURE ESTIMATES

- **National Health Accounts** (NHA) – NHA accounts are prepared by NHSRC (National Health Accounts Technical Secretariat) set up in 2014 by the Union Health Ministry.
    - NHA estimates for India 2018-19 is the sixth consecutive NHA estimates reports by NHRSC. It was released in Sep 2022.

- **NHA** for FY19 – highlights the rising importance of public healthcare and social security in ensuring universal healthcare. The NHA estimates for FY19 show that there has been an **increase in the share of Government Health Expenditure** in the **total GDP from 1.2% in FY14 to 1.3% in FY19**.
    - Additionally, the share of GHE in **Total Health Expenditure (THE**) has also increased over time, standing at **40.6% in FY19**, substantially higher than 28.6% in FY14.
    - In FY19, **THE** for India is estimated to be **Rs 5,96,440 crore** (3.2% of GDP and Rs 4,470 per capita).
        - **Current Health Expenditure** (CHE) is Rs 5,40,246 crore (90.6% of THE) and capital expenditure is Rs 56,194 crores (9.4% of THE).
    - Of **GHE**, the Union government's share is 34.3% and the State Government's share is **65.7%**.

- **Note:** Primary Health expenditure forms the majority of the health expenditure.

- **The social security expenditure on health** includes social health insurance cover, government financed health insurance cover, and medical reimbursements made to government employees. It has increased to 9.6% in FY19 (from 6% in 2014). This is significant increase which shows that citizens are better equipped and better provided in terms of healthcare at their doorstep making it accessible.
    - **Due** to these steps, **Out of Pocket Expenditure (OOPE)** as a percentage of THE has declined substantially from **64.2% in FY14** to **48.2%** in FY19.

Figure VI.16: Government Health Expenditure (GHE) and Out of Pocket Expenditure (OOPE) as per cent of Total Health Expenditure (THE)

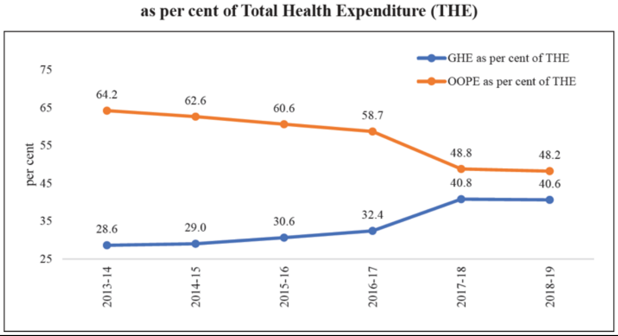
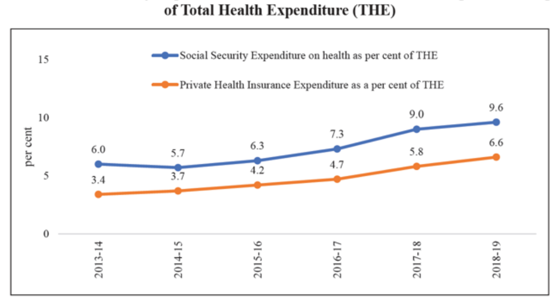


Figure VI.17: Social Security Expenditure and Private Health Insurance Expenditure as per cent of Total Health Expenditure (THE)



Source: National Health Accounts, MoHFW

3) RURAL HEALTH CARE – STRENGHTENING OF INFRASTRUCTURE AND HUMAN RESOURCE

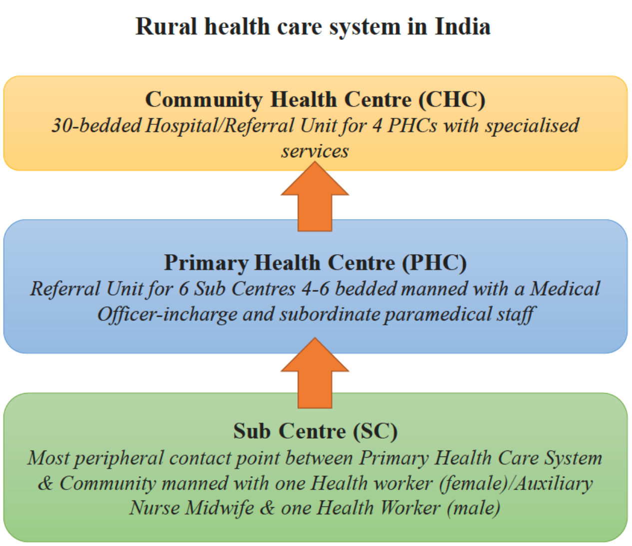
- **Introduction:**

- **Health infrastructure** is an important indicator for understanding the healthcare delivery provisions and welfare mechanisms in a country. **Public health infrastructure** has been referred to as 'the nerve centre of the public health system', forming the basic support system for the last-mile delivery of public health services.
- Alongside, **human resources for health** are identified as one of the core building blocks of the health system. These include physicians, nursing professionals, pharmacists, midwives, dentists, allied health professionals, community health workers, social health workers and other health care providers, as well as health management and support personnel

- **Increase in Health infrastructure in Rural Area:**
  - There has been a rise in the number of sub-centres (SCs), Primary Health Centres (PHCs) and Community Health Centres (CHCs) in rural areas. There has also been a rise in doctors, nurses, and other medical personnel over time.
  - **Under Ayushman Bharat:** SCs and PHCs are being strengthened by converting them into **Health and Wellness Centres** in a phase manner. As of Dec 2022, more than 1.5 lakh HWCs are already set up.

4) MAJOR GOVERNMENT INITIATIVES AND PROGRESS UNDER THEM

A) IMMUNIZATION



UNIVERSAL IMMUNIZATION PROGRAM

- The government had launched **Expanded Program for Immunization** in 1978 which was further replaced by **Universal Immunization Program (UIP)** in 1985. It is the largest Immunization Program in the world, with the annual coverage of 2.6 crore infants and 2.9 crore pregnant women. Through this India has achieved ground breaking success in eradicating/ eliminating life threatening vaccine preventable diseases like small pox, Polio, Maternal Neonatal Tetanus etc.

MISSION INDRADHANUSH

- It was launched by the MoH&FW in 2014. It is a strategic endeavor under UIP with an aim to target under-served, vulnerable and inaccessible populations.
- It covers **8 vaccines** (Diphtheria, Whooping Cough, Tetanus, Polio, Measles, Childhood TB, Hepatitis B and Meningitis.) across the country, **2 vaccines** (Pneumonia and Hemophilus influenza type B) in selected states and **2 vaccines** (Rotavirus Diarrhea and Japanese Encephalitis) in selected districts.
- **MI** contributed to an increase of 6.7% in full immunization coverage after the first two phases of Mission Indradhanush.

INTENSIFIED MISSION INDRADHANUSH 4.0 (LAUNCHED IN FEB 2022)

- In FY23, Intensified MI 4.0 was conducted **416 districts** (including 75 districts under Azadi ka Amrit Mahotsava) across 32 states/ Uts, to cover children and pregnant women who missed routine immunization during COVID-19 pandemic.

B) ESANJEEVANI PORTAL – NATIONAL TELEMEDICINE SERVICE

- **Ministry:** MoH&FW
- It is an innovative, indigenous, cost-effective, and integrated **cloud-based telemedicine system** application to enable patient to doctor teleconsultation to ensure a continuum of care and facilitate health services to all citizens in the confines of their home.

- **Two verticals of eSanjeevani**
    - **eSanjeevaniAB-HWC:** It endeavors to bridge rural-urban digital health divide by providing assisted teleconsultation and ensuring that e-beneficiaries of AB Scheme are able to avail the benefits that they are able to entitled to.
        - It operates on Hub and Spoke Model wherein the 'Ayushman Bharat - Health and Wellness Centre' are set up at the state level, act as spokes, which are mapped with the hub (comprising MBBS/ Specialty/ Super Specialty doctors) at zonal level.
    - **eSanjeevaniOPD** is the latter vertical which caters to citizens in both **rural and urban alike**. It leverages technology via smartphones, tablets, laptops etc. enabling doctor consultation to be accessible from the patient's residence regardless of location.

- **Progress So far:**
    - As of Jan 2023, 1,12,553 HWC in rural areas and 15465 Hubs at tertiary level hospitals, and medical colleges in the states have been enabled in the **eSanjeevani**.
    - **Patients Served**: It has served 9.3 crore patients so far and is serving around 4 lakh patients daily.

- **E-Sanjeevani** is evolved into the **world's largest outpatient Services system**.
- It is a cohesive part of Ayushman Bharat Digital Health Mission (ABDM) and more than 45,000 ABHA IDs have been generated using eSanjeevani Portal.

C) AYUSHMAN BHARAT – HEALTH AND WELLNES CENTRES

- H&WC was envisioned by National Health Policy, 2017 to act as the foundation of India's health system.
- Under the scheme, **1.5 lakh AB-HWCs** were envisaged to be established by upgrading the SHCs and PHCs in rural and urban areas.
- These AB-HWCs provide **Comprehensive Primary Health Car**e, by expanding and strengthening the existing Reproductive & Child Health services and Communicable Diseases services and by including services related to Non- Communicable Diseases such as hypertension, diabetes and 3 common cancers, viz. Oral, Breast and Cervix.
- **Facilities**: Each H&WC will have a eight member health and wellness team comprising of a mid-level provider called **Community Health Officer** (nurse practitioner or Ayurveda practitioner), two multipurpose workers and 5 ASHAs.

- **Progress** (as of 31st Dec 2022)
    - The first HWCs was inaugurated on 14 April 2018 in the Bijapur District of Chhattisgarh.
    - 1,54,070 HWCs operationalised across the country
    - Under the **e-Sanjeevani teleconsultation platform**, more than 9.3 crore tele-consultations have been provided through functional HWCs at 15,465 Hubs (comprising MBBS/ Specialty/Super-Specialty doctors at zonal level) and 1,12,987 Spokes (AB-HWCs at state level) across the country, as on 17 January 2023

D) AYUSHMAN BHARAT – PRADHA MANTRI JAN AROGYA YOJANA (AB PM-JAY)

- **About AB-PMJAY** (Pradhan Mantri Jan Arogya Yojana)
    - AB-PMJAY is an **entitlement based scheme** that aims to provide health insurance cover of upto **5 lakh rupees per family** to **over 10 crore poor families** (about 50 crore population) for **secondary and tertiary care hospitalization**. There is **no cap on the size of the family or age of the beneficiary**.
        - **All pre-existing conditions** are also covered from day 1 of implementation of PM-JAY in respective states/UT.
    - It is the world's largest government funded health care program.
    - **The eligible poor families** are decided on the basis of **SECC, 2011 data** and include poor, deprived rural families and occupational category of urban worker's families (Roughly 8.03 crore rural families and 2.33 crore urban families (11 occupational criteria))
        - In addition the beneficiary of RSBY are also included.
        - Further, there is no capping on number of family members or age of members -> this ensures that senior citizens and girl children also get good health services.
    - The scheme provides **cashless and paperless** access to services for the beneficiary at the point of service. Eligible people can avail the benefits at both **government and listed (empanelled) private hospitals**.
        - **In case of hospitalization,** members of the beneficiary families **don't need to pay anything** under the scheme, provided one goes to a government or an empanelled private hospital.
    - It is a **centrally sponsored scheme**, so, there is a state component too (**60:40**).
    - It is a **portable** scheme, which means beneficiary can avail benefits in any of the states that is implementing the scheme.
    - It subsumes Rashtriya Swastha Bima Yojana and the Senior Citizen Health Insurance Scheme (SCHIS).

    - **Federal process, flexibility to states**

- The **National Health Agency** (NHA), the apex body **implementing the AB-PMJAY**, has launched a website (mera.pmjay.gov.in) and a helpline number (14555)
    - This body will coordinate and improve the scheme over time, through investment in a robust IT infrastructure.

- **No Launch States/UTs**
    - Some states and UTs (West Bengal, Odisha, Telangana, and Delhi) haven't joined the scheme.

- **Outcomes** (ESI 2022-23)
    - **21.9 crore** beneficiaries have been verified under the scheme including 3 crore beneficiaries verified using state IT system.
    - Approx. 4.3 crore hospital admissions, amounting to Rs 50,409 crore, have also been authorized under the scheme through a network of over 26,055 hospitals.

E) AYUSHMAN BHARAT – DIGITAL HEALTH MISSION

- **Details**
    - » After its pilot phase, the countrywide launch of ABDHM was done in Sep 2021.
    - » The mission aims to create a **complete Digital Health Ecosystem** which will **connect the digital health solutions of hospitals across the country with each other**.
        - This digital ecosystem will enable a **host of other facilities** like Digital Consultation; Consent of Patients in letting medical practitioners access their records, etc. This will ensure that all medical records are stored digitally and are thus not lost. They would be accessible through app or web-portal.
        - All this will help in improving the quality, access and affordability of health services by making the service delivery "quicker, less expensive, and more robust".

- **Unique Health ID (now called Ayushman Bharat Health Account)**
    - » Any person wanting to be part of ABDHM will get **a health ID**, which is a **randomly generated 14-digit number**. It will be used for **three purposes** - Unique Identification; Authentication; and Threading of the beneficiary's health records, only with their informed consent, across multiple systems and stakeholders.
    - » **Facilities:**
        - You can access your digital records right from admission through treatment and discharge;
        - You can access and link your personal health records with your health ID to create a longitudinal health history.

- **Privacy:**
    - » Citizen's consent is vital for all access.
    - » Users can delete or exit the services anytime he wants.

- **Why can't Adhaar be used as Digital ID**:
    - » The Adhaar Act and Supreme Court verdict restrict the use of Adhaar ID for welfare schemes promoting government subsidies.

- **Progress So far (Jan 2023)**
    - » **More than 31 crore** Ayushman Bharat Health Account (earlier known as Health ID) created.
    - » **Verified facilities** on health facility registry : 1,92, 706
    - » More than 1 lakh healthcare professionals registered.
    - » More than 7 crore records linked.

F) NATIONAL DEWORMING DAY

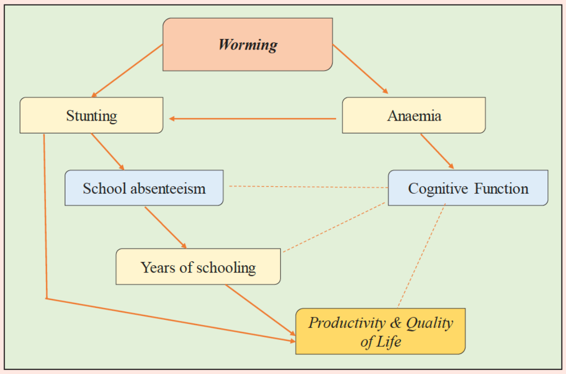
- **Background: Need of the Program:**

- » **Soil Transmitted Helminthiasis** (STH), also known as parasitic intestinal worm infection, is a significant public health concern mostly in low resource setting. It is known to have adverse negative impact on Child's growth and well-being and can cause anemia (iron deficiency) and under-nutrition (specially Vitamin A deficiency). Micronutrient deficits and worm infestation together culminate into stunted growth and development in Children.

- The combined benefits of deworming, when compared to low cost of the intervention, lead to a r**emarkably high benefit to cost ratio**.

- **Regular Deworming** as advised by the WHO eliminates worm infestation among children and adolescents living in areas with high STH burden, thereby contributing to achieve better nutrition and health.

Channels of the Impact of Deworming

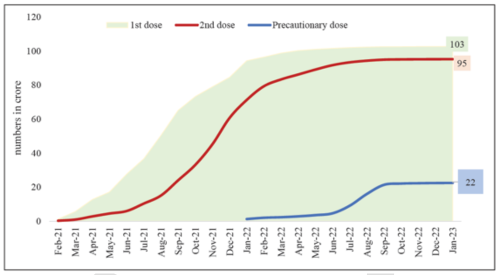


- **National Deworming Day** was l**aunched in 2015** as a flagship program of Ministry of Health and Family Welfare. It was initially launched in 11 states, but in 2016, was expanded to the whole country.
    - ▪ It is a fixed day approach to treat intestinal worm infections in children aged 1-19 years with **Albendazole tablets**.
        - ▪ It is held **biannually** every year on **10th Feb** and **10th Aug** through school and Anganwadis, followed by mop up days to cover those left out due to absenteeism or sickness.
        - ▪ Besides government and government aided schools and Anganwadis, special efforts are made to reach out-of-school children, and private schools have also enthusiastically joined the program.
- **Note:** NDD is led by the MoH&FW in collaboration with the MoW&CD, Ministry of Education, and technical assistance from WHO and other technical partners.
- **Albendazole tablet**, approved by WHO, is used for treatment of intestinal worms in children and adolescents as part of Mass Drug Administration (MDA) programmes globally.
- **Impact of National Deworming Day (NDD) Program**
    - » MoH&FW recently got a prevalence survey conducted by NCDC and partners.
        - ▪ So far, surveys have been completed in 14 states and **all 14 states have shown reduction** of the prevalence.

5) NATIONAL COVID-19 VACCINATION PROGRAM

- India's National COVID-19 vaccination program, the world's largest vaccination program, began in 16th Jan 2021.
    - » It has now expanded to cover all persons aged 12 years and above and for the precautionary dose for all persons aged 18 years and above.

Figure VI.20: Number of Covid-19 vaccinations



- **Test-Track-Treaty-Vaccinate** and adherence to COVID appropriate behaviour continue to remain the tested strategy for Covid management.
- **Key Challenges:**
    - » Vaccine availability
    - » Training of more than 2.6 lakh vaccinators and 4.8 lakh other vaccination team members.
    - » Ensuring vaccination in remote areas.
- **Progress So far:**
    - » As on 6th Jan 2023, India has been able to administer 220 crore COVID vaccine doses across the country.
        - ▫ 97% of eligible beneficiaries have already received at least one dose of COVID-19 vaccine
        - ▫ 90% of the beneficiaries have received both the doses.

A) CO-WIN: A SUCCESSFUL DIGITAL STORY OF VACCINATION TO TELL

- Co-Win is a comprehensive cloud-based IT solution for p**lanning, implementing, monitoring, and evaluating COVID-19 vaccination in India**. It provided an end-to-end solution for utilities for the entire public health system.
- The dual interface of the **open platform** made it scalable across citizens and administrator centric services.

- To ensure **accountability and transparency in supply chains** for vaccination, the platform provided real-time stock tracking at the national, state, and district levels (Government or private)

- Going beyond the users (admins, supervisors, and vaccinators), vaccination centres, and beneficiaries' registration in 12 regional languages, the web solution extended the issuance of digitally verifiable certificates.
    - ▫ The **Vaccination Certificate was designed at par with WHO Guidelines** to assist even international travellers.

- To reduce the burden of registration hinging on a single document (Aadhaar), the Government **allowed registration using any of the 10 photo identity cards** [Aadhaar Card, Driving License, PAN Card, Passport, Pension Passbook, NPR Smart Card, Voter ID, Unique Disability Identification Card, Ration Card with Photo, Student Photo ID card].

- Tackling the problem of the digital divide and digital exclusion, **multiple beneficiaries (up to six)** were allowed onboarding using a single mobile number through the National Covid helpline.

- To ensure that those having limited access to physical facilities during times of Covid, either due to age, disability or identity, are not left out, special provisions through the "**Workplace Covid Vaccination Centre"** in the Government and private sector and also "**Near to Home Covid Vaccination Centres** " were made available.

GS FOUNDATION FOR CSE 2024
ECONOMY-24
ISSUES RELATED TO PLANNING

1. TABLE OF CONTENTS

1) BACKGROUND OF INDIAN ECONOMY

A) STATE OF INDIAN ECONOMY DURING INDEPENDENCE

In 1947, when India got freedom from British rule, its economy showed signs of a tough history. The new country faced the difficult job of figuring out its economic identity, considering its diverse background. The wounds from being exploited were still there, and leaders aimed to create a system where everyone could be self-sufficient and prosperous.

As India stepped into independence, its economy had to decide whether to stick to old ways or embrace modern ideas. The guiding principles were about being inclusive and fair, aiming to overcome poverty and inequality. Mahatma Gandhi's idea of "Sarvodaya," meaning welfare for all, played a big role, steering the economic talk towards local, community-focused growth.

But it **wasn't a smooth journey**; issues like the division of the country, problems in farming, and a weak industry made things more complicated. So, the state of India's economy at independence was like a big journey, a quest for an economic order that mirrored the ideals of justice, equality, and the pursuit of a self-sustaining destiny.

B) INDIA ADOPTED SOCIALISM:

India adopted a **socialist approach** over a purely communist economic model because the leaders of the newly independent nation sought a path that would address the pressing issues of poverty, inequality, and socio-economic disparities while respecting the democratic principles enshrined in the Constitution.

- **Democratic Values:** India chose a socialist pattern of society within the framework of a democratic political system. Unlike a purely communist model, which often involves centralized control and a single-party rule, India opted for a democratic socialist approach that allowed for political pluralism, free expression, individual rights, and democratic checks and balances.
- **Mixed Economy:** A purely communist system, with complete state ownership and control of the means of production, might have hindered economic progress. Instead, India embraced a mixed economy where there was a role for both the public and private sectors. This approach is aimed at combining the efficiency of the private sector with the social welfare objectives of the state.
- **Gandhian Influence:** Mahatma Gandhi’s vision of "Sarvodaya" emphasized decentralized, community-centric development and the welfare of all. This resonated with socialist ideals, emphasizing the upliftment of the marginalized and ensuring social justice.
- **Pragmatic Implementation:** The Indian leadership recognized the practical challenges of implementing a purely communist economic system in a vast and diverse country. The adoption of

socialism allowed for gradual economic reforms, ensuring stability, and preventing potential disruptions that could arise from rapid, radical changes.

In summary, India's choice of socialism over a communist form of economy at the time of independence was a nuanced decision, considering democratic values, the need for economic growth, Gandhian principles, and a pragmatic approach to implementation. This paved the way for a mixed economy that could balance social welfare with economic development.

C) INDIA OPTED FOR MIXED ECONOMY:

A mixed economy is an economic system that incorporates elements of both a market economy and a planned or command economy. In a mixed economy, there is a combination of private sector and public sector participation in economic activities. This hybrid system aims to take advantage of the strengths of both market forces and government intervention.

Key features of a mixed economy include:

- **Private and Public Ownership:**
  - In the private sector, individuals and businesses own and operate enterprises for profit.
  - In the public sector, certain key industries or services may be owned and operated by the government.
- **Market Forces:**
  - Prices are often determined by market forces of supply and demand.
  - Competition is encouraged in the private sector to foster efficiency and innovation.
- **Government Intervention:**
  - The government plays a role in regulating and overseeing economic activities to ensure fair competition, consumer protection, and social welfare.
  - It may also intervene in areas such as education, healthcare, and infrastructure to address market failures or ensure equal access.
- **Mixed Ownership:**
  - Some industries may have mixed ownership, where both private and public entities have a stake.
- **Redistribution of Wealth:**
  - Social welfare programs and progressive taxation may be used to address income inequality and provide a safety net for vulnerable populations.
- **Flexibility:**
  - The mixed economy allows for a degree of flexibility, enabling adjustments to economic policies based on changing circumstances.
- **Government Planning:**

- In certain strategic sectors or during times of economic crisis, the government may engage in planning and direct intervention to stabilize the economy.

» **Consumer Choice:**

- Consumers have the freedom to make choices in the marketplace, but the government may regulate certain industries to protect consumers and prevent monopolies.

Many modern economies, including those of the United States, the United Kingdom, Canada, and many European countries, can be classified as mixed economies. The specific balance between the private and public sectors can vary, and the government's role may evolve over time in response to economic conditions and societal needs. The mixed economy seeks to harness the efficiency of market mechanisms while addressing social concerns and ensuring a level playing field for participants.

D) ECONOMIC LANDSCAPE AT INDEPENDENCE:

- **Population:** India's population at independence in 1947 was approximately 330 million.
- **GDP:** Estimated around USD 12.9 billion in 1950.
- **Per Capita Income:** Roughly USD 37, reflecting widespread poverty.
- **Agriculture Dominance:** The economy was primarily agrarian, with agriculture contributing significantly to GDP.
- **Colonial Legacy:** The economy bore the impacts of colonial exploitation, affecting infrastructure and industrial development.
- **Limited Industrialization:** Industries were limited in scale and scope, with a concentration in certain regions.
- **Dependency on Imports:** The economy heavily relied on imports, especially for machinery and technology.
- **Export Structure:** Exports were dominated by raw materials, with limited value addition.
- **Low Productivity:** Agricultural productivity was low, leading to food scarcity and poverty.
- **Landownership:** The concentration of land in the hands of a few landlords perpetuated inequality.
- **Limited Financial Institutions:** Financial institutions were few, hindering economic activities.
- **Resource Allocation:** Economic resources were strained due to the demands of post-partition reconstruction.

The state of the Indian economy at independence depicted a nation with immense potential but grappling with deep-rooted challenges inherited from its colonial past. Subsequent decades saw efforts to address these issues through economic policies and reforms.

2. INDIAN ECONOMY AND ISSUES RELATING TO PLANNING

1) PLANNING IN INDIA – RATIONALE, OBJECTIVES AND FEATURES

Economic planning is a consciously directed activity characterized by predetermined objectives and the systematic utilization of available resources to achieve socio-economic goals. This involves the strategic allocation of limited resources to attain specific targets.

The fundamental components of economic planning consist of two key elements: goals (or targets) and means (comprising policies and instruments). Goals delineate the desired outcomes of the plan, while policies outline the strategic actions necessary for goal fulfilment.

RATIONALE

- **Optimizing Scarce Resources:** Centralized control and intervention in the private sector aimed to efficiently allocate limited resources, fostering rapid growth.
- **Correcting Market Failures:** Planning addressed market inefficiencies, ensuring better resource allocation than unregulated markets.
- **Overcoming Market Limitations:** Planned economies countered issues like low growth, per capita income, savings, and investment, resulting in low national income.
- **Fostering Social Justice:** Planned systems sought inclusive growth, addressing disparities for equitable development.
- **Rational Resource Allocation:** Planning systems were viewed as rationalizing resource mobilization and allocation for targeted development.
- **Addressing Developmental Gaps:** Economic planning, according to D.R. Gadgil, was essential to rectify unsatisfactory development trajectories, providing direction and acceleration.

OBJECTIVES OF PLANNING:

- Fostering Economic Growth
- Achieving Self-Reliance and Sufficiency (e.g., addressing food scarcity and building a robust industrial base)
- Minimizing Unemployment (e.g., targeting high illiteracy and skill deficits)
- Ensuring Social Justice (e.g., eliminating poverty and reducing income inequalities)
- Facilitating Modernization
- Promoting Inclusive and Sustainable Economic Growth.

TYPES OF PLANNING:

- **Imperative Planning:** Full state control; target-based with no market role.
- **Democratic Planning:** Led by elected representatives.
- **Indicative Planning:** Mix of Public and Private sectors; core industries nationalized.

- **Normative Planning:** Bottom-up; respects local customs in planning.
- **Physical Planning:** Allocate men, material, and power to achieve Plan targets.
- **Financial Planning:** Estimate and allocate resources in monetary terms.
- **Perspective Planning:** Considers long-term implications of short/medium-term policies.
- **Rolling/Continuous Planning:** Prepares medium-term plans with assessments of previous plans.

WHY INDIA ADOPTED PLANNING:

- **Economic Development:** Addressing the need for rapid economic growth and development.
- **Resource Optimization:** Efficient allocation of scarce resources for maximum benefit.
- **Infrastructure Development:** Focusing on building essential infrastructure for a growing economy.
- **Industrial Base:** Overcoming a poor industrial base and promoting self-reliance.
- **Poverty Alleviation:** Tackling widespread poverty and improving living standards.
- **Employment Generation:** Mitigating high unemployment rates, particularly due to illiteracy and skill deficits.
- **Social Justice:** Reducing income inequalities and ensuring a more equitable distribution of resources.
- **Inclusive Growth:** Ensuring that the benefits of development reach all sections of society.
- **Stability:** Providing a systematic approach to economic management and reducing uncertainties.
- **Modernization:** Keeping pace with global advancements and modernizing various sectors.

DRAWBACKS OF CENTRALISED PLANNING

- **Bureaucratic Inefficiencies:** Bureaucratic decision-making is inefficient due to multiple accountability levels, rule-bound nature, and a reluctance to take risks, leading to suboptimal resource utilization.
- **Importance of Free Market:** <u>Illustrated by the collapse of the USSR</u> and the growth of economies like India and Vietnam, highlighting the advantages of a free-market economy.
- **Hindu Rate of Growth:** Refers to the <u>sluggish economic growth in India pre-1980</u>.
- **Lack of Competition:** Hampers efficiency gains, hindering optimal resource utilization.
- **Poor Governance:** Contributes to economic inefficiencies and suboptimal outcomes.
- **Import Controls Impact:** Originally intended to conserve foreign exchange, the system of import controls in India inadvertently protected domestic producers, resulting in high-cost, low-quality production, and diminished export competitiveness.
- **Strain on Public Finances:** Overemphasis on public sector enterprises strained public finances, leading to fiscal challenges and inefficiencies.
- **Stifling of Private Sector Initiative:** Centralized planning limited the scope for private sector initiatives, hindering entrepreneurship and innovation.

- **Failure to Address Regional Disparities:** The planning approach sometimes failed to adequately address regional disparities, perpetuating economic imbalances across different parts of the country.

WHAT ARE VARIOUS CAUSES OF POLICY FAILURE (GOVT FAILURE)

- **Political Self-Interest:** Politically driven decisions, like increasing welfare spending before elections lead to misallocation of resources affecting the macro-economic scenario.
- **Policy Myopia:** Ad-hoc policies and short-term fixes, such as farm loan waivers, address immediate concerns but lack long-term vision.
- **Regulatory Capture:** Regulations like the MRTP Act can impede market functioning by favouring certain interests.
  - **Note:** MRTP is Monopolistic and Restrictive Trade Practices law. It was implemented in 1969. It was designed to ensure that the economic system's operation doesn't result in the concentration of economic power in the hands of a few.
- **Government Intervention Challenges:** Well-intended government interventions, like the Essential Commodities Act, may unintentionally distort markets and lead to volatility.
- **Crony Capitalism:** Collusion between business and politics, exemplified by increasing Non-Performing Assets (NPA) in financial systems.
- **Bureaucratic Caution (Policy Paralysis):** The 4Cs (Courts, CVC, CBI, CAG) contribute to bureaucratic caution, leading to policy paralysis.
- **Implementation Failure:** Despite policies, actual implementation often falls short, hindering desired outcomes.

A BRIEF HISTORY OF PLANNING IN INDIA

- **Historical Economic Shifts:** India followed import substitution and state-led development from 1950 to 1990. In 1991, it shifted towards a more open economy, increasing the role of the private sector.
- **Planning Mechanism:** From 1950 to 2017, India used Five-Year Plans under the Planning Commission and later NITI Aayog for economic planning.
- **Early Development Strategies (1950-65):** Initially, India focused on state-led industrialization, import substitution, and directed planning, leading to slow GDP growth and increased poverty.
- **Shift to Agriculture (1965 Onwards):** The emphasis shifted to agriculture in response to food shortages.
- **Populist Policies (From 1970s):** Populist policies, like bank nationalization under the "**Garibi Hatao**" slogan, were introduced.
- **Economic Improvement Since 1980:** India's economy showed improvement from 1980 with some internal liberalization.

- **Major Economic Reforms (1991):** The significant boost in economic growth came with the 1991 reforms, opening the economy, eliminating industrial licensing, and encouraging private sector investment.
- **Change in Planning Approach (1992-97):** The 8th Five-Year Plan marked a shift from centralized to indicative planning, recognizing the changing economic landscape.
- **Policy Focus on Inclusive Growth (2007-2012):** The Eleventh Five-Year Plan shifted focus to more inclusive growth, aiming for faster and broader economic development.
- **Sustainable and Inclusive Growth (2012 Onwards):** The Twelfth Five-Year Plan emphasized faster, sustainable, and more inclusive growth.

A) VARIOUS FIVE-YEAR PLANS

FIVE YEAR PLANS	***OBJECTIVE***
First FYP Plan (1951 - 56)	➢ It was based on Harrod-Domar Model. This model stresses on the importance of savings and investment as key determinants of growth. ➢ Influx of refugees, severe food shortage & mounting inflation confronted the country at the onset of the first five year Plan. ➢ The Plan **focussed on agriculture**, price stability, power and transport it was a successful plan primarily because of good harvests in the last two years of the plan. ➢ **Objectives** of rehabilitation of refugees, food self-sufficiency & control of prices were more or less **achieved**.
Second FYP Plan (1956 - 61)	➢ **Mahalanobis Plan** - the strategy of resource allocation to broad sectors as **agriculture & Industry** was based on two & four sector Model prepared by Prof. P C Mahalanobis ➢ Second plan was conceived in an atmosphere of economic stability. It was felt agriculture could be accorded lower priority. ➢ The Plan **focussed on rapid industrialization**- heavy & basic industries. Advocated huge imports through foreign loans. ➢ The **Industrial Policy 1956** was based on the establishment of a socialistic pattern of society as the goal of economic policy. ➢ **Acute shortage of forex** led to pruning of development targets , price rise was also seen (about 30%) vis-a-vis decline in the earlier Plan & the 2nd FYP was only moderately successful

Third FYP Plan (1961 - 66)	➢ At its conception, it was felt that Indian economy has entered a "**takeoff stage**". Therefore, its aim was to make India a 'self-reliant' and 'self-generating' economy. ➢ Based on the experience of first two plans (agricultural production was seen as limiting factor in India's economic development) , **agriculture was given top priority** to support the exports and industry. ➢ The Plan was **thorough failure** in reaching the targets due to unforeseen events - Chinese aggression (1962), Indo-Pak war (1965), severe drought 1965-66. Due to conflicts the approach during the later phase was shifted from development to defence & development
Three Annual Plans (1966- 69) (Plan holiday)	➢ Failure of Third Plan that of the devaluation of rupee (to boost exports) along with inflationary recession led to postponement of Fourth FYP. ➢ Three Annual Plans were introduced instead. ➢ Prevailing crisis in agriculture and serious food shortage necessitated the emphasis on agriculture during the Annual Plans. ➢ During these plans a whole new agricultural strategy was implemented. It involving wide-spread distribution of high-yielding varieties of seeds, extensive use of fertilizers, exploitation of irrigation potential and soil conservation. ➢ During the Annual Plans, the economy absorbed the shocks generated during the Third Plan It paved the path for the planned growth ahead.
Fourth Annual Plan (1969 - 74)	➢ Refusal of supply of essential equipment and raw materials from the allies during Indo Pak war resulted in twin objectives of " **growth with stability** " and "**progressive achievement of self-reliance** " for the Fourth Plan. ➢ Main emphasis was on growth rate of agriculture to enable other sectors to move forward. ➢ First two years of the plan saw record production. The last three years did not measure up due to poor monsoon. ➢ Implementations of **Family Planning Programmes** were amongst major targets of the Plan. Influx of Bangladeshi refugees before and after 1971 Indo-Pak war was an important issue along with price

	situation deteriorating to crisis proportions and **the plan is considered as big failure.**
Fifth Plan (1974-79)	➢ The final Draft of fifth plan was prepared and launched by D.P. Dhar in the backdrop of economic crisis arising out of run-away inflation fuelled by hike in oil prices and failure of the government to takeover of the wholesale trade in wheat. ➢ It proposed to achieve two main objectives: **'removal of poverty' (Garibi Hatao) and 'attainment of self-reliance'**. ➢ Promotion of high rate of growth, better distribution of income and significant growth in the domestic rate of savings were seen as key instruments. ➢ Due to high inflation, **cost calculations for the Plan** proved to be completely wrong and the original public sector outlay had to be revised upwards. ➢ After promulgation of **emergency in 1975**, the emphasis shifted to the implementation of **Prime Ministers 20 Point Programme**. FYP was relegated to the background and when Janta Party came to power in 1978, the Plan was terminated.
Rolling Plan (1978 - 80)	➢ There were two Sixth Plans. Janta Government put forward a plan for 1978- 1983 emphasising on employment, in contrast to Nehru Model which the Govt criticised for concentration of power, widening inequality & for mounting poverty. However, the government lasted for only 2 years. ➢ Congress Govt. returned to power in 1980 and launched a different plan aimed at directly attacking on the problem of poverty by creating conditions of an expanding economy
Sixth Plan (1980 – 85)	➢ The Plan focussed on Increase in national income, modernization of technology, ensuring continuous decrease in poverty and unemployment through schemes for transferring skills (TRYSEM) and employment (IRDP) and providing slack season employment (NREP), controlling population explosion etc. ○ **TRYSEM**: Training rural youth for self-employment ○ **IRDP**: Integrated Rural Development Program ○ **NREP**: National Rural Employment Program ➢ Broadly , the sixth Plan **could be taken as a success** as most of the target were realised even though during the last year (1984-85) many

	parts of the country faced severe famine conditions and agricultural output was less than the record output of previous year
Seventh Plan (1985 - 90)	➢ The Plan aimed at accelerating food grain production, increasing employment opportunities & raising productivity with focus on 'food, work & productivity'. ➢ The plan was **very successful** as the economy recorded 6% growth rate against the targeted 5% with the decade of 80's struggling out of the' Hindu Rate of Growth'
Eighth Plan (1992 - 97)	➢ The eighth plan was postponed by two years because of political uncertainty at the Centre ➢ Worsening Balance of Payment position, rising debt burden widening budget deficits, recession in industry and inflation were the key issues during the launch of the plan. ➢ The **plan undertook drastic policy measures** to combat the bad economic situation and to undertake an annual average growth of 5.6% through introduction of fiscal & economic reforms including liberalisation under the Prime Minister ship of Shri P V Narasimha Rao. ➢ Some of the **main economic outcomes** during eighth plan period were rapid economic growth (highest annual growth rate so far – 6.8 %), high growth of agriculture and allied sector, and manufacturing sector, growth in exports and imports, improvement in trade and current account deficit. High growth rate was achieved even though the share of public sector in total investment had declined considerably to about 34 %.
Ninth Plan (1997- 2002)	➢ The Plan prepared under United Front Government focussed on "**Growth with Social Justice & Equality** ". ➢ Ninth Plan aimed to **depend predominantly on the private sector** – Indian as well as foreign (**FDI**) & State was envisaged to increasingly play the role of facilitator & increasingly involve itself with social sector via education, health etc and infrastructure where private sector participation was likely to be limited. ➢ It assigned **priority to agriculture & rural development** with a view to generate adequate productive employment and eradicate poverty

Tenth Plan (2002 - 2007)	➢ Recognising **that economic growth can't be the only objective** of national plan, Tenth Plan had set 'monitor able targets' for few key indicators (11) of development besides 8 % growth target. ➢ The targets included reduction in gender gaps in literacy and wage rate, reduction in Infant & maternal mortality rates, improvement in literacy, access to potable drinking water cleaning of major polluted rivers, etc. ➢ Governance was considered as factor of development & agriculture was declared as prime moving force of the economy States role in planning was to be increased with greater involvement of Panchayati Raj Institutions. ➢ State wise break up of targets for growth and social development sought to achieve balanced development of all states.
Eleventh Plan (2007 - 2012	➢ Eleventh Plan was aimed "**Towards Faster & More Inclusive Growth** "after UPA rode back to power on the plank of helping Aam Aadmi (common man). ➢ India had emerged as one of the fastest growing economy by the end of the Tenth Plan. The savings and investment rates had increased, industrial sector had responded well to face competition in the global economy and foreign investors were keen to invest in India. ➢ But the growth was not perceived as sufficiently inclusive for many groups, specially SCs, STs & minorities as borne out by data on several dimensions like poverty, malnutrition, mortality, current daily employment etc. ➢ The broad vision for 11th Plan included several inter related components like rapid growth reducing poverty & creating employment opportunities , access to essential services in health & education, specially for the poor, extension if employment opportunities using National Rural Employment Guarantee Programme , environmental sustainability , reduction of gender inequality etc
Twelfth Plan (2012- 17)	➢ 'Faster, Sustainable and More Inclusive Growth'; ➢ 25 Core" Monitor able Targets".; GDP growth at 8% + Agriculture growth at 4% + Manufacturing growth at 10%.

WHAT WERE THE KEY PROBLEMS WITH THE PLANNING COMMISSION:

- **Concerns Regarding Federalism:** The Planning Commission's overreach impacted Centre-State relations by influencing fund allocation, conflicting with the Finance Commission's role.
- **Concerns of Accountability:** Lack of parliamentary oversight, especially over the Deputy Chairman of the Planning Commission, undermined legitimacy, and accountability.
- **Human Resources and Organizational Structure:** Criticism for bureaucratic administration, lack of domain expertise in staff, and acting as a repository for officers without specialized knowledge.
- **Consultation Process:** Top-down planning with minimal involvement of states and local bodies led to resentment and resistance, highlighting the need for a more inclusive consultative process.
- **Prioritization:** Planning Commission's priorities, like emphasizing heavy industry, influenced education policies, contributing to inequalities and distortions in India's structural transformation.
- **Perspective Planning:** Inconsistent emphasis on long-term planning by the Planning Commission and NITI Aayog, especially regarding water, energy, and land use.
- **Shift from Input-Output Models:** Planning failed to transition from traditional input-output models to more complex behavioral and pathway models, crucial for understanding policy responses in a market-oriented economy.
- **Development Finance Assessment:** Unrealistic financing plans, lack of adjustments for unforeseen expenditures, and insufficient consideration of government liabilities led to financial strains and challenges in project execution.
- **Cooperative Devolution and Convergence:** Increasing regional imbalances post-market reforms highlighted the need for addressing inequalities in financial transfers, especially from the Planning Commission.

B) NITI AAYOG (JAN 1ST, 2015)

Replaced of Planning Commission:

Formed on January 1, 2015, by a Union Cabinet resolution, NITI Aayog is the government's premier policy think tank. It designs long-term policies, provides strategic advice, and fosters cooperative federalism by bringing states together in the national interest.

OBJECTIVES:

- **Cooperative Federalism:** Shared vision between the central and state governments. Example, Team India
- **Decentralized Planning:** Emphasis on local-level planning.
- **National Security in Economic Policy:** Integration of national security considerations into economic policies.
- **Policy Design:** Formulation of short (3 Year Agenda), intermediate (7 Year Strategy), and long-term policies (15-year Vision documents).
- **Think Tank Role:** Serving as a think tank for policy development.

- **Interdepartmental Coordination:** Facilitating coordination among government departments.
- **Technology Upgradation and Capacity Building:** Focus on upgrading technology and building capacities.
- **Monitoring and Evaluation:** Monitor and evaluate the implementation of policies and programs to assess their impact on socio-economic development.
- **Innovation and Technology:** Encourage innovation and the use of technology to address developmental challenges. Example, Atal Innovation Mission, India Innovation Index, etc.
- **Promotion of Competitive Federalism:** Encourage healthy competition among states to drive efficiency and innovation in governance. Example, SDG India Index, Composite Water Management Index, School Education Quality Index, etc.

INITIATIVES OF NITI AAYOG

- **Sustainable Action for Transforming Human Capital (SATH):** NITI Aayog aims to transform education and health in states through the Sustainable Action for Transforming Human Capital initiative, offering guidance and support.
- **Ek Bharat Shrestha Bharat:** Envisioned to foster unity and excellence across the nation, Ek Bharat Shrestha Bharat engages states in long-term cultural and educational exchanges.
- **Aspirational Districts Program:** NITI Aayog's special initiative targets the rapid transformation of 115 identified underdeveloped districts, addressing key social challenges for balanced regional development.
- **Aspirational Blocks Programme:** The program aims to accelerate holistic and sustainable development in 500 backward blocks, addressing comprehensive developmental needs.
- **SAMAVESH**: Launched as a major initiative, SAMAVESH focuses on networking and partnering with knowledge and research institutions through a hub-and-spoke model.
- **Atal Innovation Mission:** NITI Aayog's initiative is dedicated to promoting innovation and entrepreneurship throughout the country.
- **Important Indices:** NITI Aayog introduced the 'Healthy States, Progressive India' Report (Health Index), Composite Water Management Index, School Education Quality Index (SEQI), SDG India Index, and Digital Transformation Index (DTI) to measure and track various aspects of development.
- **Production Linked Incentive (PLI) Scheme:** NITI Aayog, in collaboration with ministries and departments, facilitated the introduction of a five-year Production Linked Incentive Scheme in key sectors.
- **Think Tank Role:** NITI Aayog serves as a national think tank, providing strategic advice and recommendations for policy formulation.

CRITICISM OF NITI AAYOG

- **Limited Influence on Investments:** NITI Aayog lacks a direct role in influencing both private and public investments.

- **Criticism for Continuity with Planning Commission:** Critics argue that NITI Aayog, dubbed as "old wine in a new bottle," fails to offer a fresh perspective on development and largely mirrors the functions of the Planning Commission.
- **States' Dissatisfaction with Representation:** States express dissatisfaction as their concerns are not adequately considered, with instances of Chief Ministers having insufficient time to address issues in governing council sessions.
- **Questioned Independence as a Government Think Tank:** NITI Aayog's role as a government think tank raises concerns about its independence in policy formulation, as it is susceptible to influence from the government.
- **Ineffectiveness in Addressing Economic Downturn:** NITI Aayog has been unable to reverse the economy's long-term downturn, as evidenced by a consistent decrease in Gross Fixed Capital Formation (GFCF) since 2010.
- **Limited Impact of Initiatives:** NITI Aayog faces criticism for limited on-the-ground impact.
- **Technical Expertise and Research Shortcomings:** Critics argue that NITI Aayog lacks adequate technical expertise and research capabilities, often relying on external consultants and private sector partners, leading to poor credibility of the report.

WAY FORWARD:

- **NITI Aayog as an Agent of Change:** Over time, NITI Aayog has the potential to be a catalyst for change, contributing to the government's goal of enhancing governance and implementing innovative measures for improved public service delivery.
- **Independence and Objectivity:** Strengthen measures to ensure the independence of NITI Aayog as a policy think tank, avoiding undue influence, and promoting unbiased policy formulation.
- **Technical Expertise and Research Capability:** Invest in building internal technical expertise and research capabilities to reduce reliance on external consultants, enhancing the think tank's ability to provide well-informed policy advice.
- **Performance-Based Accountability:** Implement a robust performance evaluation system for bureaucrats within NITI Aayog, linking accountability to performance metrics to overcome bureaucratic inertia.
- **Policy Impact Assessment:** Introduce a systematic process to assess the on-the-ground impact of NITI Aayog's initiatives, ensuring that they align with national development goals and effectively address challenges.
- **Capacity Building and Training:** Invest in the continuous capacity building and training of NITI Aayog personnel to keep them abreast of emerging challenges and best practices in policy formulation.

GS FOUNDATION FOR CSE 2024

ECONOMY-25

EFFECTS OF LIBERALIZATION ON THE ECONOMY

1. TABLE OF CONTENTS

2. SYLLABUS: EFFECTS OF LIBERALIZATION ON ECONOMY

3. PYQS

- Examine the impact of liberalization on companies owned by Indians. Are they competing with the MNCs satisfactorily? Discuss [Mains 2013]

- How has globalization led to the reduction of employment in the formal sector of the Indian economy? Is increased informalization detrimental to the development of the country? [Mains 2016]

4. LIBERALIZATION

Economic Liberalization refers to reducing government regulation in economic activities and allowing market forces in determining economic activities.

5. THE ORIGIN OF ECONOMIC CRISIS IN THE EARLY 1990S

- Early 1991 saw the emergence of a major economic crisis in India. Economists consider it the biggest challenge that Indian economy has ever faced since independence.
- **Key Reasons**:
  - » **Imprudent macro management of the Economy:**
    1. **High Fiscal Deficit**: It deteriorated throughout 1980s due to growing burden of non-development expenditure and reached 7.8% in FY91.
       - » **Very high growth of government expenditure** but lack of investments in capital.
       - » **PSUs were not generating profits** due to efficiency issues.
       - » **Critical infrastructures** were facing delays due to PSUs being the dominant players.
       - » **Restrictive Trade and Industrial Licensing Framework** led to serious loss of efficiency reducing the scale of output, eliminating effective competition, and creating bottlenecks.
    2. **Large Current Account Deficit:**
       - » CAD had reached $9.7 billion or 3.69% Of the GDP in FY91.
    3. **High Internal as well as External Debt**:
       - » The fiscal deficit was financed using borrowings, the internal debt of the central government increased rapidly, rising to **49.7% of the GDP** in FY91.
         - This also increased the burden of debt servicing. Interest payments reached 3.8% of the GDP and 22% of the total central government expenditure in FY91.
       - » **Increasing CAD** had to be financed using borrowings from abroad. This resulted in external debt rising to **23% of the GDP** in FY91.
       - » The **BOP position** was on the brink of disaster as in Mid-Jan 1991 and again in late June 1991 the level of Forex reserves were not sufficient to finance imports of even 10 days.

4. **High Inflation**: Rate of inflation reached 10.3% in FY91, and food prices increased drastically Inspite of three consecutive good monsoon in a row.
    - **Reasons**: Monetization of fiscal deficit and thus excessive increase in money supply. This liquidity overhand along with supply demand imbalances led to very high inflation.

- **Other Factors:**
    - **Political Instability** in the country at this juncture
    - **Gulf Crisis**: The increase in prices of crude oil led to mounting.
    - **Collapse of Soviet Union** which was India's major trading partner.
    - **Decline sovereign credit rating**: All the above factors contributed to declining confidence in India's economy leading to decline in credit rating of the economy.

6. ECONOMIC REFORMS IN INDIA

- It is generally agreed that the process of Economic Reforms was initiated in India by the government of P.V. Narasimha Rao in 1991 with the announcement of a number of measures for Liberalization of Economy by the then finance minister Dr. Manmohan Singh.

- However, **Arvind Panagariya** has argued that the process was started in the second half of 1980s during the prime ministership of Rajeev Gandhi.
    - Rajeev Gandhi had brought '**New Economic Policy**' which moved Indian economy towards increased outward and inward competition by the end of 1980s.
    - However, not being able to predict how the electorate might react, the politicians were still afraid to announce their conversion openly.

- **However,** the **reforms introduced in 1991-92** were substantially big.
    - These measures were complete renunciation of the old policy framework and brought **liberalization out in open**. It is precisely because of this reason in most of the studies on Indian economy, the process of economic reforms is assumed to have started in 1991.

1) KEY COMPONENTS OF ECONOMIC REFORMS

The process of economic reforms initiated by Dr P.V. Narsimha Rao government consisted of **two distinct strands**: **Macroeconomic stabilization** and **Structural Reforms**. While stabilization deals with demand management, structural reforms deal with sectoral adjustments designed to tackle the problems on the supply side of the economy.

2) MACRO-ECONOMIC STABILIZATION

- **Macroeconomic Stabilization (**often just referred as stabilization) involves returning to low and stable inflation and a sustainable fiscal and BOP position.
    - Stabilization is necessary to overcome a crisis, but it assumes a special importance if structural reforms are also introduced together with stabilization. (**class discussion)**

- **The macroeconomic stabilization** program adopted by the government consisted of the following components:
  1. **Inflation Control:**
     - » The rate of inflation in FY91 was around 10%. This could be brought down by introducing fiscal and monetary discipline and by improving the output and supply situation. It seems. That government's achievement was modest on both the fronts. Overall, the average inflation remained at 10.7% for three years after reforms due to high fiscal deficit and rise in administered prices.
     - » But, now with flexible inflation targeting by RBI, situation is much better.

  2. **Fiscal Consolidation:**
     - » Fiscal deficit in FY91 was at 8%. Through, a program for fiscal adjustment it was brought below 5.5% in FY92 and FY93. But it rose again. It was eventually, the FRBM Act, 2003 which led to fiscal deficit declining to 2.5% in FY08. It rose again due to requirement of fiscal stimulus during 2008 financial crisis and then in FY19 & FY20 due to structural reforms and COVID-19 crisis.
     - » **How to do fiscal consolidation** (Already covered with Budget chapter)

  3. **Improving BOP**:
     - » Forex reserve increased from a modest $2.2 billion in FY91 to more than $600 billion in FY22.
       - ▫ **Exchange Rate Reforms**:
         - ▪ Rupee was devalued twice in July 1991 leading to a 20% depreciation in its value (one of the conditions by IMF – to get rupee to its market value)
         - ▪ This was followed by Liberalized exchange rate management (LERMS) in the budget of FY93.
           - • Under this system a dual exchange rate was fixed under which 40% of foreign exchange was to be surrendered at the official rate while the remaining 60% was to be converted to market determined rate.
         - ▪ Budget 1993-94 adopted the **Unified Exchange rate system** and has been in operations since then. The experience with the system has been **satisfactory** as the period since 1993 has been marked by orderly conditions in forex market, except a few episodes of volatility.
           - • The exchange rate management policy of the RBI in this period has been '**managed float regime**' i.e. RBI has focused on managing volatility with no fixed target while allowing the underlying demand and supply conditions to determine the exchange rate movements over a period in an orderly way. This policy has withstood the test of time by ensuring a judicious mixture of 'flexibility' and 'pragmatism'.
         - ▪ For current account, rupee has been made fully convertible.
     - » In FY92, CAD was reduced to 0.4% in FY92 due to import compression which in turn adversely affected the overall performance of the economy.
     - » Liberalization reforms from FY92, further led to worsening of CAD crisis.

3) STRUCTURAL REFORMS

Since July 1991 comprehensive **liberalization measures** have been undertaken to improve the **supply-side of the economy**. Most important reforms on this side are (i) Trade and Capital Flow Reforms (2) Industrial Deregulation; (3) Disinvestment and Public enterprise reforms (4) Financial Sector Reforms. According to Montek Singh Ahluwalia, "*it is the structural reform component that signaled a paradigm shift in the way the economy was to be managed*". The earlier suspicion of the private sector and of the market gave way to a new **emphasis of freeing the creative energies of the private sector** by allowing it to respond to market forces.

A) TRADE AND CAPITAL FLOW REFORMS

TRADE POLICY REFORMS:

Since July 1991, the government has introduced a series of reforms in the trade sector which are aimed to **help integrate Indian economy better with the rest of the world**.

- **Currency Reforms**:
  - The system of fixed exchange rates was abandoned in India in Sep 1975 and since then system of **managed exchange rate float** has been in operation.
  - In July 1991, government formally **devalued rupee by 18-19%** to restore India's international competitiveness.
  - Introduction of convertibility of rupee first on trade account and then for the entire current account transactions;
- **liberalization of import regimes**
  - **Gradual reduction in tariffs**: Budget 1991-92 reduced peak rate of import duty from more than 300% to 150%. In phased manner this was reduced to 10% by 2007-08 budget.
    - Over the past few years, existing system of impot duties have been considerably rationalized with the purpose of establishing a parity in prices of goods produced domestically and internationally.
  - **Decanalization** of several export and import items in the last two decades.
    - This opened more areas of external sector to private sector.
    -

NN	**Canalization**: Under this system exports and imports used to be canalized through public sector agencies.

  - Dismantling import licensing system
  - Removal of quantitative restrictions;
- **Focus on Increasing Exports**: Government has also introduced a number of export promotion measures in recent years.
  - This include establishment of **Export Oriented Units** for promoting exports from the agricultural and allied sectors; Simplification of Export Promotion Capital Goods Scheme; introduction of Export Promotion Capital Goods Scheme for service sector; setting up Special Economic Zones (SEZs); Creation of Exporters' Grievance Cell in the ministry of commerce.

CAPITAL FLOW REFORMS:

- **The Capital Issues Control Act** was repealed, and **SEBI was set up as a watch dog for regulating the function of the capital market**.
- **In Sep 1992**, the government announced guidelines for investments by foreign institutional investors (FIIs) in the capital market.
- **FDI has been liberalized** making India one of the most attractive destinations for FDI in the world.

B) INDUSTRIAL DE-REGULATION

- Though some liberalization and streamlining of industrial policy was affected in mid-1980s, the **New Industrial Policy (NIP)** announced on 24th July 1991 and subsequent amendments brought far reaching changes in the policy regime governing industrial investments:
    - The NIP **dismantled the industrial licensing (or approval) system** in all sectors except five specified industries.
        - » These included alcohol, cigarettes, hazardous chemicals, industrial explosives, and electronic aerospace and defence equipment (all types). These sectors need to be regulated in view of environmental hazards, National Security and social well-being consideration.
    - **Number of Industries reserved for Public Sector** has been reduced from 17 to 2. These two sectors are atomic energy and railways.
        - » Now core industries like iron and steel, electricity, air transport, shipbuilding, heavy machinery etc. and even strategic industry like defence production have been opened for the private sector.
    - **Foreign investment has also been liberalized** over the years. Automatic approvals have been made available to almost all industries except those subject to public sector monopoly and industrial licensing.
    - **Monopoly and Restrictive Trade Practices Act** has now been scrapped.
        - » The act had prevented many firms from growing to optimum size and thus achieve higher efficiency levels.
        - » This scrapping allows industrial units to grow to optimum size and enjoy the benefits of economy of scale.
    - **Phased Manufacturing Program** under which domestic manufacturers were required to increase the domestic input-content of their products in a specified period has also been abolished under the new industrial policy.

C) PUBLIC SECTOR REFORMS AND DISINVESTMENT

- **Background**: PSUs were expected to be the engine of self-sustained economic growth in India. It was also expected to hold the commanding heights of the economy and to lead to technological advancements. Over the years, PSUs have played an important role in expansion and diversification of industrial base. But they also **suffered from various challenges**. They failed to generate sufficient internal resources for its further expansion and, as a result, has now become a major constraint on economic growth.
- **Reforms**: Under structural reforms government is doing the following things:
    a. **Giving managerial autonomy** to PSEs to enable them to work efficiently.

b. **Promotion of increased private sector competition** in areas where social sector considerations are not paramount.
c. **Partial disinvestment of equities** in selected entities.

D) FINANCIAL SECTOR REFORM

- **Introduction**: A vibrant, efficient and competitive financial system is necessary to support structural reforms in the real economy. To Achieve this, government had set up Committee on Financial System in 1991 and Committee on Banking Sector Reforms in 1998 (Narsimhan Committees)

- **Report of Narsimhan Committee on Financial Safety** became the basis for **introducing reforms in banking sector**:
  a. The government has over the years **brought down SLR and CRR** in a phased manner.
    - **Current SLR stands around 18% and CRR around 4.5%.**

  b. RBI has also introduced prudential norms in respect of income recognition, classification of assets, provisioning of debts and capital adequacy.
    - For e.g. now all banks' groups have CRAR much higher than minimum 9% stipulated by the RBI.

  c. Commercial banks who fulfill prudential accounting norms and capital adequacy norms have **freedom to set up new branches** without the approval of the RBI.
  d. **Permission to new private sector banks** (including foreign joint ventures)
  e. RBI has also announced **guidelines for setting up banks in the private sector.** These banks should be financially viable and should avoid concentration of credit and cross holdings with industrial groups.
  f. **Interest rates in the banking system** has been liberalized, compared to situation prevailing before 1991.
  g. **Supervisory role of RBI has been strengthened** by setting up of a new Board for Financial Supervision under the chairpersonship of Deputy Government of RBI.
  h. **Agreement** between RBI and PSBs have been made to improve management and the quality of the performance of latter.
  i. Initiatives like **SARFAESI Act and IBC** have improved recovery of the banks.

- Another committee - **Committee on Banking Sector Reforms under the chairmanship of M Narsimhan** submitted its reforms in 1998.
  » It stressed on measures like Increase in CRAR; stricter NPA norms; and provisioning requirements and the introduction of asset liability management guidelines; depoliticized bank boards under the RBI supervision; allow set up of foreign banks etc.
  » In line with these recommendations' government took following steps:
    - Raising CRAR to 9%.
    - Strengthening Prudential accounting norms
    - Laying down Asset Liability Management (ALM) and Risk Management guidelines.
    - In 2002, SARFAESI act was passed; in 2016, Insolvency and Bankruptcy Code (IBC) was introduced to improve the recovery of banks.

  » Some of the committee's recommendations which haven't been implemented are:
    - Country should have **2 or 3 large banks** with international orientation.

        - Strong banks should be merged, and relatively weak and unviable ones should be closed.
    - Bank Recapitalization is not viable and should be abandoned.
        - Weak banks should be closed.

4) IMPACT OF LIBERALIZATION

- **The liberalization** of Indian economy has had significant impact on country's economic growth and development:
    i. **Higher growth in reform period**:
        - The rate of GDP growth which used to be 3.4% in 1960s and 1970s and 5.2% in 1980s rose to 5.9% in 1990s and further to 7.6% in the first decade of the present century.
        - Correspondingly, the rate of growth of per capita GDP also increased substantially and was as high as **6.0%** per annum in the first decade of the century.

    ii. **Economic Growth Rate increased**: India's economic growth between 1992 – 2000 was 5.7% much higher than the GDP growth rates of previous years.
    iii. **Investment including FDIs and FIIs** increased.
    iv. **Service Sector growth**: new sectors like BPO, IT etc. boomed in India creating more service exports and more jobs in the country.
    v. **Expansion of Private sector** – Privatization of many PSUs and deregulation of various sectors, paved the way for various industries to thrive.
    vi. **Improved Quality of good and services**: With liberalization and globalization, Indian industries had to compete with foreign countries, eventually leading to improved quality of goods and services and thus improved competitiveness.
    vii. **Lower Inflationary Pressure**: Removal of inefficiencies and increased competition led to reduction in inflationary pressure on the economy.
    viii. **Reduction in Poverty**: The growth resurgence enabled India to move up in the per capita (PPP-corrected) GDP ranking from 93 (out of 109 countries) in the mid-1970s to 58 in 2004.

- **But**, at the same time Liberalization has also led to some challenges:
    - » **Growth has not been inclusive:**
        - **Impact of reforms on the poor people** has been negligible and there is hardly any change in their abysmal living conditions.
            - **Low rate of increase** in average per capita expenditure and real wages.
            - **Income Inequality and Regional Disparities are increasing**:
                - **E**.g., as per a recent report by Oxfam, India's top 1% owned more than **40.5%** of its total wealth in 2021.
    - » **Jobless Growth:** In the post reforms period, while the growth rate accelerated, the jobs failed to increase. Infact the quality of existing jobs has also deteriorated, with the percentage of workers in the informal sector increasing.
    - » **Neglect of education, skilling and healthcare**: This has led to development of low employment potential.
        - The economic reforms ignored education, skilling and healthcare. So, while the macro-economic stabilization and structural reforms were achieved, human development suffered.

- **Widespread malnutrition and under-nutrition**: The 2021 Global Hunger Index Report ranked India 101/135 countries with a score of 27.5.
    - Economists Dreze and Sen say "While there is much scope for debate about different ways of measuring undernourishment, what is not in doubt is that ***India still has a higher proportion of undernourished children than almost any other country in the world***.

» **Increased vulnerability to global economic** crisis due to increased linkage to global economy.

» **Agriculture and other small-scale sectors** have faced increased challenges due to global challenges and decreased incentives and subsidies for them.

» **The Question of sustainability of growth**: Environmental Pollution and Climate Change have emerged as a major challenge to sustainability and the economic reforms have only exacerbated these challenges. Unlike other problems discussed above, this is a global problem and has to be dealt at global level with each country having its contributions.

- **Conclusion:** To become a prosperous and high-income country in the next two decades, India will have to achieve economic growth rate that is superfast (growth rate of 8% or more) and inclusive (growth that is widely shared. The 1991 economic reforms have played their role and improved the fundamentals of Indian economy. It is now time for another round of radical reforms to keep the engine of productivity growth firing on all cylinders.

7. DEVELOPMENT OF INDIAN ECONOMY: TRANSITION FROM AGRICULTURE TO SERVICE SECTOR

- **Share of the three sectors in Economy:**

Year	Agriculture	Industry	Services
1947	55%	15%	30%
2022-23:	17%	29%	54

- The above table shows that in the 75 years of India's independence, Indian economy has moved from a primarily agricultural economy to an economy where service sector has the biggest contribution.
- In this period, Industrial sector has never been the major contributor in the economy and its share has remained stuck around 30%. This is unique as economies generally, in their process of development, transition from agriculture sector to industrial sector before actually.
- This is unique as all over the world, economies first transition from Agriculture to Industrial sector, before services start contributing bigger share.
- **Factors for this jump from Primary Sector to Tertiary Sector**:
    - **Why manufacturing sector suffered?**
    - **Colonial Legacy**: The British rule destroyed the industrial base of India and had made it a primarily raw material supplying economy.
    - **Infrastructure Challenges in India**: Industrial growth requires good quality of roads, storage, electricity supply etc. But governments since independence were not able to focus on these challenges.
        - Logistics cost in India remains much higher than the global average hampering the competitiveness of India's economy.

        - India's Port and Shipping sector remained inferior for a long period due to inefficiencies of trusts which manage these major ports.
        - Electricity supply has remained a concern even today, with many areas seeing a power cut regularly, hampering growth of industries.
    - **Complicated Labor laws**: Manufacturing sector is generally labor intensive sector and complicated labor laws in the country hindered businesses from scaling their factories.
    - **Complicated tax regime**: The corporate tax in India before the 1991 reforms was as high as 50%. This discouraged businesses from penetrating into manufacturing.
    - **Scarcity of Land**: India has very high population density and thus land acquisition has always been a problem. Service sector may start on small land areas. But, to set up large manufacturing bases, large areas of land needed to be acquired which has been very difficult in India.
    - **Red Tapism, Over-regulation, license raj** etc. before the 1991 economic reforms hindered manufacturing sector. Some of these problems persist even today hampering ease of doing business in India.
    - **Various challenges faced by MSME sector**: MSME sector contributes a large share of manufacturing in India. But this sector suffers from several challenges including lack of excess to finance, old technology, lack of skilled workforce, poor branding and marketing etc.

- **Why Service sector's contribution kept on improving (why service sector leapfrogged)?**
    - Service sector did better vis a vis manufacturing sector and its share in the economy leapfrogged due to following reasons:
        i. **Globalization, Information Technology and English-Speaking workforce**:
            - The time when economic reforms were taking place, India's IT sector was also emerging. Economic reforms led to IT sector/BPOs etc find easy markets abroad.
            - Further, the labor requirement here was much lesser and India's higher education system was producing people with required skills and English-speaking ability in enough numbers.
        ii. **Very Small Entry Barriers**: One could start an IT company with few computers and servers and then scale with time. This isn't the case with manufacturing sector, which to remain competitive have to produce things at large scale.
        iii. **Flexible and Scalable nature** of the service sector allowed companies to quickly respond to market dynamics, making them more resilient to economic fluctuations.
        iv. **Changing Consumer Needs**: With economic growth in India, increased the demand for services like better education and health facilities, more financing requirements etc.

- The above advantages for service sector along with the bottlenecks faced by the manufacturing sector led to the leapfrogging of service sector in India compared to manufacturing sectors.

- **PYQ**:

    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? [Mains 2014, 12.5 marks, 200 words]