Banking System in India-I

A commercial bank is a type of financial intermediary. It is a financial intermediary because it mediates between the savers and borrowers. It does so by accepting deposits from the public and lending money to businesses and consumers. Its primary liabilities are deposits and primary assets are loans and bonds.

"Commercial bank" has to be distinguished from another type called "investment bank". Investment banks assist companies in raising funds in the capital markets (both equity and debt), as well as in providing strategic advisory services for mergers, acquisitions and other types of financial transactions. It is also called merchant bank.

The commercial banking system in India consists of public sector banks; private sector banks and cooperative banks.

Currently, India has 88 scheduled commercial banks (SCBs) - 26 public sector banks (that is with the Government of India holding majority stake) that include SBI and its associates and the IDBI Bank; there are private banks and foreign banks also. Public sector banks hold over 75 percent of total assets of the banking industry, with the private and foreign banks holding 18.2% and 6.5% respectively

Public Sector Banks

They are owned by the Government- either totally or as a majority stake holder.

- State Bank of India and its five associate banks called the State Bank group
- 19 nationalised banks(earlier there were 7 associate banks but recently 2 were merged with SBI- SB of Saurashtra and Indore)
- Regional Rural Banks mainly sponsored by Public Sector Banks

Private Sector Banks include domestic and foreign banks

Co-operative Banks are another class of banks and are not considered as commercial banks as they have social objectives and profit is not the motive. (Explained later)

Reserve Bank of India lays down the norms for banking operations and has the final supervising power.

Development Banks

Development Banks are those financial institutions which provide long term capital for industries and agriculture : Industrial Finance Corporation of India (IFCI) ;Industrial Development Bank of India (IDBI) ;Industrial Credit and Investment Corporation of India (ICICI) that was merged with the ICICI Bank in 2000 ;Industrial Investment Bank of India (IIBI) ;Small Industries Development Bank of India (SIDBI) ;National Bank for Agriculture and Rural Development (NABARD) ;Export Import Bank of India ; National Housing Bank(NHB).

The commercial banking network essentially catered to the needs of general banking and for meeting the short-term working capital requirements of industry and agriculture. Specialised development financial institutions (DFIs) such as the IDBI, NABARD, NHB and SIDBI, etc., with majority ownership of the Reserve Bank were set up to meet the long-term financing requirements of industry and agriculture. To facilitate the growth of these institutions, a mechanism to provide concessional finance to these institutions was also put in place by the Reserve Bank.

The first development bank in India- IFCI- was incorporated immediately after Independence in 1948 under the Industrial Finance Corporation Act as a statutory corporation to pioneer institutional credit to medium and large-scale. Then after in regular intervals the government started new and different development financial institutions to attain the different objectives and helpful to five-year plans.

Government utilized these institutions for the achievements in planning and development of the nation as a whole. The all India financial institutions can be classified under four heads according to their economic importance that are:

- All-India Development Banks
- Specialized Financial Institutions(SIDBI)
- Investment Institutions (The Industrial Reconstruction Corporation of India Ltd., set up in 1971 for rehabilitation of sick industrial companies)
- State-level institutions(SFC)

S.H.Khan committee appointed by RBI(1997) recommended to transform the DFI (development finance institution) into universal banks that can provide a menu of financial services and leverage on their assets and talent.

Bank Nationalization

In 1969 and again in 1980, Government nationalized private commercial banking units for channelizing banking capital into rural sectors; checking misuse of banking capital for speculative purposes; to shift from `class banking' to `mass banking'(social banking); and to make banking into an integral part of the planning process of socio-economic development in the country. Today, no other developing country can boast of a banking system comparable to India's in terms of geographic coverage, operational capabilities, range of services and technological prowess.

Commercial Banks

Today banks are broadly classified into two types - Scheduled Banks and Non-scheduled Banks

Scheduled banks are those banks which are included in the Second Schedule of the Reserve Bank Act, 1934. They satisfy two conditions under the Reserve Bank of India Act

- paid-up capital and reserves of an aggregate value of not less than Rs 5 lakh
- it must satisfy RBI that its affairs are not conducted in a manner detrimental to the depositors.

The scheduled banks enjoy certain privileges like approaching RBI for financial assistance, refinance etc and correspondingly, they have certain obligations like maintaining certain cash reserves as prescribed the RBI etc. The scheduled banks in India comprise of State Bank of India and its associates (8), the other nationalised banks (19), foreign banks, private sector banks,co-operative banks and regional rural banks. Today, there are about 300 scheduled banks in India having a total network of 79,000 branches among them.

Non-scheduled banks are those banks which are not included in the second schedule of the RBI Act as they do not comply with the above vriteria and so they do not enjoy the benefits either.

There are only 3 non-scheduled commercial banks operating in the country with a total of 9 branches.

In sum, all banks which are included in the Second Schedule to the Reserve Bank of India Act, 1934 are Scheduled Banks. These banks comprise Scheduled Commercial Banks and Scheduled Co-operative Banks.
Scheduled Commercial Banks in India are categorised into five different groups according to their ownership and / or nature of operation. These bank groups are (i) State Bank of India and its Associates, (ii) Nationalised Banks, (iii) Private Sector Banks, (iv)Foreign Banks, and (v) Regional Rural Banks. In the bank group-wise classification, IDBI Bank Ltd. has been included in Nationalised Banks.

Cooperative Banks

Co-operative Banks are organised and managed on the principle of co-operation, self-help, and mutual help. They function with the rule of "one member, one vote" and on "no profit, no loss" basis. Co-operative banks, as a principle, do not pursue the goal of profit maximisation.

Co-operative bank performs all the main banking functions of deposit mobilisation, supply of credit and provision of remittance facilities.

Co-operative Banks provide limited banking products and are functionally specialists in agriculture related products. However, co-operative banks are now provide housing loans also.

Urban Co-operative Banks (UCBs) are located in urban and semi-urban areas. These banks, till 1996, were allowed to lend money only for non-agricultural purposes. This distinction does not hold today. Earlier, they essentially lent to small borrowers and businesses. Today, their scope of operations has widened considerably. Urban CBs provide working capital, loans and term loan as well.

Co-operative banks are the first government sponsored, government-supported, and government-subsidised financial agency in India. They get financial and other help from the Reserve Bank of India, NABARD, central government and state governments. RBI provides financial resources in the form of contribution to the initial capital (through state government), working capital, refinance.

Co-operative Banks belong to the money market as well as to the capital market- they offer short term and long term loans.

Primary agricultural credit societies provide short term and medium term loans. State Cooperative Banks (SCBs) and CCBs (Central Cooperative Banks at the district level) provide both short term and term loans. Land Development Banks (LDBs) provide long-term loans.

Long term cooperative credit structure comprises of state cooperative agriculture and rural development bank (SCARDB) at the state level and primary PCARDBs or branches of SCARDB at the decentralised district or block level providing typically medium and long tem loans for making investments in agriculture, rural industries, and lately housing. The sources of their funds (resources) are ownership funds

- deposits or debenture issues.
- central and state government
- Reserve Bank of India
- NABARD
- other co-operative institutions

Some co-operative bank are scheduled banks, while others are non-scheduled banks. For instance, SCBs and some UCBs are scheduled banks (included in the Second Schedule of the Reserve Bank of India Act)

Co-operative Banks are subject to CRR and SLR requirements as other banks. However, their requirements are less than commercial banks.

Although the main aim of the co-operative bank is to provide cheaper credit to their members and not to maximize profits, they may access the money market to improve their income so as to remain viable.

Prakash Bakshi Committee

In August 2012, Reserve Bank of India constituted a committee to suggest ways to strengthen the rural co-operative credit structure.The panel, headed by Nabard Chairman Prakash Bakshi, will review the existing short-term co-operative credit structure (STCCS), focussing on structural constraints in the rural credit delivery system. It will also explore ways to strengthen the rural co-operative credit architecture. The seven-member panel will make an in-depth analysis of the STCCS, and examine various alternatives with a view to reducing the cost of credit.The STCCS targets the credit requirement of the small and marginal farmers in the country.It will mainly assess the role played by State and district cooperative banks in fulfilling the requirement of agriculture credit.

Commercial banks and their weaknesses by 1991

The major factors that contributed to deteriorating bank performance upto the end of eighties were

- high SLR and CRR locking up funds
- low interest rates charged on government bonds
- directed and concessional lending for populist reasons
- administered interest rates and
- lack of competition.

The reforms to set the above problems right were

- Floor and cap on SLR and CRR removed in 2006
- interest rates were deregulated to make banks respond dynamically to the market conditions. Even SB rates were deregulated in 2011
- near level playing field for public, private and foreign banks in entry

- adoption of prudential norms- Reserve Bank of India issued guidelines for income recognition, asset classification and provisioning to make banks safer
- Basel norms adopted for safe banking
- VRS for better work culture and productivity
- FDI upto 74% is permitted in private banks

One of the sectors that has been subjected to reforms as a part of the new economic policy since 1991 consistently is the banking sector. The **objectives of banking sector reforms** have been:

- to make them competitive and profitable
- to strengthen the sector to face global challenges
- sound and safe banking
- to help them technologically modernize for customer benefit
- make available global expertise and capital by relaxing FDI norms.

Narasimham Committee
Banking sector reforms in India were conducted on the basis of Narasimham Committee reports I and II (1991 and 1998 respectively). The recommendations of Narasimham committee 1991 are

No more nationalization

- create a level playing field between the public sector, private sector and foreign sector banks
- select few banks like SBI for global operations
- reduce Statutory Liquidity Ratio(SLR) as that will leave more resources with banks for lending
- reduce Cash Reserve Ratio(CRR) to increase lendable resources of banks
- rationalize and better target priority sector lending as a sizeable portion of it is wasted and also much of it turning into non-performing asset
- introduce prudential norms for better risk management and transparency in operations
- deregulate interest rates
- Set up Asset Reconstruction Company(ARC) that can take over some of the bad debts of the banks and financial institutions and collect them for a commission .

Most of these reforms are implemented except priority sector lending which is welfare-based and relates to agriculture. SLR is 23% today and CRR is 4.75%. Bank rate is aligned with MSF.(2012)

Divestment in public sector banks led to their listing on the stock exchanges and their performance has improved.

NPAs
Non-performing assets are those accounts of borrowers who have defaulted in payment of interest or installment of the principal or both for 90 days at least.

In 2003, NPAs stood at 9% and came down to 2.5% in 2008 but rose as economy slowed down since 2011.

Reflecting the stress in India Inc, net non-performing assets (NPAs) of banks at the aggregate level rose to Rs 60,100 crore at the end of March 2012.

One of the main reasons for this sharp jump in NPAs is the loans due to state electricity boards and also Air India. On the sectoral front, metals, textiles and infrastructure sectors were among the major ones to contribute to this slide.

The sharp rise in NPAs in the banking system, although was expected, has taken a toll on the stock prices of most of these banks.

PSU banks have seen their loans go bad at a faster rate than their private sector peers, the latter have been steadily improving their asset quality over the years.

RBI rules require that banks should set aside certain amount of money(provisioning) for the NPAs. Gross NPAs include the amount due along with the amount provisioned. Net NPAs include only the amount due.

NPAs are largely a fallout of banks' credit appraisal system, monitoring of end-usage of funds and recovery procedures. It also depends on the overall economic environment like the global recession since 2008, the business cycle and the legal environment for recovery of defaulted loans. Wilful default; priority sector problems among the poor etc are also responsible.

High levels of NPAs means: banks' profitability diminishes; precious capital is locked up; cost of borrowing will rise as lendable assets shrink; stock prices of banks will go down and investors will lose; investment suffers etc.

NPAs are classified as sub-standard; doubtful and loss making assets for provisioning requirements.

The following are the RBI guidelines for NPAs classification and provisioning:
Sub Standard Assets – These are those accounts which have been classified as NPAs for a period less than or equal to 18 months.

Doubtful Assets –These are those accounts which have remained as NPAs for a period of 12 months.

Loss Assets – Such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value. But a loss asset has not been written off, wholly or partly.

What is being done

- provisioning
- CAR norms
- norms
- one time settlement
- debt recovery tribunals
- securitization law
- foreclosure
- interest waiver
- writeoffs

Foreclosure means taking over by the lender of the mortgaged property if the borrower does not conform to the terms of mortgage.

Securitization is the process of pooling a group of assets, such as loans or mortgages, and selling securities backed by these assets.

SARFAESI Act 2002

To expedite recovery of loans and bring down the non-performing asset level of the Indian banking and financial sector, the government in 2002 made a new law that promises to make it much easier to recover bad loans from willful defaulters. Called the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002(SARFAESI) , the law has given unprecedented powers to banks, financial institutions and asset reconstruction/securitization companies to take over management control of a loan defaulter or even capture its assets.

Asset Reconstruction Company

Normally banks and FIs themselves recover the loans. But in the case of bad debts (sticky loans), it is outsourced to the ARCs who have built-in professional expertise in this task and who handle recovery as their core business. ARCs buy bad loans from banks and try to restructure them and collect them. Arcs were recommended by Narasimham committee II. ARCIL- the first asset reconstruction company was set up recently.

Prudential Norms

Prudential norms relate to

- income recognition
- asset classification
- provisioning for NPAs
- capital adequacy norms(capital to risk-weighted asset ratio, CRAR).

A proper definition of income is essential in order to ensure that banks take into account income that is actually realized(received) . It helps in classifying an asset as NPA in certain cases. Once classified as NPA, funds must be set apart to balance the bank's operations so as to maintain safety of operations in case of non-recovery of NPAs.Thus, income recognition, asset classification and provisioning norms are inter-related.

Prudential norms make the operations transparent, accountable and safe.

Prudential norms serve two primary purposes: bring out the true position of a bank's loan portfolio and help in prevention of its deterioration.

Basel Norms

Banks lend to different types of borrowers and each carries its own risk. They lend the deposits of public as well as money raised from the market- equity and debt. The intermediation activity exposes the bank to a variety of risks. Cases of big banks collapsing due to their inability to sustain the risk exposures are readily available. Therefore, banks have to keep aside a certain percentage of capital as security against the risk of non-recovery. Basel committee provided the norms called Basel norms to tackle the risk.

Basel is a city in Switzerland. It is the headquarters of Bureau of International Settlement (BIS), which fosters co-operation among central banks with a common goal of financial stability and common standards of banking regulations. Every two months BIS hosts a meeting of the governor and senior officials of central banks of member countries. Currently there are 27 member nations in the committee. Basel guidelines refer to broad supervisory standards formulated by this group of central banks - called the Basel Committee on Banking Supervision (BCBS). The set of agreement by the BCBS, which mainly focuses on risks to banks and the financial system are called Basel accord. The purpose of the accord is to ensure that financial institutions have enough capital on account to meet obligations and absorb unexpected losses. India has accepted Basel accords for the banking system. In fact, on a few parameters the RBI has prescribed stringent norms as compared to the norms prescribed by BCBS.

In 1988, BCBS introduced capital measurement system called Basel capital accord, also called as Basel 1. It focused almost entirely on credit risk. It defined capital and structure of risk weights for banks. The minimum capital requirement was fixed at 8% of risk weighted assets (RWA). RWA means assets with different risk profiles. For example, an asset backed by collateral would carry lesser risks as compared to personal loans, which have no collateral. India adopted Basel 1 guidelines in 1999.
In June '04, Basel II guidelines were published by BCBS, which were considered to be the refined and reformed versions of Basel I accord. The guidelines were based on three parameters, which the committee calls it as pillars. - Capital Adequacy Requirements: Banks should maintain a minimum capital adequacy requirement of 8% of risk assets - Supervisory Review: According to this, banks were needed to develop and use better risk management techniques in monitoring and managing all the three types of risks that a bank faces, viz. credit, market and operational risks - Market Discipline: This need increased disclosure requirements. Banks need to mandatorily disclose their CAR, risk exposure, etc to the central bank.

Basel III

In 2010, Basel III guidelines were released. These guidelines were introduced in response to the financial crisis of 2008. A need was felt to further strengthen the system as banks in the developed economies were under-capitalized, over-leveraged and had a greater reliance on short-term funding. Also the quantity and quality of capital under Basel II were deemed insufficient to contain any further risk.

More

CRAR at 9 percent of the risk weighted assets is prescribed by Basel norms. It is the capital that is required to be set aside for absorbing risks. It is not to be provisioned from deposits raised but has to be additionally provided from debt, equity, reserves etc.

Presently the Basel II norms are being complied with by Indian banks as follows:

Basel 2 norms are 8% of CRAR.RBI made it 9% for greater security.

Basel-II aims to strengthen Basel I.

Not only credit risk but also market risk and operational risk are covered.

Credit risk
A bank always faces the risk that some of its borrowers may not repay loan, interest or both. This risk is called credit risk, which varies from borrower to borrower depending on their credit quality. Basel II requires banks to accurately measure credit risk to hold sufficient capital to cover it.

Market risk
As part of the statutory requirement, in the form of SLR (statutory liquidity ratio), banks are required to invest in liquid assets such as cash, gold, government and other approved securities. For instance, Indian banks are required to invest 24 per cent of their net demand and term liabilities in cash, gold, government securities and other eligible securities to comply with SLR requirements (2008-09).

Such investments are risky because of the change in their prices. This volatility in the value of a bank's investment portfolio in known as the market risk, as it is driven by the market.

Operational risk
Several events that are neither due to default by third party nor because of the vagaries of the market. These events are called operational risks and can be attributed to internal systems, processes, people and external factors.

Thus, Basel II uses a **"three pillars"** concept

Pillar 1 Specifies includes more types of risk- credit risk ,market risk and operational risk.

Pillar 2 Enlarges the role of banking supervisors.

Pillar 3 Defines the standards and requirements for higher disclosure by banks on capital adequacy, asset quality and other risk management processes.

Capital -Tier1 And Tier 2
Capital adequacy norms divide the capital into two categories. Tier one capital is used to absorb losses while the Tier 2 capital is meant to be used at the time of winding up.
Tier I Capital: Actual contributed equity plus retained earnings.

Tier II Capital: Preferred shares plus 50% of subordinated debt (junior debt)

Subordinated debt figures between debt and equity – coming after the first in terms of eligibility for benefits like compensation.

Recapitalization is lending to the bank the resources needed to conform to the capital adequacy norms which stand at 8% today – minimum level.

One of the problems perceived in Basel 1 and 2 norms was that all sovereign debt, in general, was given a risk weight of zero, while all corporate debt was given similarly an equal weight irrespective of the difference in risk of the corporate concerned. The Eurozone sovereign debt crisis taught us lessons.

The risk weights led to some curious behaviour in lending. Banks started preferring to lend to governments, which required no capital addition, while even risk-free corporates, which had good rating, demanded additional capital provisioning under adequacy norms. Thus, one size fits all approach brought in distortions in lending.

Basel 3 norms: RBI Guidelines
The draft guideline norms announced by the RBI in mid-2012 will come into effect fully by 31 March 2018.

The key capital adequacy parameter has been stipulated at 9% higher than the international norm of 8%, and unchanged from what the regulator requires in India currently.

These guidelines mean that Indian banks would require a huge amount of capital in the next six years, about $30 billion to $40 billion. Some banks may find it difficult.

That would impose a heavy financial burden on the government, which will need to infuse capital in line with its holdings in the state-owned banks.

Under Basel III norms, a countercyclical capital buffer is prescribed: keep aside capital that can be used when the cycle turns down and the loans may turn bad.
Swap line for banks under the ECB route introduced by the RBI in mid-2013. (Discussed in the class)

BIS
The Bank for International Settlements (BIS) is an international organization of central banks which fosters international monetary and financial cooperation and serves as a bank for central banks." It also provides banking services, but only to central banks, or to international organizations. Based in Basel, Switzerland, the BIS was established by the Hague agreements of 1930.

As an organization of central banks, the BIS seeks to make monetary policy more predictable and transparent among its 55 member central banks. The BIS' main role is in setting capital adequacy requirements to safeguard bank's operations.

Shadow banks
NBFCs are largely refered to as shadow banking system or the shadow financial system. They have become the major financial intermediaries. As seen in the note on NBFCs elsewhere, shadow institutions do not accept demand deposits and therefore are not subject to the same regulations. Familiar examples of shadow institutions included Bear Stearns and Lehman Brothers. Hedge funds, pension funds, mutual funds and investment banks are some examples.

Shadow institutions are not as effectively regulated as banks and so carry higher risk of failure.

Universal Banking in India
Universal banking in India was recommended by the second Narasimham Committee (1998) and the Khan Committee (1998) reports. It aims at widening and integration of financial activities.

Universal Banking is a multi-purpose and multi-functional financial supermarket.' Universal banking' refers to those banks that offer a wide range of financial services, beyond the commercial banking functions like Mutual Funds, Merchant Banking, Factoring, Credit Cards, Retail loans, Housing Finance, Auto loans, Investment banking, Insurance etc. This is most common in European countries.

Benefits to banks from universal banking are that , since they have competence in the related areas, they can reduce average costs and thereby improve spreads(difference between cost of borrowing and the return on lending) by diversification. Many financial services are inter-linked activities, e.g. insurance, stock broking and lending. A bank can use its instruments in one activity to exploit the other, e.g., in the case of project lending to the same firm which has purchased insurance from the bank. To the customers, 'one-stop-shopping' saves transaction costs.

However, one drawback is that universal banking leads to a loss in specialisation. There is also the problem of the bank indulging in too many risky activities. ICICI(Industrial Credit and Investment Corporation of India) merged with its subsidiary-ICICI Bank in a reverse merger(parent merging with the subsidiary, the ICICI Bank). Other banks are also emerging as universal banks which are popular in Europe.

The compulsions for the DFIs like ICICI, IDBI, IFCI etc to become UBs is the following:
Earlier in the sixties and seventies, the DFIs specialized in project finance for the industries with long term capital needs. But the industries of late are mobilizing the finances from external sources or from the stock market and so the DFI business suffered. The cheap Government funds that were available in the earlier pre-liberalization era also are not available today.Banks and DFIs are having to compete for the same clients. Banks have an advantage in that they have a deposit base but the DFIs do not have same.

BANKING SYSTEM IN INDIA-II

Financial inclusion

Many people, particularly those living on low incomes, cannot access mainstream financial products such as bank accounts and low cost loans. This financial exclusion forces them to borrow from the moneylenders at high cost. Therefore, financial inclusion has been the goal of government's policy since late sixties.

Financial inclusion or taking banking services to the common man was the main driver of bank nationalization in 1969 and 1980 powered by three priority areas

- access to banking
- access to affordable credit, and
- access to free face-to-face money advice.

Thus, financial inclusion is the delivery of banking services at an affordable cost to the vast sections of disadvantaged and low-income groups. The Government of India's rationale for creating Regional Rural Banks (RRBs) in the years in 1975 following the nationalization of the country's banks was to ensure that banking services reached poor people.

The branches of commercial banks and the RRBs grew from 8,321 in 1969 to about 70,000.

Priority sector credit under which 40% of all bank advances should go to certain specified areas like agriculture is a form of directed credit that is aimed at financial inclusion.

Micro-finance (savings, insurance and lending in small quantities) and self-help groups are another innovation in financial inclusion.

Differential rate of interest; kisan credit cards; no-frills account (allowing opening of account with very little or no minimum balances) etc are examples of financial inclusion.

Scaling-up access to finance for India's rural poor, to meet their diverse financial needs (savings, credit, insurance, etc.) through flexible products at competitive prices is the goal of financial inclusion.

The total number of no-frill accounts opened over a two-year period (April 1, 2007 to May 30, 2009) stands at 25.1 million.

While it is beyond doubt that financial access of the people has significantly improved in the last three-and-a-half decades, and even more so in the last two years, the focus now should be on how to accelerate it as financial inclusion is important for economic growth, equity and poverty alleviation.

Unique identification number has some advantages for financial inclusion KYC (know your customer) bottlenecks will be dramatically reduced. Millions of new customers will become bankable. Growth will get a boost. Risk management will undergo a paradigm shift. Credit histories will be available on tap. Profitability will improve and so will customer service. We could finally have a technology initiative to extend financial inclusion.

Bank consolidation
Merging public sector banks to form big and globally aspiring banks is bank consolidation. It is expected to bring about financial stability and was recommended by the Narasimham Committee-II (1997) on financial sector reform.

State Bank of Saurashtra's merger with SBI has been achieved and the remaining six are to be merged. Government says that bigger banks can take on competition; can raise more than smaller banks;

Rationalising the manpower and branch network after bank mergers is a challenge and the criticism also includes that the bigger banks will be so much more bureaucratized. Bigness also does not reduce chances of failure as seen in the west in the current meltdown.

India has more than 175 commercial banks, out of which 26 state-owned banks account for the majority of the banking sector's assets followed by private sector banks and foreign banks, which have a tiny share.

Financial stability
Financial stability is a situation where the financial system operates with no serious failures or undesirable impacts on development of the economy as a whole, while showing a high degree of resilience to shocks.

Financial stability may be disturbed both by processes inside the financial sector leading to the emergence of weak spots like excessive of leverage; dealing in doubtful products like collateralized debt options(CDS) etc. It can also be undermined through regulatory lapses and inadequate safeguards prescribed by law.

In India, the banking system was not impacted badly by the world financial crisis as Indian banks are well-regulated through proper supervision. They are also well capitalized through capital adequacy ratio according to the Bank of International Settlements (Basel, Switzerland).
Calibrated globalization also meant that we would open upon only on achieving the strength to compete successfully.

RBI and Financial Stability
Traditional role
Recent global financial crisis is largely attributed to the financial sector recklessness due to lack of quality regulation. The lesson to draw from the crisis is to provide for good regulation- need not be more regulation- by the Central bank so that there is financial stability. In India, RBI has performed the role by the following instruments

- Licensing of banks
- Deciding on who can set up a bank, expand etc
- SLR, CRR norms
- CAR rules
- Lender of last resort
- Laying down prudential norms

- Supervisory functions

RBI Governor heads the HLCC- High Level Coordination Committee of financial regulators of SEBI, PFRDA and IRDA.

RBI defines from time to time NPA norms; allows or limits or banks credit to certain sectors like real estate in order to make banking operations safe and stable. Interest rates are also changed through repo and reverse repo rates to caution the borrowers and consumers.

Post-Lehman

Maintaining and monitoring financial stability has always been a key objective of monetary policy. However, it was only from the middle of 2009(post-Lehman) that the government and the RBI sought to institutionalise the process, making financial stability "an integral driver of the policy framework."

RBI tracks the following parameters in its quest to maintain financial stability: excessive volatility in interest rates, exchange rates and asset prices; signs of excess leverage (borrowings) in the financial sector, companies and households; and the unregulated parts of the financial sector.

RBI set up a Financial Stability Unit in 2009 and started presenting periodical reports since March 2010. The first report found the banking system to be broadly healthy and well-capitalised, but noted that global economic shocks, inflation, the slow pace of fiscal consolidation and the unsettlingly large capital inflows posed significant risks to financial stability. According to the second FSR, many of the positive features are intact. Growth has rebounded strongly and the financial conditions are stable. Despite intermittent volatility in the foreign exchange and equity markets, the financial sector has been risk-free. New risk assessment measures are introduced by the RBI — such as the Financial Stress Indicator and the Banking Stability Index.

Risks to financial stability are: the widening current account deficit; volatile capital inflows and the persistently high inflation.

The asset quality of banks and their asset-liability mismatch need to be constantly monitored.

Recent developments in the microfinance institutional structure cause serious concern.

Given the increasing correlation between global economic growth and that in emerging markets, the possibility of certain exogenous risks materialising is strong.

Banking Stability Index

It has been devised by the RBI in 2009. This index is simple average of five sub indices chosen for banking stability map that RBI has constructed. Banking Stability Map has used five key risk dimensions like operational efficiency, asset-quality, liquidity and profitability. These are based on capital adequacy ratio, cost-to-income ratio, nonperforming loans to total loans ratio, liquid assets to total assets ratio and net profit to total assets ratio.

Words

PLR
Prime Lending Rate (PLR) is the rate at which banks lend to the best customers. About 15% today. (2009)

Basis point
Changes in interest rates and other variables are expressed in terms of basis points to magnify and express the importance of changes. One basis point is 1% of 1%.

Weak Bank – Narasimham Committe – II
A 'Weak Bank' has been defined by the committee as follows: Where total accumulated losses of the bank and net NPA amount exceed the net worth of the bank.

Narrow banking
For restoring weak banks to strength, restructuring is needed. Such restructuring is generally attempted by operating the bank(s) as narrow bank(s), among other things. Narrow banking would restrict banks to holding liquid and safe government bonds. It prevents bank run.

Bank run
A bank run is a type of financial crisis. It is a panic which occurs when a large number of customers of a bank fear it is insolvent and withdraw their deposits.

Subordinated debt
It is also known as junior debt. It is a finance term to describe debt that is unsecured or has a lesser priority than that of other debt claim on the same asset. This means that if the party that issued the debt defaults on it, people holding subordinated debt get paid after the holders of the "senior debt". A subordinated debt therefore carries more risk than a normal debt. Subordinated debt has a higher expected rate of return than senior debt due to the increased inherent risk.

Core banking
Core Banking is normally defined as the business conducted by a banking institution with its retail and small business customers. Many banks treat the retail customers as their core banking customers, and have a separate line of business to manage small businesses. Larger businesses are managed via the Corporate Banking division of the institution. Core banking basically is depositing and lending of money.

World bank recapitalization
Government of India has made an assessment that the public sector banking system would need as much as Rs.35,000 crore worth of Tier-1 capital by 2012, given projections of how much their business needs to expand. Past divestment of equity has significantly reduced the government's shareholding in many public sector banks. Hence, it is argued, if 51 per cent government ownership has to be maintained to secure the public sector character of these banks, this recapitalisation has to be in the form of new government equity capital. Since the government is strapped for funds

for this purpose, it has decided to use this requirement as the basis for opting for a sector-specific $2 billion World Bank loan.

Banks stress tests

A **stress test** is an assessment or evaluation of a bank's balance sheet to determine if it is viable as a business or likely to go bankrupt when faced with certain recessionary and other stress situations- whether it has sufficient capital buffers to withstand the recession and financial crisis. European banks were recently subjected to such stress tests.

Financial sector reforms

Reforming the financial sector - banking, insurance, capital market, pensions- is crucial to make them generate resources; gain efficiencies; innovate new products and serve the economy and people well. It involves adoption of best practices in regulation and other areas like micro finance etc. The need is particularly felt in the wake of the global financial crisis brought about essentially by the financial sector that ruined the real economy related to production.

Some recent initiatives in this sector relate to introduction of private banks and foreign banks being given a level playing field with Government banks; deregulation of interest rates; reduction reserve requirements; pensions system being reformed ; base rate for banks; setting up of Financial Stability and Development Council; business correspondent model for financial inclusion.

There is a need however to improve the regulation of the NBFCs as they borrow from banks and lend which means if they are not properly regulated, the whole financial system is vulnerable.

Crr and slr have been freed from floor and cap to make banking more flexible.

Consolidation of banks is taking place so that benefits of scale can push Indian banks to global heights. State Bank of Saurashtra is merged with SBI and State Bank of Indore is also merged. Bank of Rajasthan has been acquired by ICICI Bank and merged with the latter.

However, in the insurance sector, reforms are still due. The Insurance Laws (Amendment) Bill provides for enhancement of share holdings by a foreign company from 26% to 49%. The Bill is not made into law as there ar differences among the political parties.

Pension Fund Regulatory and Development Authority (PFRDA) Bill that wants r FDI in this sector is also not approved.

The government was finding it difficult to manage its rising pension liability because of the defined-benefit system, under which the pension paid to employee was based on their last salary drawn.

In 2004, it shifted to a defined contribution system, which required employee to save for retirement from their earnings.

Towards this end, it set up a new pension system (NPS) for those joining government service after January 2004 and subsequently set up the Interim Pension Fund Regulatory and Development Authority to oversee the scheme that already managed the retirement savings of lakhs of state and central government employees.

The NPS was later extended to private individuals. The government now hopes to establish the NPS as the premier retirement savings scheme.

The pension bill seeks to give statutory or legal powers to the PFRDA, and set the framework for the regulation of pension fund schemes, including the ones being currently offered.

Debt market: The bond market in India remains limited in terms of nature of instruments, their maturity, investor participation and liquidity. Recent reforms include raising of the cap on investment by foreign institutional investors, or FIIs. Infrastructure debt fund etc.

Regulatory reforms- setting up of the FSDC is crucial for better supervision and clear demarcation of the jurisdiction.

The roadmap for financial sector reforms has been defined by the RH Patil, Percy Mistry & Raghuram Rajan reports.

The Banking Laws (Amendment) Act 2012

The Act would strengthen the regulatory powers of Reserve Bank of India (RBI) and to further develop the banking sector in India. It will also enable the nationalized banks to raise capital by issue of preference shares or rights issue or issue of bonus shares. It would pave the way for new bank licenses by RBI resulting in opening of new banks and branches. This would not only help in achieving the goal of financial inclusion by providing more banking facilities but would also provide extra employment opportunities to the people at large in the banking sector.

The salient features of the Bill are as follows:

- To enable banking companies to issue preference shares subject to regulatory guidelines by the RBI;
- To increase the cap on restrictions on voting rights;
- To create a Depositor Education and Awareness Fund by utilizing the inoperative deposit accounts;
- To provide prior approval of RBI for acquisition of 5% or more of shares or voting rights in a banking company by any person and empowering RBI to impose such conditions as it deems fit in this regard;
- To empower RBI to collect information and inspect associate enterprises of banking companies;
- To empower RBI to supersede the Board of Directors of banking company and appointment of administrator till alternate arrangements are made;
- To provide for primary cooperative societies to carry on the business of banking only after obtaining a license from RBI;
- To provide for special audit of cooperative banks at instance of RBI; and
- To enable the nationalized banks to raise capital through "bonus" and "rights" issue.

Bhartiya Mahila Bank (BMB)

It is an Indian financial services banking company based in New Delhi, India. Prime Minister Manmohan Singh inaugurated the bank on 19 November 2013 on the occasion of the 94th birth anniversary of former Indian Prime Minister Indira Gandhi.Although initially reported as a bank exclusively for women, the bank will allow deposits to flow from everyone, but lending will be predominantly for women. It has employees other than women too.

In India, only 26% of women have an account with a formal financial institution, compared with 46% of men. That means an account in either a bank, a co-operative, post office or a microfinance institution, according to a study by the World Bank. Also, for women, per capita credit is 80 per cent lower than males.

Furthermore, the results of a study using a global dataset covering 350 Microfinance Institutions (MFIs) in 70 countries indicates that more women clients is associated with lower portfolio-at-risk, lower write-offs, and lower credit-loss provisions.

The bank will place emphasis on funding for skills developments to help in economic activity. Moreover, the products will be designed in a manner to give a slight concession on loan rates to women.

The bank shall also aim to inspire people with entrepreneurial skills and, in conjunction with NGOs, plans to locally mobilize women to train them in vocations like toy-making or driving tractors or mobile repairs.

One of the other objectives of the bank is to promote asset ownership amongst women customers. Studies have shown that asset ownership amongst women reduces their risk of suffering from domestic violence.

The Bank's initial capital consists of Rs 1,000 crores. The government plans to have 25 branches by the end of March 2014 and 500 branches by 4th year of operation (2017).

Initially the bank will have a board of directors consisting of eight women.

How Indian banks survived the global crisis

Even though many banks failed and some survived on huge bailouts in the west due to the global financial crisis, Indian banking is almost unscathed for the following reasons

- Public sector banks- 27- dominate
- FDI is 74% in private banks but voting rights are only 10%
- We adopted capital account convertibility in a measured manner
- RBI has been conservative and regulated the banks well. Banks were not allowed to invest in risky instruments like credit default swaps(CDS)
- Basel norms, SLR and CRR levels were well maintained
- Prudential norms also saved the Indian banks from recklessness.

Financial Inclusion

Access to finance by the poor and vulnerable groups is a prerequisite for poverty reduction and social cohesion. This has to become an integral part of our efforts to promote inclusive growth. Financial inclusion means delivery of financial services at an affordable cost to the vast sections of the disadvantaged and low-income groups. The various financial services include credit, savings, insurance and payments and remittance facilities. The objective of financial inclusion is to extend the scope of activities of the organized financial system to include within its ambit people with low incomes.

NSSO data reveal that 45.9 million farmer households in the country (51.4%), out of a total of 89.3 million households do not access credit, either from institutional or non-institutional sources. Further, despite the vast network of bank branches, only 27% of total farm households are indebted to formal sources (of which one-third also borrow from informal sources). The poorer the group, the greater is the exclusion.

While financial inclusion can be substantially enhanced by improving the supply side or the delivery systems, it is also important to note that many regions, segments of the population and sub-sectors of the economy have a limited or weak demand for financial services. In order to improve their level of inclusion, demand side efforts need to be undertaken including improving human and physical resource endowments, enhancing productivity, mitigating risk and strengthening market linkages.

JLBs are proposed by the Rangarajan committee on financial inclusion 2008.JLB is like the SHG but is confined to farming operations mainly. A Joint Liability Group (JLG) is an informal group comprising preferably of 4 to10 individuals coming together for the purposes of availing bank loan either singly or through the group mechanism against mutual guarantee. The JLG members are expected to engage in similar type of economic activities like crop production.

Micro Finance Institutions (MFIs) could play a significant role in facilitating inclusion, as they are uniquely positioned in reaching out to the rural poor. The committee feels that legislation to regulate the microfinance sector is essential.

Important additional data for financial inclusion

- The first major breakthrough in financial inclusion came through when MYRADA, an NGO working in Karnataka developed the self-help group (SHG) methodology to link the unbanked rural population to the formal financial system through the local bank branches. Thanks to the efforts of the Reserve Bank of India (RBI), Nabard, state governments and numerous civil society organisations , about 8.6 crore households now have access to banking through SHGs. There are 61 lakh saving-linked SHGs with Rs 5,545.6 crore aggregate savings and 42 lakh credit-linked SHGs with loan outstanding of Rs 22,679.8 crore as on March 31, 2009.
- The business correspondent (BC) model advocated by the RBI is another pertinent example of potential frugal innovation in the financial inclusion space. The use of BCs enables banks to extend banking services to the

hinterland without setting up a brickand-mortar branch, which is often an unviable proposition. Banks use various types of hand-held devices, (aptly nicknamed microATMs) to authenticate micro-transactions at the BC location and to integrate the same with bank's main database.

- Unique Identification Authority of India (UIDAI

RBI as a regulator (Can be constructed from above)

Basics of Base Rate

What is the base rate (BR)?

It is the minimum rate of interest that a bank is allowed to charge from its customers. Unless mandated by the government, RBI rule stipulates that no bank can offer loans at a rate lower than BR to any of its customers.

How is the base rate calculated?

A host of factors, like the cost of deposits, administrative costs, a bank's profitability in the previous financial year and a few other parameters, with stipulated weights, are considered while calculating a lender's BR. The cost of deposits has the highest weight in calculating the new benchmark. Banks, however, have the leeway to take into account the cost of deposits of any tenure while calculating their BR. For example, SBI took costs of its 6-month deposits into account while calculating its BR, which it has fixed at 7.5%.

When did the base rate come into force?

It is effective from Thursday, July 1. However, all existing loans, including home loans and car loans, continue to be at the current rate. Only the new loans taken on or after July 1 and old loans being renewed after this date are be linked to BR.

How is it different from bank prime lending rate?

BR is a more objective reference number than the bank prime lending rate (BPLR) -- the current benchmark. BPLR is the rate at which a bank lends to lend to its most trustworthy, low-risk customer. However, often banks lend at rates below BPLR. For example, most home loan rates are at sub-BPLR levels. Some large corporates also get loans at rates substantially lower than BPLR. For all banks, BR will be much lower than their BPLR.

How often can a bank change its BR?

A bank can change its BR every quarter, and also during the quarter.

What does it mean for corporate borrowers?

Under the BPLR system, large corporates who enjoyed rates as low as 4-6% will be hit.

What are its benefits?

Makes the lending rates transparent. Monetary policy changes will find genuine transmission. Cross subsidation of the corporate at the expense of MSMEs will stop and MSMEs will get credit more affordably.

What are the exceptions?
Educational loans, export credit, credit to weaker sections can be given at sub-base rate.

Securities and Insurance Laws (Amendment) and Validation Act, 2010
United Linked Invest Plans(Ulips) are the insurance products in which payment is made partly for premium(insurance) and rest of it invested in the capital market like a Mutual Fund investment. It led to jurisdictional disputes between Sebi and Irda. Sebi says that a huge amount of Ulip is invested in stock market. Government promulgated an ordinance to set up a mechanism to regulate such jurisdictional disputes.

Financial sector is inter-related. Banks keep money that is invested in stock market. Insurance companies have stock market related products like Ulips.Pension funds are becoming popular in the stock market. These players can have mutual problems of jurisdiction as seen in the case of Ulips. Therefore, there is a need for a `super regulator'.

Parliament passed a Bill- Securities and Insurance Laws (Amendment) and Validation Bill, 2010 -that provides a mechanism, headed by the finance minister, to resolve disputes between financial regulators as an ad-hoc arrangement. It has representations from the four financial sector regulators and the Finance Ministry- Sebi, Irda, Rbi and Pfrda.

The Act states that the Reserve Bank Governor will be the vice-chairman of the joint committee. The joint body can entertain only jurisdictional issues. Even here, forst the involved parties should settle it between them

However, there were apprehensions expressed by RBI over its autonomy.

The government is still working on a permanent body to settle the inter-regulator disputes such as the SEBI-IRDA turf war.
The criticism is that there is already a Hligh level Coordination Committee with Rbi Governor heading it and there is no need for the current mechanism. It has lead to politicization.

Swabhimaan 2011
The government has launched 'Swabhimaan' – a programme to ensure banking facilities in habitation with a population in excess of 2,000, by March 2012. The programme will use various models and technologies, including branchless banking through business correspondents. The government has decided to pay banks Rs 140 for every no frills account they open as part of the financial inclusion plan.

The initiative would enable small and marginal farmers obtain credit at lower rates from banks and other financial institutions. This would insulate them from exploitation of the money lenders

The government has actually decided to give Rs 500 million to banks fo helping them open no frills accounts in the fiscal year 2011-2012.

Once banking access increases, it is hoped that it enables government subsidies and social security benefits to be directly credited to the accounts of the beneficiaries, enabling them to draw the money from the business correspondents in their village itself.

Given the size of the un-banked population in the country, the ongoing project can be considered a "significant beginning". Only a little more than a third of India's population has access to banking services at present. Among the bank-supported initiatives, self-help groups (SHGs) also have a role to play, the government's FI project is reliant more on Banking Correspondent (BCs} and technology to reduce the capital-intensity of expanding the banking cover.

There should at the same time be focus on financial literacy so as to take full benefit for the inclusion. This is particularly true in a context of rapid development of branchless banking, with newly banked people being exposed to non-bank intermediaries, therefore with no possibility to directly interact with experienced bankers.

Financial inclusion should not only be about reaching high numbers of unbanked or underserved groups. It should equally be about the provision of quality financial services and products. This means that access to safe, adapted, accessible, affordable and usable financial services and products should be offered.

The Insurance Regulatory and Development Authority's (IRDA) latest Annual Report indicates life insurance penetration at just 4.6 per cent and general insurance penetration at 0.6 per cent. Majority of the people do not have bank accounts, and even though RBI mandates have ensured the opening of 50 million no-frills accounts, hardly 11 per cent are active.

Innovations in financial products and technology-based delivery methods can expand the reach of financial services and create new opportunities to provide essential services to the poor. Financial products targeting the poor, such as money transfer services, microloans, microinsurance, or weather and catastrophic risk insurance, micropensions, can all have an important transformative effect. Deepening the financial system and widening its reach is crucial for both accelerating growth and for equitable distribution, given the present stage of development of our country.

One of the key features of the National Rural Livelihoods Mission (NRLM) is to work towards achieving universal financial inclusion, beyond basic banking services to all the poor households, SHGs and their federations. The key lies in linking access to financial services with livelihood options and leveraging the same to achieve poverty eradication. The end purpose of financial inclusion is and must be poverty alleviation.

Priority sector: Nair Committee recommendations

The RBI committee under the current Union Bank Chairman MV Nair has come out with their recommendations on lending to priority sector. It has reviewed the existing guidelines on lending to priority sector categories including agriculture, MSME and export. Its recommendations are

- Priority sector targets for public sector and private sector banks could be retained at the current level of 40% of the net credit to the sector.
- It has recommended severe changes should be made to exposure of foreign banks. Foreign banks' priority sector target should be increased from 32% to 40%.
- Special treatment should be given to small and marginal farmers and housing loans below Rs 2 lakhs should be classified under priority sector.

RBI acted on these recommendations

The Reserve Bank of India (RBI) in July 2012 said that foreign banks having 20 or more branches in the country will be brought on par with domestic banks for priority sector targets in a phased manner over a maximum period of five years starting April 1, 2013.

Foreign banks with less than 20 branches will have no sub-targets within the overall priority sector lending target of 32 per cent. This is expected to allow them to lend as per their core competence to any priority sector category.

The RBI said that the revised guidelines aim at implementing the essence of recommendations of Nair Committee without dismantling the established and accepted structure of priority sector lending.

The overall target under priority sector lending is retained at 40 per cent as suggested by the Nair Committee. The targets under direct and indirect agriculture are retained at 13.5 per cent and 4.5 per cent, respectively while refocusing the direct agricultural lending to individuals, self help groups (SHGs) and joint liability groups (JLGs) directly by banks.

The RBI said that loans to micro and small service enterprises up to Rs.1 crore; all loans to micro and small manufacturing enterprises up to Rs.25 lakh and for housing in metropolitan centres above Rs.10 lakh and at other centres Rs.15 lakh would form part of priority sector lending as per the revised guidelines. Loans to food and agro processing units and individuals for educational purposes, including vocational courses up to Rs.10 lakh in India and Rs.20 lakh abroad would also be part of priority sector lending.

Loans for housing projects exclusively for economically weaker sections and low-income groups, provided the cost does not exceed Rs.5 lakh per dwelling unit, loans to distressed farmers indebted to non-institutional lenders, loans to state sponsored organisations for scheduled castes and scheduled tribes, loans to individuals for setting up of off-grid solar and other off-grid renewable energy solutions for households and loans to individuals other than farmers up to Rs.50,000 to prepay their debt to non- institutional lenders would also be part of priority sector lending.

Investments by banks in securitised assets, outright purchases of loans and assignments to be eligible for classification under priority sector provided the underlying assets qualify for priority sector treatment and the interest rate charged to the ultimate borrower by the originating entity does not exceed Base Rate of such bank plus 8 per cent per annum.

Savings bank rate deregulation

The Reserve Bank of India (RBI) in 2011 deregulated savings bank rates .
A savings deposit one where the depositor can earn interest like an FD and can withdraw from the account like a current account. The savings rate was fixed at 3.50% from 2003 to 2011 and waslater raised to 4%.

However, during the period, the RBI changed both repo and reverse repo rates many times but the same was not reflected in the interest rates that the normal household gets. There was a huge gap between savings and term deposit rates. Thus, the depositors in SB account suffered.

After deregulation, it is expected that savings rate would move in tandem with the RBI monetary policy, thus, making the policy more effective.

NBFC-MFI

RBI decided to create a separate category of NBFCs viz; Non Banking Financial Company-Micro Finance Institution (NBFC-MFI) and notified norms in 2012.

Foreign banks: WOS vs Branch

The global financial crisis of 2008 has shown that the growing complexity and interconnectedness of financial institutions have compromised the ability of home and host authorities to cope with the failure of too big to fail (TBTF) institutions. The lessons learnt during the crisis lean in favour of domestic incorporation of foreign banks as wholly owned subsidiaries (Wos)
In general, following are the main advantages of local incorporation:

- It creates separate legal entities, having their own capital base and local board of directors;
- It ensures that there is a clear delineation between the assets and liabilities of the domestic bank and those of its foreign parent and clearly provides for ring fenced capital and assets within the host country;
- It imparts clarity and certainty with respect to applicability of the laws of country of incorporation on the locally incorporated subsidiary;
- A locally incorporated bank has its own board of directors and these directors are required to act in the best interests of the bank, to prevent the bank from carrying on business in a manner likely to create a risk of serious □loss to the bank's creditors/depositors;
- Provides effective control to the regulator

A number of jurisdictions, therefore, impose requirement of local incorporation for foreign banks mainly for (i) protecting local retail depositors and (ii) affording greater regulatory comfort.

Considering the capital required to fuel economic growth, foreign banks have to play a significant role along with new private sector banks to cater to growing credit demand.

In a bid to better regulate them and avoid 2008-type crisis, RBI in November 2013 said that foreign banks with complex structures which do not provide adequate disclosure would have to operate in India only through wholly-owned subsidiaries (WOS).

The guidelines incentivise foreign banks operating in the country with 'near national treatment' if they become WOS, enabling them to open branches anywhere at par with other public and private sector banks.

The regulator also allowed foreign banks to list their subsidiaries on the local stock exchanges.

They can also acquire local banks.

Corporate guidelines for the WOS include a proviso that not less than 50 per cent of the directors should be Indian nationals/NRIs/PIOs.
Further, not less than two-thirds of the directors should be non-executive directors and a minimum of one-third of the directors should be independent of the subsidiary.
There are 45 foreign banks in India with a network of 333 branches as of 2013, most of which are held by the top three -- StanChart (100 branches), HSBC (50) and Citi (40).

Their market share stood at 6.5 percent of total banking assets in FY13.

The initial minimum paid-up equity capital or networth for a WOS should be Rs 500 crore, RBI had said.

Differences between branch and Wos models: To set up a branch, it needsto get RBI approval. Tax rate is high (40% as against domestic companies rate which is 30%) Advantage: Repatriation of money back to foreign country is easier.
If it is a wholly owned subsidiary, it becomes an independent entity - less RBI intervention, less tax rate and the rest outlined above.
Both however are subject to priority sector norms as mentioned above.

CDR

There are occasions when corporates find themselves in financial difficulties because of factors beyond their control and also due to certain internal reasons. For example, the global financial crisis and the recession that followed since 2008 along with the infrastructural investments being stalled in India for a variety of reasons. For the revival of such corporates as well as for the safety of the money lent by the banks and financial institutions, timely support through restructuring of genuine cases is called for. In India, a Corporate Debt Restructuring System was evolved and detailed guidelines were issued by Reserve bank of India early 2001.

It may be emphasized here that, in no case, the requests of any corporate indulging in fraud or misfeasance, even in a single bank, can be considered for restructuring under CDR System.

In a growing sign of companies facing difficulties in meeting their financial obligations, banks were approached for debt restructuring in a record 126 cases during 2012 for a collective amount of Rs 84,000 crore.

Debt restructuring is a process that allows a private or public company – or a sovereign entity – facing cash flow problems and financial distress, to reduce and renegotiate its delinquent debts in order to improve or restore liquidity and rehabilitate so that it can continue its operations.

Replacement of old debt by new debt when not under financial distress is referred to as refinancing.

NPAs 2013

Net non-performing assets (NPAs) or bad loans of 40 listed banks jumped by 38% or around Rs 35,424 crore in the first six months of financial year ended September 30, 2013.

As on March 31, 2013, net NPAs of 40 listed banks were Rs 93,109 crore, which rose to Rs 1,28,533 crore as on September 30, 2013.

Poverty and Inequality: Concepts, Data, Policy and Analysis

Poverty is deprivation of basic needs that determine the quality of life- food, clothing, shelter, safe drinking water etc. It also includes the deprivation of opportunities to health, education, skills, employment etc.
Many different factors have been cited to explain why poverty occurs. No single explanation has gained universal acceptance. The factors responsible for poverty include:

- Historical factors, for example imperialism and colonialism.
- Overpopulation.
- Growth is not fast enough to eradicate poverty
- Models of growth may be unsuitable for poverty alleviation. For example, capital-intense growth in a labour surplus country
- Poverty itself, preventing investment and development.
- Widespread reliance on traditional methods of agriculture. About 60% of the population depends on agriculture whereas the contribution of agriculture to the GDP is 20%.While services and industry have grown at double digit figures, agriculture growth rate has dropped from 4.8% to 2%
- Geographic factors, for example lack of fertile land and access to natural resources.
- Anti-poverty schemes not being effective due to institutional and other inadequacies
- War, including civil war, genocide
- Lack of education and skills.
- gender discrimination
- Matthew effect— the phenomenon, widely observed across advanced welfare states, that the middle classes tend to be the main beneficiaries of social benefits and services, even if these are primarily targeted at the poor. Matthew effect refers to those already having an asset base benefiting from it while those without it continue to be denied the same.

Eradication of poverty
The strategy of the Government includes the following elements

- The main plank of anti-poverty strategy is reducing poverty through the promotion of economic growth. In India, after reforms began in 1991 when growth rates increased , poverty levels fell quite steeply.(NSSO 2005)
- Socio economic planning
- Food security through the nation wide PDS- largest in the world
- Progressive taxation to garner fiscal resources for spending on poor
- Social safety net like the, National Social Assistance Programme (NSAP)
- Open society in which poverty is recognized as a national challenge and earnest efforts are made to tackle it(Amartya Sen)
- Anti-poverty programmes – NREGA 2005
- Massive social sector expenditure for skill building
- Decentralization through PRIs and Nagarapalikas for better delivery models

Poverty concepts

Types of Poverty
Human Poverty is the lack of essential human capabilities- literacy and nutrition.
Income Poverty: The lack of sufficient income to meet minimum consumption needs. The World Bank defines extreme poverty as living on less than 1.25 US$ per day, and moderate poverty as less than $2 a day.

Poverty line
It is the level of income below which one cannot afford to purchase all the resources one requires to live. People who have an income below the poverty line have no disposable income.

When comparing poverty across countries, the purchasing power parity exchange rates are used. These are used because poverty levels otherwise would change with the normal exchange rates. Thus, 'living for under $1 a day' should be understood as having a daily total consumption of goods and services comparable to the amount of goods and services that can be bought in the U.S. for $1.

Poverty lines are defined as the per capita monetary requirements an individual needs, to afford the purchase of a basic bundle of goods- only food or food and other goods. The value of this basic basket of goods can be determined in many ways, for example:
Absolute Poverty is a fixed measure in terms of a minimum calorific requirement plus essential non-food components, if any. It is used in India. Individuals are considered as poor if the per capita real income/consumption of the household to which they belong is below the benchmark poverty line. In India monetary requirement to consume 2100 calories in urban areas and 2400 calories in rural areas per day per person is the absolute poverty line.

Relative poverty lines set the line in relation to another variable: the average expenditure or income in a country, for example, the line is derived as 60 percent of the country's per capita income.
Headcount ratio

The most common standard indicator is the incidence of poverty (also called poverty rate or headcount rate). This describes the percentage of the population whose per capita incomes are below the poverty line, that is, the population that cannot afford to buy a basic basket of items. In many instances, a different poverty line--a much more austere one that generally only includes food items--is applied to derive the extreme poverty rate.

Poverty Gap (PG)
PG is a measure of the intensity of poverty among the poor: the difference between the mean income among the poor and the poverty line. This indicator measures the magnitude of poverty as well as its intensity- number of poor and how poor they are. The Poverty Gap Index is the combined measurement of incidence of poverty and depth of poverty. PG is also called the Foster-Greer-Thorbecke (FGT) index. It is the gap between the average poverty among the poor and the poverty line.

Misery index
The misery index was initiated by Chicago Economist Robert Barro in the 1970's. It is the unemployment rate added to the inflation rate. It is assumed that both a higher rate of unemployment and a worsening of inflation cause and intensify the misery. A combination of rising inflation and more people of out of work ("stagflation") implies a deterioration in economic performance and a rise in the misery index.

Agricultural wage earners, small and marginal farmers and casual workers engaged in non-agricultural activities, constitute the bulk of the rural poor. Small land holdings and their low productivity are the cause of poverty among households dependent on land-based activities for their livelihood. Poor educational base and lack of other vocational skills also perpetuate poverty. Due to the poor physical and social capital base, a large proportion of the people are forced to seek employment in vocations with extremely low levels of productivity and wages. The creation of employment opportunities for the unskilled workforce has been a major challenge for development planners and administrators.

Planning Commission and Poverty
The Planning Commission as the Nodal agency in the Government of India for estimation of poverty has been estimating the number and percentage of poor at national and state levels. Estimates of poverty are made from the large sample survey data on household consumer expenditure conducted by the National Sample Survey Organization (NSSO) of the Ministry of Statistics and Programme Implementation.

NSSO and Poverty Estimates
National Sample Survey Organisation (NSSO) collects household consumer expenditure data every five years on a large sample. Household consumer expenditure surveys are also conducted annually but the sample size is much smaller. Every five years full surveys on 1,20,000 households are carried out. In the intervening period, "thin" samples of around 20,000 households are surveyed. The "thin" samples do not indicate trends fully.

History and methodology of Poverty estimate in India
Planning commission initially gave poverty numbers and related data ratios since 1979 based on the Alagh Committee Report of that year. This procedure was subsequently modified by the Lakdawala Committee (1993).The commission in middle of last decade appointed an expert group led by Suresh Tendulkar to suggest a new poverty line for rural areas. It submitted its report in 2009. It used the latest data to construct a new poverty line basket. It moved away from the calorie intake as anchor for poverty estimation and included price indices for health and education. The all-India rural poverty line adopted by the Tendulkar Committee was 446.68 for 2004-05. Tendulkar committee did not deal with the urban poverty as the line was not controversial at that time.

New NSSO findings showed that poverty declined by 1.5 percentage points per annum between 2004-05 to 2009-10. It is the fastest decline of poverty compared to earlier periods. Both growth and public intervention have contributed. The poverty line in 2009-10 was 4,298 per month for a family in urban and 3,364 per month for a family in rural areas. There are questions on whether one can live with this money. 350 million lived below even this minimalist poverty line in 2009-10 in India. This is a matter of concern and the need for increase in incomes for these people is obvious.(read ahead for 2013 data)

The purpose of these estimates at the macro level is to see progress over time (these are already delinked from entitlements). For example, one can examine whether poverty declined faster in the post-reform period as compared to pre-reform period or whether anti-poverty programmes have had an impact on poverty. Which regions/states and social groups benefited during the reform period?

The rate of reduction in Bihar, Chhattisgarh and Uttar Pradesh was low while poverty declined by 20 percentage points in Orissa. Some other findings are: Scheduled Tribes have high poverty ratio (47%) in rural areas while Muslims have the highest poverty (33.9%) in urban areas. Despite the MGNREGS and increase in agriculture wages, the poverty ratio among agricultural labourers was 50%. These are the concerns regarding poverty estimates and have immense policy implications.

The government has taken a decision to appoint a technical group to revise/revisit 'the methodology for estimating poverty in a manner that is consistent with current realities'. The government is also waiting for the socio-economic and caste census, 2011, based on Saxena and Hashim committees. It may be noted that the Planning Commission poverty estimates relate to income poverty estimates based on private consumer expenditure (PCE). The Saxena and Hashim Committee recommendations on deprivation may relate more to non-income indicators.(See ahead).

Exclusive calorie method for estimating poverty can be misleading . Some studies have shown that if we use direct method of calorie deprivation, two-thirds of the population would be poor. Equally, Orissa and Bihar would be richer states than Tamil Nadu and Kerala.

Arjun Sengupta Commission on unorganised enteprises estimated 77% of the population can be categorised poor and vulnerable.

Rangarajan committee has to review, from time to time, the methodologies for measuring poverty in keeping with changing needs of the population.

Rangarajan Committee

The government in mid-2012 announced the formation of a new expert committee under C Rangarajan, to revisit the methodology for estimation of poverty and identification of the poor, months after a poverty line cut-off, based on the method proposed by Suresh Tendulkar, had created a flutter. It will give the report I inn 2013-14 and has 4 members. The panel would also look into the issue of linking poverty estimates with providing benefits under the Centre's social welfare schemes. The panel would also assess whether poverty can be determined on any criteria other than the consumption basket. The panel will also assess if the two (consumption basket and other methods) can be effectively juxtaposed for estimating poverty in rural and urban areas.

The panel would examine the divergence between consumption estimates based on the National Sample Survey Organisation (NSSO)'s methodology and those emerging from the National Account aggregates. It would also suggest a method to update the consumption poverty line, using the national, urban and rural consumer price index data being released since 2011.

The committee would study the various poverty estimation models used across the world and suggest the best alternative for India.

This committee has been appointed due to concern over estimating poverty using the Tendulkar committee's method. We need to look at how to define and measure poverty. So far, the level of consumption expenditure has been used as a way to estimate poverty. This is based on the basket of goods and services, and estimated using the least possible level to sustain someone. It is adjusted for price increases and consumption patterns every five years.

Tendulkar committee's approach is based on updating rural consumption data on prevailing prices, while not revising the urban consumption data simultaneously. Rangarajan committee has see if this is the right way to do it.

Poverty can be estimated in different ways. First, the absolute method, in which one considers how the economy has changed over time and the number of people living below a certain income level. The other is the relative method, in which you consider the current level of average income and the income distribution in the country. This has been widely used in India. So far, we have only looked at consumption expenditure. Now, we will also look at alternative ways—how to combine the current method with poverty estimation techniques used in other countries.

NC Saxena Committee

The rural development ministry in 2008 appointed a committee headed by NC Saxena to look at revising the parameters laid out by the earlier Sanjeeva Reddy committee to calculate the rural BPL figures in the states.

Officially, there are two sets of BPL estimates in India, one made by the Planning Commission using NSSO data on household consumption expenditure and the other by the rural development ministry through a state-level BPL house-to-house census . The mismatch between the two, with Planning Commission progressively lowering poverty estimates while the states push higher numbers, has been a source of controversy. The Centre allocates resources for BPL schemes based on the figures of the Planning Commission.

The committee chaired by NC Saxena recommended that 50% of India's population be given below-poverty-line cards. Thus, it suggests expansion of the social security net which means fiscal and administrative challenges.

While advocating exclusion of large number of families from the BPL lists, the committee has recommended that those families having double the land of the district average of the agricultural land or two wheeler or one running bore well or income tax payers would be deleted from the BPL lists.

While pointing out that the present poverty line which allows only 6.52 crore BPL cards is flawed, the committee has recommended a poverty line that would allow 50% of the country's population to get BPL cards as compared to the 28% at present. The panel has recommended that some disadvantaged communities be given BPL cards automatically. These include chronically vulnerable groups, such as households with members having tuberculosis, leprosy, disability, mental illnesses or HIV/AIDS and others,designated 'primitive tribe', designated dalit groups, homeless household etc.

The Centre has notified 13 new parameters for defining Below Poverty Line (BPL) category of people in the country. It has done away with the earlier definition based on food calories or annual earnings.

The revised definition is based on landholding, type of dwelling, clothing, food security, hygiene, capacity for buying commodities, literacy, minimum wages earned by the household, means of livelihood, education of children, debt, migration and priority for assistance. The matter had been stayed by the Supreme Court and has only now been vacated.

Urban poverty

The Planning Commission had constituted an expert group under S.R. Hashim in 2010 to recommend detailed methodology for identification of BPL families in urban areas in the context of the 12th Five Year Plan.The expert group submitted an interim report recommending that poverty in urban areas be identified through identification of specific vulnerabilities in residential, occupational and social categories.

It said that those who are houseless, live in temporary houses where usage of dwelling space is susceptible to insecurity of tenure and is affected by lack of access to basic services should be considered residentially vulnerable.

Houses with people unemployed for a significant proportion of time or with irregular employment or whose work is subject to unsanitary or hazardous conditions or have no stability of payment for services should be regarded occupationally vulnerable.Households headed by women or minors or where the elderly are dependent on the head of household or where the level of literacy is low or members are disabled or chronically ill should be considered socially vulnerable, it said.

The expert group is yet to finalise the detailed methodology for an ordinal ranking of the poor on the basis of vulnerability.

BPL survey will be done by staff of municipalities or urban departments in 45 major cities.

In smaller towns, district magistrate will be the nodal officer.

Questionnaire prepared for urban BPL survey will obtain information on several parameters including income, number of members, type of house and availability of amenities.

The survey will also give us information about housing shortage and deficiency in services in urban areas.

It is for the first time that such a survey is being done. This is important in the context of the proposed food security act and the Rajiv Awas Yojana (RAY) which aims to make cities free of slums besides better targeting of other schemes.An estimated 90 million of the 300 million living in India's roughly 45 cities and over 5,000 towns are poor.

JNNURM and RAY

The Jawaharlal Nehru National Urban Renewal Mission (JNNURM) was launched in 2005. Within JNNURM, we have urban infrastructure and governance (UIG), basic services to urban poor (BSUP), urban infrastructure and development scheme for small and medium towns (UIDSSMT) and integrated housing and slum development programme (IHSDP).

What's the difference between BSUP and IHSDP? BSUP suggests basic services that may extend to more than integrated housing and slum development. But it is also about housing and slum development. BSUP is restricted to 65 JNNURM mission cities and IHSDP is meant for non-mission cities and towns. That's the only difference.

Under both BSUP and IHSDP, there is provision for infrastructure (water, sanitation, sewerage, roads and street lights).

In 2009, Rajiv Awas Yojana (RAY) was announced, and launched in 2010 to provide housing to the urban poor. Under the ministry of housing and urban poverty alleviation, RAY aims to make the country free of slums by 2014.
States are required to prepare a plan of action based on geographic information system-enabled mapping for specific cities to be made slum-free.
Unlike previous schemes, RAY seeks to provide property rights to slum dwellers.
Tthe government is likely to use the public-private partnership (PPP) model to build infrastructure under the project.

The expenditure will be shared between the beneficiary and states and the central government.

The ministry has also decided to be more inclusive in defining slums and responded positively to the suggestion of an expert committee which said a contiguous area with 20-25 households having slum-like characteristics be considered as slums.

The States would be required to include all the mission cities of JNNURM, preferably cities with more than 3 lakh population as per 2001 Census; and other smaller cities, with due consideration to the pace of growth of the city, of slums, predominance of minority population, and areas where property rights are assigned.

Mortgage Risk Guarantee Fund

The government in 2011 proposed the creation of a Mortgage Risk Guarantee Fund under Rajiv Awas Yojana. This would guarantee housing loans taken by Economically Weaker Sections and Low Income Group households and enhance their credit worthiness.

Pronab Sen Committee

The Ministry of Housing and Urban Poverty Alleviation set up a committee to look into various aspects of Slum statistics /Census and issues regarding conduct of slum census 2011. The committee submitted its report to the Ministry of Housing and Urban Poverty Alleviation in 2010 . The salient finding / recommendations of the committee are: -

- The committee has estimated Slum population in the country in 2001 as 75.26 million and the projected slum population in the country for the year 2011 at 93.06 million.
- For the slum census 2011, the committee has recommended that for policy formulation purposes it is absolutely essential to count the slum population even in cities having less than 20,000 populations. For the purpose of planning for Rajiv Awas Yojana and slum free India it would be necessary to count the population of slums in all statutory towns in the country in 2011.
- The committee has suggested a different definition for slum than the definition adopted by the census of India 2001 and the states. The committee has recommended a normative definition of slum as: "A compact settlement of at least 20 households with a collection of poorly built tenements, mostly of temporary nature, crowed together usually with inadequate sanitary and drinking water facilities in unhygienic conditions."

The committee has suggested adoption of the following as slum-like characteristics for the purpose of identification of the slum areas: -

- Predominant roof material: any material other than concrete
- Availability of drinking water source: not with premises of the census house
- Drainage facility: no drainage or open drainage

The committee has recommended that a contiguous area with 20-25 house holds having slum like characteristics be counted as slum.

NSSO 69th round (ahead)
Poverty figures of 2013 (ahead)
Socio-economic caste census (ahead)

Stock Market
India and General

A stock exchange is an organization which provides a platform for trading shares- either physical or virtual. The origin of the stock market dates back to the year 1494, when the Amsterdam Stock Exchange was first set up. In a stock exchange, investors through stock brokers buy and sell shares in a wide range of listed companies. A given company may list in one or more exchanges by meeting and maintaining the listing requirements of the stock exchange.

In financial terminology, stock is the capital raised by a corporation, through the issuance and sale of shares. In common parlance, however, stocks and shares are used interchangeably .A shareholder is any person or organization which owns one or more shares issued by a corporation. The aggregate value of a corporation's issued shares , at current market prices, is its market capitalization. Stock broker buys and sells for an investor and does the work of arranging the transfer of stock from a seller to a buyer.

Importance of Stock Exchanges

- For efficient working of the economy and for the smooth functioning of the corporate form of organization, the stock exchange is an essential institution.
- an efficient medium for raising long term resources for business
- Help raise savings from the general public by the way of issue of equity / debt capital
- attract foreign currency
- exercise discipline on companies and make them profitable
- investment in backward regions for job generation
- another vehicle for investors' savings

Stock Exchanges in India

The first company that issued shares was the VOC or Dutch East India Company in the early 17th century (1602). Since then we have come a long way.With over 25m shareholders today, India has the third largest investor base in the world after the USA and Japan. Over 9,000 companies are listed on the stock exchanges, which are serviced by approximately 7,500 stockbrokers. The Indian capital market is significant in terms of the degree of development, volume of trading and its tremendous growth potential.

Stock exchanges provide an organised market for transactions in securities and other securities. There are 25 stock exchanges in the country, 21 of them being regional ones with allocated areas. BSE, National Stock Exchange (NSE), the Over the Counter Exchange of India Limited (OTCEI) , MCX-SX, USE and Inter-connected Stock Exchange of India Limited (ISE) are the pan Indian stock exchanges(read ahead). Important Stock Exchanges in India are Bombay Stock Exchange, popularly known as BSE and National Stock Exchange located in Bombay. MCX-SX began equity trading in 2013. MCX,-SX is a joint venture between Financial Technologies India (FTIL) and Multi Commodity Stock Exchange (MCX).

Stock Exchanges in India

1. Ludhiana	2. New Delhi	3. Jaipur	4. Meerut
5. Ahmedabad	6. Rajkot	7. Indore	8. Vadodara
9. Bombay	10. Pune	11. Hyderabad	12. Mangalore
13.Bangalore	14. Ernakulam	15. Coimbatore	16. Madras
17. Patna	18. Kanpur	19. Bhubaneshwar	20. Calcutta
21. Guwahati			

National Stock Exchange (NSE)

It is stock exchange located in Mumbai, India. National Stock Exchange (NSE) was established in 1992 and starts trading in 1993. It was recognised as a stock exchange in 1993. NSE has played a critical role in reforming the Indian securities market and in bringing transparency, efficiency and market integrity.

NSE has a market capitalisation of more than US$ 1 trillion 989 and 1,635 companies listed as on July 2013. Though a number of other exchanges exist, NSE and the Bombay Stock Exchange are the two most significant stock exchanges in India, and between them are responsible for the vast majority of share transactions. NSE's flagship index, the **CNX NIFTY 50,** is used extensively by investors in India and around the world to take exposure to the Indian equities market.

There are many domestic and global institutions and companies that hold stake in the exchange. Some of the domestic investors include LIC, GIC, State Bank of India and IDFC Ltd. Foreign investors include Citigroup.

The Standard & Poor's CRISIL NSE Index 50 or S&P CNX Nifty -Nifty 50 or simply Nifty is the leading index for large companies on the National Stock Exchange of India. The Nifty is a well diversified 50 stock index accounting for 21 sectors of the economy

The CNX Nifty Junior is an index for companies on the National Stock Exchange of India. It consists of 50 companies on the National Stock Exchange of India. It has the second tier of stocks in terms of market cap and don't make it into Nifty

The Inter-Connected Stock Exchange of India Limited (ISE)

The Inter-Connected Stock Exchange of India Limited (ISE) is being promoted by regional stock exchanges to set up a new national level stock exchange. The ISE would provide a national market in addition to the trading facility at the regional stock exchanges.

Indonext

BSE, Federation of Indian Stock Exchanges and regional stock exchanges have promoted IndoNext. The regional stock exchanges that are part of Indonext include Madras Stock Exchange, Bangalore Stock Exchange, Interconnected Stock Exchanges of India, Ludhiana Stock Exchange and Vadodara Stock Exchange. IndoNext is envisaged to bring liquidity and attention to stocks that are listed on RSEs.

MCX Stock Exchange Limited (MCX-SXAT)

It is an Indian stock exchange. It commenced operations in the Currency Derivatives (CD) segment in 2008 and equities in 2013. **SX40** is the flagship Index of MCX-SXAT.

USE

The **United Stock Exchange of India** (USE) is an Indian stock exchange. It is the 4th pan India exchange launched for trading financial instruments in India. USE represents the commitment of 21 Indian public sector banks, private banks, international banks (Standard Chartered) and corporate houses to build an institution of repute.

USE launched its operations in 2010 and deals in currency futures.

OTC Exchange Of India (OTCEI)

It also known as Over-the-Counter Exchange of India based in Mumbai.It is the first exchange for small companies.

OTCEI is promoted by the Unit Trust of India, the Industrial Credit and Investment Corporation of India, the Industrial Development Bank of India, the Industrial Finance Corporation of India and others and is a recognised stock exchange.

BSE

Bombay Stock Exchange (**BSE**) is the 11th largest stock exchange in the world by market capitalisation. Established in 1875, it has more than 5000 companies listed making it world's No. 1 exchange in terms of listed members. The companies listed on BSE Ltd command a total market capitalization of USD Trillion 1.32 as of January 2013.

BSE's popular equity index - the S&P BSE SENSEX [Formerly SENSEX] - is India's most widely tracked stock market benchmark index. It is traded internationally on the EUREX as well as leading exchanges of the BRICS nations (Brazil, Russia, China and South Africa). On Tuesday, 19 February 2013 BSE has entered into Strategic Partnership with S&P DOW JONES INDICES and the SENSEX has been renamed as "S&P BSE SENSEX".

One of the unique features inside the BSE includes the automatic online trading system known as BOLT that ensures an efficient and transparent market for trading in equity, debt instruments and derivatives.

In 2005, the status of the exchange changed from an Association of Persons (AoP) to a full fledged corporation under the BSE (Corporatization and Demutualization) Scheme, 2005 and its name was changed to The Bombay Stock Exchange Limited.

Classification of companies listed in BSE

Group	Classification
A	Companies with large capital base, large shareholder base, and good growth record with regular dividends & greater volumes in secondary market.
B1	Relatively liquid scrips with good management & satisfactory growth prospects & volumes
F	Segment for Non-convertible debentures
G	Central and State Government Securities
Z	It comprises of companies not complying with clauses of the listing agreement and are not redressing the grievances of the investor.

Sensex

Sensex or Sensitive Index is a value-weighted index composed of 30 companies with the base 1978-1979 = 100. It consists of the 30 largest and most actively traded blue chip stocks, representative of various sectors, on the Bombay Stock Exchange. Inclusion of the company is basically on the basis of market capitalization. The 30 companies in the index are revised periodically- some are replaced by others and new sectors may find representation as the economy evolves.The Sensex is generally regarded a mirror or barometer of the Indian stock markets and economy.

Demutualization

Mutualization refers to ownership and management of the exchange being combined in the same hands- brokers elected by the broker community from among themselves. Brokers are the owners of the BSE. Demutualization is when management and ownership are separated . Ownership is divested from the brokers and the company becomes a public company . All stock exchanges are to be demutualised according to the Government law made in 2004. Demutualization, thus means that ownership, management and trading rights are separated in a stock exchange.

Global rankings of BSE and NSE

The Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) are among top five bourses across the emerging economies of the world in terms of market capitalisation.Listing out a total of 14 stock exchanges across emerging countries, Sebi said the BSE stood at fourth position and the NSE at fifth among these bourses in terms of cumulative market capitalisation of all The BSE stood at the fourth position with a market cap of $1,101.87 billion as on June 30, 2012.The NSE stood at fifth spot with market valuation at $1,079.39 billion at June-end.

BSE SME and NSE Emerge

Leading bourses BSE and NSE in 2012 launched their SME exchange platforms to enable small and medium enterprises to raise funds and get listed as public entities.While BSE kick-started its SME platform under the brand name of BSE SME Exchange NSE followed suit by announcing the launch its own platform 'Emerge'.

The exchange provides an opportunity to small entrepreneurs to raise equity capital for growth and expansion. It will also provide immense opportunity for investors to identify and invest in good SMEs at early stage.

The government has been taking a number of steps for SMEs to address challenges of globalisation, higher cost of funds, IT upgrade, infrastructure constraints faced by SMEs.

SMEs have huge listing potential but so far there have been only debt-financing options, without any access to alternative equity options There is a general lack of awareness among SMEs about equity capital, stock markets and funding options, other than banks.

SEBI

The capital markets in India are regulated by the Securities and Exchange Board of India. (SEBI) It was established in 1988 and given a statutory basis in 1992 on the basis of the Parliamentary Act- SEBI Act 1992 to regulate and develop capital market. SEBI regulates the working of stock exchanges and intermediaries such as stock brokers and merchant bankers, accords approval for mutual funds, and registers Foreign Institutional Investors who wish to trade in Indian scrips. Section 11(1) of the Sebi Act says that it shall be the duty of the Board to protect the interests of investors in securities.

SEBI promotes investor's education and training of intermediaries of securities markets. It prohibits fraudulent and unfair trade practices relating to securities markets, and insider trading in securities, with the imposition of monetary penalties, on erring market intermediaries. It also regulates substantial acquisition of shares and takeover of companies and calling for information from, carrying out inspection, conducting inquiries and audits of the stock exchanges and intermediaries and self regulatory organizations in the securities market

SEBI has its head office in Mumbai and its three regional offices in New Delhi, Calcutta and Chennai.

SEBI's powers were enhanced in 2002 - strengthen the SEBI's board, enlarge it to nine from six and appoint three full-time directors; given enhanced powers to conduct search and seizure etc.

SEBI and the Reforms

The Stock Exchange Scam of 1992 (Harshad Mehta) and the scam in 2000 (Ketan Parekh) led to led to various measures by the Government to protect the interests of the small investors. SEBI introduced reforms like improved transparency, computerisation, enactment against insider trading, restrictions on forward trading, introduction of T + 2 system of settlement etc. The restriction and elimination of forward or Contango trading, referred to in India as 'Badla' is a bold step to check speculation and manipulation of the market. Some more steps taken by SEBI to strengthen markets are

- SEBI reconstituted governing boards of the stock exchanges, introduced capital adequacy norms for brokers, and makes rules for making client/broker relationship more transparent
- SEBI enforces corporate disclosures.
- Enforces ban on insider trading
- Protects retail investors
- SEBI is empowered to register and regulate mutual funds.
- introducing a code of conduct for all credit rating agencies operating in India.
- Clause 49 of the listing agreement that SEBI introduced mandates that all listed companies should have half the Directors on the Board as Independent Directors

SEBI ordinance 2013

Government promulgated ordinance a second time in 2013 September. The ordinance is for granting greater powers to Sebi to check illicit investment schemes and other market manipulations.

The Securities Laws (Amendment) Second Ordinance, 2013 would amend the Sebi Act, the Securities Contracts (Regulation) Act and the Depositories Act .Ordinance has given Sebi greater powers to crack down on ponzi schemes, seek call data records to check insider trading and carry out search and seizure operations.

The amendments also give Sebi the legal backing to clamp down on unscrupulous entities "using newer methods to take gullible investors for a ride", as per a government statement issued at the time of promulgating the first ordinance.

As per the amended law, Sebi can regulate any money pooling scheme worth Rs 100 crore or more and attach assets in cases of non-compliance, while Sebi Chairman has been authorised to order "search and seizure operations".

Sebi has also got powers to seek any information, including telephone call data records, from any person or entity in respect to any securities transaction being investigated by it.

The amendments has also sought to clear the air over regulatory gaps and overlaps with regard to different types of instruments used in raising funds illegally

Capital market reforms

Since 1991 when the Government launched economic reforms, the following measures were taken

- SEBI given statutory status- that is Act of Parliament
- Electronic trade
- Rolling settlement to reduce speculation
- FIIs are permitted since 1992
- setting up of clearing houses
- settlement guarantee funds at all stock exchanges
- compulsory dematerialization of share certificates so as to remove problems associated with paper trading; and speed up the transfer
- clause 49 of the listing agreement for corporate governance
- restrictions on PNs

Primary market

The primary market is that part of the capital markets that deals with the issuance of new securities directly by the company to the investors. Companies, governments or public sector institutions can obtain funding through the sale of a new stock or bond issue. In the case of a new stock issue, this sale is called an initial public offering (IPO). If the company already issued shares and is going to the market again with a new issue, it is called Folllow on Public Offer(FPO).

Sebi made some far reaching reforms in favour of the retail investor in August 2012- allowed electronic bidding(e-IPO) for cost effective bidding; and made the rule that retail applicant will be allotted some shares compulsorily.

Secondary market

The secondary market is the financial market for trading of securities that have already been issued in an initial public offering. Once a newly issued stock is listed on a stock exchange, investors and speculators can trade on the exchange as there are buyers and sellers.

Types of shares

There are essentially two types of shares: common stock and preferred stock.

Preferred stock is generally issued to banks by the companies though retail investors are also eligible for them. They are preferred for the following reasons

- In terms of dividend payment, generally, they are given dividends even if the common stock holders are not
- When the company is to be closed, preference stock holders are given money first from the proceeds of the sale of the assets of the companies.
- They may have enhanced voting rights such as the ability to veto mergers or acquisitions or the right of first refusal when new shares are issued (i.e. the holder of the preferred stock can buy as much as they want before the stock is offered to others).

Derivatives

Derivative is a financial instrument.It derives from an underlying asset- securities, shares, debt instruments, commodities etc.. The price of the derivative is directly dependent upon the value of the underlying asset in the present and the projected future trends. Futures and options are the two classes of derivates.

Futures

Futures are financial instruments based on a physical underlying (commodity, equities etc.). A futures contract is an agreement between two parties to buy or sell an asset at a certain time in the future for a certain price.

Futures are part of a class of securities called derivatives, so named because such securities derive their value from the worth of an underlying investment. Futures are different from forwards as the former are traded on exchange while the later may be merely a signed contract between two parties.

Options are a class of futures where the buyer or seller has the option whether to buy or not – put option is the right but not the obligation to sell. Call option is right but not the obligation to buy.

Buyback of Shares

Buyback of shares is the process of a corporation's repurchase of stock it has issued. In the case of stocks, this reduces the number of shares outstanding, giving each remaining shareholder a larger percentage ownership of the company. This is usually considered a sign that the company's management is optimistic about the future and believes that the current share price is undervalued. The company also should have reserves to do so.

Reasons for buybacks include

- putting unused cash to use
- raising earnings per share
- reducing the number of shareholders to reduce the cost for servicing them, etc.

Shares bought back need to be cancelled and thus the total equity shrinks and the shareholders benefit. Buyback price is more than the market prices.Companies can buy back with the reserves but can not borrow to buyback.It is allowed in India since 1998.

Rolling Settlement

Rolling Settlements is a mechanism of settling trades. In Rolling Settlements, trades done on a single day are settled separately from the trades of another day on the basis of Trade day + 2 days(T+2). Such netting of trades is done only for the day. As such, in Rolling Settlement, settlement is carried out on a daily basis. Since trades done on a given day can not be bunched with those of another day. Thus, speculation is drastically reduced.

Commodity exchanges

Commodity exchanges are institutions which provide a platform for trading in 'commodity futures' just as how stock markets provide space for trading in equities and their derivatives. They thus play a critical role in price discovery where several buyers and sellers interact and determine the most efficient price for the product. Indian commodity exchanges offer trading in 'commodity futures' in a number of commodities. Presently, the regulator, Forward Markets Commission allows futures trading in over 120 commodities. There are two types of commodity exchanges in the country: national level and regional. There are five national exchanges:

- National Commodity & Derivatives Exchange Limited (NCDEX)
- Multi Commodity Exchange of India Limited (MCX)
- National Multi-Commodity Exchange of India Limited (NMCEIL)
- ACE Derivatives and Commodity Exchange
- Indian Commodity Exchange (ICEX)

The unique features of national level commodity exchanges are:

- They are demutualized,
- They provide online platforms or screen based trading
- They allow trading in a number of commodities and are hence multi-commodity exchanges.

They are national level exchanges which facilitate trading from anywhere in the country.

FMC

Forward Markets Commission (FMC) headquartered at Mumbai is a regulatory authority, which was overseen by the Ministry of Consumer Affairs and Public Distribution, Govt. of India. It is a statutory body set up in 1953 under the Forward Contracts (Regulation) Act, 1952. The Commission consists of 2-4 members. Its administrative control was shifted to Finance Ministry.

It monitors and disciplines the working of the exchanges. It recognizes an exchange or can withdraw such recognition. It collects and whenever the Commission thinks it necessary, publishes information regarding the trading conditions in respect of goods.

It makes inspection of the accounts and other documents of any recognized association or registered association or any member of such association whenever it considerers it necessary.

Forward Contracts (Regulation) Amendment Bill, 2010 was introduced in the Parliament. It seeks to make FMC into a Sebi-like regulator that is independent.

Forward Markets Commission is at present is a part of the department of consumer affairs. FMC will be given more teeth to regulate exchanges and all market participants.

In addition, the bill proposes to increase the monetary penalty for contravention of the legal provisions to up to Rs 25 lakh from a meagre Rs 1,000 at present..

New products will also be traded.

Mutual Fund

Mutual fund – a financial intermediary that mops up money , from a group of investors, to invest in capital market so as to generate returns for the investors. Mutual fund does it for a fees. There are two types of MFs.

Open-ended Funds

Open-ended or open mutual funds issue shares(units) to the investors directly at any time. The price of share is based on the fund's net asset value. Open funds have no time duration, and can be purchased or redeemed at any time on demand, but not on the stock market.

An open fund issues and redeems shares on demand, whenever investors put money into the fund or take it out.

Closed-ended fund

It is a collective investment scheme issued by a fund. Only a fixed number of shares are issued in an initial public offering which may be called New Fund Offering(NFO). They trade on an exchange. Share prices are determined not by the total net asset value (NAV), but by investor demand.

Once the offering closes, new shares are rarely issued. They can be traded only on the secondary market(stock exchanges). Shares are not normally redeemable until the fund liquidates. On the other hand, an open-end fund where the fund company creates new shares and can redeem existing shares .

The total value of all the securities in the fund divided by the number of shares in the fund is called the net asset value.

FIIs

Foreign institutional investors are organisations which invest huge sums of money in financial assets - debt and shares- of companies and in other countries- a country different from the one where they are incorporated . They include banks, insurance companies, retirement or pension funds, hedge funds and mutual funds.

Foreign individuals are not allowed to participate on their own but go through FIIs.

FIIs are allowed to invest in the primary and secondary capital markets in India through the portfolio investment scheme (PIS). The ceiling for overall investment for FIIs varies from company to company.

FIIs called hot money invested in Indian equities and debt about $30 billion in 2010.The number of registered FIIs is 1,660 and that of registered sub-accounts is above the 5,000 mark. Besides buying equities from the market, FIIs have participated in Qualified Institutional Placements (QIPs), directly from the promoters requiring huge capital.

SEBI prescribes norms to register FIIs and also to regulate FII investments.

There are more than 1700 FIIs registered in India(2012). The FII's total investments in domestic markets amount to $ 122 billion in debt and equity , since India allowed them to invest here in 1992.In the calendar year 2012 upto July, about 11b dollars of FII came into India.

Reasons for FIIs having India as a favourite destination

- growing economy
- corporate profits are high
- government policies are encouraging
- compared to other countries, India has brighter prospects

FII investment is referred to as hot money for the reason that it can leave the country at the same speed at which it comes in.

QFIs

A QFI is an individual, group or association resident in a foreign country that is compliant with Financial Action Task Force (FATF) standards.Till 2012, they were investing in India through the FIIs registered with the SEBI. From 2012, they are allowed to invest in India directly for which Sebi and RBI have made the necessary rules.

They can invest in corporate debt, equities and mutual funds.

The move comes against the backdrop of significant foreign capital outflows from the domestic equity market in recent times, which has resulted in rupee depreciation.

Its aim is to widen the class of investors, attract more foreign funds and reduce market volatility and deepen the Indian capital market.

With regard to foreign portfolio investments, till 2012, only FIIs/sub-accounts and NRIs are allowed to directly invest in the Indian equity market.

The RBI would grant general permission to QFIs for investment under the Portfolio Investment Scheme (PIS) route, similar to FIIs.

The individual and aggregate investment limit for QFIs shall be 5 per cent and 10 per cent, respectively, of the paid-up capital of an Indian company.These limits shall be over and above the FII and NRI investment ceilings prescribed under the PIS route for foreign investment in India, it added.

In mid-2012, government set a separate $1-billion corporate bond investment limit for QFIs. The finance ministry also expanded the list of countries from which such investments will be permitted.A separate sub-limit of $1 billion has been created for QFI investment in corporate bonds and mutual fund debt schemes.The foreign investment limit in corporate debt, which consequently increased by $1 billion to $21 billion will boost debt inflows.

In July 2012, Sebi allowed QFIs to invest in those debt mutual fund schemes that hold atleast 25% of their assets (either in debt or equity or both) in the infrastructure sector.

The scheme was earlier open to only residents of countries that are members of Financial Action Task Force, or FATF, a global body to check money laundering and terror funding.

Government relaxed the eligibility condition to allow investors from Gulf Cooperation Council (GCC) and also the European Commission to invest in Indian debt if they meet the local rules. A resident of IOSCO can also be a QFI.

IOSCO

The **International Organization of Securities Commissions** (IOSCO) is an association of organisations that regulate the world's securities and futures markets.

Members are typically the Securities Commission or the main financial regulator from each country. IOSCO has members from over 100 different countries, who regulate more than 90 percent of the world's securities markets. The organisations role is to assist its members to promote high standards of regulation and act as a forum for national regulators to cooperate with each other and other international organisations.India is a member.

IOSCO is has a permanent secretariat based in Madrid.

to

FATF

The **Financial Action Task Force (on Money Laundering) (FATF)** is an intergovernmental organization founded in 1989.The purpose of the FATF is to develop policies to combat money laundering and terrorism financing. The FATF Secretariat is housed at the headquarters of the OECD in Paris.

FATF is responsible for setting global standards on anti-money laundering (AML) and combating financing of terrorism (CFT).

Following its inclusion into the select club, India and its tax enforcement authorities — the Financial Intelligence Unit, the Enforcement Directorate, the Central Economic Intelligence Bureau and the Directorate of Revenue Intelligence — would be able to exchange vital information from member-countries on money laundering and terrorist financing activities.

Global Depository Receipts (GDR)

Indian companies are allowed to raise equity capital in the international market through the issue of Global Depository Receipt (GDRs). GDRs are designated in dollars/euros or any other foreign currency.

The proceeds of the GDRs can be used for financing capital goods imports, capital expenditure including domestic purchase/installation of plant, equipment and building and investment in software development, prepayment or scheduled repayment of earlier external borrowings, and equity investment in JVs in India.

GDRs are listed on London SE or Louxembourg or elsewhere. They are also called euroissues in a general sense.

ADRs

American depository receipts are like shares. They are issued to US retail and institutional investors. They are entitled like the shares to bonus, stock split and dividend. They are listed either on Nasdaq or NYSE.

Like GDRs, they help raise equity capital in forex for various benefits like expansion, acquisition etc.

ADR route is taken as non-USA companies are not allowed to list on the US stock exchanges by issuing shares.

Similarly with Indian Depository Receipts(IDRs) as and when they are allowed.

Participatory notes

Participatory notes are instruments used for making investments in the stock markets. In India, foreign institutional investors (FIIs) use these instruments for facilitating the participation of overseas funds like hedge funds and others who are not registered with the Sebi and thus are not directly eligible for investing in Indian stocks.

Any entity investing in participatory notes is not required to register with SEBI (Securities and Exchange Board of India), whereas all FIIs have to compulsorily get registered. Participatory notes are popular because they provide a high degree of anonymity, which enables large hedge funds to carry out their operations without disclosing their identity and the source of funds. KYC(know your customer norms are not applied here)

Since the source of funds is not revealed, the PNs are potentially unsafe. Therefore, SEBI in 2007 October imposed certain conditions like limits on the PNs that a single FII can issue etc. SEBI wants the PN holders to register with the SEBI and invest directly as India is a long term growth story. Sebi policy paid off with the number of FIIs registering with the regulator going upto over about 1750(2011).

The SEBI action aims at ensuring that the quality of flows into stock markets and Indian forex market is clean.

Rajiv Gandhi Equity Savings Scheme

It was presented in as a part of the Union Budget 2012-13 for the new investors in stocks with an annual income of less than Rs.10 lakh. He gets 50 percent tax deduction on investments upto Rs 50,000. Money will be locked for three years. Details are still being worked out.

Hedge fund

A hedge fund is an investment fund open to only a limited range of investors. They are mostly unregulated. The term- hedge funds , is used to distinguish them from regulated investment funds such as mutual funds and pension funds, and insurance companies. Hedge funds are not allowed into India as they do not disclose data required by the Sebi.

Clearing house

An organisation which registers, monitors, matches and guarantees the trades of its members and carries out the final settlement of all futures transactions. The National Securities Clearing Corporation is the clearing house for the NSE.

Equity

Common stock and preferred stock that is, shares issued by the company.Also, funds provided to a business by the sale of stock.

Share

Share is a certificate representing ownership of the company that issued it. Shares can yield dividends and entitle the holder to vote at general meetings. The company may be listed on a stock exchange. Shares are also known as stock or equity.

Bond

A debt instrument issued for a period of more than one year with the purpose of raising capital by borrowing.

Debenture

Debt not secured by a specific asset of the corporation, but issued against the issuer's general credit- that is, it is unsecured debt. Investment earns an interest for the debenture holder. The following are various types of debentures

- convertible debentures can be converted into equity at a future date
- Non-convertible debentures will not be converted
- Partly convertible debentures will have some part converted into shares.

Bear

Bear is an investor who believes that market will go down.

Bull

Bull is an investor who believes that the market will go up- optimistic

Bear Market

A sustained period of falling stock prices usually preceding or accompanied by a period of poor economic performance known as a recession.

Bull Market

A stock market that is characterized by rising prices over a long period of time. The time span is not precise, but it represents a period of investor optimism, lower interest rates and economic growth. The opposite of a bear market.

Gilt

Gilt is a bond issued by the government. It is issued by the Central Bank of a country on behalf of the government. In India, Reserve Bank of India issues the treasury bills or gilts. Gilt Edged Market is the market for government securities.

Blue chip

Blue chip shares are the shares of the companies that are the most valuable. Companies that are profit making; usually dividend –paying and are liquid in the market- that is there is almost always in demand on the market.

Midcap company

Generally, companies with a market capitalization that is very high are called large caps and the next rung below is mid cap and the bottom one is small cap companies. Limits are not statutorily laid dwn and vary from institution to institution.

Small investor

Market regulator SEBI set the investment limit for retail investors in an initial share sale offer to Rs 2 lakh. This will cut the numerous applications investors sometimes make in the name of relatives to get more shares.

Sebi allows price discount for retail investors and company discount participating in initial public offers and follow-on offers. This discount is offered to attract retail investors into the market and broad base ownership.

Primary Dealers

The Reserve Bank of India introduced a system of Primary Dealers (PDs) in government securities market in 1995 with the objective to strengthen the infrastructure in the government securities market in order to make it vibrant, liquid and broad-based. The following can be the PD: subsidiaries of scheduled commercial banks and all India financial institutions and engaged predominantly in securities business and in particular the government securities market; or companies incorporated under the Companies Act, 1956 and engaged predominantly in securities business and in particular the government securities market.;The company should have net owned funds of Rs.50 crore.

Market depth

It is a dimension of market liquidity and it refers to the ability of a market to handle large trade volumes without a significant impact on prices.

Liquidity is the ease to find a trading partner for a given order.

Market breadth means the following:The fraction of the overall market that is participating in the market's up or down move. The greater the breadth, the more the companies that are participating.

Trading volumes means the number of shares traded.

Negotiated Dealing System

Negotiated Dealing System (NDS) is an electronic platform for facilitating dealing in Government Securities and Money Market Instruments.

Short selling

The sale of a security made by an investor who does not own the security. The short sale is made in expectation of a decline in the price of a security, which would allow the investor to then purchase the shares at a lower price in order to deliver the securities earlier sold short.

Market capitalization

Price per share multiplied by the total number of shares outstanding; also the market's total valuation of a public company.

P/E ratio

Also known as the P/E multiple, this is the latest closing price divided by earnings per share EPS). P/E is perhaps the single most widely used factor in assessing whether a stock is overvalued or cheap. A company's P/E should be looked at against those of similar companies, and against that of the stock market as a whole, since different industries and even different company are characterized by markedly different P/Es. In general, fast-growing technology companies have high P/Es, since the stock price is taking account of anticipated growth as well as current earnings. A high P/E is often a reflection of high expectations for a stock.

EPS

The portion of a company's profit allocated to each outstanding share of common stock. The amount is computed by dividing net earnings by the number of outstanding shares of common stock. For example, a corporation that earned Rs10 million last year and has 10 million shares outstanding would report earnings per share of Rs.1.

Insider Trading

Insider trading occurs when any one with information related to strategic and price-influencing information purchases or sells stocks so as to make speculative profits. SEBI is formulating rules which are tougher for the insider trading.

Depository

A depository holds securities (like shares, debentures, bonds, Government Securities, units etc.) of investors in electronic form. Besides holding securities, a depository also provides services related to transactions in securities. Benefits of a depository are reduction in paperwork involved in transfer of securities; reduction in transaction cost.

National Securities Depository Limited (NSDL)

In the depository system, securities are held in depository accounts, which is more or less similar to holding funds in bank accounts. Transfer of ownership of securities is done through simple account transfers.The enactment of Depositories Act in 1996 paved the way for establishment of NSDL, the first depository in India.

NSDL offers facilities like dematerialisation i.e., converting physical share certificates to electronic form; rematerialisation i.e., conversion of securities in demat form into physical certificates etc.

Nasdaq

Nasdaq stands for the National Association of Securities Dealers Automated Quotation System. Unlike the New York Stock Exchange where trades take place on an exchange, Nasdaq is an electronic stock market that uses a computerized system to provide brokers and dealers with price quotes. It is an electronic stock market- first in the world- run by the National Association of Securities Dealers. Many of the stocks traded through Nasdaq are in the technology sector.

Dow Jones Index

The New York Stock Exchange (NYSE) index, which reflects the movement of the world's first stock market. It is composed of the 32 most traded stocks of the NYSE. Currently there are three Dow Jones Indices: The Dow Jones Industrial Average (DJIA). The Dow Jones Transport Average (DJTA) and finally DJUA (Dow Jones Utility Average).

In recent years, broader indices such as the Standard & Poor's 500 (for large companies), the Russell 2000 (for smaller companies) and the Wilshire 5000 (for an especially broad measure) have gained currency, in part due to the rising popularity of index investing.

Important indices in the world

Market index is a number to indicate the average movement of prices of a securities market. It usually tracks select stocks.

- American Dow Jones Industrial Average and S&P 500 Index
- British FTSE 100: It is a share index of the 100 most highly capitalised companies listed on the London Stock Exchange. The index began in 1984 with a base level of 1000.The index is maintained by the FTSE Group, an independent company which originated as a joint venture between the Financial Times and the London Stock Exchange.
- French CAC 40
- German DAX
- Japanese Nikkei 225
- Indian Sensex and Nifty
- Australian All Ordinaries
- Hong Kong Hang Seng Index
- South Korea's Kospi
- Straits Times Index (STI) of Singapore
- Bovespa Index
- RTS Index (RTSI) is an index of 50 Russian stocks that trade on the RTS Stock Exchange in Moscow
- SSE (Shenzhen Stock Exchange) Composite Index- China
- SSE (Shanghai Stock Exchange) composite index-China

Ethical investing

A notable specialised index type is those for ethical investing indexes that include only those companies satisfying ecological or social criteria, e.g. those of Dow Jones Sustainability Index.

Ponzi scheme or pyramid scheme

A **Ponzi scheme** is a fraudulent investment operation that pays high returns to investors and promises higher returns to those who join the scheme later. The payments are done from investors own money or money paid by subsequent investors rather than from any actual profit earned because it is not possible to earn such high reurns on any investment.The system is destined to collapse because the earnings, if any, are less than the payments. The scheme is named after Charles Ponzi,who became notorious for using the technique after emigrating from Italy to the United States in 1903.

Decoupling

It means that a nation's economy may have an autonomous logic and need not be entirely dependent on the global economy. For example, if the world goes into a recession, all counties need not. India, for example grew at 6.7%(2008-09) while the USA and the west were contracting. Reflecting the economic realities, equity markets also perform autonomously after a point. It is called decoupling- that is, isolation from the rest.

China is more integrated with the world as itss economy is driven by exports. However, even China is decoupled as it has a lot of domestic consumption driving its growth.

Clause 49

Clause 49 of the Listing Agreement to the Indian stock exchange came into effect in 2005.

It has been formulated for the improvement of corporate governance in all listed companies as it mandates that there should be certain independent directors on the Board of a Company.

IDR

Indian Depository Receipts are issued by a non-Indian company to Indian investors for its listing on Indian stock exchanges. It is like ADR.

Shariah index

Asia's oldest stock exchange, the Bombay Stock Exchange (BSE), launched its Shariah index in December 2010. The index, structured in partnership with Taqwaa Advisory Shariah Investment Solutions has 50 stocks selected from the BSE-500 bracket.

Infrastructure, capital goods, IT, telecom and pharmaceuticals shares will form a large chunk of the 'BSE Tasis Shariah-50 Index', as the new index is known. But no stock will have more than an 8% weightage. The stock screening has been done by Taqwaa Advisory (Tasis) scholar board, and the index construction, by BSE.

The new index will attract investments from Arab and European countries, where Shariah funds are already popular.

Shariah, the religious law of the followers of Islam, has strictures regarding finance and commercial activities permitted for believers. Arab investors only invest in a portfolio of 'clean' stocks. They do not invest in stocks of companies dealing in alcohol, conventional financial services (banking and insurance), entertainment (cinemas and hotels), tobacco, pork meat, defence and weapons.

The index will be rebalanced every quarter though stocks that do not comply (at some point of time) with Shariah statutes will be excluded immediately. National Stock Exchange S&P CNX Shariah Index and Dow Jones Islamic India Index are other Shariah benchmarks that are tracked by investors. Shariah-based equity investments do not allow investors to invest in heavily indebted.

Brics cooperation among exchanges

In 2011 October seven major stock exchanges in Brazil, Russia, India, China and South Africa announced plans to cross-list derivatives on their benchmark indexes. The five founding members of the BRICS Exchanges Alliance began cross-listing benchmark equity index derivatives on each other"s trading platforms from 2012. The five exchanges, BM&FBOVESPA from Brazil, Open Joint Stock Company MICEX-RTS from Russia, BSE Limited from India, Hong Kong Exchanges and Clearing Limited (HKEx) as the initial China representative, and JSE Limited from South Africa, announced the formation of the alliance on 12 October 2011 at a World Federation of Exchanges" conference in Johannesburg, South Africa. In this initial stage of implementation, the exchanges aim to expand their product offerings beyond their home markets and give investors of each exchange exposure to the dynamic, emerging, and increasingly important BRICS economies.
The move was endorsed in the March 2012 Delhi summit of Brics.

Power exchanges

A power exchange created within the regulatory framework is an institution that is responsible for conducting auctions in a non-discriminatory fashion to sell power at competitive market prices . CERC has permitted trading of Electricity through Power Exchange with effect from June 2008. Currently, two exchanges viz. Indian Energy Exchange (IEX) and Power Exchange of India Limited (PXIL) are in operation in India which facilitate an automated on-line platform for physical day-ahead contracts.It is the core of an **electricity market** which is a system for effecting purchases, through bids to buy and sell.It would bring about efficiency as well as liquidity as power companies bought and sold electricity.

SGX Nifty

SGX Nifty is Indian Nifty traded in Singapore Stock Exchange. It moves with respect to Indian Nifty. SGX Nifty is open at 8.00 am Indian standard time (IST) on all working days and mostly it becomes initial direction to the Indian Market.

Inflation
Concepts, Facts and Policy

Inflation means a persistent rise in the price of goods and services. Inflation reduces the purchasing power of money. It hurts the poor more as a greater proportion of their incomes are needed to pay for their consumption. Inflation reduces savings; pushes up interest rates; dampens investment; leads to depreciation of currency thus making imports costlier.

Depending upon the rate of growth of prices, inflation can be of the following types
Creeping inflation is a rate of general price increase of 1 to 5 percent a year. Creeping inflation of 3 to 5 percent erodes the purchasing power of money when continued over many years, but it is "manageable." Furthermore, a low creeping inflation could be good for the economy as producers and traders make reasonable profits encouraging them to invest.
Trotting inflation is usually defined as a 5 to 10 percent annual rate of increase in the general level of prices that, if not controlled, might accelerate into a galloping inflation of 10 to 20 percent a year. If it aggravates, galloping inflation can worsen to "runaway" inflation which may change into a hyperinflation. Hyperinflation is inflation that is "out of control," a condition in which prices increase rapidly as a currency loses its value. No definition of hyperinflation is universally accepted. One simple definition requires a monthly inflation rate of 20 or 30% or more- 'an inflationary cycle without any tendency toward equilibrium'. The worst is a monetary collapse, if prices are not reined in , in time.
Other related concepts are

- deflation when there is a general fall in the level of prices
- disinflation which is the reduction of the rate of inflation
- stagflation which is a combination of inflation and rising unemployment due to recession and
- Reflation, which is an attempt to raise prices to counteract deflationary pressures.

Measures of inflation

GDP deflator

GDP stands for gross domestic product, the total value of all final goods and services produced within that economy during a specified period.GDP deflator is a measure of the change in prices of all new, domestically produced, final goods and services in an economy. The GDP deflator is not based on a fixed market basket of goods and services but applies to all goods and services domestically produced.

Cost of living index

The cost of living is the cost of maintaining a certain standard of living. It is defined with reference to a basket of goods and services. When their cost goes up, CoL is said to be dearer and the index will go up. It has a value of 100 in the base year. An index value of 105 indicates that the cost of living is five percent higher than in the base year.

PPI

Producer price index (PPIs) measures the change in the prices received by a producer. The difference with the WPI is accounted for by logistics, profits and taxes, mainly. Producer price inflation measures the price pressure due to increase in the costs of raw materials. It may be absorbed by them or made up by increases in productivity or passed on to the consumers. It depends on the market conditions.

WPI

Wholesale price indices, which measure the change in price of a selection of goods at wholesale, prior to retail sales thus excluding sales taxes. These are very similar to the Producer Price Indexes.

CPI

Consumer price index measures the changes in prices paid by the consumer at the retail level. It can be for the whole community or group-specific- for example, CPI for industrial workers etc as in India.

Types of inflation based on causes

There are four major types of inflation

- **Demand-pull inflation:** inflation caused by increases in demand due to increased private and government spending, etc. It involves inflation rising as real gross domestic product rises and unemployment falls. This is commonly described as "too much money chasing too few goods". For example, India in 2010 when the economy is said to have overheated and demand outstripped supply and prices rose. Since supplies will be augmented to adjust to demand, prices will come down. It may be refered to as `growth inflation' too. Demand-pull inflation can be caused by money supply increasing. For example, the expansionary monetary policy of the RBI in 2009 saw rates come down and easy and cheap credit pushed up prices as demand grew. From 2010 March till the end of 2011, repo rates went up 13 times and thus RBI sought to control prices by controlling demand. Wage inflation, money supply growth etc create this type of inflation.
- **Cost-push inflation:** It is also refered to as "supply shock inflation," caused by reduced supplies due to increased prices of inputs, for example, crude prices globally have gone up causing supply constraints which means higher costs of production and so higher prices. Crude and food prices shot up in 2008 July, came down and again increased. Food prices are shooting up again due to deficient monsoon and global shortages. Other examples are higher cost of capital, increases in prices of imported raw materials. Just as a shortage of goods tends to push prices up, an oversupply of commodities tends to induce the opposite effect on prices.
- **Structural inflation:** A type of persistent inflation caused by deficiencies in certain conditions in the economy such as a backward agricultural sector that is unable to respond to people's increased demand for food, inefficient distribution and storage facilities leading to artificial shortages of goods, and production of some goods controlled by some people. Food inflation currently being witnessed (2012) is structural in nature as the preference for protein foods is far ahead of its supplies and this is a phenomenon driven by income rise.
- **Speculation**
- **Cartelization**
- **Hoarding**

High Inflation hurts

If inflation is high in an economy, the following problems can arise

- low income groups are particularly hurt
- People on a fixed income (e.g. pensioners, students) will be worse off in real terms due to higher prices and equal income as before
- inflation discourages exports as domestic sales are attractive and BOP problems can be caused. Inflation may erode the external competitiveness of domestic products if it leads to higher production costs such as wage increases, higher interest rate and currency depreciation.
- inflation can drag down growth as investment climate turns bad due to instability and uncertainty and also as interest rates are raised and cost of credit increases
- Inflation may discourage saving and thus hit investment. The savings pattern also gets skewed in favour of unproductive assets like gold as inflation may be higher than interest rates and yield is negative.
- Inflation tax happens. When a government borrows and spends, the cash held by people erodes in value due to inflation
- It will redistribute income from those on fixed incomes, such as pensioners, and shifts it to those who draw an inflation-linked income and businesses.
- strikes can take place for higher wages which can cause a wage spiral. Also if strikes occur in an important industry which has a comparative advantage the nation may see a decrease in productivity, exports and growth.
- Govt fiscal deficit may go up as the need to subsidise is more to make goods and services affordable

Small amount of inflation can be good

Inflation means growth, normally- higher incomes and more demand and so more inflation. It can be argued that a low level of inflation can be good if it is a result of innovation. New products are launched at high prices, which quickly come down through competition. Therefore, there is encouragement for innovation and the problem is short lived. Also, a small price rise is necessary for wages to go up. It further helps the economy keep off deflation which can otherwise set off a recession. Besides, inflation at a moderate level is an incentive to the producer. Some see mild inflation as "greasing the wheels of commerce."

Anticipated inflation: When inflation is anticipated, individuals know what is coming, and how to deal with it. For example, banks may raise interest rates to compensate for the anticipated inflation, workers may ask for raises to maintain their real incomes, wealth holders will put their wealth into assets that will rise in value at least at the same rate as the increase in the price index, etc.

Unanticipated inflation: When inflation is unanticipated, individuals do not realize that they should protect their real purchasing power against a rising price level until the price level has already risen and their real purchasing power has already fallen. In this instance, there will be gainers and losers, in terms of purchasing power, from the inflation.

Losers: Individuals on fixed incomes, retirees, all creditors (who lent at fixed rate of interest.)

Gainers: Individuals whose incomes rise faster than inflation, debtors (who will pay back at fixed rate of interest).

In December 2013, the WPI and CPI inflation figures are as follows:
WPI showed 7% plus and CPI almost 11% rise.

To control inflation

There are fiscal, monetary, supply-side and administrative measures to control inflation to ideal/optimal rates though zero rate of inflation is never preferred for the reasons cited elsewhere in the lesson.

- Fiscal measures include reduction in indirect taxes
- Dual pricing like in sugar.
- Monetary measures include rate and reserve requirements changes. Open market operations can stabilize prices under normal conditions Also, sterilization through Government bond transactions as in the case of MSBs
- Supply side factors include making goods available- import of edible oil in India.
- Administrative measures include implementation of dehoarding and anti-black-marketing measures. Wage and price controls can also be used

Indices of Inflation

Changes in the price levels at the wholesale and retail level are tracked by various price indices in India- WPI and CPI. 3 CPIs exist for different consumer groups each of which is homogenous.

All price indices use a particular year as a "base year". That means that rises or falls in prices are measured with reference to the price in that year. For example, the base year used for the Wholesale Price Index is 2004-05. Wholesale prices of all products in the basket with their respective weightages in that year add upto "100". If, in 04-05, the wholesale price of gur was Rs 2 a kg, and rose by 50 paise the following year, it would mean that the wholesale price index for gur would rise to 125 in 2005-06. But the movement of an index is based on the average of price movement of all the goods in the basket and not just one article. Different base years are used for different price indices due to convenience, data availability, logistics etc.

WPI

The Wholesale Price Index

Government launched a new series of wholesale price index (WPI) with 2004-05 as base from 2010. Earlier, 1993-94 was used as base year to calculate WPI. The new series of WPI has 676 items as against 435 items in the previous series. Consumer items widely used by the middle class like ice-cream, mineral water, flowers, microwave oven, washing machine, gold and silver are reflected in the new series of WPI. This would give better picture of the price variation. Readymade food, computer stationary, refrigerators, dish antenna, VCD, petroleum products and computers will also be part of the new series.

Under primary article group of the new WPI, there are 102 items against earlier 98, while fuel and power category remains static at 19. In the new series, there are 555 items of manufactured products compared to 318 items earlier.

241 new items are there in the basket of commodities making up the official wholesale price index in a bid to reflect changes in India's price line and consumption pattern better. The new series altered the weight attached to each commodity group.

Manufactured items now have a higher weight of 64.972 as against 63.749 earlier. The weight for fuels has also increased to 14.910 against 14.226. But for primary articles, the weight is down at 20.118 against 22.025.

In a bid to reflect the actual consumption pattern, the new series drops as many as 200 items sach as typewriters, video cassette recorders, to make a room for items like computers, refrigerators, televisions and video disc players.

Government is also working on a two new indices to reflect the changes in the cost of services — one on financial services and the other on trade and transport.

The Indian WPI is now updated on a monthly basis. The WPI is published by the Economic Advisor in the Ministry of Commerce and Industry, with a two week lag, tracks the wholesale traded price of 676 items that include agricultural commodities (such as rice, tea, raw cotton, groundnut oil seed), industrial commodities (such as iron ore, bauxite, coking coal), intermediate products for industry (such as cotton yarn, polyester fiber, synthetic resins, iron & steel, sheet glass), products for consumers (atta, sugar, paper, electricity, ceiling fans) and energy items (petrol, kerosene, electricity for commercial use). The weight attached to each item in the index is meant to reflect the volume (by value) of wholesale trade in that item in the Indian market.

The index is a vital guide in economic analysis and policy formulation. WPI covers primary goods, power/fuel and manufactured goods.

The WPI is not intended to capture the effect of price rise on the consumer though it generally and broadly indicates it.

WPI has an All India character. It is due to these attributes that it is widely used in business and industry circles and in Government and is generally taken as an indicator of the rate of inflation in the economy.

To reflect the structural changes in the economy that have taken place over a decade, a large number of commodities have been added and a few with diminished importance have been dropped.

WPI is announced with a time lag of two weeks. The data is made final after a period of 8 weeks.

The inflation rate is calculated on point to point basis i.e. on the basis of the variation between the index of the latest week of the current year and for the corresponding week of the previous year.

There are a number of agricultural commodities, especially, some fruits and vegetables, which are of a seasonal nature. Such seasonal items are handled in the index in a special manner. When a particular seasonal item disappears from the market and its prices are not quoted, the index of such an item ceases to get compiled and its weight is distributed over the remaining items and new seasonal items, if any, in the concerned sub-group.
The advantage of the WPI is that it covers more goods; is available with relatively small time lag of fortnight; is convenient to compile. Disadvantages are that it does not include services like transport, health, education etc.

Limitations on WPI

The accuracy of WPI is unsatisfactory even after the introduction of the revised series in 2010. Services such as rail and road transport, health care, postal, banking and insurance, for example, are not part of the WPI basket. Neither are the products of the unorganised sector that are estimated to constitute about 35 per cent of the total manufactured output of the country. The index thus falls well short of being a broad based indicator of the price level even in its construction.

WPI: new reporting method

From 2009, government presented WPI inflation figures on a monthly basis instead of weekly system. Analysts say since weekly data on wholesale price index-based inflation do not adequately capture the movement of prices of manufactured goods, government has to often revise the figures later. Therefore, the government decided to have weekly release of inflation data on food and fuel prices and monthly data on WPI. Inflation of primary goods within the WPI is reported on a weekly basis. But from 2011, the WPI is reported every month, including the food and primary article data

Comparative Statement of Commodities and price quotations

	No of Commodities		No of Price Quotations	
	1993-94	2004-05	1993-94	2004-05
All Commodities	435	676	1918	5482
Primary Articles	98	102	455	579
Fuel and Power	19	19	72	72
Manufactured Products	318	555	1391	4831

Weightage of the Sub Indices

	1993-94	2004-05
All Commodities	100%	100%
Primary Articles	22.025%	20.118%
Fuel and Power	14.226%	14.910%
Manufactured Products	63.749%	64.972%

CPI

There are three Consumer Price Indices in India. Each tracks the retail prices of goods and services for specific group of people, because the consumption patterns of different groups differ.

For Industrial Workers (CPI-IW), a basket of 370 commodities is tracked; for Urban Non-Manual Employees (CPI-UNME), 180 commodities; for Agricultural Labourers (CPI-AL), 60 commodities. The respective base years are 2001, 1984-85 and 1986-87. The first two indices have services in them. These baskets and the weightages to each item have been determined on the basis of surveys of consumption patterns. Information also differs from centre to centre around the country; the all-India figures declared are averages.

Mahatma Gandhi NaREGA wages are to be indexed to the CPI(AL) from the beginning of the year 2011.

CSO decided to discontinue CPI(UNME) from 2008.

Each commodity is given a specific weightage, which differs from one index to another index. For example, the CPI-AL would give a greater weightage to foodgrains than the CPI-UNME, since a greater proportion of the agricultural labourer's expenditure would go toward foodgrains, and he would be unlikely to buy the sort of items the office-goer would buy.

The coverage of CPI IW is broader than the other indices of CPI like the CPI for agricultural laborers (AL) and the CPI for urban non-manual employees (UNME).

In the organised sector, CPI-IW is used as a cost of living index.

CPI-AL and CPI-UNME are not considered as robust national inflation measures because they are designed for specific groups of population with the main purpose of measuring the impact of price rise on rural and urban poverty.

In accordance with the Government of India (Allocation of Business) Rules, 1961, as amended from time to time, it is the responsibility of the Ministry of Labour to compile and release the data on the CPI for Industrial Workers and the data on the CPI for Rural Labourers. It is the responsibility of the Ministry of Statistics and Programme Implementation to compile and release the data on the CPI for Urban Non-Manual Employees.

The Government of India (Allocation of Business) Rules, 1961, with subsequent amendments, assigns the responsibility for compiling the WPI to the Office of the Economic Adviser in the Department of Industrial Policy and Promotion under the Ministry of Commerce and Industry. The Economic Adviser holds the final authority for all decisions regarding the WPI.
The national income deflator(GDP deflator) is a comprehensive measure statistically derived from national accounts data released by the Central Statistical Organization (CSO). Since it encompasses the entire spectrum of economic activities including services, the scope and coverage of national income deflator is wider than any other measure. At present, the GDP deflator is available only annually with a long lag of over one year and hence has very limited use for the conduct of policy.

Difference between wholesale prices and consumer prices
WPI measures price rise at the wholesale level. Wholesale means sale in large quantities and meant for resale It covers a certain set of goods that are traded at the wholesale level. CPI on the other hand measures price rise at the retail level. There is a difference between the two. The difference is due to a number of factors. A substantial portion of the differential is accounted for by the retailers' margins which are built into what the consumer pays. Besides, the way the two indices are calculated differs both in terms of weightage assigned to products as well as the kind of items included in the basket of products.

While wholesale prices are more or less the same throughout the country, consumer prices or retail prices vary across regions (rural and urban) and also across cities according to the consumer preferences for certain products, supplies and purchasing power. Besides, taxes levied by states comprise an important component of the variation in prices of many products.

Therefore, give WPI an important place in government policy as it is more representative ; figues come quickly relatively; and has an all India character.

Divergence between WPI and CPI

Why do WPI and CPIs differ? They differ in terms of their weighting pattern. First, food has a larger weight in CPI ranging from 46 per cent in CPI-IW to 69 per cent in CPI-AL whereas it has a weight of only 27 per cent in WPI. The CPIs are, therefore, more sensitive to changes in prices of food items. Second, the fuel group has a much higher weight in the WPI (14.2 per cent) than the CPIs (5.5 to 8.4 per cent). As a result, movement in international crude prices has a greater bearing on WPI than on the CPIs. Third, services are not covered under WPI while they are, to different degrees, covered under CPIs. Consequently, service price inflation has a greater influence on CPIs.

New CPI series

The Central Statistics Office (CSO) of the Ministry of Statistics & Programme Implementation introduced the new series of Consumer Price Index (CPI) numbers for Rural, Urban and Combined (Rural +Urban) on base 2010 =100 taking all segments of rural and urban population for the States/UTs and all- India . Since 2011, the new series is force. These indices are available for five major groups namely Food, beverages and tobacco; Fuel and light; Housing; Clothing, bedding and footwear, and Miscellaneous.

Present CPI numbers do not encompass all the segments of the population in the country and as such they do not reflect the true picture of the price behavior in the country. It is therefore necessary to compile a CPI which takes into account the consumption patterns of all segments of the population and includes services.

New series of CPI for urban areas

CPI (Urban) numbers are compiled at State/UT as well as at all- India level. Weighting diagrams (consumption patterns) of the CPI (Urban) have been derived from the results of the NSS 61st round of Consumer Expenditure Survey (2004-05). For regular price collection, 310 towns have been selected, which include all State/UT capitals. From each selected town, price data are collected in respect of items consumed by the population of the respective State/UT. In all, 1114 price schedules containing an average of 250 items are canvassed every month. House rent data are also collected from a fixed set of rented dwellings from the selected towns. Prices of items are collected by the field officials of the National Sample Survey Office (NSSO).

New series of CPI for rural areas

CPI (Rural) numbers are compiled at state/UT and all- India levels. Weighting diagrams of the CPI (Rural) have also been derived from the results of the NSS 61st round of Consumer Expenditure Survey (2004-05).

Considering the fact that the CPI (Rural) would provide the price changes for the entire rural population of the country, a total of 1181 villages have been selected at all India level. Regular prices are collected by the officials of the Department of Posts. One schedule containing an average of 225 items from each selected village is canvassed for collection of prices every month.

National CPI

CSO will also compile national CPI by merging CPI (Rural) and CPI (Urban) with appropriate weights, as derived from NSS 61st round of Consumer Expenditure Survey (2004-05) data.

Weighting diagrams

The share (weight) of the Food, beverages and tobacco group in the all India CPI (Rural) is 59.31% and it is 37.15% in the all India CPI (Urban). Fuel and light group has a weight of 10.42% in CPI (Rural) and 8.40% in CPI (Urban). Clothing, bedding and footwear group has weight of 5.36% in CPI (Rural) and the weightage of 3.91% in CPI (Urban). Housing group has not been given any weightage in the rural areas CPI as its share is around 1% and it has been distributed to other groups on pro rata basis. CPI (Urban) has a weightage of 22.53% in respect of Housing group. The Miscellaneous Group consisting of education, medical care, transport and communication etc has 24.91% weight in the all India CPI (Rural) and the corresponding weight in the all India CPI (Urban) is 28%.

Release of indices

Index numbers for both rural and urban areas and also combined for each month and released. Indices are released with a time lag of one month.

Revision of indices

These new CPI numbers would be revised on the basis of the results of the next round of Consumer Expenditure Survey scheduled to be conducted during 2011-12 by the NSSO. Thereafter, revision will be undertaken every five years or so (whenever large scale Consumer Expenditure Survey data become available).

New series of CPI-- All India weights			
Sub group/group	**Rural**	**Urban**	**Combined (Rural+Urban)**
Cereals and products	19.08	8.73	14.59
Pulses and products	3.25	1.87	2.65
Milk and milk products	8.59	6.61	7.73
Oils and fats	4.67	2.89	3.90
Egg, fish and meat	3.38	2.26	2.89
Vegetables	6.57	3.96	5.44
Fruits	1.90	1.88	1.89
Sugar etc	2.41	1.26	1.91
Condiments and spices	2.13	1.16	1.71
Non- alcoholic beverages	2.04	2.02	2.03
Prepared meals etc	2.57	3.17	2.83
Pan, tobacco and Intoxicants	2.73	1.35	2.13
Food, beverages and tobacco	**59.31**	**37.15**	**49.71**
Fuel and light	**10.42**	**8.40**	**9.49**
Clothing and bedding	4.60	3.34	4.05
Footwear	0.77	0.57	0.68
Clothing, bedding and	**5.36**	**3.91**	**4.73**

footwear			
Housing		**22.53**	**9.77**
Education	2.71	4.18	3.35
Medical care	6.72	4.34	5.69
Recreation and amusement	1.00	1.99	1.43
Transport and communication	5.83	9.84	7.57
Personal care and effects	3.05	2.74	2.92
Household requisites	4.48	3.92	4.30
Others	1.12	0.99	1.06
Miscellaneous	**24.91**	**28.00**	**26.31**
All Groups	**100.00**	**100.00**	**100.00**

The new series is broad based and covers the entire rural and urban population. In the new series compiled by Central Statistics Office, the consumption patterns have been derived from the results of the Consumer Expenditure Survey conducted by the National Sample Survey Office during 2004-05. Food group weights in all-India CPI (Rural), CPI (Urban) and CPI (Combined) are 59.31%, 37.15% and 49.71% respectively. Remaining weights are for non-food groups i.e. housing, fuel & light, clothing & footwear and miscellaneous group.

Which index should one use?

The WPI is useful in certain contexts. For example, for industrialists, the costs of setting up a factory over the course of several years; and further to calculate the costs of production and returns over several years. The basket of items in the CPI does not include machinery, chemicals, and so on; secondly, the price of electricity in the CPI is the consumer tariffs, not the industrial tariffs; and so on.

Figures for inflation in the WPI are on the average much lower than those in the CPI indices. There could be two reasons for this difference in rates between the WPI and CPI: first, prices of the items in the CPI basket might have risen more sharply than items excluded from it — this would mean that prices of mass consumption goods have risen more sharply than inputs for production; secondly, the retail prices of commodities might have grown more sharply than the wholesale prices, indicating that middlemen have taken a bigger share.

Services and price index

While the WPI now does not include services, the two consumer price indices (CPI) meant for urban non-manual employees and industrial workers, do include certain services such as medical care, education, recreation and amusement, transport and communication. On the other hand, some of the other major services such as trade, hotels, financing, insurance, real estate and business services do not find a mention either in the WPI or in the CPIs.

In India, the services sector accounts for about 57 per cent of the GDP.

In August 2010, Department of Industrial Policy and Promotion (DIPP), Ministry of Commerce & Industry constituted an Expert Committee to render technical advice for development of Service Price Index (SPI) and its related issues. The Committee is chaired by Prof. C. P. Chandrasekhar.

Producer price index
The process of introducing the producer price index (PPI) is also underway in India, according to Dr Abhijit Sen, Member of Planning Commission. It means prices of goods as they are sold to the wholesalers by the producers. The difference between WPI and PPI is accounted for by the margins and other transport and distribution costs.

'Core' or' Underlying Inflation'
Core or underlying inflation measures the long-run trend in the general price level. Temporary effects on inflation are factored out to calculate core inflation. For this purpose, certain items are usually excluded from the computation of core inflation. These items include: changes in the price of fuel and food which are volatile or subject to short-term fluctuations and/or seasonal in nature like food items. In other words, core or underlying inflation is an alternative measure of inflation that eliminates transitory effects .The main argument here is that the central bank should effectively be responding to the demand side- for example, the money available in the market, demand for credit and so on and not the supply shocks like energy and food. Core inflation in India on the WPI is about 2%.Headline inflation on the other hand includes the official rate of increase in prices that excludes no item in the basket. Core includes the primary articles and the food processing part of manufacturing.

Inflation Targeting
Inflation targeting focuses mainly on achieving price stability as the ultimate objective of monetary policy. This approach entails the announcement of an inflation target- either a number or a range, that the central bank promises to achieve over a given time period. The targeted inflation rate will be set jointly by the RBI and the government, the responsibility of achieving the target would rest primarily on the RBI on the demand side and supply side is that of the government. This would reflect an active government participation in achieving the goal of price stability with fiscal discipline by way of a rational borrowing programme (not borrowing in excess).

Monetary policy and fiscal policy have to converge for achievement of inflation targeting. Advantage is that it promotes transparency in the conduct of monetary policy. Further, it increases the accountability of monetary authorities to the inflation objective.

Prices impact on the macro economy in many ways – welfare of people, growth and stability of the economy in a globalised order.

We do not adopt this policy in India.

Ideal level of Inflation
Ideal inflation rate is one that takes into consideration human, social and economic impact. It is the level of inflation beyond which the adverse consequences are strong. Chakravarty Committee (1985) had indicated 4 per cent as an acceptable level of inflation on a long-term basis However, such a level of inflation cannot be fixed at one level for all times. It depends on growth rate. It also depends on what the global levels are. RBI sees about 5.5% rate of inflation as 'comfortable'- neither does it hurt in human terms nor in growth terms.

Collection of Statistics Act, 2008
Collection of Statistics Act, 2008 was made to bring in new rules aimed at improving data collection.

Government will levy higher penalty for not sharing data and tougher punishment will be imposed in cases where manipulation of data is involved, they say.

Under the new Act, people or companies not divulging data would have to pay a fine of Rs 1,000 and they would be given a 14-day notice period to comply. If the information is not provided even after two weeks, the penalty will rise to Rs 5,000 per day.

Under the old Act, which was passed in 1953, the penalty was only Rs 500 for the first default and Rs 200 per day thereafter.

The new penalty scheme will ensure that data collection is done on time. It will increase the accuracy of the data

The Act also makes wilful manipulation or omission of data a criminal offence, punishable by a prison term that may extend up to 6 months. This penalty will also apply if a company prevents or obstructs any employee from collecting data.

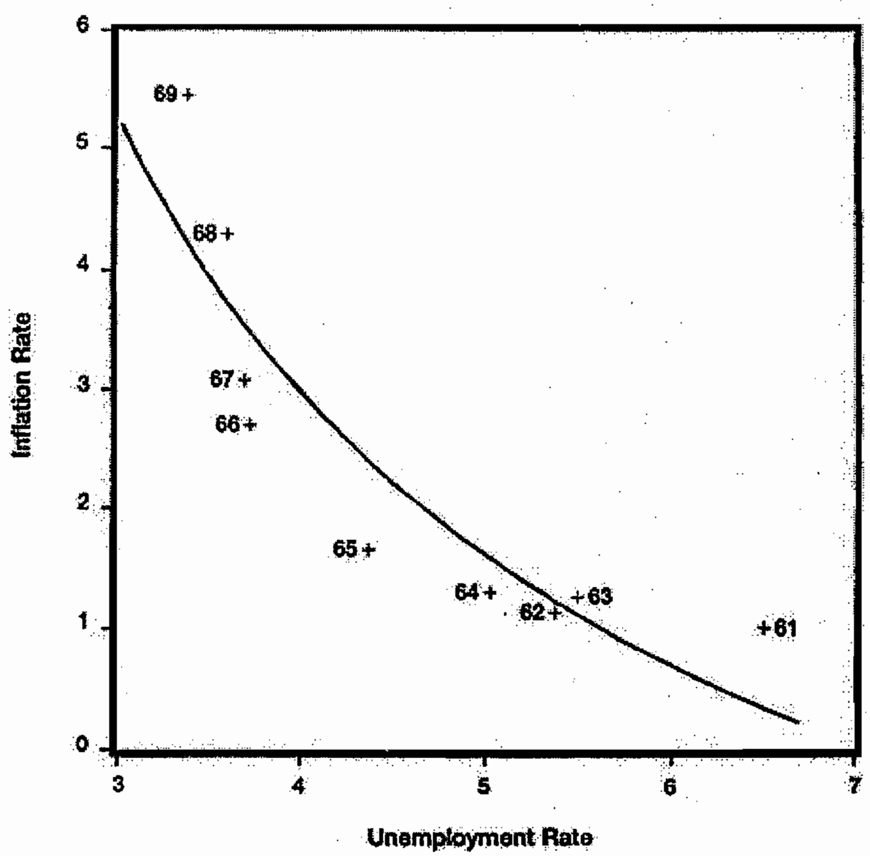
The Collection of Statistics Act, 2008, gives powers to the government to classify any statistics as "core statistics" and also determine the method to collect and disseminate the same

Philips's curve

The inverse relationship between rate of inflation and rate of unemployment is shown in the **Phillips curve:** price stability has a trade-off against employment. Some level of inflation could be considered desirable in order to minimize unemployment.

Potential output (sometimes called the "natural gross domestic product") is an important concept in relation to inflation. It is the level of GDP where the economy is at its optimal level of production, given various constraints- institutional and natural.

This level of output corresponds to the Non-Accelerating Inflation Rate of Unemployment, NAIRU. If GDP exceeds its potential, inflation will accelerate and if GDP falls below its potential level, inflation will decelerate as suppliers attempt to use excess capacity by cutting prices.



Deflation

Deflation is a prolonged and widespread decline in prices that causes consumers and businesses to curb spending as they wait for prices to fall further. It is the opposite of inflation, when prices rise, and should not be confused with disinflation, which merely describes a slowdown in the rate of inflation.
Deflation occurs when an economy's annual headline inflation indicator -- typically the consumer price index -- enters negative territory.
Deflation is hard to deal with because it is self-reinforcing. Put simply, unless it is stopped early, deflation can breed deflation, leading to what is known as a deflationary spiral.

When an economy has fallen into deflation, demand from businesses and consumers to buy products falls because they expect to pay less later as prices fall. But as producers struggle to sell and go bankrupt, unemployment rises, reducing demand further. That causes deflation to become more pronounced.

It makes it more expensive to service existing debts. This is as true of governments, who have borrowed trillions of dollars globally to prop up the financial sector, as it is for consumers.
As debt becomes more expensive to pay off, the risk of default and bankruptcy rises too, making banks more wary of lending. This reduces demand and further exacerbates the deflationary problem.
Remedy

- Tax cuts to boost demand from consumers and businesses
- Lowering central bank interest rates to encourage economic activity
- Printing more currency to boost money supply
- Capital injections into the banking system
- Increase government spending on projects that boost the return on private investment

India did not face the threat of deflation as demand has not dropped so much. Also, food scarcity meant food prices did not fall. In fact they rose.

India and deflation

On the WPI, we faced disinflation- rate of growth of prices fell but not prices themselves till the first quarter of 2009. In the second quarter and later, there was `deflation' on the WPI. This negative inflation is due to higher base as inflation peaked in July 2008 due to international energy and food price rises because of speculation.

The deflationary phase was short lived for a few weeks as the fiscal as well as monetary measures of the government started showing results and demand and growth returned.

Growth -inflation trade off

With high growth, economy overheats. .Overheating of the economy means demand overshoots supply and there is pressure on prices. As growth creates more employment and incomes rise, demands rises pushing up prices.

As prices rise, the central bank intervenes and raises rates to cool consumption and so prices fall relatively. Repo rates- the policy rate- is the tool along with CRR and OMOs available to the central bank as signals to the economy that it is ready to act to soften prices -partly because the poor suffer disproportionately and partly because inflation can derail the medium and long term growth.

Such intervention by the central bank has a dampening impact on growth as higher interest rates prevent easy borrowing and thus demand slackens.

We witnessed the same in India with CRR and repo rates going down from 2009 for one year and later till 2011 going up in reponse to priceline in the country. Today they stand at 4% and 7.75% respectively (December 2013)The primary goal of the RBI is to moderate and stabilize prices.

Thus, growth and inflation are intimately connected- one being traded for the other depending upon where the growth situation stands.

As prices stabilise, growth resumes and a new and higher base is set for the growth process. Growth and inflation do have a trade off but that is only in the short term. As Dr.C.Rangarajan says, growth is a marathon while overheating and slow down are temporary pauses to gain greater strength.

Further, unless the RBI raises the policy rates with inflation going up, there is a danger of banks failing to attract deposits as real interest rates become negative and savings may be diverted to unproductive assets like gold with serious consequences- inside and outside for the economy.

Fiscal drag operates in an overheated economy. That is the tax liability increases as wages rise. That leaves less purchasing power in the hands of the people and so demands drops automatically. It acts as an automatic stabilizer.

Inflation in India

Reasons for the current inflation

In spite of the steps of the government, prices are relentlessly on rise. WPI at 7.5% and CPI above 10% in mid-2012 have many reasons

- Growth
- The bad monsoons and the decline in production raised inflationary expectations
- Even as the buffer stocks accumulated to huge surplus, governance problems and the fiscal pressures of the states prevented them from being distributed
- Narega
- MSP increases
- Fuel price deregulation for petrol and increase in the prices of diesel and LPG
- Hoarding and cartelization as in the case of food items, cement
- Middle men
- APMC Acts of States
- Diesel price deregulation in phases
- Imported inflation due to rupee depreciation since late 2011

For food inflation, Dr. Subba Rao gave the following reasons in November 2011 and they continue to be relevant

1. Shift in dietary habits towards protein foods.
2. Pressure stemming from inclusive growth policies.
3. Large increases in MSPs of food grains.
4. Shocks from global food inflation.
5. Financialisation of commodities.

Government steps to control inflation
The Government has taken a number of short term and medium term measures to improve domestic availability of essential commodities and moderate inflation.

It has procured record food grains. Even after keeping the minimum buffer stock, there are enough food grains to intervene in the market to keep the prices at reasonable level.

A Strategic Reserve of 5 million tonnes of wheat and rice has also been created to offload n the open market when prices are high. This is in addition to the buffer stock held by FCI every year.

Issue price of grains supplied through PDS outlets are frozen.
The price situation is reviewed periodically at high-level meetings such as the Cabinet Committee on Prices (CCP).
Fiscal Measures

- Reduced import duties on food items
- Import duties are raised on gold etc to contain CAD

Administrative Measures

- Ban on exports of food items
- Dehoarding

Monetary Measures
Repo rates were raised and CRR also went up to make credit dearer.

Inflation and corruption
The link is as follows

a. through black money
b. hoarding not being checked
c. commodity prices being manipulated through speculation as NSEL crisis shows.

Open inflation
When the government does not attempt to prevent a price rise, inflation is said to be open. Thus, inflation is open when prices rise without any interruption. In open inflation, the free market mechanism is permitted to fulfill its historic function of rationing the short supply of goods and distribute them according to consumer's ability to pay. Therefore, the essential characteristics of an open inflation lie in the operation of the price mechanism as the sole distributing agent.

Repressed / suppressed inflation
When the government interrupts a price rise, there is a repressed or suppressed' inflation. Thus, it refers to those conditions in which price increases are prevented at the present time through an adoption of certain measures like price controls and subsidies like diesel subsidy etc.

Inflation tax
Price rise means more money being paid by the consumers for what they buy. Thus, it is a type of tax.

TAXATION IN INDIA: Concepts and Policies

Tax is a payment compulsorily collected from individuals or firms by government. A direct tax is levied on the income or profits of an individual or a company. The word `direct' is used to denote the fact that the burden of tax falls on the individual or the company paying the tax and can not be passed on to anybody else. For example, income tax, corporate tax, wealth tax etc. An `indirect' tax is levied on manufacturing and sale of goods or services. It is called `indirect' because the real burden of such a tax is not borne by the individual or firm paying it but is passed on to the consumer. Excise duty, customs duty, sales tax etc.

Funds provided by taxation are used by governments to carry out the functions such as:

- military defense
- enforcement of law and order
- redistribution of wealth
- economic infrastructure — roads, ports etc
- social welfare
- social infrastructure like education, health etc
- social security measures like pensions for the elderly, unemployment benefits

Taxation System in India

India has a well developed tax structure. Being a federal country, the authority to levy taxes is divided between the central government and the state governments. The central government levies direct taxes such as personal income tax and corporate tax, and indirect taxes like customs duties, excise duties and central sales tax (CST). CST is assigned to the States in which it is collected. (Art.269). The states have the constitutional power to levy sales tax apart from various other local taxes like entry tax, octroi, etc.

Taxation has always played an important role in the formulation of the government's economic policy. Taxation policy in a developing country like India can play an important part to raise resources for growth; to bring in reduction in inequalities; to direct growth in backward regions; to reduce consumption of luxury goods; to direct investment into small scale sector; to promote savings etc. In the wake of the economic reforms, the tax structure and procedures have been rationalised and simplified. Since 1991, the tax system in India has undergone substantial rationalization- reduced rates and slabs and better administration.
Some of the changes are:

- Broadening the tax base to include services, fringe benefits, stock market transactions etc
- Reduction in customs and excise duties. Peak customs rate is today 10%
- Lowering of corporate tax rates to 30%
- Rationalizing the personal income tax rates and slabs starting from 1997 `dream budget'.
- Sales tax reforms at the State level as a preliminary step towards their integration into GST
- introduction of VAT from 2005 at the state level; GST is expected to be introduced in 2011
- Simplifying income tax return filing procedures. For example, Saral, Towards better taxpayer services, in 2011-12, the IT department has introduced simple and user friendly

SAHAJ (Form) for individual salary tax-payers; SUGAM for small tax-payers availing presumptive tax scheme.(For presumptive tax, see ahead)

Tax revenue as a percentage of GDP decreased initially, after reforms began in 1991, as rates came down and growth of economy was not very robust. Compliance also did not increase proportionate to rate reduction. Since the Tenth Plan period, there has been a consistent rise in tax collections but it dipped due to global financial crisis of post-2008 period. GOI expects Rs.1.24 lakh crore for service tax collection during 2012-13 due to wider coverage and higher rate (12%).In 2011-12, the tax-GDP ratio stood at 5.5 per cent for direct taxes and 4.4 per cent for indirect taxes.

Government expected to increase its gross tax revenue by 19.5% to Rs 10.77 trillion in the financial year 2012-13.

The gross tax revenue is estimated at 10.6% of the gross domestic product (GDP) in the Budget estimates 2012-13.

Revenue from corporation tax is the highest contributor at Rs 3.73 trillion to the government's total revenue, while income tax, customs, union excise duties, and service tax yielded Rs 1.95 trillion, Rs 1.86 trillion, Rs 1.94 trillion and Rs 1.24 trillion, respectively.

Direct tax revenue growth is estimated at Rs 5.7 trillion, up 13.9% and indirect tax revenue growth is estimated at Rs 5.05 trillion, up 26.7%.

The government targeted a net tax revenue of Rs 7.71 trillion in 2012-13, after devolution to the states.

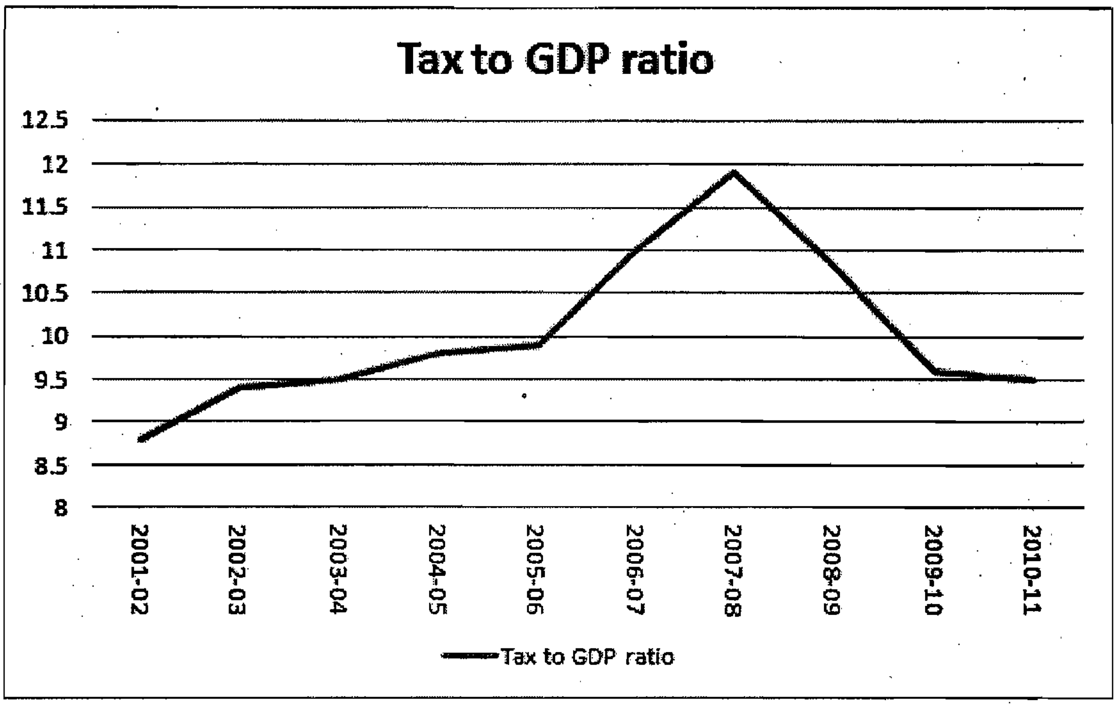
The non-tax revenue receipts are estimated at Rs 1.64 trillion and non-debt capital receipts are estimated at Rs 416.5 billion.

Expenditure:
The government's total expenditure is budgeted at Rs 14.9 trillion for 2012-13.
Of this, the plan expenditure is projected 22.13% higher at Rs 5.21 trillion.
Non-plan expenditure for 2012-13 is budgeted at Rs 9.69 trillion.

Measures for broadening tax base, strengthening compliance and simplification

- Rates and slabs are rationalized
- Negative list of services for taxation from 2012 at 12%
- adoption of VAT by almost all the states
- GST introduction
- Tax to be deducted at source on various items like interest on bank deposits; dividend distribution etc
- Quoting of permanent account number made compulsory for many transactions so more people can be brought into tax net
- securities transactions tax

Other measures suggested are: minimizing exemptions and concessions; drastic simplification of laws and procedures; building a proper information system and computerization of tax returns, and a thorough revamping and modernization of the administrative and enforcement machinery.



PROFILE OF CENTRE'S GROSS TAX RECEIPTS

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	1990-91	2000-01	2007-08	2008-09	2009-10 (BE)	2009-10 (RE)	2010-11 (BE)
DIRECT*	11024	68306	295938	309859	370000	380608	422500
Income	5371	31764	102644	106046	112850	125021	120566
Corporation	5335	35696	192911	213395	256725	255076	301331
INDIRECT	45158	118681	278845	269433	269477	244477	315000
Excise	24514	68526	123425	108613	106477	102000	132000
Customs	20644	47542	104119	99879	98000	84477	115000
Service	Nil	2613	51301	60941	65000	58000	68000
TOTAL**	57576	188603	593147	605298	640079	633095	746651
DIRECT %	19.15	36.22	49.89	52.84	57.72	60.12	56.59
TAX-GDP %	10.11	8.97	11.99	10.86	10.95	10.27	10.77

*Includes taxes on interest, expenditure, estate, gift and wealth;
**Includes 'other taxes & duties' and 'taxes of Union Territories';
BE: Budget Estimates; RE: Revised Estimates.

Tax collections 2012-13

As can be seen from the table above, Government of India's tax receipts were growing healthily. It helps government spend more on social projects.

The reasons for the tax collections being so healthy till recently

- economy is growing at a satisfactory pace- 6.5% in 2011-12
- incomes of individuals have gone up
- lower tax rates help compliance
- procedures are simple and citizen-friendly
- base has been widened
- a drive has been mounted to bring more people to pay income tax with proper investigation

Direct and Indirect Taxes in India: The Changing Scenario

As can be seen from table, direct tax collections are more than indirect tax collections. In 1990-91, less than a fifth of the Centre's gross tax revenues came from direct taxes.

The biggest taxation source of the Centre now is corporate tax and next is income tax.

The general level of prosperity in the country is increasing making more people have taxable incomes. Also, when companies are growing in number and also in their profitability, corporate tax collections increase. Global opportunities mean more profits. Stock market transactions and wealth build-up also contribute to direct tax collections by way of STT, capital gains tax, income tax. .Apart from the above reasons, the Government's measures as given below also helped increase the direct tax collections

- reduction of peak income tax rates that helps compliance
- reduction in the number of slabs
- strengthening the administration- e-governance etc
- simplification of laws(Saral etc)
- promote voluntary compliance

The increase in the relative share of direct tax collections shows that the tax system is becoming more progressive as direct taxes are paid by the well off in general while the indirect taxes are paid equally by all consumers. Direct taxes can be used to promote growth with equity.

Direct taxes help in income redistribution. Decline in the relative share of indirect taxes is also seen as good because it promotes the competitive nature of Indian economy-attracts investment.

By taxing earnings of individuals and corporates rather than production and trade, there is less stifling of economic activity and there is employment generation.
In developed countries, direct taxes contribute more to the tax collections.

Cost of direct tax collection

Buoyant economic growth along with higher tax compliance have led to a desirable decline in the cost of direct tax collections as a proportion of total direct tax collections: all-time low of 0.54 per cent in 2007-08.That is, the income-tax department spends 54 paise for every Rs 100 direct tax collected by it, which is among the lowest in the world. The income tax department has a tax base of 3.5 crore assesses..

Income-tax slabs and rates

10 per cent rate on a slab extending up to Rs 5 lakh. Likewise, the 20 per cent rate will now apply on income slabs beyond Rs 5 lakh and up to Rs 8 lakh. The maximum marginal rate of 30 per cent on an income slab of above Rs 8 lakh.

Service Tax

Service tax was first imposed in 1994. A new service tax regime, based on a negative list of exempted services, came into effect in July 2012.

With this, all services — except the 38 activities put on the negative list — came under the tax at the increased rate of 12 per cent, as announced in the Union budget 2012-13.

Till June 2012, service tax was being levied on 119 services based on a positive list. The switch-over to a negative list-based approach is aimed at aligning the indirect taxation system to the proposed Goods and Services Tax (GST) regime, which is sought to be introduced to unify the levies of the Centre and the States into a composite system.

With the services sector now accounting for 60 per cent of the gross domestic product, the Finance Ministry has set a target of Rs.1.24 lakh crore for service tax collection during 2012-13. This is significantly higher than the Rs.97,000 crore mopped up during the previous fiscal.

As per the negative list-based approach, services such as metered taxis, auto-rickshaws, transport of goods or passengers and transmission and distribution of electricity by distribution companies will not come under the service tax net.

Other important services exempted from the levy are solemn activities such as funeral, burial and transport of deceased. In the education sector, school and university courses, as also approved vocational studies, have been exempted.

Likewise, auxiliary educational services and renting of immovable property by educational institutions in respect of education will not be taxed. However, coaching classes and training institutions will be taxed.

Among the other services included in the negative list are those provided to government, local authorities or a government authority for repair and maintenance of an aircraft. Likewise, services provided by advocates to other advocates and business entities up to a turnover of Rs. 10 lakh in the preceding financial year will be exempt from the tax.

Services provided by way of public convenience, such as bathroom, washroom, urinals or toilets, are included in the negative list, just as services relating to work contracts for a scheme under the Jawaharlal Nehru National Rural Urban Renewal Mission or the Rajiv Awas Yojana.

The service sector has emerged as an important area of economic activity. Reasons for taxing services

- Its share in the country's Gross Domestic Product (GDP) has increased from about 28% in 1951, to 55% (2011).
- Taxing services is important to raise resources and increasing the tax-GDP ratio
- service providers should share the tax burden with others-industry - there should be horizontal equity that is all sectors of the economy should bear the tax burden equitably.
- as the share of industry in GDP decreases while that of services expands, the tax base shrinks unless services are taxed.
- failure to tax services distorts consumer choices, encouraging spending on services at the expense of goods and savings.
- as most of the services that are likely to become taxable are positively correlated with expenditure of high income households, subjecting them to taxation will improve equity.

Service Tax and Indian Constitution

In the Seventh Schedule to the Constitution, under Article 246, the item relating to "taxes on services" was not specifically mentioned in any entry either in the Union List or in the State List.

However, Entry 97 of the Union List empowers Parliament to make laws in respect of any other matter not enumerated in List II (State List) or List III (Concurrent List), including any tax not mentioned in either of those lists. Since "taxes on services" is not there in any of the lists, service tax was levied by the Central Government in exercise of the powers under Entry 97 of the Union List.

The 88th amendment to the Constitution(2004) amended Article 270 (made it divisible)and inserted in the Union List (List I) entry No. 92C — `taxes on services'.

The amendment to the Constitution places services tax formally under the Union List. This will pave the way for the Centre to levy and collect the tax.

The amendment becomes redundant with the introduction of GST in 2011 where the services will be jointly taxed by Centre and States.

The amendment did not come into effect as it has never been notified and thus services are still taxed on a residuary basis.

GST

Goods and Services Tax is a multi-point sales tax with set off for tax paid on purchases of inputs. There is no cascading (tax on tax) effect as there is deduction or credit mechanism for taxes paid for the inputs. The tax is levied on the value added and on consumption only. Total burden of the tax is exclusively borne by the domestic consumer. Exports are not subject to GST.

India introduced VAT at the state level in 2005. Before that, union excise duties were renamed Central Vat (Cenvat). But when states called their slaes tax Vat, centre reverted to the earlier name of excise duty. The earliest form of Vat was however taken in 1986 in the form of Modvat- modified VAT that included set off for a few commodities only and was confined to excise duties only.

Cenvat in replacement of central excise duties came into effect earlier in the decade. VAT as a replacement for state sales tax was adopted from the beginning of the fiscal year 2005-2006.Cenvat has come back to being called union excise duty to prevent confusion.

Need for GST

In the Union Budget for the year 2006-2007, Finance Minister proposed that India should move towards national level Goods and Services Tax that should be shared between the Centre and the States. World over, goods and services are integrated and taxed as a comprehensive domestic indirect taxation system based on value addition. They attract the same rate of tax. That is the foundation of a GST. The basis of GST is value addition.

The goods and service tax (GST) is proposed to be a comprehensive indirect tax levy on manufacture and sale of goods as well as services at a national level. Integration of goods and services taxation would give India a world class tax system and improve tax collections.

It would end the long standing distortions of differential treatments of manufacturing and service sector. The introduction of goods and services tax will lead to the abolition of taxes such as octroi, Central sales tax, State level sales tax, entry tax, etc and eliminate the cascading effects tax on tax.

It is aimed at forging a common domestic market, removing multiplicity of taxes, eliminating the cascading effect of tax on tax, making the prices of the Indian products competitive and, above all, benefiting the end consumers

GST: Q and A

The central and state governments moved closer to ushering in a nationwide goods and services tax on April 1, 2011, a reform intended to cut business costs and boost government revenue. The reform would eliminate multiple indirect taxes levied by states and the central government, leading to a reduction in the average tax burden on companies and a rise in the country's tax-to-GDP ratio.

HOW WILL THE GST WORK?

The GST is an indirect tax that would replace existing levies such as excise duty, service tax, and value-added tax (VAT).Both the states and the central government would impose the tax on almost all goods and services produced in India or imported. Exports would not be subject to GST. For the first two years of operation, the proposal is for two rates both at the federal and state levels, converging to a single rate in the third year. Producers would receive credits for tax paid earlier, which would eliminate multiple taxation on the same product or service. Direct taxes, such as income tax, corporate tax and capital gains tax would not be affected.

WHAT'S THE RATIONALE FOR THE GST?

Eliminating a multiplicity of existing indirect taxes would simplify the tax structure, broaden the tax base, and create a common market across states and centrally administered districts. Increased compliance and fewer exemptions to GST would lift India's federal tax-to-GDP ratio.

At the same time GST would lower the average tax burden for companies that now pay "cascading" taxes on top of taxes through the production process.

By lowering business costs it would boost economic growth and increase exports, proponents argue, and bring India in line with practices in many developed economies.

Reducing production costs would make exporters more competitive.

The GST may usher in the possibility of a collective gain for industry, trade, agriculture and common consumers as well as for the central government and the state governments for reasons cited above.

Black money and evasion will reduce as GST is transparent.

WHAT ARE THE PROPOSED GST RATES?

For the first year: 10 percent of CGST of Centre and 10% of SGST of states for goods and 6 percent each for essential items. 8% each for services. Thus, it is dual rate. Also, goods and services are taxed separately initially.

The higher rate would come down to 9 percent in the second year, and the two rates would converge at 8 percent in the third year.

ARE THERE EXEMPTIONS PROPOSED?
Yes. Goods deemed necessary or of basic importance would be taxed at a lower rate. The government will review the various lists of exempted goods to align them at the federal and state levels.

Alcohol, petroleum and electricity would not come under GST.

WILL THE STATES LOSE OUT?
GOI will compensate states for potential lost revenue and central government has assured states that if needed, it would increase a 50,000 crore -rupee ($10.6 billion) fund that the 13th Finance Commission recommended as an incentive for the states to buy into GST.

WHAT HAPPENS NEXT?
The legislation to make constitutional amendments needs to be finalised and the mechanism for administering the tax needs to be created. The government also needs to set up the technology infrastructure to manage the tax- TAGUP (see ahead)

WHAT IS THE REVENUE IMPACT?
The GST is initially intended to be revenue-neutral but is eventually expected to increase the tax collections due to more efficient collection, expanded base, transparency and increased compliance.

WHAT ABOUT THE ECONOMIC IMPACT?
Implementation of a comprehensive GST would lift India's economy of over $1 trillion by between 0.9 percent and 1.7 percent, according to a report by the New Delhi-based economic think tank the National Council of Applied Economic Research. Exports would rise by between 3.2 percent and 6.3 percent, while imports would increase 2.4 percent to 4.7 percent, the study found.

Constitutional Amendment for GST

Constitution (One Hundred and Fifteenth Amendment), Bill, 2011 (GST Bill)
Constitution (One Hundred and Fifteenth Amendment), Bill, 2011 (GST Bill) was introduced in the Parliament in the budget session in March 2011, deals with GST. The Bill seeks to introduce Goods and Services Tax (GST) and the GST Council. As per the existing structure of indirect taxation, the Parliament has the power to make laws on the manufacture of goods and the provision of services (Union List) while the State Legislatures have the power to make laws on the sale and purchase of goods within their respective states (State List). The Parliament has retained the exclusivity to make laws pertaining to sale of goods in the course of inter-state trade or commerce.

Definition of Goods and Services – Article 366

1. The above Article which defines 'Goods and Services Tax' to mean, any tax on supply of goods or services or both except taxes on the supply of petroleum products and alcohol

Seventh Schedule

- The Union Government has the exclusive power to levy excise duty on the manufacture or production of
- Petroleum Crude
- High Speed diesel
- Petrol
- Natural Gas
- Aviation Turbine Fuel
- Tobacco and Tobacco Products

The State Governments shall have the power to levy tax on the sale (other than in the course of inter-state trade or commerce) of petroleum crude, high speed diesel, petrol, natural gas, aviation turbine fuel and alcoholic liquor for human consumption.

Article 249

The Parliament has been vested with the power to make laws pertaining to GST on behalf of the state Legislature in circumstances of national interest. The power to make such laws would be pursuant to a resolution passed by the Council of States supported by not less than a two-thirds majority of the members present and voting.

Power of Parliament to make laws on subjects in State List in the case of Emergency – Article 250

The Parliament has been vested with the power to makes laws pertaining to GST on behalf of the State Legislature when there is a proclamation of Emergency.

GST Council – Article 279A

The President shall constitute a GST Council within sixty days from the Commencement of the GST Act.

Membership of the GST Council

The Union Finance Minster would be the Chairperson, the Union Minister of State for Revenue shall be one of the members, the Finance Minister or any other minister nominated by each State Government shall be the members of the GST Council.

The Members of the GST Council shall decide on the Vice-Chairperson of the GST Council for such period as decided by the members.

Functions of the GST Council

The GST Council while being guided by the need for a harmonized structure goods and services tax and for the development of a harmonised national market for goods and services shall make recommendations to the Union and the States on:

Taxes, cesses and surcharges levied by the Union and the States and local bodies which may be subsumed within the GST

- Exemptions from GST for such goods and services
- Threshold limit of turnover below which GST may be exempted
- The GST rates
- Any other matter relating to GST

Every decision of the GST Council taken at a meeting shall be with the consensus of all the members present at the meeting.

GST Dispute Settlement Authority – Article 279B

The Parliament, by law, will provide for the creation of a Goods and Services Tax Dispute Settlement Authority (DSA) which shall adjudicate any dispute or complaint referred to the DSA by the State Government or the Union Government arising out of deviation from any recommendation of the GST Council which results in the loss of revenue to the State Government of the Union Government or affects the harmonised structure of the GST. The DSA shall consist of three members namely, the Chairperson, who has been a Supreme Court Judge or the Chief Justice of a High Court, appointed by the President, recommended by the Chief Justice of India; the remaining members shall be persons who shall have expertise in the field of law, economics or public affairs appointed by the President recommended by the GST Council.

The DSA shall pass suitable orders including interim orders only the Supreme Court shall exercise jurisdiction over such adjudication or dispute or complaint.

Fiscal autonomy issues

Constitutional amendments are required to enable the Centre and the states to impose tax on the same base of goods and services. Currently, the states cannot impose tax on services. They also can not impose tax on manufacturing of goods. Centre cannot levy tax sales tax. States feel that their fiscal autonomy is being eroded for the following reasons:

- they are surrendering the power to tax sales
- they can not change rates according to their fiscal needs
- all states can not have the same rates
- centre may not compensate the states fully

The position of states is rejected on the other points for the following reasons

- centre is also surrendering and sharing its powers regarding service tax and union excise duties
- states are free to tax sin goods like liquor and also the petroleum products

It is said that like VAT, GST would also increase the revenue of the states as they will have powers to impose tax on services, which are growing at a rapid pace. However, in case..... (in the classroom)

Contentious federal issues on GST

GST rates, the division of taxing powers between the Centre and the states, compensation amount; exemptions and on certain design elements of the GST.

Goods and Services Tax (GST): Challenges for implementation

The GST is a necessary condition for a common market to exists, this permits free and unimpeded movement of goods and services across a federation, thus encouraging efficient regional specialization.

Such harmonization will significantly reduce the vertical imbalance between the Centre and the states by enhancing the tax base of the states. It is going to be the biggest ever tax reform in India.

Challenges to address:

- Integration of a large number of Central & State Taxes
- multiplicity of taxes and tax rates to be unified
- federal distribution of powers to levy and collect taxes
- necessary constitutional amendments.
- Rationalisation of thresholds and exemption limits.
- Standardisation of systems and procedures.
- road based computerizations across the Nation.
- Dispute settlement procedure and machinery.
- Training of tax administrators and assessee.
- Protecting and balancing the present and future revenues of the Centre and the States.
- Safeguarding the interests of less developed States with lower revenue potential.
- Taxing ~~of~~ Alcohol, tobacco, petroleum products which ~~are~~ out of the GST regime.

GST and fiscal federalism

Being the largest indirect tax reform requiring the centre and the states to adjust their constitutional taxing powers, GST has opened up fiscal federal challenges like never before. There is mutual surrender of powers to a uniform national taxation system where both gain. But there are apprehensions of loss of fiscal autonomy by states and central dominance as mentioned above.

The Constitutional changes proposed and being debated by the Empowered Committee of State Finance Ministers are likely to bring the federal units together for a new and innovative system of fiscal federal sharing and cooperation.

Technology Advisory Group for Unique Projects (TAGUP)

An effective tax administration and financial governance system calls for creation of IT projects which are reliable, secure and efficient. IT projects like Tax Information Network, New Pension Scheme, National Treasury Management Agency, Expenditure Information Network, Goods and Service Tax, are in different stages of roll out. To look into various technological and systemic issues, Finance Minister announced in the Union Budget 2010-11 to set up a Technology Advisory Group for Unique Projects under the Chairmanship of Shri Nandan Nilekani. It has been set up in mid-2010.

GST and tax efficiency

In the system existing now, the rates, tax imposition and collection are inefficient. Rates are not efficient as they depend on lobbying and there is no transparent basis. Exemptions are also similarly granted. Thus, deployment of labour and land along with capital and enterprise becomes subject to lower returns and waste- GST is expected to lead to efficient allocation of factors of production thus leading to gains in GDP and exports. This would translate into enhanced economic welfare and returns to the factors of production, viz. land, labour and capital. In an earlier taxation system, people paid taxes at various levels. There was no system of getting a rebate on the taxes paid previously while paying the inputs. This is also called as cascading effect. It is irrational as there is tax on tax. Ideally the taxes should be based on value addition and the producer should pay taxes on whatever value he adds to the product. In the absence of such a system, producers ended up paying much higher taxes. Higher taxes are a barrier for business and discourage business activity.

High taxes also lead to lobbying activities where producers of a certain sector ask the government to lower/waiver taxes for their sector. This also leads to multiple taxation rates for multiple products and further increases inefficiency in the system.

Before VAT States had sales taxes with multiple rates. States were often seen in a sales tax war with other states- rate war as it is called . In the war states competed with each other offering lower tax rates to certain industries to set units in their states. This resulted in revenue loss for both the states and investment decisions wre determined by tax rates in states and not other merit factors.

However, the design of VAT system in each state has also been done in a uniform fashion keeping the distinctive state economy in mind.

Tax Reforms in India

Since the beginning of the last decade as a part of the economic reforms programme, the taxation system in the country has been subjected to consistent and comprehensive reform.

The need for the tax reforms arises from the fact that

- tax resources must maximised
- international competitiveness must be imparted to the Indian economy
- transaction costs must be reduced
- the high-cost nature of Indian economy needs to be corrected so that
- compliance increases
- equity improves
- investment flows

On the direct tax front, the reforms are the following:

- Reduction and rationalization of rates- there are only three rates of income tax today with the highest rate at 30%
- Simplification of procedures
- Strengthening of administration
- Widening of the tax base to include more tax payers in the tax net
- Exemptions are gradually being withdrawn.
- MAT was introduced for the `zero tax' companies
- The Direct Tax Code of 2010 is meant to replace the outdated Income Tax Code of 1961

Indirect Taxes

- Reduction in the peak tariff rates- 10% is the peak customs duty today which was more than a 90% reduction since 1991.
- The number of slabs has come down drastically
- There is a progressive change from specific duty to ad valorem tax
- VAT is introduced
- GST is being rolled out
- Negative list of service tax from 2012

Tax expenditure

Tax expenditure refers to revenue forgone as a result of exemptions and concessions (personal, corporate, indirect tax). It was introduced for the first time in 2006-07 Union Budget. The revenue foregone due to tax incentives in 2009-10 is estimated at Rs 5,40,269 crore. Such exemptions have been justified for promoting balanced regional growth; dispersal of industries; neutralisation of disadvantages on account of location; and incentives to priority sectors, including infrastructure. These should be subject to a sunset clause, as tax exemptions often create pressure groups for their perpetuation.

While some may be justified as they enhance investment and generate nmore taxes for the government, others are not.

Such exemptions and concessions can distort resource allocation and stunt productivity. They also result in a multiplicity of rates, legal complexities, classification disputes, litigation etc. If these exemptions are rationalized, they can help the government spend more on social and infrastructure and help reduce the fiscal deficit.

Tax havens and G20

A **tax haven** is a country or territory where certain taxes are levied at a low rate or not at all. Individuals and/or corporate entities can find it attractive to move themselves to areas with reduced or nil taxation levels. This creates a situation of tax competition among governments. Different jurisdictions tend to be havens for different types of taxes, and for different categories of people and/or companies. For example, income tax, wealth tax or corporate tax etc.

The important features of a tax haven arte:

- nil or nominal taxes;
- lack of effective exchange of tax information with foreign tax authorities, that is, personal finance information is not shared with other countries
- no requirement for a substantive local presence; and
- self-promotion as an offshore financial center.

Switzerland, Singapore, the Cayman Islands, Monaco, Luxembourg and Hong Kong are among 45 territories blacklisted by the Organisation for Economic Co-operation and Development and threatened with punitive financial retaliation for their banking secrecy. Among the sanctions being considered by the G20 are the scrapping of tax treaty arrangements, imposing additional taxes on companies that operate in non-compliant countries and tougher disclosure requirements for individuals and businesses that use shelters.

Words

Tax-incidence: It shows the entity on whom tax is imposed. It is different from the tax burden as shown below: if government increases tax on petrol, oil companies may absorb it if competition is intense or they may pass it on to private motorists. Tax incidence here refers is on companies and the burden may be on the consumer.

Tax Burden: It means those who actually pay taxes- from whom tax is collected. Depending on the market forces involved, a tax can be absorbed by the seller or by the buyer (in the form of higher prices), or by a third party like sellers' employees in the form of lower wages.

Tax Base: The value of goods, services and incomes on which tax is imposed. When economists speak of the tax base being broadened, they mean a wider range of goods, services, income, etc. has been made subject to a tax. In the case of income tax, the tax base is taxable income. Some kinds of income are excluded from the definition of taxable income, such as savings. For sales tax, the tax base is the value/volume of items that are subject to tax; essential goods , for example, are not part of the tax base.

Tax rate: It indicates how much tax is due from each source. Some tax systems have high rates but have a narrow base allowing generous deduction of business expenses. Other tax systems have a wide base with few exemptions and lower rates.

Tax Shelters: Any technique which allows one to legally reduce or avoid tax liabilities. It is a way in which the taxpayer can invest his income in a particular kind of investment that gives tax concessions.

Difference between tax avoidance and tax evasion: There are provisions in the law that allows one to save and invest in a manner that leads to reduction in taxable income. If these provisions are used for the benefit, it is called tax avoidance. It is lawful to take all available tax deductions.

Tax evasion, on the other hand, is a punishable offence. Tax evasion typically involves failing to report income, or improperly claiming deductions that are not authorized.

Hidden taxes: are taxes that are concealed in the price of articles that one buys. Hidden taxes are also referred to as implicit taxes. The most well-known form of the hidden tax is the indirect tax. Examples of hidden taxes are import duties.

Proportional, progressive and regressive tax

An important feature of tax systems is whether they are proportional tax (the tax as a percentage of income is constant over all income levels), progressive tax (the tax as a percentage of income rises as income rises), or regressive tax (the tax as a percentage of income falls as income rises). Progressive taxes reduce the tax incidence on people with smaller incomes, as they shift the incidence disproportionately to those with higher incomes.

Specific duty: Weight or quantity or number is the basis for taxation.

Ad Valorem - A Latin term meaning "according to worth," referring to taxes levied on the basis of value. Taxes on real estate and personal property are ad valorem. Luxury goods are taxed higher even if they weigh the same or number the same as ordinary goods.

Compound duties are a combination of value and other factors based on which tax is imposed.

Excise Duty: Excise duty is a tax on manufacture and is levied on the manufacture of goods within the country.

Customs Duty: When goods are imported or exported, customs duty is imposed and collected by the Union Government. Peak customs duty today is 10%.

Negative income tax: Subsidy is a negative income tax. It is a taxation system where income subsidies are given to persons or families that are below the poverty line. The government will send financial aid to a person who files an income tax return reporting an income below a certain level.

Pigovian tax

The Pigovian tax is imposed on bodies that have a negative externality. For example, pollution. Externality means impact of one person's actions on the well being of an outsider (bystander or third party). For example, the seller and consumer of cigarettes together will harm the third person with pollution. Example of negative externality is exhaust fumes from automobiles. Positive externality refers to a good effect on the third party. For example, restoration of historic buildings, research into new technologies. Carbon tax is one example in the context of the need to discourage fossil fuels and encourage renewable sources due to climate change threat.

Octroi: Entry 52 of the State List, VII Schedule, which specifies tax on the entry of goods into a local area is the octroi. Octroi has been a main source of revenue for most of the urban local bodies in India. It is criticized for the fact that it is an obsolete method of tax collection; and involves stoppage of vehicles at the check posts outside the city limits, thereby obstructing a free flow of vehicular traffic; waste of business hours; loss of fuel etc.

Tax Buoyancy: It refers to the percentage change in tax revenue with the growth of national income. That is, growth-based increase in tax collections.

Tax Elasticity: Tax elasticity is defined as the percentage change in tax revenue in response to the change in tax rate and the extension of coverage. Buoyancy, on the other hand is the response to economic growth when the base increases but there is no change in the rate.

Tax Stability: It means no frequent changes and continuity of policy in a predictable and transparent manner. Although revenue from different taxes varies from year to year, revenue stability is desirable because it makes it easier for a government to build a credible spending and borrowing plan for the year ahead. Taxes whose revenue is relatively stable contribute to overall revenue stability. Market players also can plan better.

Tobin tax

James Tobin, an economist, proposed a worldwide tax on all foreign exchange transactions- when foreign capital enters a country and when it leaves. The aim is to check speculative flows. Long term investment – generally FDI, will not suffer as it does not invest for speculative (short term) reasons like FIIs.

Tobin justified the tax on two grounds.

First, it would reduce exchange rate volatility and improve macroeconomic performance.
Second, the tax could bring in revenue to support for development efforts or exchange rate stabilization.

The defining characteristic of a Tobin tax is that the tax is levied twice- once when one acquires foreign exchange, and again when one sells the foreign exchange.

The south East Asian currency crisis (1997) is attributed to the 'dynamics of hot money'(portfolio investments or FII flows).

Tobin tax can be imposed only if all the countries accept the proposition. Otherwise, FIIs can go to countries where the tax is not imposed.

India does not prefer it as we need foreign inflows as we are a CAD country and don't have a surplus.

In the EMU, there is a proposal to see a microtax levied at 0.1% on share and bond transactions, and 0.01% on deals involving complex securities such as derivatives. It is called the Financial Transaction Tax. The FTT, or "Tobin tax" as it is also known is a "Robin Hood tax", - collected from speculators and used for rescuing the financial system when there is such a need. Angele Merkel and Francois Hollande both want it.

India and FTT

Group of 20 saw the European countries like Germany and France propose a tax on their transactions so that fund could be mobilised in order to bail out future bank failures. The idea is to avoid taxing ordinary people. India along with Brazil and other countries opposed it on the following grounds

- Regulation is the remedy
- Banks can pay the tax and not shed their reckless behavior
- It may in fact induce them to be more reckless as there is a ready fund available and bailout is guaranteed
- India has a well regulated banking system and so did not suffer the same fate as the banks in developed economies. The problems of the advanced countries should not be imposed on others
- banks, as private entities, would simply push the added costs onto consumers.

India has a similar tax though not for the same purpose- securities transaction tax (STT)

Minimum Alternative Tax (MAT)

Normally, a company is liable to pay tax on the income computed in accordance with the provisions of the Income Tax Act, but the profit and loss account of the company is prepared as per provisions of the Companies Act. There were large number of companies who show book profits as per their profit and loss account (according to the Companies Act) but do not pay any tax by showing no taxable income as per provisions of the Income Tax act . Although the companies show book profits and may even declare dividends to the shareholders, they do not pay any income tax. These companies are popularly known as Zero Tax companies. In order to bring such companies under the income tax act net, MAT was introduced in 1996. They are required to pay MAT at 18% (2012).

Book profit is Profit which is notional made but not yet realized through a transaction, such as a stock which has risen in value but is still being held. It is also called unrealized gain or unrealized profit or paper gain or paper profit.

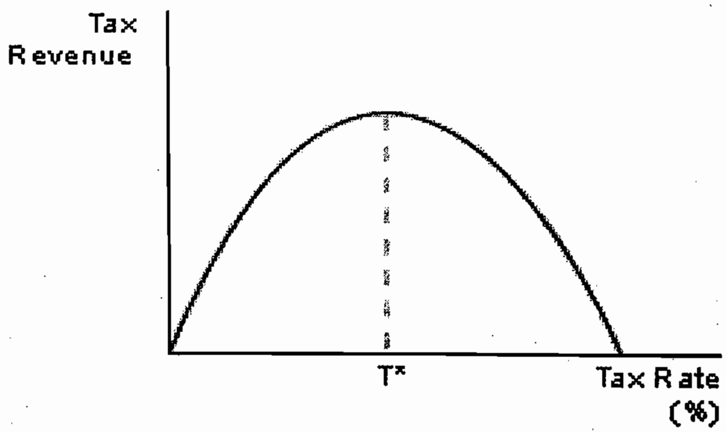
Presumptive Tax

Presumptive Tax the Estimated Income Method of assessment for certain categories of businesses is prevalent in several countries. Presumptive taxation involves the use of indirect means to ascertain tax liability, which differ from the usual rules based on the taxpayer's accounts. The term presumptive is used to indicate that there is a legal presumption that the taxpayer's income is no less than the amount resulting from application of the indirect method.

The reason for the presumptive tax is that in a number of businesses the assessees do not maintain books of accounts or the books of accounts maintained are irregular and incomplete. It was introduced in India in the early nineties for traders but was withdrawn as the success rate was low.

Laffer curve

Developed by Arthur Laffer, this curve shows the relationship between tax rates and tax revenue collected by governments. The chart below shows the Laffer Curve:



The Laffer curve has been debated in the country since 1997-1998 Budget reduced rates and slabs in the income tax regime in the country.

Inverted duty structure

Higher import duty on the raw materials than on the finished product are called inverted duty structure .It puts the domestic manufacturers at a disadvantage making them uncompetitive. For instance, compact fluorescent lamps (CFLs), where the import duty on raw materials for manufacturing CFLs is 9.7 per cent more than on finished bulbs. This skewed duty structure makes domestic CFL manufacturers uncompetitive.

There is no Basic Customs Duty for import of solar cells and modules. However, under the existing duty structure, the inputs (like EVA, Tedlar, Toughened Glass) which go into the manufacturing of solar cells and modules attract duty .This results in an inverted duty structure, which favours the import of the cells / modules and puts the domestic manufacturers to a disadvantage.

Similarly, if rubber is imported at a higher duty than tyre, manufacturing in India is discouraged.

The Economic Survey (2010-11) said FTAs also lead to a new type of inverted duty structure with duties for final products being lower from FTA partners compared to duties for the previous-stage raw materials imported from non-FTA countries. "This acts as a disincentive to local manufacturing which is not competitive against FTA imports because of the inverted duty structure phenomenon," the Survey said.

Import duty on raw silk is more than silk fabric (2013 December)

Dividend Distribution tax

Companies giving dividend have to pay tax on the amount distributed as dividend.

Withholding tax

It means withholding of tax from certain payments including interest, salaries paid to employees, professional fee, payments to contractors etc. It is the same as TDS.

Capital gains tax

It is the tax on the gains made from buying and selling assets like land, shares etc.

If the gain is made in the assets held for over three year (one year for shares) , it is called long term capital gain and taxed. For shares, there is no long term capital gains tax. For short term capital gains (less than one year), it is 15% for shares.

Wealth Tax

When income accumulates into wealth, it gets taxed after a point. Wealth tax is levied only in respect of specified non-productive assets such as residential houses, urban land, jewellery, bullion, motor cars etc.

Securities transaction tax

Introduced in the Union Budget 2004-2005, it is a tax on the value of all the transactions of purchase of securities that take place in a recognised stock exchange of India. It is meant to make up revenue loss from the abolition of long term capital gains tax.

Transfer Pricing

Transfer pricing involves charging for goods supplied to the subsidiary. The international norm in this regard is the `arms length principle' which means that when two related parties deal in goods and services, pricing must be done objectively and commercially. If the principle is not followed, it means losses for the government. For example, an MNC has a subsidiary in India and elsewhere. The corporate tax rates are high in India. Therefore, the price of goods sold by the MNC to the two subsidiaries in the two countries is shown differently- higher in India and less in the other country. In that case, Indian subsidiary shows less profits or more losses and tax liability (corporate tax) is less.

Thus, transfer pricing is generally done in a way as to show high profit in countries where the corporate tax rate is low and low profits/losses where the rate is high. Therefore, transfer pricing norms existing today need to be rationalised so that the tax revenues that are due to the government are not eroded. Tax evasion and money laundering has to be checked by tightening the transfer pricing regime.

The introduction of Advance Pricing Agreement (APA) under Transfer Pricing Regulations in the union budget of year 2012 -13 is positive step to reduce the litigation as it will be based on bilateral understanding between two countries.

According to the memorandum of union budget, Advance Pricing Agreement is an agreement between a taxpayer and a taxing authority on an appropriate transfer pricing methodology for a set of transactions over a fixed period of time in future. The APAs offer better assurance on transfer pricing methods and are conducive in providing certainty and unanimity of approach.

Death tax (in the class)

Rupee is raised and spent like this

For every rupee in government kitty, 29 paise will come from market borrowing in 2012-13.

The government's dependence on debt has gone up from 27 paise in the previous Budget to 29 paise in the coming year, reflecting the pressure on revenue collections.

The net borrowings of the government in 2012-13 are pegged at Rs 4.79 lakh crore against Rs 4.36 lakh crore for the current fiscal.

On the expenditure side, central Plan will account for an outgo of 22 paise, followed by 18 paise of interest payments.

Defence allocation has been maintained at 11 paise. As the single largest source of revenue income, the collection from corporate tax has decreased to 21 paise to 24 paise as a per centage of every rupee earned, indicating the sluggish growth in the industry.

However, with increase in the service tax rate, the government expects revenue collection from service tax and others to go up to 7 paise against 6 paise in 2011-12.

Besides, other indirect tax component excise and customs would earn 21 paise for the government.

Despite tax incentives given to individuals, direct tax contribution has been retained at 9 paise.

With rising crude oil price due to global economic uncertainty, the subsidy burden on the government would go up 10 paisa against 9 paise for the year ending March 2012.

At the same time, other non-plan expenditure is expected to account for 11 paise of every rupee spent by the government in 2012-13, while the states' share of taxes and duties would amount to 17 paise of every rupee earned.

Plan assistance to states and Union Territories has been retained at 7 paise in 2012-13. (Figures to be revised after the General Budget is presented in June 2014).