SRIRAM's IAS

GENERAL STUDIES

Old Rajinder Nagar
General Studies
SRIRAM's IAS
CSAT
GTB Nagar

INDIAN ECONOMY 2022

PART1

महाज्योती
— ज्ञानदीप समतेचा —

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Chapter - 1
Economy and Economics

Introduction

Economy is the social activity where people come together to produce, stock, distribute, trade and facilitate consumption of goods and services. The entire activity is meant for the market, that is, for buying and selling. Goods and services may either be exchanged for other goods and services (barter)—as it used to happen as a practice in primitive economies—or they are exchanged for money, which is the practice adopted by contemporary economies in the world.

Economic growth is the quantitative difference in the production of goods and services between two points of time. If the difference is negative, it is called degrowth.

Economic development, on the other hand, qualifies economic growth with human development terms of education, health, equity, and so on. Economic policy is a government or non-government policy aimed at generating growth and development, among other aims. Government economic policy has many subsets, like fiscal policy, monetary policy, industrial policy, agricultural policy, foreign trade policy, and so on.

Economics: As a Discipline

Economics as an academic discipline studies the economic activity and also strives to make it viable in the face of scarcities. Economics as a term comes from two Greek words oikos meaning family, household, or estate and nomos meaning norm or law. The origin of the term itself is revealing. Be it household or village or a nation-state, the universally acknowledged reality is that people have limitless needs and the available resources to meet the needs are limited. What is the norm at the micro level (household) is true for the macro economy as well at the national or even global level, i.e., scarcity of resources.

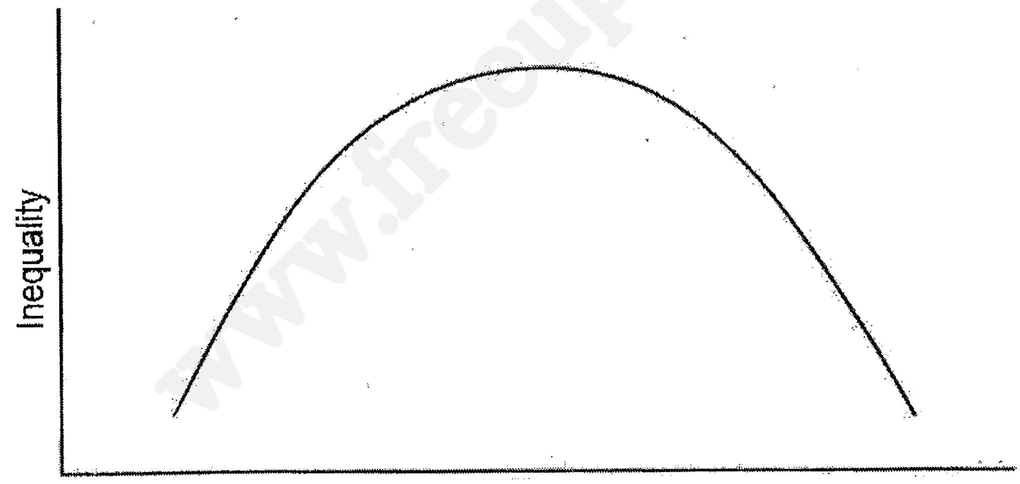
The need for the field of economics as a branch of social science becomes relevant to balance the needs with resources. Study of rational management of scarce resources is the substance of economics. Rationality is choosing the right means for the given end. Since last century, economic rationality which started with the study of production, distribution and consumption, has come to include equity and sustainability as well.

We need to understand economics as a discipline based on scarcity. Take for example, land. It is a scarce resource. India has 15% of the global population but only 2.4% of the global land. Thus, there is huge pressure on land. It is needed for agriculture (food and non- food); manufacturing; forestry; residential purposes, and so on. The task of economics is to arrive at optimal ways of prioritizing the use of such limited resources. Land Acquisition and Rehabilitation and Resettlement Act, 2013 addresses the land claims of farmers, industry and other sections in a balanced manner.

Similarly, water is scarce and is becoming even more so. There are demands for agricultural, industrial, domestic and other uses. How to apportion the existing amount of water among all these users is a public policy challenge tackled in the Draft National Water Policy (NWP, 2012).

Same is the purpose of the food security law. Being a welfare state, Government is committed to it. But there are many operational challenges relating to the quantity of food that can be given at concessional prices, and the methods of distribution and should it be through government outlets by government departments or by Public Private Partnerships (PPP). Besides, the extent of food subsidy is also a critical matter as it impinges on govern- ment finances and influences the market prices. Economics as a field of study draws from experience, within the country and from other countries and advises on such public policy dilemmas.

Initially, economics focused on wealth. That is, initially, what mattered was creation of wealth at any cost. It did not interest economists to be sensitive to the human dimension—



Kuznets Curve

the misery that it produced. Opinion was divided about the human misery that economic growth created. There was hue and cry about children being made to overwork and receive paltry payment for their work; the inhuman conditions of work, the squalor, and so on. At the same time, some justified it on grounds that it gave comparative advantage in trade as it cuts down the cost of production. When there was relative prosperity and government collected enough taxes and democratic dissent grew, welfare became the new concern of the discipline. Kuznets curve shows, in the form of an inverted U, the initial increase in inequality and how inequality reduces with economic growth in industrial democracies.

Tradeoffs

In the study of government policies, from the perspective of economics, there are tradeoffs because scarcity of resources is the basic assumption of the discipline. Tradeoffs involve making choices in policies, wherein there is a compromise on one goal to achieve another goal. It is a way of balancing among desirable goals. Multiple examples can be given. Reserve Bank of India aims at price stability which is the overriding objective of its monetary policy even as some growth is eroded in the process as it involves at times increase in interest rates. Thus, a bit of growth is traded off for price stability. Similarly, government wants to give subsidies to the poor and weak. It may mean more borrowings, and thus some fiscal excess. But poverty is addressed, and thus political stability is gained. Thus, fiscal prudence may be traded off to some extent in pursuit of welfare. Similarly, public investment is crucial, and so is the need to limit government borrowings. Setting the right level of balance between the two involves a tradeoff. Fiscal Responsibility and Budget Management (FRBM) Act laid down 3% of annual central government borrowing, whereby infrastructure investment is facilitated even as government finances are partly strained. In the land acquisition law, compensation for the land owners is increased to balance the interests of the farmers and industrialists. Investment may moderate in the process, but social justice gets addressed. Land is to be acquired for manufacturing and consent of the land owner may be conditionally dispensed within public interest, i.e., the tradeoff.

Opportunity Costs

The concept of tradeoffs is related to opportunity costs. Resources like money or land, for example, can be put to multiple uses. Choices have to be made as to what is the best way to use resources. The choice that is made is in preference over others. Among the competing choices, the best course of action is chosen, and others are discarded. The cost of discarding the second best choice is the opportunity cost. Literally, it is the cost of the second best opportunity that is not chosen. For example, money can be deposited in a bank earning interest or invested in stock market. If the latter is preferred, what is foregone, the interest that the money would have earned in a bank is the opportunity cost. In government finance, the concept is at times relevant. For example, the opportunity cost of government expenditure on health is what it could not spend on education or roads and the yields missed in the process.

There is government land in a city and it can be used in many ways and the work of the economist is to choose among the following:

1. Build hospital or school
2. Build municipal park
3. Give it free of cost to a private investor who will build a hospital or school and provide free services to poor and low income groups
4. Auction it to the highest bidder

Which choice is made depends on many considerations like government's financial position, levels of literacy, need for recreation facilities, etc. Whichever choice is made will have an opportunity cost (as described above.)

Macro, Micro and Mesoeconomics

Macroeconomics deals with the entire economy of a given unit, province, nation or the world itself. For example, variables like the size of the economy in the form of national income, economic growth, inflation, employment, foreign trade, poverty, inequality are the phenomena that characterize the economy as a whole, though with local variations. Micro- economics, on the other hand, studies the units of the economy and the behaviour of consumers, sellers, business firms, etc.

The two belong to the same economic system and influence each other. Interest rates are a macroeconomic feature, but they impact the consumers, traders and firms. Taxes influence prices and thus consumption and investment decisions. Consumer and business confidence depends on the state of economy. Consumer confidence or sentiment is the optimism of the consumer about the economy and their financial position. If they are confident, it is reflected in purchases and sales, and thus economic growth. Similarly, business confidence helps in investment and growth picking up. Thus micro and macro factors feed into each other.

Mesoeconomics studies the intermediate level of economic organization in between the micro and the macroeconomics like study of a sector of economics, like auto, infrastructure may be considered mesoeconomics while the study of each unit may fall under micro.

There are many schools of thought and approaches in the discipline of economics based on essentially the relation between State and markets. Of late, concerns related sustainability, welfare and behaviour are also emerging as centres of theory.
As mentioned above, the study of economic activity called the discipline of economics began with focus on growth which may also be understood as wealth generation. Adam Smith, regarded as the Father of Economics and author of the classic 'An Inquiry into the Nature and Causes of the Wealth of Nations' defined economics in two ways. One corresponds to the title of his book—as the science of wealth. The other definition is a predictable one: the science relating to the laws of production, distribution and exchange. He called economics a science but that is debatable though the urge to make it science is laudable as policy becomes evidence-based and personal biases are drastically reduced.

Initially, the definition in terms of wealth creation was attractive, but later it dawned that it meant that economic growth at any cost in the name of wealth was at the expense of equity and the social groups that could not participate in the market economy were seen as liabilities, for example, women, children and old people. Misery of the weak was taken as a necessary price for economic growth. Such a perspective being unconscionable in democratic terms underwent evolution with 'markets with a human face' opinion gaining ground. There was a demand to balance wealth creation with focus on social and human welfare. Thus, came the shift in the focus to welfare economics, growth should be accompanied by equity. All social groups should benefit from economic growth. It was achieved partly by factory legislation demanding of the employers that they limit work hours and provide just and humane conditions of work. Partly, the fiscal position of the government with tax collections also enabled the emergence of welfare economy. Economics as a study incorporated social justice and not money and goods alone.

As the production process evolved and as more problems cropped up, the discipline expanded bringing within its fold the need to balance growth with human development, environmental sustainability, human happiness and so on as we will see ahead.

Political Economy

We need to understand another approach to the study of economic activity. It is the school of political economy. Its position is that politics and economics need to be studied together to understand why public (government) policy takes a particular direction. For example, land reforms are a political decision for re-distributive justice. But its impact is on economic productivity, investment in agriculture, agriexports, employment and so on. To understand land reforms, we need to under- stand the politics of social and economic justice. Similarly, bank nationalization had costs and benefits. To see why the policy was adopted in 1969 and 1980, the political dimension of financial inclusion, checking con-centration of economic wealth and planned economic development need to be grasped. The two cannot be separated. Equally, the entire economic model based on liberalization, privatization and globalization that became the global norm since 1980's can be understood partly from the political perspective of retreat and demise of communism as a political idea. The de-globalization that started some years after the 2008 global financial and economic crisis that is reflected in protectionism (protecting the domestic economy with high tariff walls on imports) and trade war (nations fighting with higher tariffs to weaken each other) can be understood only as a subject of political economy. The economic consequences of US-China trade tensions are predominantly driven by political preferences of US leader- ship, since 2016. It aims at addressing the anxieties of those who lost in the globalization process, like workers. Thus, it is a political response to popular demands expressed as economic policies.

If we take the example of demonetization that took place in India in 2016, the entire process of choosing to embark on it was a political choice aimed at eliminating black economy and enforcing fiscal laws strictly; while the economy went through so many fundamental effects of it—in banking, fiscal, industrial, agricultural sectors, and the likes.

In China, a political party, Communist Party of China, decides how the economy is to be structured. The priorities and policies of economy drastically altered according to the beliefs and biases of the political party and its leaders. Politics sets the larger framework in which economy operates. Thus, understanding the two as they inter- connect is the substance of political economy studies. While politics sets the values, economists set the prices!

Liberal and Neo-liberal Economics

Liberalism as an economic philosophy is founded on the belief that individuals are rational in the decisions they take in the economic system. Producers make goods and services that are in demand. Consumers spend their money to realize maximum value for it. The rationalities of all the economic actors-producers, traders, consumers and others, add-up to collective and systemic rationality that guides the economy well.

Adam Smith, the 18th century Scottish economist and philosopher and a formidable proponent of laissez-faire economic policies, in his first book, The

Theory of Moral Sentiments, proposed the idea of an invisible hand. Invisible hand means the unintended social benefits and public good produced by individuals acting in their own self interests.

Achievement of the most efficient level of production, consumption and distribution of goods in the society takes place without any wishing it. It secures the welfare of the society. In other words, the self-interest of each when rationally followed becomes the common interest of all.
Based on this premise, Adam Smith said that there is an 'invisible hand' that steers the economy well and so there is no need for State regulation. State should only provide support services like public goods-police, judiciary, essential infrastructure, etc.

With this concept, Adam Smith answered critics of capitalism that it could lead to lack of stability and neglect of welfare.

However, there were many crises in capitalism since then, and also great amount of misery and inequality that the theory of invisible hand may not be able to explain.

The euphoria in markets that is based on the principle of laissez faire (French term that literally means 'Let (people) do (as they choose).' It stands for minimum government controls by way of laws and regulations in economic transactions) did not find justification in decades that followed industrial revolution in the mid-18th century.

Thus, the central premises of liberal school were:
1. Individual economic actors are rational and so state need not regulate their actions by way of too many laws,
2. State should provide only public goods, and thus facilitate economic activity; and
3. Economy should be left to the market forces- Laissez Faire. Liberalism as a philosophy suffers from many infirmities:
   - Rationality of the producer is to maximize profit and if human misery, steep economic inequality and environmental degradation result from it, liberals after Adam Smith had no answer.
   - Market failure also is a relevant issue—market failure is defined as an inefficient distribution of goods and services in the free market which has negative implications for vast pockets of society and geographies.

- Consumer rationality is distorted by lack of reliable information and asymmetric information which is—when one party to an economic transaction possesses greater knowledge than the other party.

While the economies grew initially based on the above philosophy, there was widespread poverty and exclusion created by the economic growth. As a reaction, welfare and socialist schools of economics emerged. However, by the late 20th century, liberalism found renewed favour with the world after all other models of growth showed their inadequacies as we will see ahead. The return of liberalism late last century is known as neo-liberalism (any school of thought that returns after decline is given the prefix, neo).

Neoliberal philosophy did not change much from liberal assumptions and policies. After all, it returned to popularity because its adherence to free market economic model was proved historically right as communist command economy (State commands the economy in its decisions) with state ownership did not yield long-term growth and proved to be antithetical to innovation and entrepreneur- ship. Neoliberals championed as earlier for withdrawal of State from economic activities: globalization, privatization, price deregulation, etc. It is summarized by the saying that government is the best which governs the least.

Margaret Thatcher who was British Prime Minister between 1979–90 privatized many government industries and utilities—steel, railways, air- ways, airports, gas, electricity, telecom and water. Donald Trump, American President, discarding the Obamacare health insurance programme and cutting down the corporate tax rates steeply are two typical examples of neoliberal preferences.
Neo-liberalism is the same as Washington Consensus—the free market approach of the IMF and other institutions. Individualism, competition, economic rationality and efficiency are its basic values.

India's economic reforms since 1991 are largely centred around it.
While supporters of neoliberal school cite the above advantages, critics hold that inclusivity suffers; inequality sharpens; public services will be neglected and even rolled back; education and health, when privatized will harm public interest; environmental degradation could deteriorate as profiteering and 'growth at any cost' may become the motive; and so on.

The economic crisis created by the Covid-19 pandemic in 2020 questioned the premise of the neo-liberal premise that state should retreat from social investments and welfare interventions and leave it to the market. It is the widespread belief even among the liberals that state has an important social role to play in building up human capital.

Keynesian Economics

It essentially believes in the liberal economic principles but distinguishes itself by its prescription of stimulus when the economy slows down relatively or dramatically or stops growing or goes into negative mode of degrowth. The Keynesian solution is known as pump priming the economy which is as follows:

- Government should borrow and spend on infrastructure and other core economic activity that leads to more investment by the private sector and thus public and private sector investment converge to create employment, demand and business. For example, Bharat Mala for national highways and Pradhan Mantri Gram Sadak Yojana (PMGSY).
- The central bank should reduce interest rates and make more money available to consumers and investors and thus create demand and supply.

It is a time tested solution for general macroeconomic slowdown. It was tried successfully across the world, including India, in the aftermath of the global economic crisis and deep recession that lasted for a few years since 2008.

Socialist and Communist Economics

Communist economics is complete ownership of the national economy in government hands, and there is no room for private property. Socialist economics believes that a large part of economic resources should be in government hands so that inequality can be minimized and can give workers greater control of the means of production. It comes in many forms—Nehruvian socialism where there is public and private sector coexisting and complementing called mixed economy. An extreme form of socialist economics is communist control. For example, Soviet economy and China under Mao Zedong (1893–1976).

Nehruvian economics

- It is a subset of socialist economics. It is the thought of Jawaharlal Nehru (1889–1964) who was the first Prime Minister of India. It rests on state-ownership of basic parts of economy, like infrastructure, higher education, metal and other industries, etc., through centralized socio-economic planning. India adopted Nehruvian socialism for a variety of reasons. These are:

- Soviet Russia showed that it could be an expeditious way of achieving equitable growth;
- Nehru personally believed in the values of welfare State and equity;
- Given the historical circumstances in which it emerged, self-reliance in economic growth seemed relevant; and
- India lacked any significant private sector when we became Independent.

Gandhian economics

It is the set of ideas that Mahatma Gandhi (1869–48) propounded for economic management and distribution. It has a unique socialist content. Gandhian socialism is not centered around State policies but are a decentralized growth of economy based on full participation of adult labour and certain moral prescriptions. Mahatma Gandhi questioned the scarcity assumption when he said: 'Earth provides enough to satisfy every man's need but not for every man's greed'.

Gandhian socialism and his economic thought is based on small scale and locally oriented production; using local resources and meeting local needs, so that employment opportunities are made available everywhere and to everyone; promoting the ideal of Sarvodaya: the welfare of all, in contrast to the rich dominating. Gandhian economy aims to boost employment which is very desirable for India where there is abundance of labour. It had no aversion to machinery and welcomes it where it avoids drudgery and reduces monotony, for example, sewing machine. However, it is opposed to labour-displacing technology. It emphasizes dignity of labour, and criticizes the society's contemptuous attitude to manual labour. It insists on everybody doing some 'bread labour': to live by one's own labour to satisfy all one's primary needs both moral and physical, an idea that Gandhi borrowed from Leo Tolstoy and John Ruskin. Another principle of Gandhian economics is trusteeship: while an individual or group of individuals is free to set up an economic enter- prise and even accumulate wealth, their surplus wealth above what is necessary to meet basic needs and investment, should be held as a trust for the welfare of all, particularly of the poorest and most deprived. It thus combines economics of employment-intensive development with ethics of equity, self-reliance (with minimum wants), sustainability, trust and cooperation.

Development Economics

After the World War II, many countries were decolonized. Their economies were distorted by the imperialist countries and there was widespread poverty and no sizeable private sec- tor. Traditional schools of economics did not have answers to them in a manner that combined democratic values with equitable economic growth. These poor countries were the focus of school of development economics. Development economics looked at the policies and institutions that raise per capita income for all. Their concern was not only the challenge of promoting economic growth and structural change (from agriculture to industry to services) but also improving the well-being of the population as a whole through focus on health, education and employment, whether through public or private channels or a blend of the two through public private partnerships. The most prominent contemporary development economists are Nobel laureates Amartya Sen and Joseph Stiglitz and also Jean Dreze and Jeffrey Sachs.

State Capitalism or Beijing Consensus

There are many ways of understanding state capitalism. One is that the State owns large businesses itself and they co-exist with the private sector. It is the simplest model which is also called mixed economy and we find it in India. State capitalism in China is different. This is a form of market economy—capitalism, in which the authoritarian State acts as the dominant economic player, by owning and controlling businesses, and uses markets primarily for political capital. This model of state capitalism is called Beijing Consensus, which is floated as a rival of the Washington Consensus. In the Beijing Consensus, State sets long- term strategic priorities, and pursues them in multi-year plans. It does not follow textbook economics, but sets out its own mix of State, market and redistribution. Its growing global reach is striking. Officially, it is called socialism with Chinese characteristics, but critics call it capitalism with Chinese characteristics.

State capitalism also describes a system in which the state intervenes in the economy to protect and advance the interests of large-scale businesses. For example, the bailouts that the large companies received from the US government after the Lehman crisis in 2008, when their survival was in question.

Mercantilism

Mercantile school advocates that Government should make policies for maximizing net exports because the best way of ensuring a country's prosperity is by promoting exports. It will lead to foreign exchange reserve build up which will have humongous benefits by way of foreign investments, acquisitions, loans that are very commercially attractive, etc. The reserves can be used to manipulate the currency as well to give further advantage to foreign trade. In the last century, mercantilists believed that the country with huge gold reserves could dominate the world. In the present global economic order, it is the accumulation of foreign currency that is the biggest advantage as gold is limited. It dominated European economic thought and policy thought between the 16th and 18th centuries.

There are two models of mercantilism that we see presently. China followed mercantilist policies and shifted global trade balance in its favour by exporting to the whole world by putting up huge economies of scale for global supply since the 1980's. But it did not have to follow import substitution policies that are associated with mercantilism. (Import substitution means using domestically produced goods instead of importing the same.) It needed imports to make its exports. Its single focus was on export-oriented economic growth for which it liberally allowed multinationals into its economy who are encouraged to export. Chinese companies came up in competition and started exporting.

Another example is trade policies followed by US under President Donald Trump. He wants the US trade deficit to be cut with rest of the world. His mercantilism is based on waging trade wars with all major trading partners of the US. It includes imposition of relatively high tariff walls on imports. Re-negotiating long-standing trade agreements, like North American Free Trade Agreement (NAFTA) in favour of the US. Applying bilateral pressure through State dominance to open up markets for American exports is another aspect of it. Also, making the work of multilateral trade body—World Trade Organisation (WTO) difficult by weakening its dispute settlement process. Invocation of national security clauses in an unprecedented manner in the WTO to resort to high import duties. Besides, it involves barring human capital from abroad by tightening the immigration norms.

Behavioural Economics

Behavioural economics is a multidisciplinary study and application that uses findings from various fields of study to understand economic behaviour of people and influence the same. Richard Thaler, who won the Nobel Memorial Prize in Economic Sciences in 2017 challenged the view of rational expectations in economics by writing about anomalies in people's behaviour that could not be explained by standard economic theory. Thaler's ideas led to the creation of behavioural science teams called nudge units to help to motivate and influence people's behaviour by making subtle changes to the context in which they make decisions. Nudges can make a significant difference to micro and macro economy. It can improve savings, make people com- ply with tax laws, help people formalize their businesses, adopt cleanliness (Swachh Bharat); volunteer social work for health or education or traffic management, etc.

The Economic Survey 2019 drew on Nobel Laureate Richard Thaler's behavioural economics theory (nudge economics) to bring in social change through better implementation of schemes, such as Swacch Bharat Mission, Jan Dhan Yojana and Beti Bachao Beti Padhao for gender equality, a healthy India, savings, tax compliance, subsidy enjoyment and credit discipline.

Green Economics

Economic growth was accompanied by environmental costs in the form of pollution of air, water and land at a rate that threatened human and social well-being. It made economic growth itself unsustainable as it depleted natural resources and caused productivity losses. The school of economics that alerts us about sustainability issues and advocates harmonious interaction between humans and nature and attempts to reconcile the two is the school of green economics. Examples are in agriculture (Green revolution in India that degraded land by overdrawing water from underground); irrigation where the improper mix of small and big dams led to environmental degradation by cutting of forests; industrial development driven by fossil fuels that cause climate change, and so on. Thomas Malthus's An Essay on the Principle of Population (1798) was the earliest such warning. Limits to Growth report in 1972 commissioned by the Club of Rome alerted us to the threat of unsustainability. Our Common Future, published by the UN's World Commission on Environment and Develop- ment (1987) popularly known as Brundtland Commission, as it was headed by Gro Harlem Brundtland defined sustainable development as development that meets the needs of the present without compromising the ability of future generations to meet their own needs. That is, sustainable development is inter-generational equity. William Nordhaus was one of the laureates of the 2018 Nobel Memorial Prize in Economic Sciences for integrating climate change into long-run macroeconomic analysis.

Green economics advocates a triple bottom line—sustaining and advancing economic, environmental and social well-being. New indices of measuring growth have been developed to promote green economy—Green GDP, Social Progress Index and Environmental Performance Index (EPI) are some examples. Millennium Development Goals (MDGs) and Sustainable Development Goals (SDGs) also advocate green economics.

Chapter - 2
Economic Growth and its Measures

Introduction

There are formidable benefits of economic growth. The first benefit of economic growth is wealth creation. It helps create jobs, increase income and ensures an increase in the standard of living. The government has more tax revenues—fiscal dividend, which the government can use to finance capital formation and welfare. For example, the flagship programmes of the government such as the Pradhan Mantri Awas Yojana–Gramin (PMAY-G), Pradhan Mantri Ujjwala Yojana (PMUY), Deen Dayal Upadhyaya Gram Jyoti Yojana (DDUGJY), Pradhan Mantri Gram Sadak Yojana (PMGSY), Ayushman Bharat, and Saubhagya are a direct result of the tax buoyancy of growth. It sets up the positive spiral: rising demand encourages investment in new capital machinery, which helps accelerate economic growth and create more employment.

The side effects are inequalities, environmental degradation, mental stress, and so on. GDP is defined as the total market value of all final goods and services produced within the country in a given period of time, usually a calendar or financial year or a fraction, like a quarter.

Business Cycles: Slowdown, Recession, Great Recession and Depression

Economic growth is cyclical. There are periods of expansion and stagnation or decline and growth resumes. This is built into the nature of a nation's economy, where a boom is followed by a bust. In a boom, more is produced due to the economies of scale, which makes supplies cheaper when produced in bulk. Their sales take time, and thus there is a slowdown. Factors not inherent to the growth process can also cause such slowdowns. It may happen that commodity prices could rise, causing inflation that can reduce demand, and so there is a slowdown. Banking crisis—bad loans and non-recovery—can take place when economic expansion comes to a halt. Alternating periods of growth and slowdown in economic activity is called a business cycle. When a slowdown leads to negative growth, it is called recession or degrowth.

When an economy slows down to a level where it starts to produce less than what it produced, it is in a recession. It may be called contraction or degrowth. Macroeconomic indicators, such as investment, consumption, employment, prices, capacity utilization, profits of companies, government tax revenues, show a downward negative trend. Technically, recession occurs when in two successive quarters economic production is less than the same two quarters in the previous year. Recession may be caused by various events, such as a financial crisis (2008), an external trade shock where prices of commodities shoot up, for example, oil or physical supplies crash, like, foodgrain production fall due to successive droughts. Rarely, a pandemic can cause a global recession as Covid-19 did starting in 2020.

Governments usually respond to recessions by adopting expansionary macroeconomic policies, such as increasing money supply through the monetary authority, increasing government spending and decreasing taxation. A recession may end with corrective measures taken by the government and the market. If it does not end and relapses for any reason, due to external or internal shocks or the inability of the government to invest to lift the economy out of recession, it is called a double-dip recession. When recession worsens, degrowth deepens with more job losses and even greater deflation, and it is called a great recession as in 2008 global financial crisis. When it worsens, it can become depression as in Greece in 2012 and some countries in 2020 due to Covid-19.

Great recession lasted in the world for some years after the Lehman crisis of 2008. If a great recession is not corrected and becomes worse with a contraction of the GDP by approximately 10 per cent after the recession sets in, it is called a depression.

Measuring Economic Growth

Economic growth is the change—increase or decrease—in the value of goods and services produced by an economy. It needs to be measured as government and private sector decisions and policies need a base for their actions. All important aspects of an economy are linked to growth—tax collections, interest rates, inflation and its expectations, employment, foreign trade, and so on. Without measuring growth, there can be no rationality in institutional or individual behaviour. Investment decisions depend on growth and inflation rate, to give one example. That is the reason for the Central Statistics Office (CSO) of India to project growth figures weeks before the Union Budget is presented, facilitating rational projection of revenues and expenditure, which in turn influences private-sector decisions.

We need to measure economic growth since:

- When growth is quantified, we can understand whether it is adequate or not for the given goals of the economy. We can understand its potential and accordingly set targets.

- We can adjust growth rates for their sustainability.
- We can prevent inflation or deflation to some extent if we see the performance of the economy in quantitative terms.
- We can balance the contributions of the three sectors of the economy and steer the direction of growth towards national goals, away from agriculture to manufacturing, as in the case of India in recent years.
- We can target appropriate levels of employment creation and poverty alleviation.
- We can forecast tax revenues for governmental objectives.
- Corporates can plan their business investments.

Unless economic growth is measured, growth rates cannot be calculated. In the absence of such data, economic rationality—both investment and consumption—diminishes. The US economy in the Great Depression (1929–39) could end only when the data were available. The economist Simon Kuznets gave the notion of National Income in the 1930s to capture all economic production in the country. It is popularly known as Gross Domestic Product (GDP) and its variant, Gross National Product (GNP). The rules and methods that are used to capture economic growth data and conclude relevant statistics are known as national income accounting.

Gross Domestic Product (GDP) and Gross National Product (GNP)

While GDP includes the production within a country by all producers—citizens as well as foreign multinational corporations—GNP captures all that is produced by the citizens of a country, whether within the geography of the country or abroad. In other words, GDP is a geography-related concept, while GNP is citizen related. GDP focuses on where the output is produced, while GNP shows who produced it. GNP is GDP plus the net factor income from abroad. That is, from the domestic product, we need to deduct what foreigners have produced in the country and to that amount we need to add what citizens have produced outside the country.

In a highly globalized and competitive economy, where many of its MNCs are operating in other countries, the GNP tends to be greater. The perfect example of this is Japan.

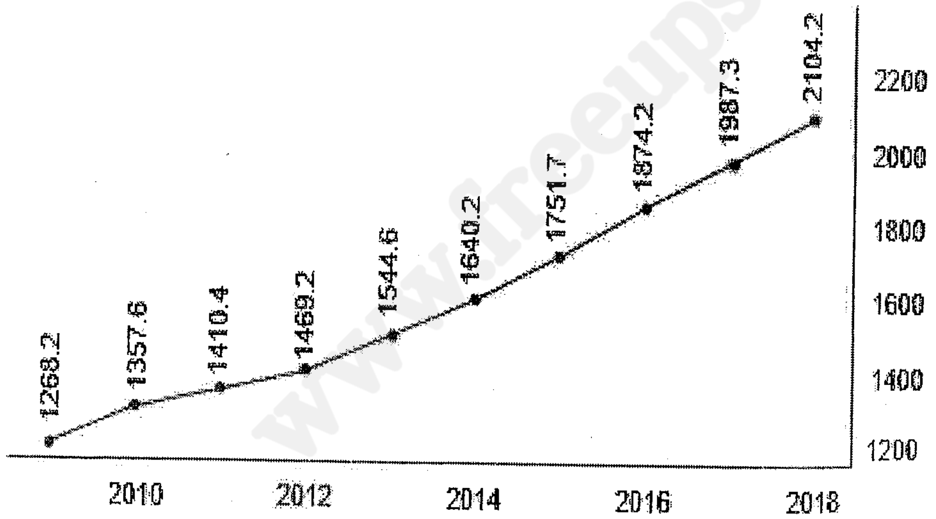
In the age of MNCs and globalization, one country's GDP is another country's GNP. For example, in the case of a Germany-owned car factory operating in the US, the profits from the factory would be counted as part of German GNP and US GDP.

China's GDP was much more than its GNP until the last decade, as many foreign MNCs were operating in China. However, with China's Belt and Road Initiative gaining ground, the nation's GNP is catching up with its GDP. If MNCs relocate out of China due to the trade tensions with the US, its GDP will diminish even more relative to its GNP.

In a closed economy, GDP is relatively greater, as for example in India, till it opened up in 1991. For most countries, however, the GDP and GNP have more or less the same value.

Take the case of Ireland. Its GNP is much larger than its GDP. In Ireland, Google, Apple, Microsoft, Accenture and such other multinational corporations are headquartered due to the tax advantage they get as corporate tax rates are very low. They only have registered offices in Ireland and no production activity. The higher GNP value, however, is illusory as these companies are in reality non-Irish. Ireland is a tax haven, thus attracting companies to register there rather than giving them the ecosystem for production and innovation as China did since the 1980s.

India's GDP is a little more than its GNP as inbound Foreign Direct Investment (FDI) is many times that of the outbound FDI—Indian MNCs produce far less in foreign countries than what foreign MNCs produce in India. There are remittances from abroad sent by Indians working across the world and it amounted to about US $69 billion in 2017, but that is outnumbered by the outflows on a variety of accounts, such as interest payments, royalty on technology, and so on.



Source: World Bank

GDP vs GNP

Analysts tend to say that GDP is a better measure than GNP. The reason is that GDP is domestic production, where employment is created, inflation is moderated, tax revenues are yielded, where exports help in foreign exchange reserve build-up, and so on.

GNP also has its advantages, and India is a big beneficiary of it, including remittances from abroad, acquisition of foreign companies, investments abroad to tap on foreign opportunities, and so on. However, the consensus is that the former is of greater value than the latter for the reasons cited.

	Sector	GVA in 2018–19 (Rupees in Crore)			
		Constant prices	Share (%)	Current prices	Share (%)
1	Primary Sector	2,228,008	17.39 %	3,149,734	18.57 %
1.1	Agriculture, forestry and fishing	1,842,873	14.39 %	2,692,433	15.87 %
1.2	Mining and quarrying	385,135	3.01 %	457,301	2.70 %
2	Secondary Sector	3,644,647	28.45 %	4,585,286	27.03 %
2.1	Manufacturing	2,346,216	18.32 %	2,853,986	16.83 %
2.2	Electricity, gas, water supply and other utility services	287,109	2.24 %	452,683	2.67 %
2.3	Construction	1,011,322	7.90 %	1,278,617	7.54 %
3	Tertiary Sector	6,936,122	54.15 %	9,226,346	54.40 %
3.1	Trade, hotels, transport, communication and services related to broadcasting	2,467,622	19.27 %	3,157,709	18.62 %
3.2	Financial, real estate and prof services	2,775,970	21.67 %	3,555,780	20.96 %
3.3	Public Administration, defence and other services	1,692,530	13.21 %	2,512,857	14.82 %
	GVA at basic prices	12,808,778	100.00 %	16,961,365	100.00 %

Source: GOI

Gross Value Added (GVA)

Gross Value Added (GVA) is GDP minus indirect taxes. It gives a more truthful measure of the economic product and the rate of growth as indirect tax collected on a commodity is in no way a contribution to the growth of the economy. A commodity price is known as basic price once its indirect taxes are deducted from its market price. When the basic prices of all goods and services produced are added up, it gives the Gross Value Added (GVA).

GVA helps us determine the GDP–tax link. If the GDP growth is not the same as the GVA, the discrepancy is caused by tax buoyancy. If the output grows and the tax buoyancy is not commensurate, it may mean one of the following or both: the non-taxed part of the GDP is growing (agriculture, for example) or there is tax evasion.

Year	Annual Growth Rate
2018–2019	6.81
2017–2018	7.17
2016–2017	8.17
2015–2016	8.00
2014–2015	7.41
2013–2014	6.39
2012–2013	5.46
2011–2012	5.24
2010–2011	8.50
2009–2010	7.86
2008–2009	3.09
2007–2008	7.66
2006–2007	8.06
2005–2006	7.92

Source: GOI

Estimating GDP

There are three different ways of calculating GDP.

- The output approach adds the market value of final goods and services.
- The expenditure approach adds consumption, investment, government expenditure and net exports (exports minus imports).
- The income approach adds what factors earn, like wages, profits, rents and so on.

The three methods must yield the same results because the total expenditures on goods and services (GSE) must by definition be equal to the value of the goods and services produced (GNP), which must be equal to the total income paid to the factors that produced these goods and services. In reality, there will be minor differences in the results obtained from the various methods. This is because some goods in the inventory have been produced (and therefore included in GDP) but not yet sold. Also, payments may not have been made, that is, the interest on loans, and salaries or rents have not been paid. So, the value of goods and services produced is arrived at, but it does not match the income or expenditure as the case may be. Inventory is a detailed list of all the items in stock.

GDP considers only marketed goods. If a cleaner is hired, his pay is included in the GDP. If one does the work himself, it does not add to the GDP. Thus, much

of the work done by women at home, such as taking care of the children or the aged, daily chores, and so on, which is called care economy, is outside the GDP. In estimating GDP, only final goods and services are considered. Inputs and inter- mediates are not counted as they are part of the final value. Prices of intermediate goods included in the calculation of GDP would lead to double counting for example, the value of tyres would be counted once when they are sold to the car manufacturer and again when the car is sold to the consumer. It artificially inflates the value of production.
Some goods are used both as inputs and also as final goods. Car tyres sold to a car manufacturer are intermediate (input) goods. The same tyres, if sold to a consumer, would be a final good.

In calculating GDP, only newly produced goods are counted. Transactions in existing goods, such as second-hand cars and houses, are not included, as these do not involve the production of new goods. However, in resale, services provided by the agents are counted. That is, the commission that the auto or the real estate agent charges; and the indirect taxes on it are added to the GDP.
There are imputed values of GDP. All houses are assumed to be rented as it is not possible for the government to check which is owner-occupied and which is not. Thus, the rental value of all houses is a part of GDP. It is called imputation.

Final goods are goods that are either consumed or used in the production of another good or service. For example, a car sold to a consumer is a final good, and so is a car that is used as a cab. The former is consumption and the latter is investment.

Transfer Payments

Transfer payments are a one-way payment of money for which no good or service is received in exchange. Governments use such payments as means of income redistribution (universal basic income) under social welfare programs, such as social security, old age or disability pensions, student grants, unemployment compensation, and so on. There is a need to differentiate them from subsidies. Transfer payments are a part of personal income. Subsidies paid to exporters, farmers, manufacturers are not considered transfer payments because they are linked to a commodity transaction.

Transfer payments may be conditional cash transfers or unconditional cash transfers (universal basic income). Under the Indira Gandhi Matritva Sahyog Yojana (IGMSY), GOI provides financial aid to pregnant women who undergo institutional delivery in hospitals. The aid is also meant to help with the child's vaccination as well as nutritional food. The money is directly transferred to the bank accounts of pregnant women. The scheme is aimed at encouraging institutional deliveries in order to reduce maternal as well as infant mortality. IGMSY is a transfer payment, and it is a conditional cash transfer.

Pradhan Mantri Ujjwala Yojana helps select beneficiaries access stoves free and LPG cylinders at a subsidized price. It is a subsidy and not a transfer.

Rythu Bandhu scheme (Farmers' Investment Support Scheme, FISS) is a welfare pro- gram to support farmers' investment for two crops a year by the Government of Telangana. The government provides farmers a certain amount per acre per season to support the farm investment for rabi and kharif seasons. It is transfer payment. Similarly, PM–Kisan disbursements are not a part of the government expenditure under the GDP calculations.

Universal basic income (UBI) that the government gives is a one-way transfer and is not a payment involving purchase. Therefore, such expenditure is not included in the GDP.

Factors of Production

Economic production is essentially value addition: inputs are added to add value to produced goods and services. Inputs are called factors of production or resources. The four factors of production are as follows:

- Land
- Labour
- Capital
- Enterprise

The first three are brought together to produce a commodity with the fourth one. There are two types of factors—primary and secondary. Primary factors are land, labour (the capacity to work) and capital goods. Materials and energy (fuel) are secondary factors, as they are produced from land, labour and capital. Land includes not only the site of production but natural resources above or below the soil.

Capital has many forms: physical, technological, financial, human (experience, knowledge and skills), intellectual, social (networks of relationships necessary for cooperative work for production of value) and even civic (citizens working together for facilitating rule of law, right to business, good governance which are crucial for economic growth).

Market Price and Factor Cost

Market price refers to the actual transacted price, and it includes indirect taxes, which are Goods and Services Tax (GST), custom duty, and so on.

Factor costs are the actual production costs at which goods and services are produced by the firms and industries in an economy. They are the costs of all the factors of production, such as land, labour and capital. This means the rent of the land along with the cost of resources that the land supports, the interest on the capital that is used to buy various inputs, and labour which has to be paid wages. Factor cost refers to the price arrived at after deducting indirect taxes from the market price and adding to the resulting number of government subsidies, if any.

MP (market price) = FC (factor cost) + indirect taxes – subsidies

If the market price is `100, Indirect taxes are `18, Subsidies are `8, the factor cost will be

100 – 18 + 8 = `90

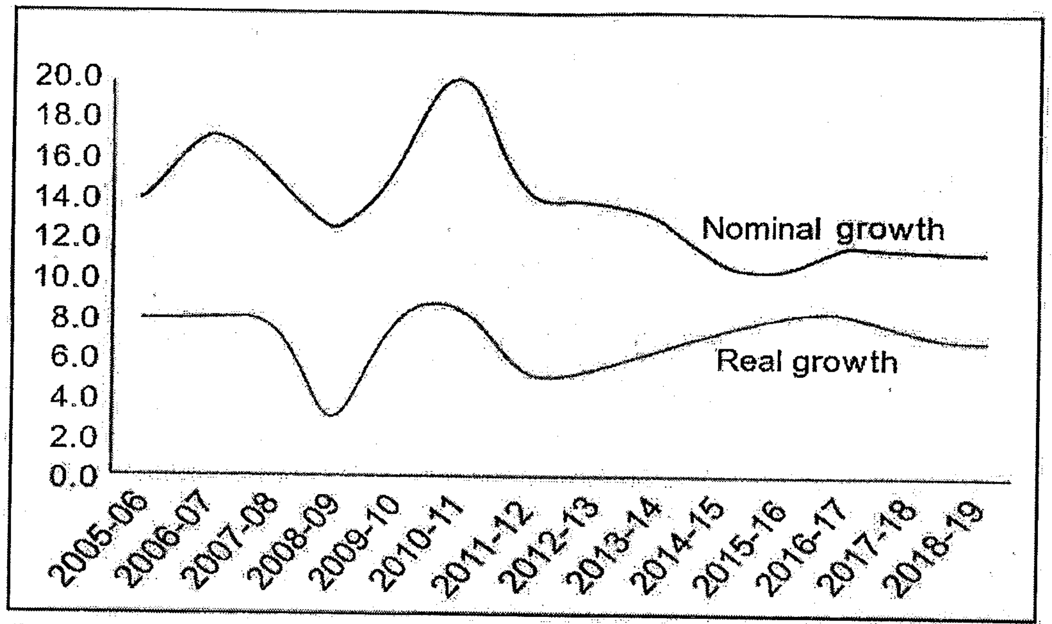
The concept of GDP at factor cost is useful to see how competitive market forces and distortionary indirect taxes are. If there is a high productivity of factors, there is no need to subsidize. The differentiation helps public policy to rationalize both indirect taxes and subsidies.

GDP and NDP

GDP is a gross value. In the production of goods and services, the productive machinery and infrastructure undergo wear and tear. Monetary value can be attached to such depreciation. If the depreciation is removed from the GDP, what we get is the Net Domestic Product (NDP).

Real and Nominal GDP

GDP can be real or nominal. Nominal GDP is a GDP without adjusting for inflation. For example, even if the amount of production is the same as last year, the market value of GDP can vary depending on inflation or deflation—the former increases market value, while the latter decreases. Real GDP refers to the current year production of goods and service valued at prices of the year of comparison. Thus, current production valued at, let's say, previous year prices gives real production. The rest is price difference. Unless we know the real production, there can be a statistical illusion due to inflation that can distort decision making.



Data Source: Central Statistics Office

GDP Deflator

Arriving at real from nominal involves the use of deflator. It helps take out the contribution of inflation to the value of the output. GDP deflator is a price index. When we value the current production at base year prices or prices of any other year for comparison, price changes are captured. For example, if 10 apples made up the GDP last year/base year, and the market value was `10, and the current year's GDP is valued at `15, it does not automatically mean that in the current year 15 apples are produced. The number may be anything—1 apple or more. In order to arrive at the number of apples produced in the current year, we have to find out the price change from the previous year. If prices are constant, the number of apples produced is 15. If there is inflation, it is fewer, and if there is deflation, it is greater.

So, as per a GDP deflator, if we produced only 10 apples in the current year also, then inflation is 50 per cent on a base of `10, which is the value of the GDP last year/base year. GDP deflator shows it as 50 per cent.

It is called deflator because it takes the value of the current year and compares it to the last year/ base year and thus, we generally go from high to low prices. It is deflation from the current to the previous/base year and inflation from previous/base year to current year. The value is the same. The terms are different for the reasons mentioned above.

When GDP deflator is in the negative, nominal GDP is less than real GDP. It means there is deflation in the country.

A change in prices can distort the perception of actual gross domestic product even without an increase or decrease in the quantity of goods and services produced by an economy. Therefore, the impact of prices has to be removed to arrive at a true measure of economic growth.

GDP deflator is a price index. It covers the whole economy unlike any other price index that is confined to a basket of goods as in Wholesale Price Index (WPI) and Consumer Price Index (CPI). It is infered from the national income data of two comparable periods. It is available with a long lag and hence has very limited use for public policy.

National Income

National Income is calculated by deducting indirect taxes from the Net National Product (NNP) and adding subsidies. National Income (NI) is the NNP at factor cost.
NI = NNP – Indirect Taxes + Subsidies

Base Year

For economic growth to be measured by comparison, there has to be a starting point in time. It is called the base year. All the organized commercial production in that year make up the GDP, and based on that number, measurement of growth is made in subsequent years in percentage terms. For example, if GDP is worth 100 rupees in the base year 2011–12, and in the next year (2012–13) the value was 108, the rate of nominal growth is 8 per cent. The same goods and services are considered as the output in both the years. If there are new goods produced in the later years after the base year is fixed, those goods are not included in the GDP figures and are not considered for comparison. That is a limitation while measuring growth from one point to another.

Current and Constant

Base year prices are considered constant as they make up the base for comparison of two or more figures. It is allocated at the value of 100 in an index. The market value of the current year GDP for the given output is the current value. When it is valued at base year prices (constant prices), real growth rate is arrived at. It gives the real output (base year prices), which is different from the nominal output (current prices). In this process, the increase in the value of the GDP due to inflation is excluded and the real increase of goods and services is found.

National income series includes growth figures of all the years having the same base year. The base year of national accounts is changed periodically to add the new goods and services in the economy, and thus to depict a true picture of economic production and growth. For example, software, smartphones, etc., are of recent origin, and if the base year remained in the 1990s, the same would be not tracked. Thus, the numbers do not give a true picture of growth and its related concepts like employment. Similarly, when we continue to measure the goods and services that are no longer in production as they were, for exam- ple, jute, typewriters, etc, we see the decline as fall of production, while in reality they are replaced by new products. Therefore, the base year needs to be brought closer to the current year. The National Statistical Commission recommends that the base year should be revised every five years.

The criteria based on which a base year is chosen are:

- It should be as close as possible to the current year.
- At the same time, the data should be available on a reliable basis.
- It should not be an exceptional year with large fluctuations due to any one-off events, like demonetization, war, severe drought, and so on.

Seasonality

When we measure and compare economic growth, similar periods need to be compared. When we say that economic growth in a certain quarter of the year is 5 per cent, it means that on the base provided by the same quarter in the previous year, there is a 5 per cent growth. It is called seasonality; in very simple terms, the same seasons should be com- pared. Seasonal adjustment ensures that the movements in GDP, or any other feature, like inflation, employment, foreign financial inflows, more accurately reflect true patterns in economic activity.

National output is seasonally determined. For example, in the quarter October–December, there are many festivals like Dussehra, Diwali, Christmas, etc., and so there is more production and purchase. Also, kharif crop comes into the market. October–December quarter in any given year has these important events, and so is comparable. If we compare the July–September quarter of the current year with same quarters in the previous years, it yields actionable results, since the southwest monsoons begin in June and continues for 2–3 months, impacting construction activities.

Potential GDP

Potential output is what the economy can produce without destabilizing the macroeconomic fundamentals like inflation, interest rates, fiscal deficit and so on. It is the optimum production that can be achieved over the long term. The actual GDP is what is produced, and the difference between potential output and actual output is referred to as output gap or GDP gap. It indicates the policies that need to be followed, either to accelerate or decelerate the growth rate.

Sustainability is crucial in deciding on potential output. Sustainability is in terms of prices, fiscal deficit, current account deficit (exports cannot be boosted by devaluing the exchange rate as it can be dysfunctional), financial sector not accumulating Non- Performing Assets (NPAs), etc.

Potential output is what an economy can achieve by way of growth in a durable way. It means, it is not a level of growth that is achieved by short-term measures like incurring high fiscal deficit; import liberalization for consumption, reduction of interest rate to encourage consumption. Such potential for growth is short term and so is not accepted for public policy normally.

If the actual GDP rises and stays above potential output, it is called positive gap. It is inflationary, as demand exceeds supply due to an excess of money that may once again be due to fiscal excess or reduction in interest rate. In the opposite set of conditions, if actual GDP is below potential GDP, called negative gap, the inflation will come down. Employment implications are that when the gap is positive, there will be full employment (all those looking for work find work) and, in fact, productivity will also rise. Ideally, potential GDP is not to be exceeded for the reasons given above. Towards this objective, the government's fiscal policy and Reserve Bank of India's (RBI) monetary policy are suitably used.

Potential output in the long run depends on a variety of factors, such as infrastructure, human capital and skills, potential labour force (which depends on demographic factors), level of technological development and labour productivity. The limits thus relate to natural and institutional factors.

Per Capita Income

GDP/GNP divided by mid-year population of the corresponding year. Per capita income is shown as an indicator of how rich or poor the country is, its standard of living and so on. However, like all averages, per capita income is indicative of the prosperity of a country to a limited degree, as there can be steep inequality, which is often the case in a majority of countries.

GDP: Limitations in Coverage

The measurement of national income encounters many coverage issues, as the following:

- The GDP does not capture black money, which may be generated by two means: illegal activities like smuggling and also by unreported incomes due to tax evasion. Thus, parallel economy poses a serious hurdle to accurate GDP estimations.
- In the rural economy, a considerable portion of transactions occurs as barter economy. The GDP does not cover it.
- Quite a large portion of the economy is in the informal sector—small and marginal farmers, landless labourers, vegetable vendors, domestic help, and so on. These are outside official GDP estimates.
- The national income accounts do not include care economy—domestic work and housekeeping.
- Social Services, such as voluntary and charitable work, are ignored as they are unpaid.

GDP: Limitations Due to Quality of Data

GDP data does not capture the following qualitative data:

1. Environmental costs. National income calculations are not useful to see whether the output causes pollution or not. What matters is the output and its market value.
2. Poverty is not revealed. In a rich country, the illusion is created that everyone enjoys a high standard of living.
3. Inequality is not indicated.
4. Health and education standards escape calculation in the GDP figures, except as a sectoral estimate.

GDP: A Measure of Growth and not Progress

GDP indicates growth that is quantitative. Development, progress and well-being, on the other hand, factor in the qualitative aspects of growth as we shall see ahead. Seen thus, GDP shows broad national economic growth in output. Simon Kuznets, who pioneered the notion of national income and GDP, did not offer this benchmark as a measure of welfare but only as a way to quantify, monetize and compare.

Growth, it must be stressed, is a precondition for welfare. Countries with higher GDP often score highly on measures of welfare, such as life expectancy.

However, even in such developed countries, GDP cannot be cited as a measure of progress because it does not value intangibles such as leisure and quality of life, which is determined by many criteria other than economic goods like relationships, lack of stress, good mental health, quality–gender relations, clean environment, culture, etc.

Even while the above limitations exist in GDP methods, the reasons for using GDP as an indicator of advancement of the economy and standard of living are that it is measured frequently, widely and consistently. It can be undertaken relatively conveniently, and global comparisons are feasible.

National Income Statistics in India

The Central Statistical Office (CSO) of the Ministry of Statistics and Programme Implementation (MoSPI) is responsible for the compilation of National Accounts Statistics (NAS). At the state level, State Directorates of Economics and Statistics (DESs) have the responsibility of compiling their State Domestic Product and other aggregates. The statistics that are released by the CSO and the State DESs relate to various macro-economic aggregates of the Indian economy at current and constant prices, which include gross and net domestic product, consumption, saving, capital formation, public sector transactions, per capita income, etc. The CSO releases both annual and quarterly GDP estimates. Since 2015, in the new national income series, the data relate to GVA too.

The first official estimates of national income were prepared by the Central Statistical Office (CSO) with base year 1948–49. These estimates were published in 1956. Since then, the base years changed as Indian economy grew to make new goods and services. In 2015, CSO changed the base year to 2011–12. Normally, when the base year of national accounts statistics is changed, there is some change in the levels of GDP estimates due to the widening of coverage as new commodities produced in the economy are considered, some informal economy becomes formal as the enterprises grow, and also because of more sophisticated methods of data collection. The CSO revises the base year of the NAS series periodically.

The first estimates of growth for the current year, called Advance Estimates (AE) of National Income, are released before the fiscal year is over, sometime in January, so that the budget figures can be projected rationally for the upcoming fiscal year. The advance estimates are subsequently revised and released as Quick Estimates of NAS after the full fiscal year is completed. But they are still not fully validated. Quick Estimates are further revised to Provisional Estimates and the last figures are the Final Estimates. The improvization is based on the availability of data in course of time. Final estimates arrive years after the quick estimates.

New Institutional Framework for National Statistics 2019

National Statistical Office (NSO)

MOSPI, Ministry of Statistics and Programme Implementation merged the Central Statistics Office (CSO) and the National Sample Survey Off ice (NSSO) into National Statistical Office (NSO) in order to bring in more synergy. It is headed by the Chief Statistician of India (CSI). The CSO brings out macroeconomic data, such as economic (GDP) growth data, industrial production and inflation. The NSSO conducts large- scale surveys and brings out reports on health, education, household expenditure and other social and economic indicators.

National Statistical Commission (NSC) oversees statistical works in India. The government had set up the NSC in 2006 on the recommendations of the Rangarajan Commission, which reviewed the Indian Statistical System.

The NSC's mandate is to evolve policies, priorities and standards in statistical matters. The NSC has four Members and a Chairperson, each with specializations and experience in specified statistical fields. Be it census or other data, public policy needs genuine data for its formulation and effectiveness. Growth, prices, employment, exports, human development, gender parity, etc., all need standard data.

New GDP Series 2015

The Central Statistics Office (CSO) came out with a new series of national accounts with 2011–12 as base year for computing the size of the economy and economic growth rate. It has the effect of broadening the coverage across segments, including farm, corporate and unorganized. Under the new series, the data for corporate income is collated from the corporate affairs min- istry's MCA21 records, a comprehensive compendium that allows the collection of granular information even from the level of the small firms. In the earlier series, such data were taken primarily from the Reserve Bank of India's study on companies and finances.

On the basis of new data available by 2015, it came to be known that the 2004–05 GDP data was underestimating industrial growth, as the coverage was low and the weights were misallocated. Under the new GDP series, the share of manufacturing increased to 15.8 per cent from 11.9 per cent in 2004–05. The share of agriculture has increased marginally in the new series to 17.2 per cent from 16.8 per cent.

Nominal GDP or GDP at current prices in the year 2018–19 is estimated at `190.10 lakh crore, with growth rate of 11.20 per cent. The real GDP at constant (2011–12) prices in the year 2018–19 is estimated at `140.78 lakh crore. At constant prices, GVA (Gross Value Added) is estimated at `129.07 lakh crore. At current prices, it is `172.00 lakh crore.

India contributes 3.17 per cent of the world's total GDP on exchange rate basis. The country's per capita income is estimated to have risen by 10 per cent to `10,534 a month in 2018–2019.

GDP Back Series

The new GDP series was announced in 2015 with 2011–12 as the base year. GOI announced new GDP data from 2012–13 onwards. Since then, all GDP data, whether quarterly or annual, have been based on the new series. This new series is globally more comparable as it takes into account a far greater representation of the Indian economy and is more reflective of the real state of the Indian economy.

The Debate About GDP Growth Rate

A new study by the former Chief Economic Adviser Arvind Subramanian says the economic expansion was overestimated between 2011 and 2017. It did not grow at about 7 per cent a year in that period as claimed. The growth was about 4.5. The former CEA's analysis has been based upon 17 key economic indicators for the period 2001–02 to 2017–18 that are intimately related to economic growth. For example, growth in real credit to industry collapsed, real exports fell and real imports slowed, to mention some indicators that did not go well with the claims of 7 per cent growth rate.

It is the usual practice of governments that whenever a new national income series is introduced from a particular year, experts work on applying the same methodology to find out the output values for the years preceding the new base year. It helps in understanding the economy, its size, growth rate, and so on, more accurately. It is called the back series. If data is not available, splicing method is used.

Splicing Method

In an index number, be it growth or price index, it may become necessary at certain times to make provisions for the appearance of new items or the deletion of items previously in use. For instance in price index numbers, when new commodities enter the market or old commodities go off the market. The method of affecting the change is known as splicing. Essentially, these are inclusions and exclusions as adjustments for comparability. It has been applied for preparing the estimates partially in agriculture, trade, repair, hotels and restaurants, real estate, ownership of dwelling and professional services, public administration and defence and other services.

System of National Accounts 2008 (2008 SNA)

The System of National Accounts 2008 (2008 SNA) is the latest version of the international statistical standard for the national accounts, adopted by the United Nations Statistical Commission (UNSC).

The aim of SNA is to provide a complete system of accounts, enabling international comparisons of all significant economic activity. The suggestion is that individual countries use SNA as a guide for constructing their own national accounting systems to promote international comparability. However, adherence to an international standard is entirely voluntary and cannot be rigidly enforced. India follows them.

Indian Economy: Sectors and their Components

CSO in India divides the three sectors of the economy with their respective components in the following way:

1. Agriculture, forestry and fishing sector, crops, livestock, forestry and logging fishing and aquaculture.
2. Industry sector, mining and quarrying, manufacturing food products, beverages and tobacco, textiles, apparel and leather products, petal products, machinery and equipment, other manufactured, goods electricity, gas, water supply and other utility services, construction.
3. Services sector, trade, repair, hotels and restaurants, trade and repair services, hotels and restaurants, transport, storage, communication and services related to broadcasting, railways, road transport, water transport, air transport, services incidental to transport, storage, financial, real estate and professional services financial services, real estate, ownership of dwelling and professional services community, social and Personal Services, public administration and defence, other services.

Notice that mining and quarrying are in the secondary sector.

At 2011–12 prices, the contribution of agriculture and allied, industry, and services sec- tor are 15 per cent, 31 per cent, and 54 per cent, respectively.

Structural Composition of Economy

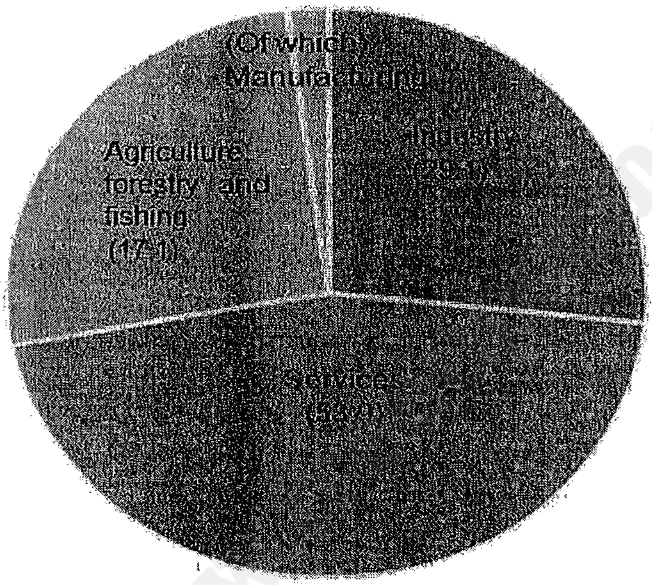
Basically, going by the nature of economic activity, there are three sectors in the economy: extraction of raw materials (primary), industry (secondary), and services (tertiary). The structure of the economy consists of these three sectors.

As an economy advances, the proportion of these sectors changes, and there is a progression from primary to secondary to tertiary sector. Progress from one sector is caused by technology, innovation, productivity, education and human skills, all of them being interrelated.

The primary sector of the economy involves converting natural resources into goods. This sector is the supplier of raw materials for the more advanced economies. This sector includes agriculture, fishing, forestry and all mining and quarrying industries. In developing countries, it plays a large role and has a diminishing share in the GDP as the economy evolves.

The secondary sector of the economy includes those economic activities that work on raw materials of the primary sector with technology and turn out finished products: industry, manufacturing and construction. It includes both the manufacturing and non-manufacturing components. Cement, steel, chemicals and auto parts are examples of manufacturing. Water supply and construction are non-manufacturing parts of the secondary sector.

2017–18 (PE)



Source: Statistics Times

With the rapid advancement of the tertiary sector, a new subsector of the tertiary sector emerged, i.e., the quaternary sector, which consists of research and development, science and technology, information services, intellectual property, producing services requiring highly educated manpower.
The quaternary sector is not clearly conceptualized like the preceding three sectors. Some include the highest levels of decision-making in an economy in it:

CEOs of firms, HODs in the government, sciences, universities, non-profit organizations, health- care, culture and the media. Some economists include care economy in it.

The industrial sector has capital-intensive heavy and light industry. Light industry is labour intensive and largely makes consumer goods. Clothes, shoes, furniture and house- hold items like consumer electronics are the examples of light industry. Heavy industry is capital intensive and produces goods for businesses—auto, steel, cement, petroleum, etc—in large quantities.

The tertiary sector of economy (service sector) produces 'intangible or invisible goods' for businesses as well as consumers. The service sector is made up of the 'soft' aspects of the economy, such as health, banking, tourism, insurance, government, retail and wholesale trade, education, entertainment, transport, etc.

Structural Change in the Economy

When the contributions of the three main sectors of the economy change due to modernization and technological developments, the changes that the structure of the economy undergo are called structural changes. Initially, agriculture dominated and later industry and still later the services sector become the predominant portions of the economy as it progresses.

The given meaning of structural change is the original and main view. It may also mean a subsistence economy is transformed into a commercial economy or that a regulated economy is liberalized. An insulated and protectionist economy becomes open and globalized. India has been structurally reorienting its economy since 1991, under which there is more room for markets, the public sector is exposed to domestic and global competition, there is a greater flow of foreign investment and foreign goods, etc.

Formal and Informal Sectors of Economy

Economic production may be formal or informal. A formal sector is one that is registered with the government, and many government laws apply to them, for example, Factories Act and Shops and Establishments Act. The informal sector is unregistered. It consists of street vendors, domestic help, small and marginal farmers, landless labourers, etc., and is sizeable.

Units that have 10 employees or more using electricity or 20 or more without electric- ity are the entry level for the formal sector. All bigger companies are also in the formal sector. They are called the organized sector, and it is necessary for them to register and report to the government. Employees of such firms have a variety of benefits in the form of limited working hours, holidays, insurance, etc. Those forms below the criteria are the unorganized sector. They are registered but are below the threshold of the organized sector. They are formal and unorganized.

There is thus a need to formalize the economy, for which in recent years government took many steps such as demonetization, GST, Jan Dhan, Digital India and incentives.

Public policy becomes more accurate with genuine data, for which formalization is important. Even otherwise, formalization is inevitable with the evolution of an economy.

Economic Growth: Cyclical and Structural

In order to understand the difference between the two, we need to know what a business cycle is. A business cycle refers to periods of expansion or recession. During expansion, the economy produces more goods and services.

It has indicators like employment, industrial production, sales and personal incomes. The indicators are on a rising trend. During recession, the indicators are negative. It shows that an economy is contracting.

Growth can be structural or cyclical. Structural growth is driven by long-term factors, such as demographic advantages with youth driving the economy; and suitable macroeconomic policies boosting growth that is employment-intensive. There can be structural de-growth or negative growth also for a different set of reasons, such as an aging population and so on.

Cyclical is short term. Cyclical growth can be positive due to soft interest rates, subsidies, commodity prices being globally low that can cause investment, low inflation and so on. In India, it can be optimal weather conditions also. On the other hand, growth cycle can turn down if monsoon is sub optimal; inflation is high; currency is volatile; commodity prices like global crude prices are high; crisis in the banking sector – either commercial banks or shadow banks like the Non-Banking Financial Companies (NBFCs).

The combined collapse of demand in credit-driven sectors, such as housing and auto and consumer non-durables, is seen in growth slowdown.

Private consumption contributes over 55–60 per cent of the gross domestic product (GDP) and was the force behind India's rapid recovery after the global turmoil during the 1997 Asian Financial Crisis and the sub-prime crisis of 2008.

Chapter - 3
Growth and Development: Alternative Measures

Introduction

Gross Domestic Product (GDP), along with its sister concepts of GNP and GVA have been in use because they are simple to measure and have global comparability. We have, however, seen the limitations of the concept in multiple ways. According to the critics of GDP as a concept, not only is it inadequate, it even distorts and misleads. Following examples amplify the point:

- Rising crime rates can lift GDP by raising expenditures on security personnel and technology.
- Despite the destruction wrought by the oil spills, it boosts GDP as cleaning up adds to hiring and purchasing services and equipment.
- When more guns are sold as people feel insecure, it magnifies GDP.
- Commercial agricultural production boosts GDP even when it is unsustainable.

Many alternative measures have come up to capture not only the quantitative side of growth but also the qualitative aspects of progress. They are:

- Human Development Index (HDI)
- Inequality Adjusted Human Development Index
- Social Progress Index (SPI)
- Genuine Progress Index
- Gross National Happiness (GNH)
- Happiness Index
- Green GDP

Human Development Index (HDI)

UN Human Development Index (HDI) was developed in 1990 by the Pakistani economist Mahbub ul Haq who was assisted by Amartya Sen. It has been used since 1993 by the United Nations Development Programme in its annual report. The HDI measures the aver- age achievements of a country in three basic dimensions of human development as follows:

- A long and healthy life, as measured by life expectancy at birth.
- Knowledge as measured in terms of adult literacy rate and the combined primary, secondary and tertiary gross enrolment ratio.
- A decent standard of living, measured by gross domestic product (GDP) per capita at purchasing power parity (PPP) in US Dollars.

Each year, UN member states are listed and ranked according to these measures. The 2010 Human Development Report came up for the first time with an Inequality-Adjusted Human Development Index (IHDI), which factors in inequalities in the three basic dimensions of human development (income, life expectancy and education) and adjusts the HDI accordingly.

India climbed one spot to 130 among 189 countries in the 2018 HDI rankings. Between 1990 and 2017, India's HDI value increased from 0.427 to 0.640, an increase of nearly 50 percent and an indicator of the country's remarkable achievement in lifting millions of people out of poverty. Between 1990 and 2017, India's life expectancy at birth increased by nearly 11 years, with even more significant gains in expected years of schooling.

Genuine Progress Indicator (GPI)

Redefining Progress is a think tank in the USA that devised a new measure to assess national progress. It is called the Genuine Progress Indicator (GPI). It is a metric that is designed to take fuller account of the well-being of a nation beyond the size of the nation's economy, by incorporating environmental and social factors which are not measured by GDP. GPI deducts environmental costs of economic activity like biodiversity loss, resource depletion, pollution, loss of farm- land and wetlands, and ozone depletion and social costs like increase in crime and family breakdown.

Today, Indian children of school-going age can expect to stay in school for 4.7 years longer compared to 1990. India's per capita income increased by 266.6 per cent between 1990 and 2017.

About 26.8 per cent of India's HDI value is lost on account of inequalities.

Social Progress Index

Social Progress Index is similar to the GPI as it includes social and environmental factors for economic growth to arrive at an indicator of progress. The indicators are different in number and weight, but the basic thrust is the same. The index is published by the non- profit Social Progress Imperative and is based on the writings of Amartya Sen and Joseph Stiglitz.

The index has three aspects:
- Basic human needs
- Foundations of well-being
- Opportunity

The above three broad heads include: health, sanitation, personal safety, ecosystem sustain- ability, shelter, access to knowledge, personal rights and tolerance and inclusion.

Gross National Happiness (GNH)

GNH is an attempt to define quality of life in more holistic terms than Gross National Product. The term was coined by Bhutan's former King Jigme Singye Wangchuck. While conventional development models stress economic growth as the ultimate objective, the concept of GNH is based on the premise that true development takes place when the following four dimensions are fulfilled in the right measure:

1. Equitable and sustainable socio-economic development
2. Preservation and promotion of cultural values
3. Conservation of the natural environment
4. Good governance

Happiness Index

The World Happiness Report is a measure of happiness published by the United Nations Sustainable Development Solutions Network to help nations make their public policies for the happiness of their people. It is inspired by the GNH of Bhutan. The first World Happiness Report was released in 2012. The World Happiness Report 2020 ranked 156 countries by their happiness levels. Finland is the world's happiest country followed by Denmark and Switzerland.

Six key variables are the basis to assess well-being: income, healthy life expectancy, social support, freedom, trust and generosity.

The entire top ten were wealthier, developed nations. Yet, money is not the only ingredient in the recipe for happiness. In fact, among the wealthier countries, the differences in happiness levels had a lot to do with differences in mental health, physical health and personal relationships: the biggest single source of misery is mental illness. Few factors that are strikingly different in the report are generosity, social support and so on.

Indian States and Happiness

Madhya Pradesh became the first state to set up a happiness department. Andhra Pradesh was the second state to do so. Madhya Pradesh set up an Anand Department made up by members for working in the areas of culture, society, psychology and academia. It started happiness festivals helping people to be happy through folk music, dance, singing, drama and sports and traditional activities. It also created Anand Clubs for people to form self-help groups in their local communities where skills to live a happy life could be taught and shared among members.

It placed India in the 144th position. Data was compiled from surveys.

The OECD Better Life Index

It was adopted by the club of rich countries, Organisation for Economic Co-operation and Development (OECD) in 2011 and takes the best metrics of well-being based on the recommendations of the Commission on the Measurement of Economic Performance and Social Progress (2009). It includes 11 dimensions of well-being:

1. Housing: housing conditions and expenditure (e.g., real estate pricing)
2. Income: household income and financial wealth
3. Jobs: earnings, job security and unemployment
4. Community: quality of social support network
5. Education: education and what one gets out of it
6. Environment: quality of environment (e.g., environmental health)
7. Governance: involvement in democracy
8. Health
9. Life satisfaction: level of happiness
10. Safety: murder and assault rates
11. Work-life balance

Green GDP

Green Gross Domestic Product (Green GDP) is an index of economic growth which factors in the environmental consequences of the growth. From the final value of goods and services produced, the cost of ecological degradation is deducted to arrive at Green GDP. In 2004, China announced that the green GDP index would replace the Chinese GDP index. But the effort was dropped as green GDP figures shrank the size of the GDP to unimpressive levels.

Natural Resources Accounting and Green GDP

Natural resources are the natural capital that include biodiversity, soil, water and air. They support one another. There is a widespread recognition that natural capital should be of the same importance as man-made capital in accounting terms, so that the ability to generate income in the future is sustained by the judicious use of the stock of natural capital. By failing to account for reductions in the stock of natural resources, standard measures of national income do not represent economic growth genuinely.

The National Biodiversity Action Plan published by the Government of India, Ministry of Environment, Forests and Climate Change in 2008 highlighted the value of goods and services provided by biodiversity. The aim of the Action Plan is: to assign appropriate market value to the goods and services provided by various ecosystems and to strive to incorporate these costs into national accounting.

It is interesting to note that US GDP is valued higher by market rate than by PPP as the global confidence in the US$ is more than its real strength. The opposite is the case with Chinese Yuan.

Big Mac Index

The Big Mac index was developed by the Economist magazine of London. It is based on the theory of purchasing power parity (PPP). It shows the parity of any two currencies, for example, between Indian Rupee and the US$, based on their purchasing power of a specific variety of hamburgers sold by MacDonald's called Big Mac in America and Maharaja Burger in India. The parity generally works out to be around 20–25 rupees per dollar. Thus, the rupee at its exchange rate value is seen to be grossly undervalued.

The advantage with PPP is that it corresponds to the ground level value of the currency in India and it does not change in a volatile manner.

Developed, Developing and Least Developed Countries

Based on criteria like GDP, level of industrialization, HDI, infrastructure and standard of living, countries can be classified. If the above criteria are in an advanced stage of development, the country is developed. Developed countries have post-industrial economies: service sector is highly developed and forms predominant portion of the GDP. A developing country or under- developed country have an underdeveloped industrial and infrastructural base though there may be pockets of development, low HDI, low standard of living, high demographic growth and so on. Among the developing countries, those which opened up economies in the nineties or later and are rapidly urbanizing, like India, are classified as Newly Industrialized Countries (NIC). Some place them between developed and developing countries. NICs are attractive investment destinations given their strong economic growth rates and future potential.

World Bank Classification

Based on per capita income, World Bank classified countries as shown below:

Category Per	Capita (current US$)
Low-income	> 1,005
Lower-middle income	1,006 – 3,955
Upper-middle income	3,956 – 12,235
High-income	< 12,235

A high-income economy is defined by the World Bank as a country with a per capita income of US $12,235 or more in 2017. A high-income country need not be a developed country though all developed countries have a high per capita income. According to the United Nations, for example, some high-income countries may also be developing countries. The Gulf Cooperation Council (GCC) countries, for example, are classified as developing high-income countries. GCC countries are rich but not developed. They have pockets of export economy based on oil and gas and the rest of the economy is underdeveloped.

Least Developed Countries (LDCs)

According to the United Nations, a country is classified as a Least Developed Country if it meets three criteria:

- Poverty: per capita less than US $1,035
- Human resource weakness (based on indicators of nutrition, health, education and adult literacy)
- Economic vulnerability (based on instability of agricultural production, instability of exports of goods and services, economic importance of non-traditional activities, merchandise export concentration, handicap of economic smallness and the percentage of population displaced by natural disasters).

LDC criteria are reviewed every three years. There are currently 47 countries in the list of LDCs.

Public Goods

Public goods and private goods are the two classes of goods in an economy. Public goods are non-excludable and non-rivalrous: 'non-rivalry' means that one person's enjoyment of a good does not diminish the ability of other people to enjoy the same good. For example, municipal park, streetlights and public roads. The other is 'non-excludable', meaning that people cannot be prevented from enjoying the good. Air quality is an example of a public good. Oxygen cylinder or gas masks are private good. National defence is non-excludable. Everyone in the country is protected and no one can be excluded. Markets do not produce public goods, the government provides them.

There are also merit, non-merit and demerit goods. Merit goods are worthy of subsidization by the government. For example, food for low- income groups and fertilizers and seeds for small and marginal farmers. Non-merit goods are relatively unworthy of subsidies. Even though they are important for public consumption and need to be made available affordably, the government is not in a position to do so for fiscal/financial reasons. For example, all college education. Demerit goods are those whose consumption needs to be discouraged as it is unhealthy for the consumers as well as society at large, so-called sin goods: tobacco, alcohol and so on. It may not be feasible to ban them and so they are highly taxed.

महाज्योती
— ज्ञानदीप समतेचा —

SRIRAM's IAS

महाराष्ट्र शासन

महात्मा ज्योतिबा फुले संशोधन व प्रशिक्षण संस्था (महाज्योती) नागपूर

(महाराष्ट्र शासनाच्या इतर मागास बहुजन कल्याण विभागाची स्वायत्त संस्था)

महाज्योती
— ज्ञानदीप समतेचा —

महाज्योती

पोलीस भरती पूर्व प्रशिक्षण योजना

महाज्योती, नागपूर मार्फत निवड केलेल्या उमेदवारांना ऑनलाईन पध्दतीने लेखी परीक्षेचे संपूर्ण मार्गदर्शन करण्यात येते तसेच व्हिडीओ मार्फत शारीरिक चाचणीकरिता मार्गदर्शन देण्यात येते. महाज्योती, नागपूर मार्फत प्रशिक्षणार्थींना पुस्तक संच घरपोच देण्यात येते.

* लाभार्थी पात्रता/ निकष :

* महाराष्ट्राचा रहिवासी असावा.
* उमेदवार हा इतर मागासवर्गीय, विमुक्त जाती- भटक्या जमाती तसेच विशेष मागास प्रवर्गातील नॉनक्रिमीलेयर गटातील असावा.
* पोलीस भरतीकरिता आवश्यक शैक्षणिक व शारिरीक पात्रता पूर्ण केलेली असावी.
* महाराष्ट्र शासनाकडून वेळोवेळी होणाऱ्या बदलानुसार पात्रता असणे आवश्यक राहील.

* योजनांचा लाभ घेण्यासाठी आवश्यक कागदपत्रे:

१. रहिवासी दाखला   २. जात प्रमाणपत्र   ३. नॉनक्रिमिलेयर प्रमाणपत्र

४. आधारकार्ड   ५. शैक्षणिक गुणपत्रक

* योजनेचा लाभ घेण्यासाठी अर्ज कुठे व कसा करावा.

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Chapter - 4
Planned Economic Development and NITI Aayog

Introduction

Independent India's economic development was driven by the government's socio-economic planning. A planned economy is one in which the state may own, partly or wholly, the economy and direct it in a centralized manner. The state sets the priorities for growth. The private sector is given a role, large or small, depending on its capability. Till the 1970s, the private sector in India had a residuary role. Later, it expanded, and today, it dominates the Indian economy.

An economy is referred to as the command economy if it works at the command of the government. Command economies were set up in communist China and erstwhile USSR for rapid economic growth and social and economic justice but have been dismantled in the latter and overhauled in the former in the last three decades as they do not create wealth sustainably and are not conducive for innovation and efficiency. North Korea is still a command economy.

In a market economy, the state has a limited role in the management of the economy. Production, distribution and consumption decisions are predominantly left to the market, that is, to demand and supply.

History of Economic Planning in India

India adopted socio-economic planning after Independence due to the following reasons:

- There was no significant private sector in the country.
- Soviet experience with planning for economic development attracted our leaders.
- Planning held superior benefits by way of balanced regional development and redistribution of wealth.
- British colonialism through the East Indian company was severely resented by the people.
- Jawaharlal Nehru was attracted by the benefits of democratic socialism.

But before Independence itself, there were attempts to prepare an Independent India for planned economy, though the models offered by different sections differed quite significantly.

Sir Mokshagundam Visvesvaraya

M. Visvesvaraya (1860–1962) was an engineer and designed the Krishna Raja Sagara Dam and sponsored the Bhadravati Iron Works. He was an admirer of

Japan's industrial progress and also studied the Soviet Five-Year Plans and the initiatives of the American President Roosevelt whose New Deal (it was a huge government economic intervention to revive economy mired during the Great Depression) showed the power of the state to rebuild economies. In 1934, he published suggestions for a ten-year plan for India which was the first attempt at economic planning in India. It was proposed under the plan to double the income of the country within ten years. He believed that left to private enterprises, industries will not make satisfactory progress. Government should take the lead, an official planning body should be set up, and correct comprehensive statistics should be published yearly. In his book titled Planned Economy for India (1934), he set the goal of poverty eradication through growth.

National Planning Committee

The Indian National Congress established a National Planning Committee under the chairmanship of Jawaharlal Nehru (1938) to formulate plans to ensure an adequate standard of living for the masses and get rid of poverty. It advocated heavy industries that were essential both to build other industries and for Indian self-defence; heavy industries had to be under public ownership, for both redistributive and security purposes; the redistribution of land away from the big landlords would eliminate rural poverty.

Bombay Plan

In 1944, leading businessmen and industrialists (including Sir Purshottamdas Thakurdas, JRD Tata, GD Birla and others) put forward A Plan of Economic Development for India, popularly known as the 'Bombay Plan'. It saw India's future progress based on further expansion of the textile and consumer industries which were already flourishing in cities like Bombay and Ahmedabad; the state should provide infrastructure, invest in basic industries like steel, and protect the Indian industry from foreign competition. Its objectives were doubling the output of the agricultural sector and a five-fold growth in the industrial sector over 15 years. The Bombay Plan was premised on the view that that the economy could not grow without government intervention and regulation.

MN Roy and People's Plan

During the 1940's, the Indian Federation of Labour published its People's Plan by MN Roy that emphasised on employment and wage goods.

SN Agarwala and Gandhian Plan, 1944

S.N. Agarwala was a follower of Mahatma Gandhi and published the Gandhian Plan that emphasized on decentralization, agricultural development, employment, cottage industries, etc.

Mixed Economy

A mixed economy combines features of both market economies and socialist planned economies. In a mixed economy, state owns a significant portion of economic resources and leaves a portion to the private sector. The extent of private sector participation depends on the level of its growth. It combines the efficiency of the markets with the equity of state regulation. It ensures environmental and welfare regulations for sustainability while attracting private capital- both domestic and foreign. Thus, public and private sector complement each other.

The public sector generally covers areas which are deemed strategically important or not profitable enough for the private sector. Railway passenger services and atomic energy are exclusively carried out by the Indian government.

Since Independence, for four decades, the public sector dominated. However, from the time of economic reforms in 1991, greater role for the private sector defined the economy, be it by de-regulation or privatization. Thus, the state-market mix changed towards the market since 1991, but the economy is predominantly mixed.

Planning Goals

India launched five-year plans for rapid growth from 1951. The long-term goals that were common to all the five-year plans were:

- Growth
- Modernization
- Self-reliance
- Social justice

Economic growth was one of the primary objectives and is expected to spread to all sections and regions, raise resources for the Government to spend on socio-economic priorities, etc. It would trickle down to all people and regions. Growth is the precondition for all other objectives like poverty eradication, employment generation inequality reduction, human capital building, etc.

Modernization is improvement in technology. It is driven by innovation and investment in Research and Development (R and D). Education is the foundation of modernization.

Self-reliance means relying on the resources of the country and not depending on other countries and foreign MNCs for investment and growth. It was a pragmatic as well as an aspirational decision to be self-reliant. Since India had no foreign exchange to import, it was important that we produce the goods ourselves. Invitation to MNCs re-generated the fears of colonialism returning as neo-colonialism. The Nehru-Mahalanobis model of growth that closed Indian economy and relied on basic industries is the main pillar of self-reliance. However, self-reliance lost its relevance by the nineties when India opted for the Liberalization, Privatization and Globalization model (LPG) and later became the founding member of World Trade Organization (WTO) in 1995. LPG offered scope for faster growth. India was in a position to globalize and benefit unlike its state immediately after Independence.

The term self-reliance should not be confused with self-sufficiency—the former means depending on country's own resources as much as practical and only then resorting to imports or foreign investment, thus avoiding dependence on external inflows; the latter means that the country has all the resources it needs. No country can be self-sufficient.

Social justice means inclusive and equitable growth where inequalities are not steep and benefits of growth reach all, rural-urban, man-woman and the caste divide and inter-regional divides are reduced.

While the above four are the long-term goals of the planning process, each five-year plan has specific objectives and priorities.

Financial Resources for Five-Year Plans

The resources for the FYPs come from:

- Gross Budgetary Support: GBS is the amount from the central budget that goes to fund the plan investments during the plan period. It is the central share in the five-year plan, assistance offered to states for their five-year plans and also extra funding for the central public sector.
- State budgets
- Public Sector Enterprises (PSEs)
- Domestic private sector
- FDI, or foreign direct investment, into India to produce goods and services, like producing cement or setting up a bank.

History of Planning

- First Plan (1951–1956): The First Plan stressed on agriculture, in view of large-scale import of food grains and inflationary pressures on the economy. The annual average growth rate during the First Plan was 3.61 per cent as against the target of 2.1 per cent. Renowned economist KN Raj was one of the main architects of India's first five-year plan.

- Second Plan (1956–1961): With agricultural targets of the previous plan achieved, major stress was on the establishment of heavy industries. The rate of investment was targeted to increase from 7 per cent to 11 per cent. The plan achieved more than the targeted growth rate. The plan was based on the Nehru-Mahalanobis model, that reflects self-reliance and basic industry-driven growth.

Nehru-Mahalanobis Model of Economic Growth

The Indian economy at the time of Independence was characterized by dependence on exports of primary commodities like cotton and natural minerals, negligible industrial base, underproductive agriculture, etc. The first FYP focused on agriculture for food security. But industrialization was urgently needed to modernize the economy and improve technology and national defence.

To deliver these results, the second FYP adopted the Nehru-Mahalanobis strategy of development as it was articulated by Jawaharlal Nehru's vision and P.C. Mahalanobis was its chief architect. The central idea underlying this strategy is well conveyed by the following statement from the plan document. 'If industrialization is to be rapid enough, the country must aim at developing basic industries and industries which make machines to make the machines needed for further development'.

The Mahalanobis model of growth is based on the predominance of basic goods (capital goods or investment goods, which are goods used to make further goods like machines, tools, factories, etc.). It is based on the premise that it would attract all-round investment, ancillarisation (the industries that supply inputs), build townships and result in a higher rate of growth of output: the trickle-down effect. That will boost employment generation, poverty alleviation, exports and so on. The emphasis was on expanding the productive ability of the system through forging strong industrial linkages as rapidly as possible.

Other elements of the model are:

- 'Import substitution Protective barriers against foreign competition to enable Indian companies to develop domestically produced alternatives for imported goods and reduce India's reliance on foreign capital.
- A sizeable public sector active in vital areas of the economy like power, roads, rail transport, etc.
- A vibrant small-scale sector driving consumer goods' production for dispersed and equitable growth and producing entrepreneurs.

In terms of the core objective of increasing the rate of growth of industrial production, the strategy paid off. The rate of growth of overall industrial production picked up. The strategy laid the foundation for a well-diversified industrial structure within a reasonably short period and this was a major achievement. It gave the base for self-reliance.

However, the strategy is criticized for the imbalances between the growth of the heavy industry sector and other spheres like agriculture and consumer goods that resulted from it. It is further criticized as it relied on the trickle-down effect, which means the benefits of growth will flow to all sections in due course of time. This approach to eradication of poverty is slow and incremental. It is believed that a frontal attack on poverty is required. It should be noted that the trickle-down effect does produce results, but given our population size, growth has to be in double digits for a long period sustainably for the trickle-down effect to work.

Industrial Policy Resolution of 1956 is a resolution adopted in April 1956. According to this resolution, the objective of the social and economic policy in India was the establishment of a socialistic pattern of society. It laid down three categories of industries which were more sharply defined. These categories were:
1. **Schedule A:** Those industries which were to be an exclusive responsibility of the state.
2. **Schedule B:** Those which were to be progressively state-owned and in which the state would generally set up new enterprises, but in which private enterprises would be expected only to supplement the effort of the state.
3. **Schedule C:** All the remaining industries and their future development would, in general, be left to the initiative and enterprise of the private sector.

- **Third Plan (1961–1966):** It tried to balance industry and agriculture. The aim of the third plan was to establish a self-sustaining economy. For the first time, India resorted to borrowing from the IMF. The rupee was also devalued for the first time in June 1966, though technically it was not during the third FYP.
- **Annual Plans:** As the third plan experienced difficulties on the external front (war with China in 1962 and Pakistan in 1965) and the economic troubles mounted on the domestic front, inflation, floods, forex crisis; and there was also political instability with the death of Nehru and Lal Bahadur Shastri, the fourth plan could not be started in 1966. There were three annual plans till 1969. This period is called plan holiday when five-year plans are not implemented and only annual plans are operated. The Annual Plans were: 1966–1967, 1967–1968 and 1968–1969.

- **Fourth Plan (1969–1974):** The main objective of this Plan was growth with stability. The plan laid special emphasis on improving the condition of the under-privileged and weaker sections through the provision of education and employment. Bank nationalization, privy purse abolition to princes (privy purse was a payment made to the families of erstwhile princely states as part of their agreements to integrate with India after Independence), results of green revolution, oil shocks (oil exporting countries raising the price of oil many times to use it as a political weapon to demand a home for Palestinians), the Indo-Pak war were the significant developments in this plan period.
- **Fifth Plan (1974–1979):** The main objective of the plan was growth with social justice. It was cut short by the Janata Party that came to power in 1977. The Janata party's 6th FYP was launched in 1977 but was removed from official records by the government that came to power in 1980 and the official 6th FYP was launched. The original FYP lasted full term. The year 1979-1980 was thus a gap year when there was no FYP and again became a plan holiday.

Rolling Plan

It was adopted in India in 1962 in the aftermath of the Chinese attack on India in the Defence Ministry in India. Professor Gunnar Myrdal (author of Asian Drama) recommended it for developing countries in his book Indian Economic Planning in Its Broader Setting. It was considered by the Janata government in 1977. In the rolling plan model, even as annual and multi-year goals are set, they are not rigidly followed as ground level conditions may not be conducive, and so, they are liable to be reset according to the circumstances. A rolling plan becomes necessary in an economic situation that is fluid. The main advantage of the rolling plans is that they are flexible and are able to overcome the rigidity of fixed five-year plans by resetting targets, projections and allocations as per the changing conditions in the country's economy. The main disadvantage of this plan is that if the targets are revised each year, it becomes very difficult to achieve them. Frequent revisions result in the instability of the economy.

- **Sixth Plan (1980–1985):** The removal of poverty was the foremost objective of the sixth plan. Another area of emphasis was infrastructure, which was to be strengthened for the development of both industry and agriculture. The achieved growth rate of 5.7 per cent was more than the targeted one. Direct attack on poverty was the main focus of the plan. Integrated Rural Development Programme (IRDP), Training of Rural Youth for Self-Employment (TRYSEM), Development of Women and Children in Rural Areas (DWCRA), National Rural Employment Programme (NREP) and Rural Landless Employment

Guarantee Programme (RLEGP) were started in the 6th plan to aid economic growth in tackling poverty. The year 1981 saw India take a loan from the IMF.

- **Seventh Plan (1985–1990):** This Plan stressed on rapid growth in food grain production and increase in employment opportunities. The growth rate of 5.81 per cent achieved in this plan was more than the targeted one. The plan saw the beginnings of liberalization of the Indian economy. Consensus was built during the plan for economic liberalization. Long-term fiscal policy was started. For the first time, a 3-year export-import policy was announced.

The eighth plan could not be started in 1990 due to an economic crisis, external uncertainties and political instability. There was plan holiday for two years, that is, plan holiday: 1990–1991 and 1991–1992.

- **Eighth Plan (1992–1997):** It was a watershed plan as the country's economic growth model was reoriented. India had to take another IMF loan to ease the balance of payments (BOP) situation when the foreign currency reserves were depleted to a very low level, less than 1 billion USD. The twin deficits of budget and current account had to be managed, and so, 'structural reforms' were adopted.

Major Plan objectives included controlling population growth, poverty reduction, employment generation, strengthening the infrastructure, institution building, involvement of Panchayati Rajs, Nagar Palikas. The target growth rate was 5.6 per cent and the actual growth rate was 6.8 per cent.

India became a member of the World Trade Organization on 1 January 1995. Panchayati Raj and Nagar Palika institutions were given constitutional status so that plan benefits could percolate to the grassroots. Democratic decentralization was needed to enable bottom-up planning and better service delivery. Participative socio-economic growth has since been consolidated (SEBI) that already existed since 1988 was given a statutory status for which an Act of parliament was passed. The plan was based on the Rao-Manmohan Singh model of liberalization.

Rao–Manmohan Singh Model of Growth

Economic reforms since 1991 have been based on the Rao-Manmohan model. Narasimha Rao was the P.M. in 1991 and Dr. Manmohan Singh was the finance minister. The model had the following aims:

- Reorient the role of the state in economic management. The state should focus on social and infrastructural development primarily.
- Dismantle controls and permits selectively in order to encourage private sector to invest liberally.

- Open up the economy and create competition for PSEs- for better productivity and profitability
- External sector liberalization in order to integrate the Indian economy with the global economy to benefit from the resource flows and competition.

Forex reserves accumulated thus alleviating BOP pressures and foreign flows, FDI and FII increased. The Indian economy became competitive. Exports started to pick up.

Indicative Planning

With the launch of the economic reforms in 1991, indicative planning became inevitable. It was adopted from the 8th five-year plan (1992–1997). It is characterized by an economy in which the private sector is given a substantial role. The state would turn its role into a facilitator from that of a controller and regulator. The remodelling of economic growth (LPG) necessitated recasting the planning model from imperative and directive (hard) to indicative (soft) planning. Since the government did not contribute the majority of the financial resources, it had to indicate the policy direction to the corporate sector and encourage them to contribute to plan targets. Government should create the right policy climate, fiscal, monetary, investment and so on, that is predictable, irreversible and transparent, to help the corporate sector contribute resources for the plan.

It was decided that trade and industry would be increasingly freed from government control and that planning in India should become more and more indicative and supportive in nature.

Government provides the right type of policies, tax, trade, investment and other related policies, in aid of the priorities and creates the right milieu for the private sector, including the foreign sector to contribute to the results. This was known to have brought Japan results in shifting towards microelectronics. In France too, indicative planning was in vogue.

The Planning Commission would work on building a long-term strategic vision of the future. The focus would be on anticipating future trends and evolving strategies for competitive international standards.

- **Ninth Plan (1997–2002):** The plan started in the midst of political instability. The East Asian financial crisis took place in 1997. The millennium changed during the plan. India went for its first American depository receipt (ADR) in 1999, an Indian company was listed in a stock exchange in the USA called NASDAQ. The Kargil war took place in1999. The 9/11 terrorist attack took place. Nuclear bombs were detonated in 1998 in India.

Swarnajayanti Gram Swarojgar Yojana (SGSY) was launched in 1999 by subsuming previous programmes like the Integrated Rural Development Program (IRDP) in 1980, TRYSEM, Development of Women and Children in Rural Areas (DWCRA) in 1982) etc. Pradhan Mantri Gram Sadak Yojana (PMGSY) was started in 2000. Golden Quadrilateral (GQ) national highway network connecting the four major metro cities of India – Delhi (north), Kolkata (east), Mumbai (west) and Chennai (south) was launched in 2001. The privatization of public sector units was started during the ninth plan, while disinvestment began in the previous plan.

- **Tenth Plan (2002–2007):** The main objectives of the tenth five-year plan of India were:
  - Attain 8 per cent GDP growth per year.
  - Reduction of poverty rate by 5 per cent points by 2007.
  - Providing gainful and high-quality employment at least to those who become eligible for work every year (there are millions of people already looking for work, the backlog of unemployed people).
  - Reduction of the gender gap in literacy and wage rates by at least 50 per cent by 2007.

The plan began on a note of severe drought that the nation suffered in 2002–03. GDP growth plunged to about 4 per cent. The next year, due to the 'base effect', growth went beyond 8 per cent. Base effect means when absolute numerical changes are expressed in percentage terms, they look muted or magnified. On a low base, the same number looks large while on a high base, it looks small. For example, 5 on 10 is 50 per cent but out of 100 it is only 5 per cent.
The period saw the global economy grow. India also benefited. NREGA and National Rural Health Mission were begun during this plan. The economy grew at 7.8 per cent.

- **Eleventh Plan (2007–2012):** The plan was launched when the global economy went into a great recession with the bankruptcy of Lehman Brothers in the USA and many banks and insurance companies in US and western Europe. Greece suffered a sovereign debt crisis when the government could not service the loans it took from the world. Fiscal stimulus was the norm in the world of post-Lehman crisis when governments borrowed beyond conventional limits and spent to revive economies in the Keynesian manner.

Towards Faster and More Inclusive Growth was the central theme of the plan. It promised to accelerate economic growth and make it more inclusive, lower poverty, generate 70 million new jobs and reduce unemployment to less than 5 per cent. The chief thrust of the plan was agriculture, education and infrastructure, areas that remain a concern in a rapidly growing economy. The growth target was 9 per cent but actual achievement was 8 per cent.

- **Twelfth Plan (2012–2017):** It aimed to achieve an annual average economic growth rate of 8 per cent. Its aim was 'faster, sustainable, and more inclusive growth'. The government changed in 2014 and the plan was not pursued. It achieved a 6.9 per cent growth rate. Demonetization)took place in this plan in 2016.

Achievements of Planning

In the past 70 years, the national income has increased many times. In 2018, India became the third largest economy in Asia, with a GDP of about $2.85 trillion, after China and Japan. In 2019, India is the seventh largest economy in the world after the U.S., China, Japan Germany, UK, and France. By PPP measurement, India is the third largest in the world after China and USA.

Social indicators have improved—Maternal Mortality Rate (MMR), Infant mortality rate (IMR), literacy, disease eradication among others. The industrial infrastructure is relatively strong—for cement, steel, fertilizers, chemicals, and so on. Agricultural growth is also gaining momentum with food grains production at record levels.

Forex reserves are substantial, which is a dramatic turnaround from 1991 when we had one billion dollars. India's services sector is now acknowledged globally. There has been considerable expansion of higher education. At the time of Independence, there were 20 universities and 591 colleges, while today, there are more than 700 universities and about 40,000 colleges.

The failures of planning are equally clear:

- Poverty is still rampant
- Unemployment is high
- Quality of education outcomes is low
- Gender disparities are still steep
- Research and Development (R and D) is not globally competitive
- Exports are not growing much
- Farm productivity is low
- Regional imbalances are intensifying
- Malnutrition haunts about half the children in India.

Economic Reforms

Since July 1991, India took up economic reforms towards greater involvement of market forces and private investment to achieve higher rates of economic growth so that socio-economic problems like unemployment, poverty, shortage of essential goods and services, regional economic imbalances and so on can be successfully solved. The reasons to reform the economy were:

- Indian economy reached a level of growth and strength to be able to benefit from an open market model.

- The private sector in India had come of age and was willing and capable of playing a major role.
- The Indian economy needed to integrate with the world due to gain advantages like capital flows, technology, higher level of exports, state-of-art stock markets, Indian corporates raising finances abroad and so on.

The country under the leadership of Dr. Manmohan Singh, Union Finance minister (1991–1996 and Prime Minister 2004–2014), converted the economic crisis–caused by domestic cumulative problems of economy, political instability and gulf crisis–into an opportunity to initiate and institutionalize economic reforms to open up the economy.

The deep crisis in 1991 could not be solved by superficial solutions. Therefore, structural reforms were adopted. The old structure was characterized as closed, over-regulated and uncompetitive. Therefore, the LPG strategy was embarked upon.

It was realized that by closing the economy to global influences, the country was missing on technological developments as well as gains from global trade and investments.

India needed exports, FDI and FPI for stability on the BOP front and higher growth rates for social development. Worldwide, countries were embracing market model of growth, China for example, with proven results. So, India could make the historic shift from centralized planning to a market-based model of growth.

Initially, reforms were feared and resisted as there was scepticism and fear related to:
- Large scale unemployment due to capital intensity of the growth process to be competitive.
- Worsening of poverty as fiscal concerns would reduce social sector expenditure.
- Flood of imports as customs duties would come down.
- Food security suffering as social sector expenditure would reduce.
- Pressures on labour sector due to domestic industry's compulsions to cut costs.

Some fears have indeed come true—jobless growth and uncertainty in farming. But by and large, reforms have done well.

Reforms mainly targeted the following areas:
- Dismantling the licence raj so that private sector and government were on a level playing field.

- Drive public sector towards sustainable profitability and global play by dereservation, disinvestment, professionalization of management and so on.
- Fiscal reforms (FRBM) for a variety of objectives
- Monetary policy institutional infrastructure revamped by the Monetary Policy Committee; inflation targeting introduced.
- Banking sector selectively deregulated and global prudential norms adopted for financial stability.
- Move towards free float of rupee and relaxation of controls on convertibility, aggressive export promotion FDI and FII inflows, etc.

Reforms were prioritized and sequenced in such a way so as to make them sustainable and render further reforms feasible. For example, first generation reforms involved essentially non-legislative government initiatives—reducing SLR and CRR for the banking sector, disinvestment of the PSEs, deregulation of the rupee gradually and later making the exchange rate of the rupee market-driven and so on. The second generation reforms depend on the success of the first generation reforms, involve legislative reforms and touch a wider section of the society, labour reforms, GST, FDI expansion, etc. The former prepares the economy for the latter.

Above all, reforms with a human face was the goal, unlike elsewhere in the world like in South America in the 1980's. It yielded results – the social effect of the reforms in India is seen in the flagship schemes making an impact on health, education, social protection, etc. The reforms gained consensus and showed positive results as can be seen below:

- Rates of economic growth went up.
- BOP crisis has been solved in the first few years and today the country has nearly sizeable forex reserves.
- Services sector (tertiary sector) has grown in importance and today contributes almost 55 per cent of the GDP emerging as a global player, India being the global back office.
- Resilience of the economy in the face of the Great Recession (2008–2013).
- Consumer choice has increased.
- Tax-GDP ratio may have shrunk but the tax collections and base increased.
- Nature of external debt has changed, and the short term component is lesser.
- Indian companies are listed on NASDAQ and New York Stock Exchange and raised billions of dollars for investment.
- FIIs and FDI picked up.
- Indian corporates have become MNCs and acquired global majors like Jaguar and Anglo-Dutch steelmaker Corus.

India and the Manufacturing Sector

India's development experience with planning in the 1950s began with a heavy emphasis on manufacturing. The Nehru-Mahalanobis model (Second FYP) was premised on capital goods industry and self-reliance. India had the manpower. Technical institutes were set up and higher education received its due. R and D was focused on to feed into manufacturing through better technology. However, the momentum could not be sustained for a variety of reasons:

- Entrepreneurial initiative was discouraged with laws like Industries Development and Regulation Act 1951 (IDRA), which was enacted to pursue the Industrial Policy Resolution 1948 and was formulated for the purpose of development and regulation of industries in India by the central government. But it led to license-permit raj that dampened the private sector.
- Monopolistic and Restrictive Trade Practice under MRTP Act 1969 suppressed large- scale production.
- 17 per cent of the world population lives in just 2.4 per cent of the global area that is India and thus there is huge pressure on land, and it poses problems of land acquisition.
- The Rehabilitation and Resettlement Policy (R and R) for big infrastructural and industrial projects could not be implemented satisfactorily, and as a result, land acquisition became even more difficult in a democracy.
- We did not open up to FDI and thus competition suffered as did productivity.
- Our neglect of primary and secondary education along with health did not create adequate human capital for sustained manufacturing.
- Infrastructure bottlenecks—power, roads, telecom, etc—acted as limitations for industrial growth.
- Reservation for the MSMEs and favourable terms to them led to a moral hazard; they developed a vested interest in not scaling up.
- Rigid labour laws deterred investment and thus competition suffered and so did growth in industry. Manufacturing being, labour intensive, suffered more.
- There was no tax on services, and so, investment went into that sector.
- Lack of ease of doing business also hampered investment and industrial growth, though India's position has been improving significantly and stands at 63rd position on the World Bank's ease of doing business ranking in 2019.
- In the last two decades, the services sector emerged as a globally strong force and it seemed that we could skip the secondary sector and focus on becoming a global back office. In the process, manufacturing got further neglected.

By the 1990s, China was already becoming a global industrial powerhouse. Since then, Chi- nese imports did not allow Indian local manufacturing, and in fact, led to de-industrialization in India; e.g., solar cells, tyres, steel, electronic items, etc. The India-China bilateral trade in 2018-19 was $95.5 billion and India ran a trade deficit of $58 billion.

Services Sector-led Growth in India

The service sector is the dominant sector in India's GDP with about 55 per cent contribution. There is more FDI into services sector than manufacturing. Service exports are making up for merchandise trade deficit. In general, the service sector grows after the industrial sector has developed. In today's developed economies, manufacturing led the growth process in the early stages of development. After agriculture matured, a fairly high level of industrial development had been reached and then services took over the lead role. The same pattern was also observed in the East Asian tiger economies and in China.

Like many other developing countries, India's economic growth has not conformed to this classical historical pattern of agriculture to industry to services. We opted to promote the services sector in preference to manufacturing as we saw global opportunity in it also because our land resources did not allow us to go for large-scale manufacturing. Special economic zones (SEZs), thermal power plants, nuclear power plants, steel plants, huge multipurpose dams all faced problems of land acquisition. India differs from China in this regard as well as the fact that in China, the government held all the land.

Inadequate attention to the development of physical infrastructure constrained manufacturing more than services. The services sector did not require such sizes of land.

In the 1990's, government policies favoured services and disadvantaged manufacturing. Compared to manufacturing, services were not taxed till 1994, and since then, were lightly taxed. Rise in per capita income also had a significant effect on the demand for better services in the country—education, health, transport, finance, advertising, telecom, insurance, etc.

Since the reforms of the early 1990s, trade and foreign investment for services have been more liberal than those for manufacturing. Services contribute more than manufacturing to India's output growth, productivity growth and job growth.
Technology and globalization helped India to think of scaling up through digitization. The digital drivers of economic growth made globalization inevitable and irreversible and raised prospects for service sector growth in

India. It automatically led to growth in financial services, telecom, retail and spread to transportation, travel, tourism, media, health services and so on, as government policies favoured, and the per capita incomes rose. Technology facilitated new ways of doing business by increasing computing power, data storage capacity and data transmission capacity. Telecom connectivity has grown at a rapid pace. Farmers who were earlier dependent on middlemen, now have better information on pricing. The organized retail sector has brought in efficiency in the supply chain. We are now seeing the rapid growth of e-commerce and online retail stores. The automobile industry is a key contributor as the rise in sales of personal vehicles has created a multiplier effect in support services required after sales. Transportation and logistics services grew rapidly as demand for goods grew across the country.

Service sector not only creates direct output and direct employment but also expands ancillary services and leads to employment generation. For every job created in the IT and IT-enabled services sector, four jobs are created elsewhere. India's current per capita income is about US$ 2,000 and has enormous implications for savings growth, consumption demand and the ability to be a sustainable driver for the demand in services. Travel sector is seeing growth as air and road travel grow, in turn, leading to a growth in demand for tourism and hotels. It is aided by initiatives like Paryatan Parv organized by Ministry of Tourism in collaboration with other central ministries and state governments across the country.

Similarly, other sectors like media, entertainment, health care and education all benefited with increased aspirations of the retail consumer.

Technology continues to drive innovation and creation of new smart business models which are based on leveraging digitization, mobility and social media. Given these factors, coupled with our demographic dividend and the expected jump to a higher trajectory for both growth and per capita GDP, we have the right conditions for a virtuous cycle to sustain for many years. The GOI wants the service sector boosted and so has many incentives in a wide variety of sectors such as health care, tourism, education, engineering, communications, transportation, information technology, banking, finance, management, among others.

Ejaz Ghani, World Bank economist and a service sector evangelist for India's rapid economic growth, says 'The digital revolution, by lowering transaction costs in services and overcoming problems of asymmetric information, has made services more dynamic than in the past. The long-held view that services are non-transportable, non- tradable, and non-scalable no longer holds with the technological changes in the digital world. For example, telemedicine, consultancy, knowledge process outsourcing (KPO) The globalization of services provides new opportunities for India to find areas beyond manufacturing, where it can specialize, scale up, and achieve high growth'.

NITI Aayog

In 2015, the GOI set up the NITI Aayog or National Institution for Transforming India Aayog by replacing the Planning Commission. In Hindi, NITI means policy, and Aayog means commission. The reasons were that the nature of economy changed towards a mar- ket-dominated system and that the rights of states were to be given greater consideration for which a new structure and dynamic was required. The Planning Commission was largely portrayed as overriding the sensitivities and priorities of states and thus was not respectful of federalism.

The NITI Aayog is a policy think tank of the Union Government of India that aims to involve the states in economic and development policy making in India. It provides strate- gic and technical advice to the government. The Prime Minister of India heads the Aayog as its chairperson.

The reason for forming the NITI Aayog is that India is a diversified country and its states are in various phases of economic development with their own strengths and weaknesses. In this context, a 'one size fits all' approach to economic planning is obsolete. It cannot make India competitive in today's global economy.

The NITI Aayog comprises the following:

1. Prime Minister of India is the Chairperson.
2. Governing Council comprising the Chief Ministers of all the States /UTs and Lieu- tenant Governors of Union Territories and special invitees. It resembles the erstwhile national Development Council (NDC) that no longer meets.
3. The full-time organizational framework comprises of:
   - Vice-Chairperson
   - Members: Full-time
   - Part-time Members: Maximum two from leading universities research organizations and other relevant institutions in an ex-officio capacity. Part-time members will be on a rotational basis.
   - Ex Officio Members: Maximum four members of the Union Council of Ministers to be nominated by the Prime Minister
   - Special invitees from the Union Council of Ministers.

- Regional Councils may be formed to address specific issues and contingencies impacting more than one state or a region. These are formed for a specified tenure. Regional Councils will be convened by the Prime Minister and will comprise of the Chief Ministers of States and Lt. Governors of Union Territories in the region. These will be chaired by the Chairperson of the NITI Aayog or his nominee.
- Experts, specialists and practitioners with relevant domain knowledge as special invitees nominated by the Prime Minister.
- Chief Executive Officer: To be appointed by the Prime Minister for a fixed tenure.

At the core of NITI Aayog's creation are two hubs—Team India Hub and the Knowledge and Innovation Hub. The Team India Hub leads the engagement of states with the Central government, while the Knowledge and Innovation Hub builds NITI's think tank capabilities. These hubs reflect the two key tasks of the Aayog.

Aims and Objectives of NITI Aayog

NITI Aayog provides a critical directional and strategic input into the development process. It is a think tank that provides governments at the central and state levels with relevant strategic and technical advice across the spectrum of key elements of policy, such as Make in India, Digital India and Swachh Bharat.

It fosters better Inter-Ministry coordination and better Centre-State coordination. It helps evolve a shared vision of national development priorities and foster cooperative federalism, recognizing that strong states make a strong nation.

It develops mechanisms to formulate credible plans at the village level and aggregate these progressively at higher levels of government, a bottom up-approach to development. It ensures inclusive economic growth.

It creates a knowledge, innovation and entrepreneurial support system through a collaborative community of national and international experts, practitioners and partners.

NITI Aayog will monitor and evaluate the implementation of programmes and focus on technology upgradation and capacity building.

Through the above, the NITI Aayog aims to accomplish the following objectives and opportunities:

- An administration paradigm in which the Government is an enabler rather than a pro- vider of first and last resort.
- Progress from food security to focus on a mix of agricultural production as well as actual returns that farmers get from their produce.
- Ensure that the economically vibrant middle-class remains engaged and its potential is fully-realized.
- Leverage India's pool of entrepreneurial, scientific and intellectual human capital.
- Incorporate the significant geo-economic and geo-political strength of the non-resident Indian community.
- Use urbanization as an opportunity to create a wholesome and secure habitat through the use of modern technology.
- Use technology to reduce opacity and potential for misadventures in governance.
- Leveraging of India's demographic dividend and realization of the potential of youth, men and women, through education, skill development, elimination of gender bias, and employment.
- Elimination of poverty and the chance for every Indian to live a life of dignity and self- respect.
- Redressal of inequalities based on gender bias, caste and economic disparities.
- Integrate villages institutionally into the development process.
- Policy support to more than 50 million small businesses, which are a major source of employment creation.
- Safeguarding of our environmental and ecological assets.

NITI Aayog Functions

NITI Aayog is developing itself as a state-of-the-art resource centre, with the necessary resources, knowledge and skills that will enable it to act with speed, promote research and innovation, provide strategic policy vision for the government and deal with contingent issues.

NITI Aayog's entire gamut of activities can be divided into four main heads:

1. Design policy and programme framework
2. Foster cooperative federalism
3. Monitoring and evaluation
4. Think tank and knowledge and innovation hub

NITI Aayog vs Planning Commission

The composition and functions of the two bodies are different:

1. Planning Commission did not have state/UT representation.
2. Planning Commission was the operational arm of the NDC which is a political institution. NITI Aayog has the Governing Council that approximates to the NDC. That is, NITI is PC and NDC in one body.
3. Planning Commission was directed by the NDC to flesh out the five-year plans. The NITI Aayog, in contrast, has no responsibility for socio-economic planning as it has been abolished.
4. NITI Aayog has the provision of regional councils that the Planning Commission did not have.
5. Planning Commission had more members and they were all full-time members.
6. Planning Commission had allocative functions— recommending plan financial transfers, centrally sponsored schemes, etc. NITI Aayog does not have such a function.

NITI's Achievements

The NITI Aayog as a policy think tank of the GOI works with the aim to achieve the Sustainable Development Goals and to strengthen cooperative federalism by bringing the involvement of state governments of India in the socio-economic policy-making process using a bottom-up approach. Its initiatives include '15-year vision map', '7-year strategy' and '3-year action agenda', AMRUT, Digital India, Atal Innovation Mission, Medical Edu- cation Reform, agriculture reforms (Model Land Leasing Law, Reforms of the Agricultural Produce Marketing Committee Act, Agricultural Marketing and Farmer Friendly Reforms Index for ranking states), Indices Measuring States' Performance in Health, Education and Water Management, Sub-Group of Chief Ministers on Rationalization of Centrally Sponsored Schemes, Sub-Group of Chief Ministers on Swachh Bharat Abhiyan, Sub-Group of Chief Ministers on Skill Development, Task Forces on Agriculture and Elimination of Poverty. Amrut is the Atal Mission for Rejuvenation and Urban Transformation. The scheme was launched in 2015 with the focus to establish infrastructure that could ensure adequate sewage networks and water supply for urban transformation by implementing urban revival projects.

There is a very good example of the equality in the relationship (between NITI Aayog and states). In 2015, three sub-groups of chief ministers were set up for making recommendations in three important areas (centrally-sponsored schemes, skill development and Swachh Bharat). The sub-group on centrally-sponsored schemes was asked to study 66 centrally-sponsored schemes and recommend which ones to continue, which to transfer to states and which to cut down.

Critical Appraisal

The government's move to replace the Planning Commission with NITI Aayog to play a facilitative role and not allocative role and assist in federalizing the growth process in the country with the empowerment of states received mixed reactions. Supporters say the idea to create an institution where state leaders will be a part of the collective thinking with the centre and other stakeholders in formulating a vision for the development of the country is right as compared to the previous structure, in which a few experts formulated the vision and presented it to the NDC.

The relationships under the previous institution (Planning Commission) was unequal, because the institution gave plan assistance to states and made states dependent on it. Now, NITI tries to have a more equal relationship.

NITI Aayog does monitor, coordinate and ensure the implementation of the globally accepted Sustainable Development Goals (SDGs). It is nominated as the nodal body that will bring the 17 development goals into action across India.

Vision Document, Strategy and Action Agenda beyond the 12th Five-Year Plan

Replacing the Five-Year Plans beyond March 2017, the NITI Aayog prepared the 15-year vision document, A 7-year strategy document spanning 2017–2018 to 2023–2024 to convert the long-term vision into implementable policy and action as a part of a 'National Development Agenda'. The 3-year Action Agenda for 2017–2018 to 2019–2020 aligns development plans to the 14th Finance Commission Award period.

Two Contrasting Growth Models

Sen vs Bhagawati

In 2014, a national debate arose about the relative merits of economic models offered by Nobel Laureate and economist Amartya Sen and eminent trade economist Jagdish Bhagwati.

Bhagawati argued that economic growth will trickle down and will create conditions for education and health for all. If growth is disrupted through redistribution policies through excess taxation at the initial stages, neither growth nor welfare will materialize. Modernisation, productivity and development will lag. There could be no redistribution without rapid growth. Free markets are the recipe for social development in due course. It is a neo-liberal argument.

Sen argued that social equity and health and education form the durable foundation for rapid growth. Sen made a case for social investments in schools, health infrastructure, skills and so on which will pave way for investments that will have assured supply of human capital. Thus, high growth rate will be sustainable with strong foundations of human capital and inclusion.

Building infrastructure for education and health will means lakhs of crores of investment that is employment intensive as well.

The Asian miracle economies posted high growth rates on the basis of social investments and equity.
Bhagwati and Arvind Panagariya made their point in a book, 'Why Growth Matters'.

Sen and Jean Dreze argued their case in 'An Uncertain Glory: India and Its Contradictions'.

The Covid -19 Pandemic revived the debate as it precipitated a economic and humanitarian crisis. Critics of neoliberal case for economic growth pointed to the health crisis and attributed it to retreat of State from social areas. With low per capita public expenditure in health; number of hospital beds per thousand people being low; average life expectancy at birth being low; after all these decades of high growth, hundreds of thousands of people die from tuberculosis every year in India.

The lack of public health infrastructure is one prominent reason for resorting to lengthy periods of lockdown as we lacked good and adequate hospital facilities, equipment, beds. Trickele down effect theory has come to be questioned.

World Bank says 'Investments in people, education, and health are legitimate roles for government and its adherents stress the importance of human capital in the growth process.

The COVID-19 pandemic has bright back global attention to human issues in economic growth.

Chapter - 5
Five Trillion Dollar Economy

Introduction

India is one of the fastest growing major economies and is currently ranked as the world's seventh largest economy (2019). India's commitment to fiscal discipline, sound external position, unprecedented foreign direct investment (FDI) inflows, comprehensive structural reforms and enhanced emphasis on social protection and financial inclusion have provided a robust framework for sustaining strong and inclusive growth going forward. India's performance in the Doing Business Ranking, Logistics Performance Index and Global Innovation Index are all positive and encouraging.

Strengths of the Indian Economy

There are several additional underlying strengths that are indicative of the latent potential of the economy:

- India currently enjoys a youth bulge—the average age in India is 29 years (2020).
- India offers an expanding market with income levels and the size of the middle class increasing. Investments in infrastructure are projected over the medium term to lead to better connectivity and reduced logistics costs for businesses.
- Digital technology has led to positive disruption in both governance and businesses.

Thus, India's potential of achieving a US$ 5 trillion GDP by 2024–25 is within the realm of possibility.

We need to steadily accelerate the gross domestic product (GDP) growth rate to achieve a target of about 8 per cent during 2019–23. This will raise the economy's size in real terms to nearly US$ 4 trillion by 2022–23. Besides rapid growth, which may reach 9–10 per cent by 2022–23, it is also necessary to ensure that the growth is inclusive, broad based (all sec- tors, regions and states), sustained and formalized.

The investment rate should be raised from 29 per cent to 36 per cent of GDP, which has been achieved in the past, by 2022–23. The exports of goods and services combined should be increased from US$ 478 billion in 2017–18 to US$ 800 billion by 2022–23.

High growth rate has been achieved in India with strong macroeconomic fundamentals, including low and stable rates of inflation and a falling fiscal deficit. This needs to be maintained.

Five Trillion US$ and Macroeconomic Stability

Sustained high growth requires macroeconomic stability, which is being achieved through a combination of prudent fiscal and monetary policies.

- The government has been undertaking fiscal consolidation on an annual basis.
- The government has targeted a gradual lowering of government debt-to-GDP ratio. The FRBM Act prescribes that the debt to GDP ratio of the Government of India should be brought down to 40 per cent by 2024–25.
- This will help reduce the relatively high interest cost burden on the government budget that can be used productively for investment. It will also help avoid crowding out the private sector.
- One of the major institutional reforms of recent years has been to legally mandate the RBI to maintain '... price stability while keeping in mind the objective of growth'. Inflation needs to be contained within the stated target range of 2 per cent to 6 per cent. Inflation targeting provides a reasonably flexible policy framework to respond appropriately to supply shocks.
- Our external sector policies like export promotion, etc., should be such that there is no volatility on the rupee front and there is a balance of payments stability.

Investment-led Growth for Five Trillion Dollar Economy

The measures required to boost both private and public investments are as follows:

1. India's tax–GDP ratio of around 17 per cent is half the average of the OECD countries (35 per cent) and is low even when compared to other emerging economies such as Brazil (34 per cent), South Africa (27 per cent) and China (22 per cent). To enhance public investment, India should aim to increase its tax–GDP ratio to at least 22 per cent of GDP by 2022–23. Demonetization and GST will contribute positively to this critical effort. Efforts being made to rationalize direct taxes for both corporate tax and personal income tax should be sustained. Simultaneously, there is a need to ease the tax compliance burden and eliminate the direct interface between taxpayers and tax officials using technology.
2. States could also undertake greater mobilization of own taxes such as property tax and taking specific steps to improve administration of GST to increase tax collections.
3. India's savings rate needs to be increased from the current sub-30 to about 40 per cent of the GDP.
4. Two areas in which higher public investment can be absorbed are housing and infrastructure. Investment in housing, especially in urban areas, will create very large multiplier effects in the economy through demand for

inputs, employment, bank credit, etc. Investment in physical infrastructure—roads, inland waterways, ports, airports, irrigation, digital connectivity—will address longstanding deficiencies faced by the economy.

5. The government has taken significant measures to attract foreign direct investment by easing caps on the extent of permissible stake holding and the norms of approval. The government may consider further liberalizing FDI norms across sectors. Domestic savings can be complemented by attracting foreign investment in bonds and government securities. Regulatory limits can be relaxed for rupee denominated debt.
6. The government should continue to exit central public sector enterprises (CPSEs) that are not strategic in nature. Inefficient CPSEs surviving on government support distort entire sectors as they operate without any real budget constraints. The government's exit will attract private investment and contribute to the exchequer, enabling higher public investment.
7. Private investment needs be encouraged in infrastructure through a renewed public–private partnership (PPP) mechanism on the lines suggested by the Kelkar Committee.

Agriculture and Five Trillion Dollar Economy

Agriculture and allied activities constitute about 17 per cent to the economy. Agriculture sector and rural economy have a significant role not only in ensuring food security and providing livelihoods but also in providing impetus to the growth of industries and service sectors. It is important that we optimize the returns for agriculture for the economic growth to be sustainable, high and inclusive. The areas to be focused upon are

- Modernizing agricultural technology
- Increasing productivity
- Crop diversification
- Generating income and employment through a paradigm shift that ensures food security while maximizing value addition in agriculture
- Ensuring marketing reforms so that the farmer makes profit

Manufacturing and Five Trillion US$

India is the fifth largest manufacturer in the world. The sector registered a compound annual growth rate (CAGR) of around 7.7 per cent between 2012–13 and 2017–18.

The government has taken several initiatives to promote manufacturing. Among these are:

- Make in India action plan, aimed at increasing the manufacturing sector's contribution to 25 per cent of GDP by 2020–2022.

- National Investment and Manufacturing Zones (NIMZs), which are an important instrument of National Manufacturing Policy, 2011. NIMZs are envisaged as large areas of developed land with the requisite eco-system for promoting world class manufacturing activity. So far, three NIMZs, namely Prakasam (Andhra Pradesh), Sangareddy (Telangana) and Kalinganagar (Odisha), have been accorded final approval and 13 NIMZs have been accorded in-principle approval. Besides these, eight Investment Regions along the Delhi-Mumbai Industrial Corridor (DMIC) project have also been declared as NIMZs. NIMZs are based on the principle of industrial growth in partnership with states and focuses on manufacturing growth and employment generation.
- Start-up India initiative, to promote entrepreneurship and nurture innovation, and Micro Units Development and Refinance Agency (MUDRA) and Stand-up India, to facilitate access to credit.
- Recapitalisation of public sector banks to ease the availability of credit to micro, small and medium enterprises (MSMEs).
- Major infrastructure projects, such as the setting up of industrial corridors, to boost manufacturing.
- The foreign direct investment (FDI) regime has been substantially liberalized, significantly improving India's rank in terms of annual FDI inflows from 14 in 2010 to 9 in 2017. However, India receives only 25 per cent of the FDI that China gets and only 10 per cent of what the USA receives.

However, manufacturing as a percentage of the GDP has remained at about 16 per cent. Constraints that are faced in boosting manufacturing are that

- Land acquisition laws are restrictive.
- Labour laws are rigid and discourage investment.
- Infrastructure in terms of power, roads and so on is to be strengthened.
- Skill deficit
- Regulatory uncertainty: Regulatory risks and policy uncertainty in the past have dented investor confidence.
- Technology adoption: The adoption of new technologies like artificial intelligence, data analytics, machine-to-machine communications, robotics and related technologies, collectively called 'Industry 4.0', are a big challenge for SMEs and for organized large- scale manufacturing.
- Data security, reliability of data and stability in communication/transmission also pose challenges to technology adoption.
- There has been no export driven industrial growth. Domestic demand alone may not be adequate for sustained, high value manufacturing.

- Despite improvements in our global Ease of Doing Business (EODB) rank, it continues to be a burden on the system. This is also true of investment condition in the states. Getting construction permits, enforcing contracts, paying taxes, starting a business and trading across borders continue to pose constraints for doing business.

The share of manufacturing in India's GDP is low relative to the average in low- and middle-income countries. It has not increased in any significant measure in the quarter century after economic liberalization began in 1991. Within manufacturing, growth has often been the highest in sectors that are relatively capital intensive, such as automobiles and pharmaceuticals. This stems from India's inability to capitalize fully on its inherent labour and skill cost advantages to develop large-scale labour-intensive manufacturing. Complex land and labour laws have also played a notable part in this outcome. That needs correction.

If we can remedy the constraints mentioned above, Indian manufacturing can take off.

Services and Five Trillion Dollar Economy

Services (other than construction) can be broadly divided into traditional and modern services, the latter making up a sizeable part and growing rapidly. The services sector makes up about 55 per cent of the GDP.

Modern services include financial services, communication services, real estate, ownership of dwelling and professional services, hotels and restaurants and other services. Modern services tend to use information and communication technology more intensively than traditional services, and their share tends to rise or move in tandem with an increase in income.

Traditional services' share in GVA declines as a country's income increases.
The Union Government adopted the Action Plan on Champion Sectors in Services in 2018. Twelve service sectors, namely information technology and information technology enabled services (IT and ITeS), tourism and hospitality services, medical value travel, transport and logistics services, accounting and finance services, audio-visual services, legal services, communication services, construction and related engineering services, environmental services, financial services and education services have been identified as champion service sectors. The aim is to achieve the expansion of the services sector output and increase service sector exports.

A dedicated fund of `5000 crore to support initiatives in the identified champion service sectors has been approved.

A High-level Committee would undertake timely and regular monitoring of sectoral action plans.

Exports and Five Trillion Dollar Economy

India needs to remain globally competitive in the production and exports of manufactured goods and services, including processed agricultural goods. Without export promotion, a 5 trillion US$ economy is not possible. The following reforms would help in improving the competitiveness:

- A focused effort is needed on making the logistics sector more efficient.
- Power tariff structures may be rationalized to ensure global competitiveness of Indian industries.
- Connectivity should be improved by accelerating the completion of announced infrastructure projects. Enhancing physical connectivity will help reduce delivery times and improve global connectivity and the reach of our exporters. By 2022–23, we should complete projects that are already underway such as the Delhi–Mumbai Industrial Corridor (DMIC) and Dedicated Freight Corridors.
- Working with states to ease labour and land regulations
- The government has recently established a dedicated fund of INR 5,000 crore for enhancing 12 Champion Services Sectors. Among others, these include IT and ITeS, tourism, medical value travel and audio-visual services. Given the significant role of services exports in maintaining India's balance of payments, the government should continue to focus on these sectors.
- Explore closer economic integration within South Asia and the emerging economies of South East Asia, particularly Cambodia, Laos, Myanmar and Vietnam, using the existing Bangladesh, Bhutan, India, Nepal (BBIN) and the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Co-operation (BIMSTEC) frameworks.
- Credit should be available in time, in adequate amount and also at the right rate.
- Under the GST, refunds must be given in time.

Industry 4.0 and Five Trillion Dollar Economy

The technological trend of digitization in manufacturing, automation and data exchange in manufacturing technologies is called Industry 4.0. Also referred to as the fourth industrial revolution, it includes cyber-physical systems, the Internet of Things, cloud computing and so on. The adoption of computers and automation to enhance productivity in the new age was seen in the times of the first industrial revolution. The fourth industrial revolution is different from earlier revolutions in its velocity, breadth and depth and its impact on systems.

It will significantly impact sectors like automobile, pharmaceuticals, chemicals and financial services and will result in operational efficiencies, cost control and revenue growth. Experts feel that emerging markets like India could benefit tremendously from the adoption of Industry 4.0 practices.

As India's GDP enters the US$ 5 trillion orbit, we will face both challenges and opportunities. Greater integration into the global economy, expansion and growth, and the importance of good governance will matter more.
If Indian companies adopt Industry 4.0 across functions such as manufacturing, supply chain, logistics and procurement, they can enhance productivity with much less expenditure.

Greenfield smart cities present a huge opportunity because they start from scratch and have the ability to start everything afresh, including modern facilities with public transportation, ICT-enabled infrastructure and impart the right kind of skills to its people. Greenfield cities can become centres of excellence for new-age industries and become innovation hubs.

India is expecting a revenue of US$ 800 billion through exports in 2022, along with the creation of 100 million jobs. Advances in technology are vital to achieve this feat— while some jobs may be lost, many more will be created in education, skills and materials. Similarly, our needs in health, environment and education can benefit from Industry 4.0.

One challenge is the lack of skilled professionals who are capable in this domain. Our education system is still structured towards meeting demands of the earlier era of industrialization, yet advanced analytics, big data, robotics, AI and IoT are affecting every aspect of how we live.

The Indian education system is one of the largest in the world with more than 1.5 million schools, 8.5 million teachers and 250 million students from varied socio-economic backgrounds. A high-quality, research-led and skills-based education system is the need of the hour to reboot our economy in the fourth industrial revolution.

The development of industries that produce the key building blocks forming the basis of Industry 4.0 could be incentivized. Incentives could be focused on MSMEs that maufacture products such as sensors, actuators, drives, synchronous motors, communication systems, computer displays, and auxiliary electromechanical systems. Similarly, industries adopting Industry 4.0 standards could be provided support for a fixed period of time.

Atma Nirbhar

Covid-19 severely disrupted global supply chains and global trade. The threat to economic growth as a result made the policy makers in India revive the original idea of five year plans: self-reliance. The Nehru-Mahalanobis model (1956-61) that laid the foundations of industrial growth in the country is a prime example of self-relaince. Green revolution of late 1960's is another.

The economic reforms of liberalization and globalization in 1990's changed the strategy. The earlier model excluded globalization and liberalization due to the conditions prevalent at that time. In 1990's, self-reliance meant bringing foreign direct investment(MNCs) into the country to strengthen the domestic economy. Earlier it was isolation and protectionism that were the characteristics of self-reliance. Since 1991, it is globalization for domestic growth.

Atma Nirbhar Bharat – self-reliance economy – is the new need of the hour in the wake of global disruptions in 2020 due to the pandemic. It depends on globalization and FDI but ensures that goods and services are made in India for domestic consumption and exports. Economic Survey 2019-20 made a cake for `assemble in India` to promote investments, exports and employment. Atma Nirbhar means globalization with India having a larger contribution to it by way of scales of economy, consumption and exports. Thus, it will accelerate India's progress towards $5 trillion economy.

Chapter - 6
Fiscal Policy

Fiscal Policy: Definitions

- Fiscal Policy is that part of government policy which is concerned with raising revenue through taxation and other means, and decides on the amounts and purposes of government spending.
- It is the government revenue and spending policy that influences macroeconomic conditions. Fiscal policy affects tax rates and government spending to control the economy.
- Fiscal policy is the policy of a government which deals with revenue and expenditures, which together make up the budget.
- It is the means by which a government adjusts its levels of revenue and spending in order to monitor and influence a nation's economy.

Fiscal policy relates to raising and spending money in quantitative and qualitative terms— how and how much. The entire budget exercise with all the policies within it is the core of a fiscal policy.

Main channels from where fiscal receipts can be obtained are disinvestment proceeds and borrowings from internal and external sources and taxes and user charges levied for the services like power, transport charges, water and so on. All receipts are not earned (some are borrowed) What is earned is revenues and the rest are receipts. Receipts and expenditure are divided into revenue and capital accounts; Art.112 in the Constitution talks of revenue and other expenditure and does not mention capital account explicitly.

Fiscal policy does not deal only with the quantity but also the quality of public finance. This implies that it is concerned with not merely how much is raised and spent but also how has it been raised, for example, whether is it raised by way of taxes or borrowings, are they excessive or irrational, etc. Also, the way the finances so raised are used productively for capital formation or for welfare or wastefully. Fiscal policy also sheds light on populistic expenditure–spending without economic rationality and in a counterproductive manner. For example, power subsidy for farmers.

Fiscal policy can achieve important public policy goals like:

- Growth
- Equity
- Sustainability
- Gender empowerment

- Promotion of small-scale industries.
- Encouragement to agriculture.
- Location of industries in rural areas
- Labour-intensive growth
- Export promotion
- Development of sound social and physical infrastructure, etc.

Plan and non-plan expenditure was shown in the budget till 2016–17 but was dropped since 2017–18 due to distortionary effects that we will see ahead. They are not constitutional terms.

Revenue Account and Revenue Expenditure

A break up of the finances into revenue and capital streams, in general, is as follows:

Revenue Account: It has receipts and expenditure.

Revenue receipts include: taxes and non-tax sources, Taxes are of two types direct and indirect.

Income tax, corporation tax, for example, are direct. Indirect are GST, basic customs duty, etc.

Non-tax resources include:

- Profits
- Interest receipts on loans given
- Dividends, from PSEs, RBI, etc.

Revenue account expenditure include, but are not limited to, the following:

- Interest payments
- Defence
- Subsidies
- Public administration
- Financial grants to states (also part of this account as they do not create any assets for the central government). The Finance Commission grants are given to the State Governments under Article 275(1) of the Constitution. There are grants in aid for State disaster response funds and in aid for rural and urban local bodies.

Revenue account expenditure in conventional terms, is synonymous with maintenance and consumption expenditure as well as welfare expenditure. It does not create assets directly.

Capital account receipts are:

- Recoveries of loans and advances made by the Union Government to States, UTS and PSUs.

- Receipts from sale of assets like public sector units and their shares—privatization and disinvestment respectively. However, Government earned from the 3G spectrum auction and the broadband wireless spectrum auction a total revenue of about `1 lakh crores and it was classified as a one-time revenue receipt in 2010 even as spectrum was an asset.
- Fresh borrowings from inside the country and from overseas.

As is clearly aforementioned, some of them are debt and some are non-debt.
Capital account expenditure is:
- Loans made to States, UTs and PSUs
- Expenditure for asset creation in infrastructure and social areas
- Loans repaid

Deficits

Governments usually do not have all the financial resources necessary for investment and inclusion. Therefore, they run deficits which are the following:
- Revenue deficit
- Effective Revenue deficit
- Fiscal deficit
- Budget deficit
- Monetized deficit Primary deficit

Revenue Deficit

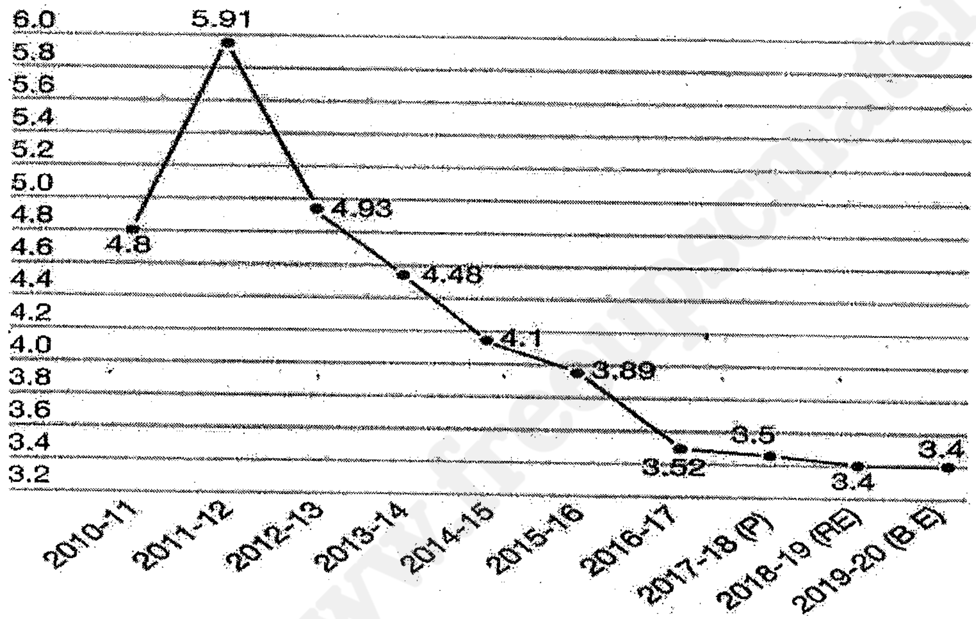
Revenue Deficit (RD) is the difference between the revenue receipts on tax and non-tax sides and the revenue expenditure. Revenue expenditure is conventionally considered synonymous with consumption and non-development. However in India's case, social sector expenditures on education, labour welfare, health, contributions to agriculture, social security, etc., (in government-flagship schemes) are part of revenue expenditure. When revenue deficit is zero, we can fund for consumption from government's own resources and not borrow. RD at zero was the goal of the Original Fiscal Responsibility and Budget Management (FRBM) Act in 2013.

Effective Revenue Deficit (ERD)

An additional fiscal indicator, namely, effective revenue deficit, was introduced in the FRBM Act 2012. Effective revenue deficit is defined as the difference between 'the revenue deficit and the grants for creation of capital assets'.
Grants for creation of capital assets are defined as 'the grants-in-aid given by the Central Government to the State Governments, constitutional authorities or bodies, autonomous bodies and other scheme implementing agencies for creation of capital assets'. This concept was devised to protect part of the

revenue deficit that created capital assets like school and hospital buildings, irrigation works, etc., and to make rest of the RD zero.
However, since 2018–19, the government has abandoned fixing targets for the reduction and elimination of revenue deficit and ERD.

Fiscal Deficit
It is the difference between what the government earns and its total expenditure, i.e., the difference between what is received by the government on revenue account and all the non-debt creating capital receipts and the total expenditure. It amounts to all borrowings of the government in a given period which is normally a fiscal year. Fiscal Responsibility and Budget Management (FRBM) Act was amended in 2018 to fix fiscal deficit target at 3 per cent for 2020–21.
Difference between Gross Fiscal Deficit and Net Fiscal Deficit: Total borrowings of the union government in a given fiscal year are the Gross Fiscal Deficit. We deduct the following from the Gross Fiscal Deficit to get Net Fiscal Deficit: Loans to states and central public sector enterprises, etc. Government borrows for the states as the states may not be creditworthy and may have to pay higher rates.



Source: RBI Budget

Budget Deficit
It is the difference between total budgeted expenditure and receipts that include the money borrowed from market by the RBI by floating government securities. The deficit is filled by borrowing from the RBI through printing of fresh currency.

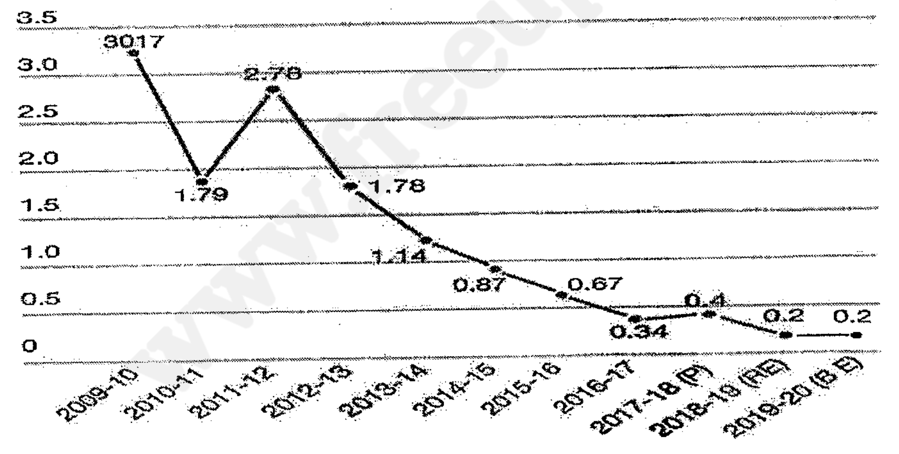
The concept was discarded in 1997 as it led to accounting distortions. It considered only the printed part of the deficit but overlooked the amount that the RBI borrowed from the markets (banks, etc.) Thus, budget deficit presented only a partial picture of government debt.
Fiscal Deficit mirrors the health of government finances most comprehensively and accurately unlike the budget deficit concept and so is the only deficit that is tracked to be rationalized by the government of India from 2018.

Monetized Deficit

It is borrowings made from the RBI through printing fresh currency. It is resorted to when the government cannot borrow from the market (banks and financial institutions, like LIC etc.) any longer due to inadequacy of credit available and pressure on interest rates. It means infusion of fresh currency into the market. It was discontinued from 2006 as a part of the FRBM and since then RBI does not normally print to lend to the GOI. It is equal to budget deficit when the concept was in vogue.

Primary Deficit

It is the difference between the fiscal deficit and the interest payments. The concept helps in assessing progress of the government in its current fiscal control efforts. A new government is assessed for its fiscal performance on the basis of primary deficit as interest payments are a legacy. Rest of the fiscal deficit can be rationalized and in fact brought down to a level where government may end up borrowing less than interest payments. It is called primary surplus. Later when all the borrowings stop, interest payments are made from budgetary revenues though such a budgetary phenomenon may only be in remote future, if at all.



RE- Revised Estimates, BE- Budget Estimates. P- Provisional
Unit: % of GDP

Deficit Financing

When the Government has to spend more than what it can raise through tax, non-tax and other sources, it borrows from the market. It cannot borrow above a certain amount from the market as it may be inflationary, push up interest rates and thus make it even more costly for the government to service the loan—and 'crowd out' private investment. Under such circumstances, Reserve Bank of India prints money and supplies credit (at a cost). It is called deficit financing.

Total money printed by the RBI is called high powered money or reserve money or monetary base.

Contribution of deficit financing to India's economic development is manifold.

- In the early 1950s, our domestic savings ratio was less than 9 per cent of GDP, and that constrained the investment and welfare activity of the government.
- The capacity to raise non-inflationary sources of financing (taxes, small savings, genuine public borrowings, etc.) was highly limited.
- If the government laid claim to the available credit in the market, it would crowd out the resources for the business and consumption.
- External aid could supplement domestic funding only to a limited extent. (It is better to source debt from inside than outside.)
- Foreign Direct Investment was discouraged as a source of investment and thus scarcity of investment resulted. Therefore, government had to itself take up investment even if it meant borrowing through monetization (printing of money).

Regarding the notion of deficit financing, some scholars use the term generally and equate it to the amount of borrowings of the government in a given period (like one year) while some confine the use to the money that is printed by the RBI in a given year.

Limits of Fiscal Deficit

Fiscal Deficit (FD) is an annual amount while what accumulates historically is the public debt—domestic and external together. To a limited extent, fiscal deficit is important as the government's ability to help growth and welfare increases. Government can always return the loans when its revenues improve due to tax buoyancy. However, fiscal deficit becomes problematic when it overshoots a rational threshold. Sovereign debt crisis (country finds it difficult to service external debt contracted in foreign currency) is the result of unsustainably high debt. Therefore, moderation of fiscal deficit is important.

Large deficits deprive the nation of sustainable economic growth—inter-generational equity is damaged as the next generation gets burdened with higher

taxes because the present generation is reckless and has raked up a heavy debt. Government liabilities and interest payments increase and there is far less left for development.
BOP pressures may mount if inflows drop due to the country being downgraded by rating agencies like Standard and Poor, Moody, Fitch, etc., due to its macroeconomic instability caused by excessive borrowings. Therefore, fiscal deficit must be moderated—they are desirable within limits but hurtful beyond them.

The above analysis applies to fiscal deficit in normal times. But in abnormal times like 2008–09 when the world crashed into the great recession impacting Indian economy negatively, fiscal deficit was increased for the fiscal stimuli which was necessary to arrest downturn in the economy and revive growth. FRBM allows such counter-cyclical expenditure. Even then, deficit should be incurred not for populist expenditure but to stimulate the economy.

Fiscal deficit should be kept within rational limits—laws like FRBM should control the deficit and borrowed money should be used productively. The viability and desirability of deficit financing, in short, depends on extent of borrowing and end use of the money borrowed.

Revenue Deficit Target Abolition: Pros and Cons

In 2018, Fiscal Responsibility and Budget Management (FRBM) framework was amended and the target for the RD was scrapped. The reason is that much of RD is for funding flagships like Ujjwala, Saubhagya, Bharatala, etc. From 2018–19, only fiscal deficit will be targeted and should reach incrementally with annual targets at 3 per cent of GDP by 2020–21. The criticism is that all the borrowings can be used for consumption if there is no target to zero the RD.

Twin Deficit Challenge

Budget deficit (fiscal deficit) and Current Account Deficit (CAD) are together known as twin deficits. If they are not prudently managed, they can mutually damage each other. The explanation is as follows: Current Account Deficit can grow when exports do not increase, and imports do or when there are supply shocks like in 2018 when international crude prices went up rapidly and India is 85 per cent dependent on crude imports.

The Result: Foreign inflows will slow down and outflows will increase (capital flight) as the country may face serious difficulties in financing exports. Rupee will depreciate making the Current Account Deficit problem even worse. When imports are made with costly rupee, it leads to inflation at home. Government has to subsidise goods and services to moderate inflation. Thus, government borrowings mount and fiscal deficit breaches rational targets. That in turn makes foreign investors panic and leave the country making rupee lose even more value.

Thus, fiscal deficit and Current Account Deficit feed into each other and need to be jointly managed very well.

Fiscal Stimulus

Global recession impacted India and our economy was threatened with slowdown in 2008. Tax revenues were hit. There was a fall in demand. Corporate sector postponed investment. Threat to employment was real. Therefore, Government took recourse to the Keynesian solution of borrowing and spending. FRBM limits were set aside and the need of the hour was not prudence but stimulus. It is called pump-priming or stimulus. The result is that fiscal deficit reached an abnormally high level—6.8 per cent in the year 2009-10.

The fiscal stimulus package involved:

- Higher deficit and spending
- Tax reliefs—direct and indirect

Monetary stimulus was:

- Rate cuts
- SLR cuts
- CRR cuts

These measures were effective in preventing slowdown. The growth rate improved to 8.4 per cent for the next two fiscal years of 2009–10 and 2010–11. The unsustainably high fiscal deficit could not be continued for long and had to be rolled back to normal levels in a calibrated manner and it was embarked upon in since 2010–11.

The lockdown in the world and in India in 2020 due to the global pandemic and the resulting crash in economic activity also demanded that the government breach the FRBM limits on fiscal deficit.

FRBM Act

It was originally passed in 2003 and was amended many times later. FRBM was necessary to ensure that the:

- Government does not borrow beyond rational limits.
- Borrowing for consumption must be brought to zero over a period.
- Only borrowing for asset creation is to be allowed.

• Total debt of the GOI should be limited.
• RBI should not be the primary lender, that is, RBI cannot print to give credit to the government.

The original aim was to ensure all the above targets to be realized by 2008–09, but global great recession intervened, and the targets have since not been feasible. Budget 2018–19 amended the FRBM Act. The net effect of all the amendments is:
• To shift the target of fiscal deficit 3 per cent GDP ratio to 2020–2021.
• No target has been set for revenue deficit.
• General (Centre and states) and Central government debt—GDP ratios are to be reduced to 60 per cent and 40 per cent of GDP, respectively, by 2024–25.

In 2018, the FRBM Act was amended to insert what is popularly known as the `escape clause` as recommended by the NK Singh FRBM Review Committee in 2017. It said that the exceptional circumstances cited in the FRBM Act, 2003 had to be laid down clearly leaving no scope for misuse. In 2018, the FRBM Act was amended to allow breach of the rules – for example, exceed the fiscal deficit target- under three conditions:
1. over-riding considerations of national security, acts of war, and calamities of national proportion and collapse of agriculture severely affecting farm output and incomes
2. far-reaching structural reforms in the economy with unanticipated fiscal implications.
3. a sharp decline in real output growth of at least 3 percentage points below the average for the previous four quarters.

The FRBM amendments permit a maximum deviation of 0.5 percentage points in a year, from the stipulated fiscal deficit target.

In the 2020-21 Budget, the government invoked the second condition.

1 and 2 conditions from above seem to be relevant in the context of the demand destruction caused by the corona pandemic in 2020-21.

When the FRBM Act limits government borrowing, it applies to a cap on the level of guarantees that the Government stands as well and not only to the amount the government borrows.

FRBM Act is based on Art.292 of the Indian Constitution that gives power to Parliament to limit borrowing by the GOI on the security of Consolidated Fund of India (CFI).

Under the FRBM Act, the following documents are to be laid in both the Houses of Parliament along with the Annual Financial Statement and Demands for Grants in the budget session:

- Medium-Term Fiscal Policy Statement
- Fiscal Policy Strategy Statement Macroeconomic Framework Statement

In 2012 the Act was amended to ensure that the following fourth document is to be laid in the session immediately following the budget session in which the aforementioned documents are presented in the Parliament: Medium Term Expenditure Framework Statement (MTEF).
Medium Term Expenditure Framework MTEF statement presents a three-year rolling target for the expenditure indicators with specification of underlying assumptions and risks involved. The statement gives an estimate of expenditure commitments for various items like Education, Health, Rural Development, Energy, Subsidies and Pension, etc.

The Medium-term Fiscal Policy Statement (MTFP) sets out three-year rolling targets for five specific fiscal indicators in relation to GDP at market prices:

- Revenue deficit
- Effective revenue deficit
- Fiscal deficit
- Tax to GDP ratio
- Total outstanding debt as percentage of GDP at the end of the year.

FRBM act further mandates that on a quarterly basis, the Government shall place before both the Houses of Parliament an assessment of trends in receipts and expenditure.

It is only under some exceptional circumstances that the Government is compelled to breach targets. In case of deviations, the Government would not only be required to take corrective measures but the Finance Minister shall also make a statement in both the Houses of Parliament. Borrowing from the RBI through monetization is permitted in exceptional situations like natural calamities.

In a nutshell, FRBM was brought in, among other reasons for fiscal discipline, to increase plan expenditure, to reduce the amount of borrowings, meet consumption from government's own fiscal resources, and to leave the RBI with the autonomy for money creation.

New Zealand was the first country to enact a Fiscal Responsibility Act in 1994. A sim- ilar legislation, the Charter of Budget Honesty, was enacted in Australia. The UK too, enacted a Code for Fiscal Stability. The global recession from 2008 onwards has made the government breach the FRBM targets vastly. However, fiscal consolidation since then has been on track and the target for fiscal deficit under modified FRBM is 3 per cent of GDP by 2020–21.

Fiscal Consolidation

Fiscal consolidation means strengthening government finances. It essentially means reduce government annual borrowings and further reduce the historic cumulative public debt. Fiscal consolidation is critical as:

- It provides macroeconomic stability
- It cuts wasteful expenditure
- It can enable the government to spend more on infrastructure and social sectors

Tax reforms, disinvestment, better targeting of subsidies and so on are the hallmarks of fiscal consolidation. Enactment of FRBM Act provides an institutional framework and binds the government to adopt prudent fiscal policies. Fiscal consolidation requires that the centre and states both work for balancing their budgets.

In recent years, fiscal consolidation in India included the following reforms:

- Revenue reforms that include tax reforms like GST, corporate tax reform, wealth tax abolition, capital gains tax reforms, rationalization of tax exemptions, improving efficiency of tax collection and tax stability.
- Capital side receipts were boosted through disinvestment and privatization.
- On the expenditure side, reform areas include rationalizing subsidies through adoption of digital technologies and better targeting through Aadhaar, cutting out non-essential and unproductive activities, schemes and projects, allocation of resources to priority areas, reducing cost of services, rationalizing subsidies, reduction of time and cost overruns on projects, getting proper 'outcome' from output.

The reduction in fiscal deficit should not be achieved by a reduction in capital expenditure. It should be done by way of realization of higher revenues and rationalizing revenue expenditure. Austerity measures may also be applied to cut down on administrative waste.

N.K. Singh Review Committee on FRBM

Five member FRBM Review Committee was set up in 2016 under the Chairpersonship of Shri N.K. Singh with Terms of Reference (ToR) that included comprehensive review of the existing FRBM Act in the light of contemporary changes, past outcomes, global economic developments, best international practices as well as to recommend the future fiscal framework and roadmap for the country. The committee submitted its report in 2017. It suggested:

- Creation of a new Fiscal Council that will prepare multi-year fiscal forecasts for the central and state governments (together called the general government) and provide an independent assessment of the central government's fiscal performance and compliance with targets set under the new law.
- Gradual lowering of debt to GDP ratio from the present level of 68% to 60% comprising 40% of Centre and 20% of States.
- Adopting fiscal deficit as the key operational target at 3 per cent of GDP for three years, between 2017–18 and 2019–20.
- Prescribed a glide path to these targets—steady progress towards them—and suggested that there be some flexibility in the deficit targets on both sides, downwards when growth is good and upwards when it isn't.
- To deal with unforeseen events such as war, calamities of national proportion, collapse of agricultural activity, far-reaching structural reforms and sharp decline in real output growth of at least 3 percentage points, the committee has specified deviation in fiscal deficit target of not more than 0.5 percentage points. The committee said that if there is a sharp increase in real output growth of at least 3 percentage points above the average for the previous four quarters, fiscal deficit must fall by at least 0.5 percentage points below the target.
- For any deviations, the Centre would be expected to hold formal consultations with the three-member Fiscal Council.

Crowding Out

Excessive government borrowing can lead to shrinkage of the liquidity in the market for the private sector and forces the interest rates to go up. Investment suffers and growth decelerates. It is called crowded-out. The Government also may not spend the borrowed resources well to generate returns. It may spend on populist schemes. However, if the government deploys the funds well, it may have a 'crowding-in' effect: the infrastructure built can have a multiplier effect on investment, jobs, tax collections and growth. For example, Bharatmala, the highway project.

Off Budget Financing

FRBM Act Compliance Report for FY2017 of Comptroller and Auditor General of India (CAG) presented recently gave suggestions for presenting details about off-budget financing of government expenditure. Contextualize the issue with CAG's suggestions for introduction of parliamentary accountability in this matter.

Fiscal Responsibility and Budget Management (FRBM) Act Compliance Report for FY2017 of Comptroller and Auditor General of India (CAG) was tabled in Parliament in 2019 where it highlighted the off budget expenditure of the GOI and its implications and suggestions.

Fiscal Responsibility and Budget Management (FRBM) Act aims to institutionalize fiscal discipline, reduce fiscal deficit, improve macro-economic management, reduce wasteful expenditure and reduce debt and the overall management of the public funds by moving towards a balanced budget.

However, Comptroller and Auditor General of India (CAG) in a recent report, stated that the government is resorting to off-budget expenditure—expenditure not being shown in the fiscal accounts of the budget as it is being made by public sector enterprises.

They are as follows:
- Deferring fertilizer arrears.
- Food subsidy arrears of Food Corporation of India (FCI) through borrowings.
- For implementation of irrigation scheme (AIBP) through borrowings by NABARD under the Long-Term Irrigation Fund (LTIF).
- Financing of railway projects through borrowings of the Indian Railway Finance Corporation (IRFC).
- Financing of power projects through the Power Financing Corporation (PFC).

They have serious fiscal implications and thus impact private investment, growth and macroeconomic stability.

CAG suggested that government should consider presenting a policy framework for off-budget financing. The framework should specify the rationale and objective of off- budget financing, quantum of off-budget financing and sources of fund, etc.

Fiscal Council

Fiscal policy has to be data-driven as it is the lifeline of the national economy. Revenue projections have to be realistic and transparency in tax administration is necessary. In 2017, Comptroller and Auditor General of India (CAG) reported the use of off-budget entries to manage the government's books. Such practices are temporary solution but create medium to long term destabilisation.

In order to ensure that the Government follows best fiscal practices, there is a need to set up an independent and statutory watchdog to oversee the state of public finances based on its own assessments.

An International Monetary Fund (IMF) working paper in 2019 showed that the presence of an independent fiscal council tends to boost accuracy of fiscal projections and helps countries conform to fiscal rules.

In India, two expert committees have advocated the institution of such a council in recent years. In 2017, the N.K. Singh Committee to Review the FRBM suggested the creation of an independent fiscal council that would provide forecasts and advise the government on whether conditions exist for deviation from the mandated fiscal rules.

In 2018, the D.K. Srivastava committee on fiscal statistics established by the National Statistical Commission (NSC) also suggested the establishment of a fiscal council that could co-ordinate with all levels of government to provide harmonized fiscal statistics across governmental levels and provide an annual assessment of overall public sector borrowing requirements.

13th and 14th finance commissions also advocated the establishment of independent fiscal agencies to review the government's adherence to fiscal rules, and to provide independent assessments of budget estimates.

Budget Reforms

In recent years the budget reforms were taken up for more efficiency, better synchronization of public finance with general economy, cutting down populism, etc. Budget presentation got preponed. Union budget was traditionally presented on the last working day of February and passed by mid-May. However, since 2017–18, Union budget is being presented on February 1, and passed before the onset of the next fiscal year.

- The Railway Budget was presented separately since 1924 on the recommendation of committee led by Sir William Acworth. This was done because economy depended on Railways. From 2017– 18 onwards, railway budget is merged with the general budget as the revenue had shrunk and for the government to take a holistic view.

- Plan and non-plan expenditure removed because it was creating distortions.
- Shankaracharya committee on calendar for budget was set up to suggest the pros and cons of different budget calendars like presenting it on January 1 or February 1 or July 1 or in November.

Zero Base Budgeting (ZBB)

When financial resources are scarce and the priorities are many, a method is worked out to select the most important ones. ZBB is one such. ZBB methodology was taken up first in 1987 in the Union Budget for some items. Many state governments also applied it, for example, Government of Rajasthan and Maharashtra. The Maharashtra Government renamed it 'Development-based budget'.

The name of ZBB comes from the fact that every year budget making starts from a base of zero and programmes are added according to their worth. Under the ZBB, a close and critical examination is made of the existing government programmes, projects and other activities to ensure that funds are made available to high priority items by eliminating outdated programmes and reducing funds to the low priority items. Governmental programmes and projects are appraised every year as if they are new and funding for the existing items is not continued merely because a part of the project cost has already been incurred. Programmes are discarded if the cost-benefit ratio is below the prescribed norms.
Zero-based budgeting runs contrary to traditional budgeting where the previous year's budget is taken as a base. It re-evaluates portions of budget.

ZBB as a resource planning and control technique and process yielded substantial benefits in advanced countries such as New Zealand, UK, Australia and Sweden in terms of efficiency gains, better resource use, lower costs and finally surplus budgets. (Particularly in New Zealand.)

However, the use of ZBB for human development programmes and poverty alleviation and employment generation programmes and other government flagships is limited, the results are cumulative and cannot be assessed annually. For example, Ayushman Bharat, Saubhagya, Ujjwala, etc. But they can always be improved.
The Economic Survey 2014 says that the expenditure on social schemes needs to be rationalized. 'What is needed is a 'zero budgeting' approach with a revamp, reorganization, and convergence of schemes.'

Outcome Budget

The budgetary outlay is followed by creation of physical assets for the given goals such as education, health, afforestation and infrastructure. But what matters even more is the developmental impact. For example, the output for school education is buildings and appointments. Outcome is enrollment, retention, learning outcomes, elimination of child labour, and vocationalization among others.

Gender Budgeting

It involves sensitivity towards the needs and expectations of women. It should be reflected in how taxes and finances are raised and spent. It also encompasses the extent of spending for women empowerment.

Plan and Non-plan Expenditure Classification

In the Budget, receipts and expenditure are shown under revenue and capital accounts. Till 2016–17, each account of expenditure was subdivided into plan and non-plan. The former was for asset creation—physical, human and social. The latter was for maintenance of assets. Assets are dams, roads, power plants, etc. It can also be social and human capital.

While the intent was good, one important perverse effect was that assets created were not being maintained because maintenance expenditure would be classified as non-plan and public perception was that government was spending more on consumption/maintenance and less on capital formation. Thus, assets were neglected. Also, human and social assets were classified as planned but under the revenue account. It created an opinion that revenue expenditure was mounting though in reality it was for flagship programmes. Therefore, from 2017–18, the budgetary distinction was dropped.

Gross Domestic Savings

Saving are excess of income over expenditure. It refers to income not used for immediate consumption. The domestic sources of savings are household, private corporate and government. Household savings are of three types—voluntary, involuntary and forced savings.

When there is more income than is necessary, there is a propensity to save it either in financial form like a bank deposit or physical form, like gold or land. Households save from income. Companies save from profits for investment. Savings improve if there are tax concessions and interest rate subsidies.

When the government gives incentives to save in the form of tax or pension or higher interest rates (Post Office certificates and accounts), it generates savings, but they are involuntary. However, it must be stated that voluntary and involuntary savings overlap significantly.

Forced savings are the result of high inflation. Banks may offer interest rates that are positive in real terms (inflation-adjusted). Reserve Bank of India may float Inflation Indexed Bonds (IIBs) to protect the money of the savers.

Household savings in India or elsewhere depend on the following factors:

- The Level of Per Capita GDP: Higher the per capita income, more the savings; normally though many more causes come together to dictate savings' rate. For example, in the US, even as there is high per capita, domestic household savings rate is much less than 10 per cent of GDP because of low inflation, low interest rates, social security and abundant availability of public goods among other factors.
- Demographic Factors: In an economy that is predominated by the young as in India, savings rate is expected to be high as working age population works, earns and saves more. However, demographic factors are necessary but not enough for growth and savings and it must be complemented by a stable and consistent macroeconomic policy.
- Real Interest Rate: Inflation-adjusted interest rate is a major influence on savings. If savers are offered inflation plus rates, they tend to save more.
- Fiscal Policy Related to Budget and Taxes: If there is tax incentive to save as in mutual funds, post office deposits, etc., it can motivate savings. Similarly, in disinvestment, good shares sold concessionally to small investors can make them attractive for savings.
- Rising Wages: New jobs being created with decent wages can also create savings. In fact, that is one of the bases for being optimistic about the demographic dividend in India.
- The Distribution of Income: Have a crucial bearing on savings rate. If there is extreme inequality, the wealth does not get distributed and the economy will not have economic mobility for most people and thus savings will become scarce. If there is equity, it sets off economic growth through demand and savings will also be one of the multiplier effects.
- Financial Reforms: Where the financial products are good, savers will come forth. For example, Payments Banks, Small Finance Banks, micro-finance institutions, Jan Dhan, etc., can all induce financial inclusion and boost savings.
- The Effects of Taxation: Can be positive for savings. For example, raising the entry level for tax liability as was done in February 2019 in the Union

interim Budget when up to the amount of ` 5 lakhs, all income tax liability was removed. Rebates on long term capital gains tax also help. However, tax stability is important.

To discuss savings meaningfully, we need to separate the capacity to save from readiness to save. Capacity to save is driven by the following aspects: per capita income, growth of income and distribution of income. The readiness, on the other hand, is based on the rate of interest, access to financial institutions, suitable financial products and the rate of inflation.

Most importantly, no single factor determines a major macroeconomic feature like domes- tic savings rate. It is a moving combination of most of the outlined aforementioned factors.

Savings and Investment

Savings are the lifeline for investment-related economic growth. Savings provide a vital source of funds for a growth-oriented economy. Financial savings provide investible funds through banks, non-banking finance companies, bonds, stock market and so on for investment in fixed capital of factories; purchase of Machinery; infrastructure, exports, innovation and so on. Physical savings create demand for land and buildings and thus assist economic growth.

However, increased savings do not always convert to increased investment. There is more than one condition necessary for this conversion:

- If savings are not made in financial assets as in banks and NBFCs, but in assets such as gold, they cannot be lent for investment.
- If the economy is slowing down or is in recession, the money in the bank cannot be lent as there is no demand for credit. It is called a liquidity trap. This means that savings may increase without increasing investments.
- If savings go beyond a point, it will lead to 'paradox of thrift' which means that up to a point, higher the savings rate, more the investment and growth. But at a certain point, the positive relation reverses because as savings overshoot the optimal point, there is less left for consumption. When consumption falls, so does investment and growth.

Domestic Savings in India

Central Statistics Office (CSO) releases statistics on savings rate. While preparing the estimates of saving, the Indian economy is officially divided into three broad sectors, viz. the public sector, the private corporate sector and the household sector.

The public sector comprises government including its enterprises. It normally records deficits called dissavings.

The private corporate sector is limited to the organized corporations run under company form of ownership and management.

The household sector comprises besides individuals, all non-government and non-corporate enterprises like sole proprietorships, partnerships and non-profit institutions which furnish educational, health, cultural, recreational and other social and community services to households.

Domestic Savings Trends in India

Savings (household, corporate and government) are needed to finance investments and sustain growth over medium to long term periods. As growth picked up through the decades, savings rate grew as well from the low of 7.9 per cent of GDP in 1954, it reached an all-time high of 37.8 per cent in 2008.

The positive correlation and the complementary relation between savings and growth was particularly witnessed in India in the period 2003–2008, when savings rate peaked along with investments.

However, savings rate, or the proportion of gross domestic savings in Gross Domestic Product (GDP), in India has trended downwards in the past decade.
Overall savings rate fell to 32 per cent in fiscal 2018 from a peak of 37 per cent in fiscal 2008, with a steep fall in household savings rate. Within household savings, both financial and physical savings rate diminished, with a sharper fall in the latter. But the private corporate sector savings went up to 11.6 per cent of the GDP in fiscal 2018 from 7.4 per cent about a decade ago. Part of this is the result of a change in the base year to 2011–12 and the methodological change, which led to physical assets of some types of firms being excluded from households and included in private corporations.
The largest savers in the economy, household savings fell from 23.1 per cent as a percentage of the GDP in fiscal 2010 to 17.2 per cent in fiscal 2018. As a result, its share in gross savings fell from 68.2 per cent to 56.3 per cent. Household savings in physical form (largely in real estate and gold), declined from 15.9 per cent to 10.3 per cent. Financial savings declined too, from 7.4 per cent to 6.6 per cent. The reasons for the fall are as follows:

- Consumption has increased given the fact that young population has a higher capacity for consumption.
- Deceleration of growth and thus incomes and savings rate.

(Per cent of GDP at Current Market Prices)	
Household Savings	17.2
Private Corporate Sector Savings	11.6
Public Sector Savings	3.2
Gross Domestic Savings	32

Data Source: Economics Times

Small Savings

Small savings instruments are Post Office Monthly Income Schemes and Time Deposits, National Savings Scheme, Indira Vikas Patra, Kisan Vikas Patra, Public Provident Fund and so on. They are aimed at promoting safe and long-term savings by individuals. They are called small savings because the amount saved is relatively small. They are initiated by the central Government but mobilized by the State Governments; and are deposited with and managed by the central government. As a reward for promoting savings, State Governments receive all such savings as loan—each state is lent what is collected from its territory at a slightly higher rate of interest than what the GOI pays to the saver.

Small savings are a sizeable portion of the financial savings of the country. They con- tribute to the finances of the Government—federal and State—that is, they are an important source of borrowing for the government. These schemes have tax concession that enhance their attraction for the small savers. They also earn a rate of interest that is higher in comparison to what the banks offer. They are meant to be savings by low income and other groups but are open to all.

Small savings instruments in India are retailed through 1.53 lakh post offices of which about 1.29 lakh are in rural areas.

The National Small Savings Fund (NSSF), in the Public Account of India has all the small savings. Money in the fund is invested in Central and State Government Securities.

The fund is administered by the Government of India, Ministry of Finance (Department of Economic Affairs) under National Small Savings Fund (Custody and Investment) Rules, 2001, framed by the President under Article 283(1) of the Constitution.

States informed the centre that they are not ready to borrow from the NSSF as the rates are much higher than the market. The government in 2017 exempted few states from mandatory borrowing from NSSF. It meant that most states were not borrowing the small savings mobilized in their territories. But the centre needs to keep up with these schemes to promote savings and offer attractive rates to senior citizens and such others in need. Thus, what the states are not borrowing from NSSF, the centre takes and uses it to part-fund the fiscal gap in the budget.

It will help the Centre lower its dependence on market borrowings through the RBI. But states will make up with their new demand. The NSSF borrowings are serviced from Consolidated Fund of India (CFI).

Public Debt

Government liabilities have been broadly classified as:

- Debt contracted against the Consolidated Fund of India (defined as Public Debt)
- Other liabilities in the Public Account

Public debt means the debt of the government. It includes government's internal and external debt. Internal debt essentially comprises of:

- Market loans through government securities
- Borrowing from the RBI through printing

Other Liabilities include liabilities on account of Provident Funds, small saving deposits, etc.

External debt is the amount that a country borrows from foreign lenders, including commercial banks, governments, or international financial institutions. Borrowings may be by the government or private entities.

That is, that part of national external debt which is contracted by the union government becomes the external debt part of public debt. India's debt to GDP ratio, when the total out- standing liability–internal and external, is included as of 2018–19, was 68.3 per cent. Of this, States have a share of 24.5 per cent. Rest is that of the Centre's. India's public debt reached an all-time high of 83.23 per cent in 2003 and a record low of 47.94 per cent in 1980.

N.K. Singh Committee, which reviewed the Fiscal Responsibility and Budget Management Act of 2003, suggested in 2017 to reduce the debt-to-GDP ratio to 60 per cent with the Centre's at 40 per cent and the states' at 20 per cent by 2022–23. Government set the target of 2024–25 for centre to reduce it to 40 per cent of GDP.

Generally, Government debt as a percentage of the GDP is used by investors to measure a country's ability to make future payments on its debt, thus affecting the country's borrowing costs and government bond yields.

External Debt

Annual Publication India's External Debt: A Status Report' prepared by the Department of Economic Affairs, Ministry of Finance, Government of India gives a detailed analysis of India's External Debt position. Sources of external debt are:

- Multilateral
- Bilateral
- IMF
- Export Credit
- Commercial Borrowings
- NRI Deposits (dollar)
- Rupee Debt (Foreign portfolio investment—FPI; and NRI rupee deposits)

By March 2019, India's external debt stood at $543 billion having increased due to a rise in short-term debt, commercial borrowings and Non-Resident Indian (NRI) deposits.

- The external debt-to-GDP ratio stood at 19.7 per cent.
- Long term and short-term debt ratio is approximately 80:20. (Short-term debt includes all debt having an original maturity of one year or less and interest in arrears on long- term debt. Rest is long term debt.)
- Commercial borrowings were the largest component of external debt, with a share of 38 per cent, followed by NRI deposits (24 per cent) and short-term trade credit (18.9 per cent).
- The share of Government (Sovereign) debt in the total external debt is about 21 per cent.
- US dollar denominated debt continued to be the largest component of India's external debt with a share of 50.5 per cent at end-March 2019, followed by the rupee (35.7 per cent), Japanese yen (5 per cent), Special Drawing Rights or SDR (4.9 per cent) and the Euro (3 per cent).
- Debt service payments declined to 6.4 per cent of current receipts.

The value of the external debt stock changes in time due to valuation effect. Valuation effect arises because external debt which is denominated in different currencies is converted into dollars and expressed. US dollar, which is the international unit for debt, fluctuates over time vis-à-vis other currencies.

Rupee Debt

Rupee denominated debt refers to that part of India's total external debt that is denominated in India's domestic currency, the Rupee.
In India, rupee denominated external debt mainly comprises of the following:

- Rupee denominated NRI Deposits

- Foreign Portfolio Investors (FPI) Investment in Government securities and corporate debt (with such investment ceiling set by GOI annually)
- Masala bonds
- Rupee denominated external debt is necessary for the country as
- domestic liquidity is inadequate;
- It is returnable in the form of rupee;
- comes as foreign currency into the country and thus forex reserves build up and rupee is rendered stable;
- Currency risk (the risk arising from appreciation or depreciation of the nominal exchange rate) is borne by the creditor and not by the borrower unlike foreign currency-denominated external debt like External Commercial Borrowing (ECBs), NRI foreign currency deposits or sovereign bonds; and
- Borrower returns as much as he borrowed with interest, in rupees, irrespective of the exchange rate.

Debt Position of the Central Government (in ` lakh crore)	
Items	**2018–19**
A. Public Debt (A1+A2)	75.79
A1. Interal Debt (a+b)	70.66
a. Marketable Securities	59.68
b. Non-marketable Securities	10.98
A2. External Debt	5.13
B. Public Account-Other Liabilities	8.89
c. Total Liabilities (A+B)	84.68

Data Source: Department of Economics, Government of India

Masala Bonds

Masala bonds are issued in global capital markets outside India by international financial institutions to raise money and lend to Indian companies. Masala is an Indian word for spices. It was used by the International Finance Corporation (IFC) to evoke the culture and cuisine of India. Other similar terms for international bonds are Samurai (Japan) and Dim Sum (Chinese). The first Masala bond was issued by IFC in 2014 to lend to Indian companies. Later IFC, for the first time, issued green masala bonds and lent to Indian corporates. HDFC, NTPC and Indiabulls Housing Finance are among Indian corporates which raised funds via this option. These bonds are traded on the London Stock Exchange (LSE).

The mechanics of masala bonds are the following: the bond is issued to global investors by well-rated international financial institution. Investors buy in foreign currency and their returns too are in the foreign currency with interest. The financial firm that borrowed converts the foreign currency into Indian rupees and lends to Indian companies on certain terms such as period considered, interest rate, etc. Thus, Indian companies return the loans with interest in rupees. When the Indian company services/ returns the loan in rupees to the global financial firm, it is reconverted into foreign currency and used to service/return to the global investor who lent in foreign currency. Thus, Indian borrower is not touched by the volatility of the Indian rupee in forex market. For example, those who borrowed when rupee was ` 65 per dollar in 2018, returned the same when rupee dropped to ` 74. If they borrowed in dollars, depreciation of rupee would have hurt. Besides helping diversify funding sources, the cost of borrowing is lower than domestic markets. As masala bonds are denominated in rupees, foreign investors take the currency risk.

NTPC was the first Indian company that issued corporate green masala bonds.
Masala bonds are a step to
- internationalize the Indian rupee,
- make rupee convertible, and
- deepen the Indian financial system.

Before masala bonds, corporates had to primarily rely on instruments such as external commercial borrowings or ECBs. The problem with the ECBs are loan and interest have to be paid in foreign currency and exchange rate risk.

India and Sovereign Bonds

It was proposed in the Union Budget 2019-20 that the Indian Government would borrow some of its funds in overseas markets in foreign currencies. Currently, the government of India only issues bonds in the domestic market in rupees.

India has never resorted to large scale foreign currency borrowing even during the time of the 1991 balance of payments crisis. Thus, sovereign bond issue represents a major shift in policy. The need for such bonds arises because:
By going overseas,
- the pressure on domestic liquidity eases and domestic interest rates remain reasonable
- prevents 'crowding-out effect'
- cost of credit abroad is less
- country gets foreign currency
- We will be using foreign savings for domestic investment.
- Since the government's external debt is less than 5% of GDP, we get attractive rates

The caution steps from the following:

- It sends the impression that domestic credit has dried up.
- Borrowing in foreign currency for use as rupees by the sovereign sounds unnecessary. Companies should do it.
- Foreign currency risk is that if the rupee depreciates sharply, the government ends up paying more.
- India is still vulnerable to global economic risks because of the twin deficit problem—fiscal and current account deficits.
- Once we begin the bond issue overseas, we will get used to it and borrow more and more and thus may cause a sovereign debt crisis.

Sovereign Debt Crisis (SDC)

Sovereign Debt Crisis (SDC) is the term that describes the difficulties that a nation faces to service the loans it takes from foreign sources in foreign currency. Nations do not borrow from outside their country for use as domestic currency generally because domestic currency can always be raised from within through internal debt. External debt serves the purpose to finance imports, service external loans, etc. However, if a nation uses foreign currency for internal purposes, it may turn out to be problematic. The difficulty that arises in SDC is that foreign currency cannot be printed by the borrower and can only be earned by exports and other types of healthy foreign inflows.

External Debt Management

The external debt management policy of the Government of India is prudent and involves monitoring long and short-term debt, raising sovereign loans on concessional terms with longer maturities from multilateral bodies, regulating external commercial borrowings through end-use, encouraging rupee denominated Masala bonds and rationalising interest rates on NRI deposits.

NRI Bonds

To boost the foreign exchange reserves and reverse the slide of rupee exchange rate, GOI floated NRI bonds thrice so far since 1998 when it was done for the first time. RBI has to permit the same and implicitly stand guarantee, as the AAA credit rating of the RBI enables better terms for the country for these bonds. In 1998, the government floated $5 billion worth of Resurgent India Bond (RIB) to withstand sanctions on India following the second round of Pokhran nuclear tests. They raised $4.8 billion.

The second such bond offer was the India Millennium Deposit (IMD) worth $5 billion, issued in 2000 with a five-year tenure. These bonds attract NRIs because they get higher returns. Foreign currency non-resident deposits (FCNR-

B) special deposit worth $34 billion was floated in 2013 and raised $30 billion with a three-year maturity.

Internal Debt

Internal debt includes:

- Loans raised by the government in the open market through treasury bills and government bonds sold by the RBI
- Special securities issued to the RBI
- Other liabilities like money collected by the government under small-savings schemes, provident funds, etc.
- Printing by the RBI

A detailed discussion of these items is found in the Chapters on Monetary Policy and Money and Capital Market.

Debt-GDP Ratio

Public debt of a country in relation to GDP expresses this ratio. Public debt is sustainable within limits. That is, government can repay the loans only if they are limited. The limits are revealed by this ratio. However, the optimal ratio is not the same for all countries. It depends on the following factors:

- Size of the economy
- Growth rates of the economy
- Tax-buoyancy of the country
- Nature of government expenditure—productive or populist
- Internal-external debt ratio, etc.

India's debt-GDP ratio is about 68 per cent. US has 104 per cent. Japan has about 230 per cent. Each country has its own macroeconomic strengths and weaknesses and based on it, viability is estimated. Internal debt is far more viable than external debt as the latter can only be repaid by exports and healthy foreign inflows. The former can be printed though within limits as otherwise financial stability suffers.

A country's sovereign rating partly depends on the ratio. Rating means the creditworthiness of the country in global markets. If the rating is good, there will be sizeable foreign financial inflows and the government and firms of the country can raise overseas loans at attractive terms.

State Development Loans (SDLs)

SDLs are debt securities auctioned by RBI to raise loans for state governments. They are like GOI securities but with a difference: central government issues both treasury bills and bonds while state governments issue only bonds or

SDLs. Bills have a maturity of less than one year and bonds one year or more. SDLs are eligible securities for SLR and LAF (Repo) purposes, and are bought by banks, insurance companies, mutual funds, provident funds and other institutional investors.

WMAs

Ways and Means Advances (WMA) are temporary advances made by RBI to centre under the RBI Act to bridge the short-term mismatches between expenditure and receipts. Interest rate is the Repo rate and if the government wants more than the allotted amount (overdraft), a penal rate of 2 per cent extra is charged on the additional amount. WMA are clean advances without any security.

States and RBI

SDF, WMAs and Overdraft

The RBI serves as the banker to State Governments, whereby it manages all the transactions of the State. As States are not authorized to raise short term loans, they have to approach the RBI for their short term funding requirements. The RBI extends financial support to the State Governments through various facilities to tide over temporary shortfalls in their cash flows (receipts and payments) and thereby enables them to carry on their essential activities within the ambit of normal financial operations.

State governments receive short term financial support from the RBI through WMA (ways and means advances)
which has to be repaid not later than 90 days. There are 2 types of WMAs:
1. Normal Ways and Means Advances (WMA) and
2. Special Drawing Facility (SDF).

The SDF is available before availing of WMA. SDF is a secured advance against the collateral of government securities (GoI) dated securities and Auction Treasury Bills). Additionally, the investments of States in Consolidated Sinking Fund (CSF) and Guarantee Redemption Fund (GRF) can be used for availing SDF. When the funds advanced to the State Governments exceed the SDF and WMA limits, an overdraft (OD) facility is provided by the RBI. There is a state-wise limit for the funds that can be availed via WMA. The RBI decides the WMA limit and the interest cost of such advances based on the recommendations of various committees which are set up periodically.

State Governments maintain the Consolidated Sinking Fund (CSF) and the Guarantee Redemption Funds (GRF) with the Reserve Bank as buffers for repayment of their liabilities. State Governments can avail of Special Drawing

Facility (SDF) from the Reserve Bank against the collateral of the funds in CSF and GRF. The rate of interest charged is below the Repo Rate at which Ways and Means Advances are extended to the State Governments.

Fiscal Drag

When the economy experiences inflation, there are automatic stabilizers that come up. One of them is fiscal drag. The sequence is as follows—when there is inflation because of rising demand, wages go up; those with higher wages pay higher direct taxes; disposable income comes down; demand moderates and so do prices. Since tax-related issue drags the prices down, it is called fiscal drag. In high-growth and high inflation economies (overheated), fiscal drag acts as an automatic stabilizer, as it acts naturally to keep demand stable.

Fiscal Cliff

The term was in news a few years ago. At the time, US President Barack Obama was rationalizing tax rebates for US firms to consolidate the fiscal position. He wanted to cut down some of the tax concessions that earlier governments gave and cut down the fiscal deficit— both meant to strengthen government finances for macroeconomic stability. He embarked on cutting those concessions that were not growth-linked and thus outlived their utility. But the criticism was that two reforms being contemplated would slow down the economy which was growing well. Critics opined that the economy would fall from the cliff.

Cutting tax rates and enabling investment and consumption is known as supply-side economics. Classic example is the steep cut in the corporate tax rate by the US President Donald Trump. When India cut tax rates, it is only a rationalization of the irrationally high rates earlier and is not supply-side economics.

Chapter - 7
Monetary and Credit Policy

Monetary Policy: Definitions

- The strategy of influencing movements of money supply and interest rates to affect out- put and inflation.
- The actions of a central bank that determine the size and rate of growth of money supply, which in turn affects interest rates.
- A macroeconomic policy tool used to influence interest rates, inflation and credit availability through changes in the supply of money available in the economy.
- An attempt to achieve broad economic goals by the regulation of supply of money.
- The regulation of money supply and interest rates by a central bank in order to control inflation and stabilize currency.
- It is the process of managing a nation's money supply to achieve specific goals such as constraining inflation and achieving full employment among others.
- It is made by the central bank to manage money supply to achieve specific goals such as constraining inflation, maintaining an appropriate exchange rate, generating jobs and economic growth. Monetary policy involves changing interest rates, either directly or indirectly through open market operations, setting reserve requirements or trading in foreign exchange markets.

Monetary policy relates to making money available to the market at reasonable rates in adequate amounts at the right time to achieve:

- Price stability
- Accelerating growth of economy
- Exchange rate stabilization
- Balancing savings and investment
- Generating employment
- Financial stability

Credit policy is a part of monetary policy as it deals with how much and at what rate credit is advanced by the banks. Both are the functions of a central bank of the country.

Monetary policy can be:

- **Expansionary:** Expansionary policy increases the total supply of money in the economy by easing its availability by relaxing the rates and ratios (cheap money).
- **Contractionary:** A contractionary policy decreases the total money supply by increasing rates (dear money).

Expansionary policy is used to revive economic growth while contractionary policy aims to reduce prices that have gone up due to excessive money supply or growth.

Historically, in India, Monetary Policy was announced twice a year—a slack season policy (April–September) and a busy season policy (October–March) in accordance with agricultural cycles. However, since monetary Policy became dynamic in nature, Reserve Bank of India decided to announce Bi-monthly Monetary Policy Statements—once every two months—from 2014 as recommended by the Urjit Patel Committee.

The tools available for the central bank to achieve the monetary policy ends are the following:

- Liquidity Adjustment Facility (LAF) involving Repo rate
- Marginal Standing Facility (MSF)
- Bank rate
- Reserve ratios
- Standing Deposit Facility (SDF)
- Open market operations
- Quantitative easing
- Intervention in the forex market
- Moral suasion

Liquidity Adjustment Facility (LAF)

Banks need liquidity to meet their daily mismatches between need and availability. RBI helps them with a limited amount on a short-term basis through LAF. Liquidity Adjustment Facility (LAF) was introduced by RBI in 2000. It is the window through which RBI adjusts liquidity (credit) in the market against the collateral of government securities. When banks borrow under LAF, they do so at Repo rate. Banks undertake to repurchase the security at a later date, be it over night or a few days.

Reverse Repo is when RBI borrows short-term from the market (absorbs excess liquidity) based on government securities and repurchases them. The rate at which it borrows is called Reverse Repo rate as it is the reverse of the Repo operation. Reverse Repo rate is 25 basis points (0.25 per cent) below the Repo rate. A basis point is 1/100th of a percentage point. The Repo/Reverse Repo transaction can only be done in securities as approved by RBI (Treasury Bills, Central/State Govt. securities). RBI uses Repo and Reverse Repo as instruments for liquidity adjustment in the system. Repo Rate is known as policy rate and is used as signal to the financial system to adjust their lending and borrowing operations.

All commercial banks (except Regional Rural Banks) and primary dealers (financial firms that help RBI sell and buy government securities) are eligible for LAF. The government securities that banks and primary dealers use under the LAF are the securities that they have purchased over and above what they are mandated to purchase under the Statutory Liquidity Ratio (SLR) requirement.

Marginal Standing Facility (MSF)

In 2011, RBI introduced the Marginal Standing Facility (MSF) to enable the commercial banks to borrow from the RBI at a penal rate:

- When the amount allotted under the LAF is exhausted, or
- When their government securities in excess of SLR were exhausted, or
- When they did not hold more than the SLR limit.

aim is to make more liquidity available if banks are ready to pay a higher rate of interest. It balances between the need for liquidity and regulation of the same.
MPC announces the policy rate, i.e., repo rate. Reverse repo rate and the MSF are normally adjusted with a difference of 0.25 per cent—Reverse Repo rate is that much less, and MSF, that much more. However, the law does not say so and it has only been the convention. Under the exceptional conditions of the Covid economy of 2020, the gaps changed. By June 2020, repo rate stood at 4%; reverse repo rate at 3.35% and MSF was at 4.25%.

Bank Rate

Bank Rate is the rate at which RBI used to lend long term to commercial banks. It is a tool which RBI used for managing money supply and facilitate investment and growth.

Any revision in the bank rate by the RBI was a signal to banks to revise deposit rates. On introduction of LAF, the Reserve Bank of India discontinued with long-term lending. As a result, the bank rate became dormant as an instrument of monetary management.

RBI lends only short-term under the LAF at Repo rate. Thus, bank rate has no use. However, since it is there in the statute, the RBI uses bank rate as a penal rate when banks breached their mandates—for shortfalls in meeting their reserve requirements, cash reserve ratio and statutory liquidity ratio.

When the RBI introduced MSF in 2011, which is also a penal rate, bank rate has been aligned with the MSF. The two rates are the same.

Long Term Repo Rate (LTRO)

RBI introduced the LTRO in 2020 in order to infuse liquidity in the financial markets for long term lending at a relatively cheap rate. Under LTRO, banks borrow one to three-year funds from the central bank at the repo rate, by providing government securities with similar or higher tenure as collateral. LTRO helps banks get funds for a longer duration as compared to the short-term liquidity provided by the RBI through the repo window under the liquidity adjustment facility (LAF) and marginal standing facility (MSF).

It is called 'Targeted' LTRO as the central bank wants banks opting for LTRO funds to deploy in investment-grade corporate debt.

LTROs provide banks with access to cheaper capital from the RBI. This, in turn, encourages them to lend more to the corporates for medium to long term and spur economic activity. They can also invest these long-term funds in assets that yield better returns to improve profitability.

Also, as banks provide government securities as collateral, the demand for such government bonds increases and helps in lowering yield. Thus, LTRO helps inject liquidity in the system; bank profitability; corporate investment for growth; and ensure more effective monetary policy transmission.

Base Rate and MCLR

Passing on the rate changes made by the central bank is crucial for growth, equity, inflation management, etc. It is called monetary policy transmission. The RBI introduced the concept of base rate in 2011 to ensure that each bank sets its own base rate below which it should not lend to anyone except in rare cases approved by the RBI. The reason behind the base rate was that if the best customers are lent at low rates, others like the small industry will be charged very high (Reverse cross subsidization) which runs against the principle of growth with equity. But over some years, it was found out that base rate system was not working well.

RBI introduced Marginal Cost of Funds Based Lending Rate (MCLR) system in 2016 for improving the monetary transmission. MCLR is set by each bank based on current cost of funds while base rate was calculated based on overall cost of funds. MCLR may ensure quicker transmission of the RBI rate cuts to borrowers as after every rate change by the RBI, the MCLR is bound to reflect it.

Reserve Requirements

Fractional reserve banking is a global norm in which banks keep a fraction of the total deposits of the bank as reserves that are not to be lent to public. The reserve ratios are periodically changed by the RBI and aim at:

- Price stability
- Providing loans to the Government (SLR)
- Safety of banking operations
- Management of liquidity—infusion and absorption under different conditions
- Management of interest rates
- Checking speculation.

Under Reserve Requirements, there are two instruments: Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR).

Statutory Liquidity Ratio (SLR)

It is the portion of time (fixed deposits) and demand liabilities (savings and current accounts) of banks that they should keep in form of the RBI-approved liquid assets like government securities, cash and gold. Excess CRR balance is also treated as liquid assets for the pur- pose of SLR. SLR aims at ensuring that the need for government funds is partly but surely met by the banks.

The assets allowed under the SLR obligation are as follows:

- Cash
- Gold valued at a price not exceeding the current market price
- Statutory Liquidity Ratio (SLR) Securities: Government of India bonds, Treasury Bills of the Government of India, State Development Loans (SDLs) of the State Governments and any other instrument as may be notified by the RBI.

Within the mandatory SLR requirement, some Government securities are classified as High Quality Liquid Assets (HQLAs) for the purpose of computing Liquidity Coverage Ratio (LCR) of banks. They help the banks remain liquid in difficult times.

The main objectives for maintaining the SLR ratio are:

- To control bank credit. By changing the level of SLR, the Reserve Bank of India can increase or decrease bank credit availability.
- To ensure the solvency of commercial banks.
- To make the commercial banks invest in government securities like government bonds so that government has adequate financial resources for its commitments.
- Changes in SLR signal to the economy on a long-term basis unlike other instruments.

SLR is a blunt instrument and was unchanged for more than a decade and half till the Lehman Brothers'-induced global financial and economic crisis of 2008. Banking Regulation Act, 1949 says SLR can vary between 0–40 per cent of bank's depos- its. The RBI has, as a result, the freedom to reduce the SLR to any rate depending on the macro economic conditions below 40 per cent. The amendment was an enabling one. SLR is being gradually cut since 2018 to bring it to 18 per cent of NTDL by the end of 2019.

Liquidity Coverage Ratio (LCR): After the global financial crisis of 2008, the Basel Committee on Banking Supervision (BCBS) proposed certain reforms to strengthen global capital and liquidity regulations with the objective of promoting a more resilient banking sector. Liquidity Coverage Ratio (LCR) was one of them. The LCR promotes short-term resilience of banks to potential liquidity disruptions by ensuring that they have sufficient high-quality liquid assets (HQLAs) to survive an acute stress scenario lasting 30 days.

HQLAs can be converted into cash to meet its liquidity needs for 30 days under a severe liquidity stress scenario. In 30 days, it is assumed that appropriate corrective actions can be taken. Liquid assets comprise of high-quality assets that can be readily sold or used as collateral to obtain funds in a range of stress scenarios. For example, cash, government securities, etc.

Cash Reserve Ratio (CRR)

Under the Reserve Bank of India Act, 1934, the Reserve Bank prescribes CRR for banks. CRR is used for liquidity management and as a monetary tool to regulate money supply. It is the portion of the bank deposits that a bank should keep with the RBI in cash form. CRR deposits earn no interest. The more the CRR, the less the money available for lending by the banks to players in the economy. If inflation is high, excess money needs to be taken out and so CRR is generally increased. But in a regime of moderate inflation, low CRR is in place. If the markets need more liquidity, CRR is reduced to infuse liquidity as it took place in May 2020 when CRR was reduced to 3% from 4%.

It can be 0–100% of bank deposits. CRR is medium to short-term liquidity management tool unlike SLR which is a long-term tool.

Incremental CRR

Incremental CRR is a short-term measure which is used to deal with excess liquidity conditions with banks. For example, post-demonetization, the RBI imposed 100 per cent incremental CRR for deposits collected between September 16 and November 11 by scheduled commercial banks. The aim was to prevent the banks from lending such huge amounts of money that can trouble the economy, banks and the consumers as well. For rest of the deposits, CRR stood unchanged.

In 2020, RBI sought to promote lending to automobiles, residential housing and Micro Small and medium Enterprises(MSMEs). It made the incremental CRR on the deposits that were lent to these sectors zero.

All scheduled banks had deposits of ₹1,35,00,000 crore in January, 2020. The banks are statutorily obliged to maintain CRR on this amount. CRR then was 4%. The CRR-amount was thus ₹5,50,000 crore.

As per the revised incremental CRR policy, banks could reduce their CRR balance from any incremental increase in credit to the said sectors. It thus creates additional liquidity on which there is no CRR burden. Thus, banks are encouraged to lend to these sectors for equity and growth with the newly created liquidity. As the RBI does not pay any interest on CRR, any loans availed through this liquidity facility will increase profitability for the banks.

This exemption is a temporary one lasting for a specified period of time.

SLR vs CRR

Both CRR and SLR are instruments in the hands of RBI to regulate money supply in the markets. Both manage liquidity but are used for different purposes. CRR has a short- and medium-term relevance while SLR is a long-term tool. SLR enables banks to earn money while CRR does not earn any interest. CRR is maintained in cash form with central bank, whereas SLR is held as government securities, etc., and kept with the banks themselves.

Standing Deposit Facility (SDF)

The RBI Act was amended in 2018 to enable the introduction of the Standing Deposit Facility (SDF). The need for the SDF arose during and immediately after demonetization when the liquidity in the market—money with banks—

expanded astronomically. Since they were not voluntary deposits, they could not be lent. If they were to be lent, they would be inflationary in an unprecedented manner and banks would be in danger. Therefore, the RBI had to sterilize excess money from the market (absorb the excess) by selling government securities to the banks. However, the scale of sterilization (absorption of excess cash in the market that can inflate the economy) being unusually large, it could be done only with the government's permission and special government securities which took time in coming. Normal LAF window was a very small one in such conditions. Meanwhile the RBI banned lending of the entire amount collected as deposits between the two dates (points of time) by imposing 100 per cent incremental CRR on those deposits collected in the given period. The absence of an instrument like the SDF was felt. The RBI recommended that the government create a statutory space for it. It allowed banks with extra liquidity to deposit with the RBI for an interest which is the Reverse Repo rate. This would considerably strengthen the conduct of monetary policy as it would provide the RBI the where withal to absorb exceptionally large expansion of liquidity. This additional instrument in the hands of the RBI could then address such episodes (demonetization) and surges of capital inflows.

Open Market Operations (OMO)

OMOs of the RBI can be described as outright purchase and sale of government securities in the open market (open market essentially means banks and financial institutions) by the RBI in order to influence the volume of money and credit in the economy. Government securities purchases inject money into the open market, and thus, expands credit. Sales, however, have the opposite effect, it absorbs excess liquidity and shrinks credit. Open market operations are RBI's most important and flexible monetary policy tool. Open market operations do not change the total stock of government securities but change the proportion held by the RBI, commercial and cooperative banks.

Operation Twist

In late 2019, RBI undertook Operation Twist. It involved selling short term government bonds and buying long term government bonds in the market for the same amount. The reason is that the demand for long term bonds was falling and for the short term bonds was rising. Interest rates and demand for a security are in inverse proportion. The more the demand, the less the rate in the secondary market. For example, a government security that is short term may carry an interest rate of 8%. The face value in simple terms is Rs.100. If the demand for it is high, there are buyers ready to pay Rs.100 plus for it as it offers security. The yield (adjusted interest rate for the new price of the bond) is thus less than 8%. Thus, yields have fallen due to demand rising. For long term bonds, it is the reverse. The confidence in the economy for the long term was weakening and bonds were being sold below face value thus yields were soaring.

RBI through its Operation Twist, wanted to synchronise the long and short term bond yields. Therefore, it bought long term bonds and created demand for them and reduced the rates and sold short term bonds.

It is essentially a confidence building measure in the long term prospects of the economy and ensure that the government's borrowing programme for long term goes through successfully.

US Federal Reserve undertook Operation twist in 2011 in the aftermath of the global financial crisis.

Market Stabilization Bonds

For normal liquidity management, there are open market operations of the RBI when the RBI sells and buys G-secs as the market conditions demand. But when the need to absorb huge amounts of cash arises, for example post-demonetization in 2016, normal OMOs do not work. Similar was the condition since 2004 for some years when India started attracting foreign currency inflows of unprecedented magnitude. When foreign currency comes into the country, it gets converted into rupees and enters the economy. RBI prints rupees to buy the foreign currency. Thus, the rupee flow increases and is inflationary. It needs to be absorbed by the RBI. In 2004, RBI floated large amount of Government securities, as a part of the Market Stabilization Scheme (MSS), to absorb excess liquidity from the market. MSS is a sterilization effort of the central bank. The normally available government securities are not enough for the RBI to draw out the huge rupee supply (printed money) that was created for buying the dollar. Therefore, the MSS was started.

Quantitative Easing

The term Quantitative Easing describes an unconventional form of monetary easing used to stimulate the economy in the US after the Lehman Brothers' crisis. It involves the central bank buying financial instruments, which in ordinary times are not accepted for OMOs, for example, the housing market securities that were discredited in the USA since 2008. It is a step that is taken after the interest rate reduction to very low levels and similar downward adjustment of reserve ratios like CRR fail to induce any positive change. It involves printing fresh currency and buying debt paper that is otherwise substandard thus flushing the market with huge money to de-risk lending as rates and supply of money ease to unprecedented levels.

Federal Reserve of the US (US' central bank like the RBI for India) used quantitative easing (2009–13) to overcome the liquidity crisis since the fall of Lehman Brothers in 2008 September when many banks went bankrupt and credit froze. It worked as the US came out of recession.

EU, Japan and Britain also used the technique of QE to shore up growth.
When the QE tapered (gradually ended), India and other countries expressed resentment as foreign currency inflows into India went down with implications for our forex reserves and the rupee exchange rate. This resentment is called 'taper tantrums.' But India did not suffer as our growth rates were high, forex stock was impressive, and our relatively high interest rates were found to be attractive to foreign investors; our capital market also was doing well on its own.
The aforementioned instruments at the disposal of the RBI are the quantitative tools that made a difference to the overall liquidity in the market.

Liquidity Trap

A liquidity trap is a situation when rates and reserve requirements are lowered to stimulate demand, but it does not have the positive impact on reviving demand and growth. There are no takers for bank credit. It happens in times of recession that is getting worse. There are deflationary expectations and the economy can be faced with the problem of short-term interest rates reaching or nearing zero. This makes the monetary policy ineffective. Money supply can be increased by printing more to make credit cheap and de-risk lending. Otherwise, recession can turn into depression. It is called the Zero Lower Bound (ZLB).

Qualitative Tools

There are qualitative tools that can be used to change the inter-sectoral allocation of credit without changing the total quantum of credit in the market. RBI may change the quantum and cost of credit for a certain sector depending upon whether the sector needs more or less. For example, if real estate is turning risky, less may be lent and at dearer terms to restrain banks from lending to it.

Selective Credit Controls

Under selective credit controls, the RBI encourages flow of credit to certain types of borrowers and discourages bank credit for certain other purposes. It can be done by setting limits on credit availability, charging high or low interest, and/or margin requirement.

Explanation for the selective credit controls is:

Margin Requirement: Lending to a select sector may be accompanied by having to set aside a certain percentage of money for safety. When banks must keep aside some money (margin) whenever they lend to the specified sectors, it hurts them with blocked funds. Thus, the credit flow to such sectors comes down as intended. In case the flow of credit must be increased, the margin requirement will be lowered or removed.

Rationing of Credit: Under this method there is a maximum limit to loans and advances that can be made to a sector which the commercial banks cannot exceed. The RBI fixes ceiling for specific categories.

Both these tools can be imposed for discouraging hoarding and black-marketing of certain essential commodities by traders, etc., by giving them less credit.

Moral Suasion

Central banks at times use their informal and moral power to make the financial system, especially banks to adopt a certain behavior—lower interest rates or lend to small businesses, etc. It is not a rule that the bank enforces but a point made to persuade in a meeting or increased severity of inspections, appeals made in a press conference, etc.

Interest Rates and their Importance

Interest rates may be deposit rates that are the rates offered to money that is deposited in the banks, invested in bonds, etc., or lending rates—rates at which banks lend to investors and consumers. Rate setting involves balancing the interests of savers and debtors. Savers want higher interest rate while investors want the cost of credit to be low. There must be a balance. The determinants of interest rates are:

- **Inflation:** Higher the inflation, higher the interest rates because money in circulation keeps demand and prices high and so money needs to be brought into banks which is possible if an attractive rate of return in given.
- **Need for Growth:** Lower interest rates reduce cost of credit and facilitate investment and consumption.
- Promotion of savings.
- **Government's Need to Borrow:** The magnitude of government's borrowing programme also determines interest rates. More the borrowing, higher the interest rates.
- If rates are attractive, foreign money flows in. For example, interest rates on NRI deposits are kept high to attract their dollar deposits under the FCNR (B).

As a part of economic reforms in 1990's, interest rates were deregulated so that banks can adjust rates quickly according to market conditions, financial innovations should be facilitated, competitive rates can be good for savers and investors, global alignment is possible more dynamically, etc. The RBI, however, uses LAF, OMOs and SLR/CRR adjustments to influence interest rates.

Interest rates are arrived at in two ways: fixed and floating. If they are offered together (when they co-exist), it is called flexible interest rate regime. Floating interest rates are linked to an underlying benchmark rate. In other words, the interest rate offered 'floats' in relation to the interest rate of a government security instrument of similar maturity (5 years or 10 years maturity, etc.) as determined by the market. That is, floating rates of interest are basically market driven rather than 'fixed'. Fixed rate is regardless of market conditions. For example, small savings instruments in post offices offer fixed rate. Savings account in commercial banks offer fixed rate.

Negative Interest Rates

Interest rates are generally positive, i.e., they are inflation rate plus. If inflation rate is 5 per cent, interest rates tend to be 5 per cent plus. There are two ways of seeing interest rates:

- Nominal interest which is unadjusted to inflation.
- Real interest rate which is adjusted to inflation.

If inflation rate is 5 per cent and the interest rate is 4 per cent, the real interest rate is minus 1 per cent. That is negative interest rate. In other words, real interest rates can be negative, when nominal interest rates are below inflation. When the government influences rates to be low, it is called financial repression and can lead to real interest rates being negative.

There is a 'Negative Interest Rate Policy' (NIRP) being practiced by leading central banks for years now. It is a negative, sub-zero, central bank interest rate for the reserves that are kept with it by banks. Commercial banks have accounts with the central bank as the central bank is a bankers' bank. When they deposit their excess money in their central bank accounts, generally they get paid for it. But in the NIRP regime, it is in reverse. NIRP is an instrument of unconventional monetary policy to encourage lending by making it costly for commercial banks to hold their excess reserves at central banks. Thus, NI is a rate when lender pays the borrower. A negative interest rate can be described as a 'tax on holding money'. Such policy can be associated with recession or very slow economic growth and deflation. NIRP makes lending by banks cheaper as banks will not keep their excess reserves in a central bank deposit account due to negative returns. They have to lend it. Further, there is competition among banks to lend their excess reserves and that also push the rates down.

Money Supply

Money supply as a term indicates the total value of monetary assets available in an economy at a given point of time. It includes:

- Currency and coins in circulation
- Demand and time deposits of banks
- Post office deposits and such related instruments

Monetary Aggregates

The Reserve Bank of India defines monetary aggregates as a measure of the amount of money in circulation within a country. RBI adopts four of them:

- M1 (Narrow Money): Currency with public + Demand deposits with the Banking sys- tem (current account, saving account) + Other deposits with the RBI (deposits from foreign central banks, etc.)
- M2 = M1 + Deposits of post office savings accounts
- M3 (Broad Money) M1 + Time deposits with the banking system
- M4 = M3 + All deposits with post office

It is important that the RBI should keep track of the money supply in different ways so that it can estimate growth, investment, inflation, consumption, etc.
The RBI uses monetary tools like Repo, Reverse Repo, CRR and SLR to manage money supply in the economy.

Demonetization

Demonetization is the governmental action that divests a currency unit of its status as legal tender. On 8 November 2016, the Government of India announced demonetization of all `500 and `1,000 bank notes. Those with these notes had to deposit them in the bank and exchange them for new notes.
The Indian government had demonetized bank notes on two prior occasions—once in 1946 and then in 1978—and in both cases, the goal was to combat tax evasion by 'black money' held outside the formal economic system. Demonetization under the two occasions was done by an ordinance while the 2016 decision was an executive decision.

Pros and Cons of Demonetization

If demonetization is implemented well, it can have many benefits such as:

- It can attack black money.
- Since black money is used for funding terrorism, gambling, human trafficking and speculation in real estate, gold and other social evils, there are positive effects in these areas as well.
- Formalize and digitalize the economy.

- Tax net widens (more people file returns) giving government enough fiscal means for welfare expenditure.
- Helps minimizing use of cash which, when it happens voluntarily, has benefits.

If demonetization is not implemented well, it can lead to the following:

- Inconvenience caused to people in depositing invalid notes as well as the time it takes to have their money from the bank.
- Logistical nightmare in a large economy like ours
- Cost of printing new currency.
- Cash is a very miniscule part of black economy and unless accompanied by a multi pronged strategy, demonetization may not succeed fully.

Urjit Patel Committee

An expert committee was appointed to examine the existing monetary policy framework of the Reserve Bank of India (RBI) in 2014 under Urjit Patel. It suggested:

- Inflation Targeting: The target for inflation being set at 4 per cent with a band of +/– 2 per cent around it.
- That the nominal anchor should be defined in terms of headline CPI inflation, which closely reflects the cost of living and influences inflation expectations relative to other available metrics.
- That the fiscal deficit as a ratio to GDP is to be brought down.
- That monetary policy decision-making should be vested with a Monetary Policy Committee (MPC) headed by Governor of the RBI.

Indian Financial Code (IFC)

The Financial Sector Legislative Reforms Commission under Justice (Retd.) B. N. Srikrishnawas constituted in 2011. The commission was set up to review the legal and institutional structures of the financial sector in India and modernize them. The commission recommended Indian Financial Code to replace the bulk of the existing financial laws. IFC proposes changes in the way monetary policy is made and public debt is managed, etc. Indian Financial Code (IFC) suggested, like the Urjit Patel panel, an MPC to take rate decisions by a majority vote.

Monetary Policy Committee (MPC)

Monetary policy is assuming critical role in economic growth and developmental goals including equity: consumer loans, corporate investment, government borrowing, savings, economic growth, price stability and financial stability. Given the importance, the GOI thought that a high-powered committee-based policy making is necessary.

In 2016, the GOI amended the RBI Act to create the Monetary Policy Committee (MPC). MPC was set up after the agreement between Government and the RBI giving the RBI additional responsibility of inflation-targeting under the Monetary Policy Framework Agreement 2015.

By this amendment, it was written into the preamble of the RBI Act that the primary objective of the monetary policy is to maintain price stability, while keeping in mind the objective of growth and to meet the challenge of an increasingly complex economy.

MPC is a six-member body headed by Governor of the RBI that fixes the policy rate (Repo rate). The MPC replaced the system where governor of the RBI, with the aid and advice of a technical advisory committee, had complete control over monetary policy decisions.

It has three members from the RBI—Governor, the RBI Deputy Governor in charge of monetary policy, one official nominated by the RBI Board and three independent members to be selected by the Government. The three central government nominees of the Monetary Policy Committee (MPC) is appointed by the search-cum-selection committee. It holds office for a period of four years and is not be eligible for re-appointment. As per the RBI Act any Member of Parliament or Legislature or public servant cannot be appointed as an MPC. The committee meets at least four times a year. All the decisions are taken based on majority vote (by those who are present and voting). In case of a tie, the RBI governor has the second or 'casting' vote. The decision of the committee lies on the RBI.

MPC decides the changes to be made to the policy rate (Repo rate) to contain the inflation within the target-level specified to it by the Central Government. Minutes of the MPC meeting are published by the RBI after 14 days. In addition, subsequent to the MPC meeting, the RBI has to publish a document explaining the steps to be taken by it to implement the decisions of the Monetary Policy Committee. The committee was created in 2016 to bring transparency and accountability in making the Monetary Policy.

The government may, if it considers necessary, convey its views, in writing, to the MPC from time to time. There are four advantages of monetary policy formulation by a committee:

- First, a committee can represent different viewpoints and studies show that collective wisdom is better than a single person.
- Second, spreading the responsibility for the decision can reduce the internal and external pressure that falls on an individual.
- Third, a committee will ensure broad monetary policy continuity when any single member including the Governor changes.
- Fourth, it leads to institutionalizing the process of monetary policy formulation which is vital given that the RBI has a clear inflation target by a statute.

Monetary Policy Framework Agreement

The RBI and Government of India signed the Monetary Policy Framework Agreement in 2015 which made inflation targeting the statutory responsibility of RBI. As a result, Reserve Bank of India (RBI) Act, 1934 was amended for giving a statutory support to the Monetary Policy Framework Agreement and for setting up a Monetary Policy Committee (MPC).

Under the Monetary Policy Framework Agreement, the RBI will be responsible for containing inflation targets at 4 per cent (give or take 2 per cent) in the medium term. Central Government determines the inflation target in terms of the headline (unadjusted) Consumer Price Index, once every five years in consultation with the RBI. The RBI would have to give an explanation in the form of a report to the Central Government, if it failed to reach the specified inflation targets for three consecutive quarters. In the report, it has to give reasons for failure, remedial actions and estimated time within which the inflation target is achieved. Further, RBI has to publish a Monetary Policy Report every six months, explain- ing the sources of inflation and the forecasts of inflation for the coming period of six to eighteen months.

Monetary Policy Transmission

Monetary policy changes—in rates and reserve ratios—are aimed at bringing about desired effects in growth of the economy through:

- Demand management
- Prices
- Credit availability
- Asset prices like stocks and real estate
- Consumption

The effectiveness of the policy, that is how well it is transmitted, depends on many factors:

- Adequate and timely availability of data.
- Reach of the financial institutions like banks. India has hundreds of millions of people who are financially excluded.
- If banks are sitting on bad loans, they tend to charge higher interest rate even if the RBI
- reduces the rate as they need to make up their losses from bad loans.
- If government gives loan waivers, raises MSP for farmers, etc., it infuses money into the market that inflates, which the RBI may not be able to manage even if it reduces rates.
- If the fiscal deficit of the government is relatively high, interest rates are likely to stay high normally even if the RBI reduces them because there is demand for credit.

External factors that are important include:

- Monetary policies of the US (QE)
- Rate hikes in the US
- Currency manipulation by countries like China, etc.

The importance of the global factors comes up as India needs to either retain or attract further funds for which the interest rate is an important input.

The steps taken by the RBI to enhance the effectiveness of monetary policy by having it transmitted are

a. deregulate the savings account rate offered by the commercial banks
b. replace the PLR with Base rate and later, MCLR
c. incremental CRR being made zero for loans to certain sectors like MSMEs for a specified period (2020)
d. LTRO (2020)

Repo Rate and Deposit Rate Linkage 2019

Monetary policy transmission is necessary for the benefits of the policy changes to reach the intended groups and the economy. The RBI made many changes—base rate, MCLR and so on. The new idea is that banks should have Repo-linked deposit and lending rates.

From 2019, India's largest bank, State Bank of India, announced that it was linking the interest rate on its savings bank accounts as well as short-term loans to RBI's Repo rate.

Many other banks—Syndicate Bank, Union Bank, Indian Bank, Bank of India and Allahabad Bank—have now announced plans to roll out their own versions of Repo-linked rates.

It helps in realizing the benefits of credit policy changes—be it managing inflation or liquidity.

The reason for repo rate changes being reflected in deposit and lending rates is that banks source only about 1 per cent of their funds from RBI's Repo window and the rest come from deposits from the public. Some banks do not borrow from the Repo route at all.

The Reserve Bank of India

The central bank of the country is the Reserve Bank of India (RBI). The Reserve Bank of India Act, 1934 that came into effect in 1935 provides the statutory basis of the functioning of the bank. It was established based on the recommendations of the Hilton Young Commission. The RBI, when it was set up, was privately owned.

There is a short history to the RBI. The Imperial Bank was formed in 1921 by amalgamating the Presidency Banks of Bombay, Calcutta and Madras. It functioned as commercial bank and as central bank till the RBI was set up in 1935 and that was when the RBI took over the central banking duties. The Reserve Bank of India was nationalized in the year 1949. In 1955 the Imperial Bank became SBI by an act of parliament. The general superintendence and direction of the Bank is entrusted to the Central Board of Directors that has: the Governor and four Deputy Governors, one Government official from the Ministry of Finance, ten nominated Directors by the Government to give representation to important sections in the economic and social life of the country and four nominated Directors by the Central Government to represent the four local Boards with the headquarters at Mumbai, Kolkata, Chennai and New Delhi. The RBI Act 1934 states that the capital of the Bank shall be five crore rupees. Government is the sole owner of the RBI.

RBI's Functions

The Reserve Bank of India Act of 1934 entrusts all the important functions of a central bank to the Reserve Bank of India. Functions of the RBI are:

- Monopoly on the issue of banknotes
- Setting the official interest rate (taken over by the MPC)
- The Government's banker
- Bankers' bank
- Lender of Last Resort
- Manages the country's foreign exchange and gold reserves
- Regulation and supervision of the banking sector

Bank of Issue

Under Section 22 of the Reserve Bank of India Act, the Bank has the sole right to issue bank notes of all denominations. The distribution of one-rupee notes and coins and small coins all over the country is undertaken by the Reserve Bank as agent of the Government.

Legal Tender and Fiat Money

Legal tender is any currency declared legal by a government. It may be backed by metal like gold or silver or it may not. In the latter case, it is Fiat money. The value of Fiat money based on macroeconomic variables like inflation and demand and supply.

RBI and Printing Currency

The amount of money the RBI could print is linked to the availability of gold and foreign exchange reserves of `200 crores, of which `115 crores should be in gold to be able to issue currency. Both these assets being liquid, the RBI would be able to infuse or absorb liquidity as conditions demanded.

In the current economy, RBI prints for the following reasons:

- Replace soiled notes
- Print notes with better security features
- Print to infuse money into the economy as economy grows and demand rises
- Lend to the government (stopped monetizing deficit since 2006)
- Buy foreign currency and gold in the market

In the final analysis, printing is related to the needs of the monetary economy and reflects on the monetary and fiscal discipline.

Gold Standard

It is a type of monetary system in which money printed by the central bank is pegged to the availability of gold; currency can be returned to the central bank for a certain value of gold. Gold standard ensured that excess money supply was prevented, and holders of currency felt safe that their holdings retained value as they could be exchanged for a definite amount of gold.

Seigniorage

It is the difference between the face value of a currency note or coin and its actual production cost. The difference is the surplus of the RBI and a part of it retained by the RBI and the rest is transferred to the GOI as dividend. How much is to be retained is the discretion of the RBI as the economic situation demands. It is only one of the sources of the RBI surplus. Higher denomination notes earn higher profits. Coins cost as much to produce as they are valued.

The issue of RBI dividend dominated headlines post-demonetization as it was assumed that a sizeable portion of the old notes rendered invalid would not be returned to the banking system and the RBI did not have to honour so much and that could be considered profit and could be handed over to the GOI. But almost all the inlaid notes were returned.

The event was remonetisation and not demonetization. The entire money invalidated was revalidated through new notes. Therefore, there was no question of new seigniorage. In fact, there were additional costs to printing that reduced the dividend otherwise available.

Banker to Government

The Reserve Bank of India is the Government banker, agent and adviser. The Reserve Bank is agent of the Central Government and of all State Governments in India. The Reserve Bank has the obligation to transact Government business, to receive and to make payments on behalf of the Government and to carry out their other banking operations. The Reserve Bank of India helps the Government—both the Union and the States to raise loans. The Bank makes Ways and Means Advances (WMA) to the Governments. It acts as adviser to the Government on all monetary and banking matters.
Advances are always short term and secured which loans may not be and loans are not secured always.

Banker's Bank

Banks are required to maintain a portion of their demand and time liabilities as cash reserves with the Reserve Bank. For this purpose, they need to maintain accounts with the Reserve Bank. They also need to keep accounts with the Reserve Bank for settling inter-bank obligations such as clearing transactions of individual bank customers who have their accounts with different banks or clearing money market transactions between two banks and buying and selling securities and foreign currencies. In order to facilitate a smooth inter-bank transfer of funds, or to make payments and to receive funds on their behalf, banks need a common banker. By providing the facility of opening accounts for banks, the Reserve Bank becomes this common banker, known as 'Banker to Banks'.

Lender of Last Resort

Reserve Bank acts as the 'lender of the last resort'. It can come to the rescue of a bank that is solvent but faces temporary liquidity problems by supplying it with much needed liquidity when no one else is willing to extend credit to that bank. The Reserve Bank extends this facility to protect the interest of the depositors of the bank and to prevent possible failure of the bank, which in turn may also affect other banks and institutions and can have an adverse impact on financial stability and thus on the economy.

Banks may face short-term or temporary liquidity crisis which arise out of mismatches between assets and liabilities. Banks try to fill the gaps by going to the call money market (Refer the chapter on money market). Call money markets function normally when some banks or others have excess and can lend to others. But if the entire market has a liquidity crisis, the temporary need may be felt by the entire banking system. The RBI as a lender of last resort steps in and bails out the banks in need through Repo facilities.

Even if the call money has enough money, unless the RBI plays its role as the lender of last resort through the Repo window, call rates are bound to rise.

Controller of Credit

The Reserve Bank of India is the controller of credit, i.e., it has the power to influence the volume of credit advanced by banks in India and the rate of it. It can do so through the variety of instruments available to it like Repo rate, OMOs, reserve requirements, etc. All its monetary policy tools have a bearing on this function directly or indirectly.

Agent and Adviser of The Government

The RBI acts as a financial agent and adviser to the Government. It renders the following functions:

- As an agent to the Government, it manages public debt on behalf of the Government.
- It issues Government bonds, treasury bills, etc., on behalf of the Government and sells them to raise credit for the Government from the market (banks) in the country.
- Acts as the financial adviser to the Government in all important economic and financial matters.

RBI as the Debt Manager of the Government

The Reserve Bank manages public debt on behalf of the Central and the State Governments. It involves floating of bills and bonds, payment of interest and repayment of these loans.

Debt Management Office (DMO)

In recent years, there has been a debate whether there should be a separate Public Debt Management Agency (PDMA) that manages the internal and external liabilities of the Central Government and renders advice. As of now, the RBI manages market borrowing programmes of Central and State Governments. External debt is managed by the GOI. DEA (Department of Economic Affairs), Ministry of Finance, Government of India along with the Reserve Bank of India, monitors and regulates External Commercial Borrowing guidelines and policies.

Supporters of the idea of PDMA say:

- Establishing a debt management office would consolidate all debt management functions in a single agency and bring in holistic management of the internal and external liabilities.
- It is further argued that there is a conflict of interest between setting interest rate and raising loans for the government. RBI must manage inflation for which the rates have to be kept high when the prices are high. But being a debt manager, it must borrow at lower rates of interest for the GOI.
- As a regulator of banks, as in India, there is another aspect to the conflict of interest: It may set the SLR high for banks to hold more of the government bills and bonds mandatorily. It in turn can prevent development of the corporate bond market as bank deposits are used up in buying government securities.
- Jahangir Aziz Panel went into the question of establishing a Debt Management Office (DMO) and suggested an independent public debt management office. Dr Raghuram Rajan chaired the Committee on Financial Sector Reforms (2009) which also favoured it. Justice B. N. Srikrishna chaired the FSLRC or Financial Sector Legislative Reforms Commission Report (2013) also recommended setting up the independent Public Debt Management Agency (PDMA).

There are arguments against the idea of DMO as well:

- First, RBI says that in countries such as India, given the large size of the government borrowing programme, the sovereign debt management is much more than merely an exercise in resource-raising, as it could impact interest rates, systemic liquidity and even loan growth through the crowding out of private sector loan demand. Only central banks have the necessary expertise, wherewithal and multifunctional perspective which an independent debt agency, driven by narrow objectives, will not be able to do.
- Second, there is a larger conflict of interest if the DMO is set up as it could function as an arm of the ministry of finance, when the government is the owner of the majority of banks in India and the banking sector is the dominant player for government market borrowing.
- Third, since the RBI has been replaced as a rate setting agency with the MPC, the said conflict of interest question has been resolved and so the idea of DMO is to that extent redundant.

As an interim arrangement for a full-fledged agency for managing public debt to be called as Public Debt Management Agency (PDMA), the government in 2016 set up Public Debt Management Cell (PDMC) at RBI's Delhi office.

RBI as National Clearing House

In India the RBI acts as the clearing house for settlement of banking transactions. This function of clearing the house enables banks to settle their interbank claims easily. Further it facilitates the settlement economically. It essentially means the inter-bank cheque clearing settlement.

Custodian of Forex Reserves

The Reserve Bank of India has the responsibility to act as the custodian of foreign exchange reserves. It takes up operations in the forex market to stabilize the exchange rate of rupee and ensure that there is no speculation and there is order. To be able to do so effectively, it holds forex reserves which it buys from the market which includes foreign currency assets, gold and IMF's SDRs. Since 2008 when the dollar stability came under question, the RBI has been increasing SDR and gold in its holdings for greater security. Such diversification and hedging of risk are being done by all central banks.

Supervisory Functions

The Reserve Bank Act, 1934, and the Banking Regulation Act, 1949 have given the RBI wide powers of supervision and control over commercial and co-operative banks, relating to licensing and establishments, branch expansion, setting reserve ratios, etc. They are:

- Granting license to banks.
- Inspect banks.
- Implementation of Deposit Insurance Scheme whereby all deposits upto `One lakh is insured.
- Periodical review of the work of commercial banks.
- Giving directives to commercial banks.
- Control the non-banking finance corporations.
- Ensuring the health of financial system through on-site and off-site verifications.
- Banking Regulation (Amendment) Act 2017 enables the GOI to authorise the RBI to issue directions to banks to initiate insolvency resolution process to recover bad loans.

Promotional Functions

RBI performs a variety of developmental and promotional functions. The Reserve Bank promotes banking habit, extend banking facilities to rural and semi-urban areas and establish and promote new specialized financial agencies to promote savings and to provide general finance and agricultural finance. NABARD was set up in 1982. It has an important role in facilitating microfinance for financial inclusion. Further, its innovations include banking correspondent model for rural banking.

RBI's Role in Economic and Financial Stability

One of the responsibilities of a central bank is to maintain macroeconomic stability and financial stability. Macroeconomic stability refers to achieving sustainable growth with low and stable inflation. To achieve such stability, central banks use the tools of monetary policy and their other regulatory and supervisory functions.

To deal with threats to financial stability, central banks' main instrument is provision of liquidity, called 'lender of last resort' (LAF).

The RBI also depends on regulation and supervision for financial stability. By setting prudent rules and principles and inspecting and monitoring banks' adherence to these rules and principles, the central bank aims at healthy and robust banking and financial system.

Across the world, we have been witnessing financial panics or 'bank runs' (depositors want to withdraw all their money due to doubt about the solvency of the bank) and failure of one bank may lead to failure of others leading to threats to financial and economic stability.

As 'lender of last resort', central bank, in periods of panics, bails out banks and NBFCs for larger goal of financial stability.

The RBI and Bitcoin

Bitcoin is a worldwide private cryptocurrency and digital payment system. It is the first decentralized digital currency, as it works without a central repository or single administrator. It was developed under the name Satoshi Nakamoto and released as open-source software in 2009. The system is peer-to-peer, and transactions take place between users directly, without an intermediary. These transactions are verified by network nodes and recorded in a public distributed ledger called a blockchain.

The legal status of bitcoin varies from country to country—some countries have allowed its use and trade, others have banned or restricted it.

The Reserve Bank of India is in control of Fiat currency which is the legal status given to a currency issued by the central bank. Non-Fiat crypto currencies such as Bitcoins were initially not approved by the RBI.

RBI's objections to crypto currencies is based on:

- Black money risks
- They are susceptible to misuse by terrorists and fraudsters for laundering money
- Bitcoin could be a Ponzi (financial fraud) scheme
- Bitcoins can be inflationary and thus the RBI should have a role in regulating it
- With global circulation, exchange rate of rupee is also impacted
- The RBI has instructed banks not to deal with entities that deal in cryptocurrencies.

The RBI had cautioned the cryptocurrency users, traders and holders of digital currencies. The GOI is thinking of floating a cryptocurrency of its own.

Autonomy for the RBI

Powers of the RBI are statutorily laid down in the RBI Act 1934. The RBI, being the architect of the monetary policy, requires autonomy to be effective. Advocates of central bank independence argue that a central bank being a group of professionals should be autonomous to manage money, credit and exchange rate dynamics in the globalizing economy. It helps check populist pressures and schemes that the government may be tempted to operate like in financial repression (keep rates low to suit government and corporates) even as the inflation is high. It can resist the pressure if it has autonomy.

John Maynard Keynes while giving his opinion to Hilton and Young Commission which recommended the setting up the RBI in 1926 said: 'I conceive a central bank as independent of the government though ultimately dependent on the State in general interest.' Hilton Young Commission itself said: 'Banks, especially Banks of Issue, should be free from political pressure, and should be conducted solely on lines of prudent finance.'

Others believe that the elected governments should have the final say within which the RBI should be autonomous as government is democratically elected. The arguments in favour of autonomy are:

- Monetary and economic stability can be best achieved if professional central bankers with the long-term perspective is given charge.
- Without such autonomy, government tends prevail with its profligate policies of automatic monetization, lower rates, indiscriminate lending and so on.

The arguments against autonomy are:

- Democratic systems are run with Parliament and Cabinet making all important policies.
- Monetary policy is an integral policy of the overall economic policy and so the RBI has to subordinate itself to the larger objective.

Accountability of the RBI

RBI is held accountable through:

- Consultations with the Union Government Ministry of Finance
- The Parliamentary committees
- The parliament through the Finance Minister
- To the judiciary

Conventionally, the RBI and GOI coordinate in public interest. Autonomy of the RBI as a professional body was respected as an unwritten law. Section 7 of the RBI Act was never invoked.

It may be suggested that there should be a collegium to appoint the Governor and the Deputy Governors so that the autonomy of the RBI becomes so much more an article of faith.

The recent measures to make the RBI independent are:

- No automatic monetization since 1997.
- FRBM Act says RBI cannot print money to supply credit to the government from 2006.
- The RBI Act, amended in 2006, gave it more power for reserve requirement management regarding caps on CRR.

The RBI: Central Board of Directors

The central board of directors is the main committee of the central bank. Its maximum members can be 21, including the Governor and four deputy governors, four directors to represent the RBI regional boards, 2 members—usually the Economic Affairs Secretary and the Financial Services Secretary—from the Ministry of Finance and 10 other directors from various fields. It is mentioned in the RBI Act of 1934. The Board is required to meet at least six times a year and at least once every quarter.

Section 7 of the RBI Act 1934

Section 7 of the RBI Act 1934 provides authority to the government to give directions to the central bank in public interest from time-to-time after consultation of the RBI Governor.

Section 7 of the Reserve Bank of India Act, 1934 reads:

1. 'The Central Government may from time to time give such directions to the Bank as it may, after consultation with the Governor of the Bank, consider necessary in the public interest'.
2. 'Subject to any such directions, the general superintendence and direction of the affairs and business of the Bank shall be entrusted to a Central Board of Directors which may exercise all powers and do all acts and things which may be exercised or done by the Bank.'

The prevalence of the government over the opinion of the RBI is to, if at all, take place on two conditions being followed:

1. After consultation with the Governor
2. Public interest

Section 7(1) of the RBI Act was not a part of the original 1934 Act but was amended at the time of nationalization of the RBI in 1949, to empower the Centre to issue directions to central bank in public interest.

RBI: Assets, Capital and Dividend

The RBI functions according to the Reserve Bank of India Act of 1934 which says that prof- its (surplus) made by the RBI after using some of it for certain purposes like salaries, etc., should be transferred to the GOI. The RBI earns its profits through its Seigniorage, Open market operations, LAF operations, Forex market interventions, buying gold etc.

Some of the profits are real, for example, what it earns through LAF, OMO, buying and selling foreign currency etc. Some are notional, for example, what it gains from holding foreign currency reserves and gold. However, they must be set off against the uncertainty of the valuations for the assets that the RBI holds—government bills and bonds and foreign currencies and gold.

The RBI sets aside from the annual profits the maintenance expenditure, printing costs and some money for its contingency fund. CF is a specific provision meant to act as a buffer against unexpected exigencies. The profits (surpluses) made annually are accumulated as reserves after passing dividend to the government of India.

Together the cumulative assets (realized and notional profits) accounted for almost `11 lakh crores by 2018—two-thirds notional and one third real. These assets remained with the RBI after the transfer of surpluses every year as dividend. They are referred to as capital. It is meant to:

- Build financial credibility
- Borrow relatively cheap

- Raise the rating of the country as a whole
- Inspire stakeholder trust

When the RBI chooses not to transfer all the surplus as dividend, its motive is:
- If it is 'overcapitalised', its rating will improve and so it can borrow at lower costs. It enjoys AAA rating while the sovereign rating for India is less.
- If more dividend is given, it flows into the economy which is inflationary unless sterilized.
- Sterilization costs in terms of interest payments are exorbitant and put further pressure on the fiscal condition, macroeconomic stability and BOP.
- It is back door monetization of the deficit. The GOI may differ. GOI says:
- The RBI holds much higher capital as a percentage of its total assets (around 28 per
- cent) compared to countries such as the US, the UK, France and Singapore.
- The RBI's assessments of capital requirements and terms for the transfer of its reserves to the government is based on a very conservative assessment of risk and needs to be revised. As a result, the RBI has over-estimated its capital reserves requirements. Hence, part of it can be transferred to GOI as dividend.

But RBI's answer is each country has its own structural requirements in view of its unique- ness and so we cannot emulate advanced countries.

Bimal Jalan Committee on Economic Capital Framework

In 2018, RBI, in consultation with the GOI, had constituted a committee chaired by former RBI Governor Bimal Jalan to review the economic capital framework of the RBI prevailing at the time. Jalan Committee submitted its report to the Governor of the RBI in 2019.

The Committee's recommendations were based on the following criteria:
- consideration of the role of central banks' financial resilience,
- cross-country practices,
- statutory provisions,
- impact of the RBI's public policy mandate and operating environment on its balance sheet, and
- risks involved.

The Committee's recommendations were guided by the fact that the RBI forms the primary pillar for monetary, financial and external stability. The Committee recognized that the RBI's provisioning for monetary, financial and external stability risks is the country's savings for a 'rainy day' (a monetary/ financial stability crisis) which has been consciously maintained with the RBI in view of its role as the Monetary Authority and the Lender of Last Resort.

Economic capital is the total reserves- realized and unrealized: the former is the profit (surplus already made) and the latter is the profit that is notional profit which is still unbooked. The need for the distinction arises because a realized equity is money in hand and can be used for meeting all losses and are available for distribution; while revaluation balances represent unrealized valuation gains and hence are not distributable. Realized equity is required to cover credit risk and operational risk.

The risk provisioning is made primarily from retained earnings and is referred to as the Contingent Risk Buffer (CRB).

The realized equity that is above its requirement, for contingency is transferable to the Government as dividend.
Recommendations of the Committee are:

- Alignment of the financial year of the RBI with the fiscal year of the government for 'greater cohesiveness' in various projections and publications brought out by the RBI.
- The Economic Capital framework may be periodically reviewed every five years.
- The RBI can pay interim dividend to the government, a practice that started in 2016–17, only under exceptional circumstances.
- Contingency Fund (CF) should be in the range of 6.5–5.5 per cent of the economic capital (total reserves).

(Economic capital is a combination of realized equity and revaluation reserves. Revaluation refers to notional gains from the increase/decrease in the value of the unsold asset like foreign currency or gold or government security. Realized equity means gains that are real.)

The RBI Central Board accepted the recommendations and adopted 5.5 per cent for the Contingency Fund to be considered adequate.

RBI and its Subsidiaries

Reserve Bank of India has three fully owned subsidiaries:

- Deposit Insurance and Credit Guarantee Corporation of India (DICGC)
- National Housing Bank (NHB)
- Bharatiya Reserve Bank Note Mudran Private Limited (BRBNMPL)

Besides, there are three autonomous institutions run by RBI namely National Institute of Bank Management (NIBM), Indira Gandhi Institute of Development Research (IGIDR) and Institute for Development and Research in Banking Technology (IDRBT).

Financial Stability and Development Council (FSDC)

There are many financial products that involve more than one regulator. They have, in the past, created friction among the financial regulators. Also, India's financial system is becoming diversified and complex and needs a body that has all the financial regulators and is headed by the Union Finance Minister. That is the reason for setting up the Financial Stability and Development Council (FSDC) in 2010 as was first mooted by Raghuram Rajan Committee in 2008. The global economic crisis was primarily triggered by unregulated financial system and so GOI saw the need to regulate the financial sector for stability.

FSDC aims to strengthen and institutionalize the mechanism of maintaining financial stability, financial sector development, inter-regulatory coordination along with monitoring macro-prudential regulation of economy. FSDC replaced the High-Level Coordination Committee on Financial Markets (HLCCFM). A sub-committee of FSDC was set up under the chairmanship of the RBI Governor to discuss and decide on issues relating to financial sector and stability including inter-regulatory coordination.

Its Chairperson is the Union Finance Minister and its members are:

- Governor Reserve Bank of India (RBI)
- Finance Secretary and/or Secretary, Department of Economic Affairs (DEA)
- Secretary, Department of Financial Services (DFS)
- Chief Economic Advisor, Ministry of Finance
- Chairman, Securities and Exchange Board of India (SEBI)
- Chairman, Insurance Regulatory and Development Authority (IRDA)
- Chairman Pension Fund Regulatory and Development Authority (PFRDA)
- Joint Secretary (Capital Markets), DEA, will be the Secretary of the Council
- The Chairperson may invite any person whose presence is deemed necessary for any of its meeting(s).

Responsibilities:

- Financial Stability
- Financial Sector Development
- Inter-Regulatory Coordination
- Financial Literacy
- Financial Inclusion
- Macro prudential supervision of the economy including the functioning of large financial conglomerates.
- Coordinating India's international interface with financial sector bodies like the Financial Action Task Force (FATF), Financial Stability Board (FSB) and any such body as may be decided by the Finance Minister from time to time.

Macro Prudential Analysis

In the wake of the 2008 financial crisis that started in the USA, central banks across the world became acutely aware of the need to assess the health of the financial system, essentially banks, to estimate the stability the financial institutions. Central banks have adopted macroprudential analysis to detect vulnerabilities in the financial system. This involves essentially stress tests. Stress tests evaluate large banks to determine whether those institutions have enough capital to withstand significant declines in asset prices, a deep recession and a slowdown in global economic activity. Macroprudential analysis is designed to indicate how resilient an economy is.

महाज्योती
—— ज्ञानदीप समतेचा ——

SRIRAM's IAS

महाराष्ट्र शासन

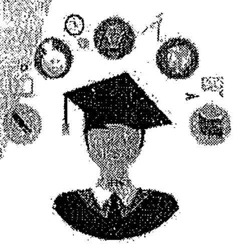
महात्मा ज्योतिबा फुले संशोधन व प्रशिक्षण संस्था (महाज्योती),नागपूर
(महाराष्ट्र शासनाच्या इतर मागास बहुजन कल्याण विभागाची स्वायत्त संस्था)

महाज्योती

JEE/NEET/MHT-CET परीक्षा पूर्व प्रशिक्षण

महाज्योती, नागपूर मार्फत JEE/NEET/MHT-CET परीक्षापूर्व रसायनशास्त्र, भौतिकशास्त्र, गणित व जीवशास्त्र या विषयांचे सखोल ज्ञान हे तज्ञ व अनुभवी प्रशिक्षकांमार्फत ऑनलाईन पध्दतीने देण्यात येईल.

* लाभार्थी पात्रता/ निकष :



* उमेदवार हा महाराष्ट्राचा रहिवासी असावा.
* उमेदवार हा इतर मागासवर्गीय, विमुक्त जाती-भटक्या जमाती तसेच विशेष मागास प्रवर्गातील नॉनक्रिमीलेयर गटातील असावा.
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* महाराष्ट्र शासनाकडून वेळोवेळी होणाऱ्या बदलानुसार पात्रता असणे आवश्यक राहील.

* योजनांचा लाभ घेण्यासाठी आवश्यक कागदपत्रे:

१. रहिवासी दाखला २. जात प्रमाणपत्र ३. नॉनक्रिमिलेयर प्रमाणपत्र
४. आधारकार्ड ५. शैक्षणिक गुणपत्रक

* योजनेचा लाभ घेण्यासाठी अर्ज कुठे व कसा करावा.

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Chapter - 8
Money Market and Capital Market in India: Instruments and Dynamics

Introduction

There is need and demand for funds for both short and long periods of time—less than one year is short and a year or more is long. The market for the former is money market and the latter, capital market. Thus, the differentiation between money and capital markets is not based on the amount but the period. The need for finance in the money market is for working capital requirements, servicing of loans, consumption, etc.

Money Market

Money market for short-term funds has maturities ranging from overnight to one year. Money market transactions could be both secured (with collateral) and unsecured (clean, without collateral).

Banks and financial institutions (LIC etc.), mutual funds, foreign institutional investors (FII), companies, individuals and the government (the RBI) are the main lenders and borrowers. The informal market operates through small-scale moneylenders as well as others outside the RBI control.

Money market instruments broadly are:

- Call money
- Bill market—both commercial bills and treasury bills
- Certificates of Deposit (CD)
- Commercial paper (CP)

Call Money

Call/Notice money is the money that is borrowed or lent for a very short period of time. If that period is more than one day and is up to 14 days, it is called 'Notice money' otherwise the amount is known as 'Call money'. No collateral security is required to cover these trans- actions and promissory notes are enough. The call market enables the banks and institutions to even out their day to day deficits and surpluses of money.

Commercial banks, both Indian and foreign, co-operative banks, Discount and Finance House of India Ltd. (DFHI) and Securities Trading Corporation of India (STCI) participate as both lenders and borrowers and Life Insurance Corporation of India (LIC), Unit Trust of India (UTI) and National Bank for Agriculture and Rural Development (NABARD) can participate only as lenders. Interest rates in the call and notice money market are market determined.

Bill Market

Treasury Bills

Treasury bills are a type of Government Securities. Government securities comprise of:

- Bonds issued for a year or more by the Government of India and state governments.
- Treasury bills issued by the Government of India for a period upto 364 days.

Reserve Bank of India manages and services these securities through its public debt offices located in various places as an agent of the Government.

T-Bills: A Money Market Instrument

Treasury bills (T-bills) are short-term investment opportunities, generally upto one year. They are thus useful in managing short-term liquidity. There are three types of treasury bills issued by the Government of India through auctions, these are 91-day, 182-day and 364-day. No treasury bills are issued by the State Governments. These bills are available for a minimum amount of `25,000 and in multiples of `25,000. These bills are issued at a discount and are redeemed at par. That is, they are issued at a price which becomes face value when the interest rate is calculated, and added to the issue price for the given period of loan. Treasury bills, thus are, zero-coupon securities and pay no interest. The return to the investors is the difference between the maturity value or the face value (that is `100) and the issue price.

Treasury bills are also issued under the Market Stabilization Scheme (MSS) and are available in primary and secondary market.

The usual investors in these instruments are banks, insurance companies, FIs, etc. T-bills auctions are held on the Negotiated Dealing System (NDS) and the members electronically submit their bids on the system.

Cash Management Bills (CMBs)

The CMBs have the generic character of T-bills but are issued for maturities less than 91 days. Like T-bills, they are also issued at a discount and redeemed at face value (par) at maturity.

Interbank Term Money

Interbank market for deposits of maturity beyond 14 days and upto three months is referred to as the term money market.

Certificates of Deposit

Certificate of Deposit (CD) is issued by scheduled commercial banks and Financial institutions (FI). The Certificate of Deposit cannot be issued by Regional Rural Banks and Local Area Banks.

A Certificate of Deposit is a secured negotiable promissory note. A CD is issued at a discount to the face value. The discount rate is negotiated between the issuer and investor. The maturity period of CDs issued by the banks should be not less than 15 days and should not be more than one year. The financial institutes can issue CDs for a period not less than 1 year and not more than 3 years from the date of issue. The minimum deposit from a single subscriber should not be less than `1 lakh, and should be in multiples of `1 lakh thereafter. CDs can be issued to individuals, corporations, companies (including banks and PDs), trusts, funds, associations, etc.

Inter Corporate Deposits Market

Apart from CDs, corporates too have access to another market called the Inter Corporate Deposits (ICD) market. An ICD is an unsecured loan extended by one corporate to another. Designed mainly as an alternative for low rated corporates, this market allows fund-surplus corporates to lend to the other corporates.

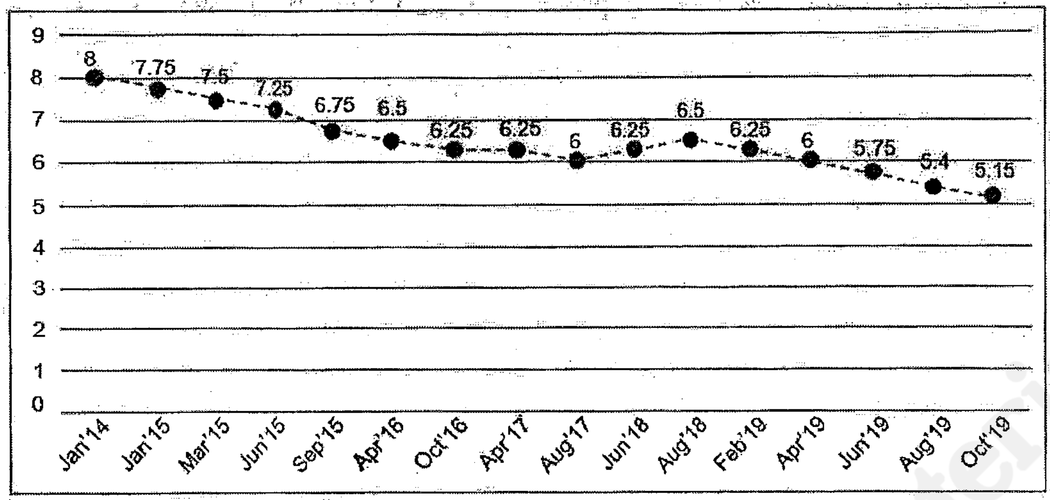
Commercial Paper (CP)

It is a short term unsecured promissory note issued by top rated corporates, Primary Dealers (PDs), Satellite Dealers (SDs) (those who are the sub-dealers for the PDs) and the all-India Financial Institutions (FIs). CP can be issued for maturities between a minimum of 7 days and a maximum of up to one year from the date of issue. How- ever, the maturity date of the CP should not go beyond the date up to which the credit rating of the issuer is valid. CP can be issued in denominations of `5 lakh or multiples thereof. The main features of these papers are:

- Corporates having tangible net worth of not less than `4 crore can issue them.
- All CPs require credit rating from a credit rating agency.
- Minimum amount invested by single investor is `5 lakh or multiple thereof.
- CPs are issued at a discount to face value.

Ready Forward Contracts (Repos)

Repo is an abbreviation for Repurchase Agreement, which involves a simultaneous 'sale and purchase' agreement. When banks have any shortage of funds, they can borrow it from Reserve Bank of India or from other banks. The rate at which the RBI lends money to commercial banks based on government securities is called Repo rate.



Data Source: RBI

Commercial Bills

Bills of exchange are negotiable instruments drawn by the seller (drawer) of the goods or services on the buyer (drawee) of the goods for the value of the goods delivered. These bills are called trade bills. These trade bills are called commercial bills when they are accepted by commercial banks for discounting. If the bill is payable at a future date and the seller needs money immediately, he may approach his bank for discounting the bill. The bank or any other discounting body takes a commission for it.

Discount and Finance House of India (DFHI)

It was set up in 1988 by the RBI to strengthen the bill market and to deal in money market instruments in order to provide liquidity. Thus, the task assigned to DFHI is to develop a secondary market in the existing money market instruments. The main objective of DFHI is to facilitate the smoothening of the short-term liquidity imbalances by developing an active money market and integrating the various segments of the money market. At present DFHI's activities are:

- Dealing in Treasury Bills
- Re-discounting short term commercial bills
- Participating in the inert bank call money, notice money and term deposits

- Dealing in Commercial Paper and Certificate of deposits
- Government dated Securities (long-term securities)

London Interbank Offered Rate (LIBOR)

The LIBOR is the average interest rate estimated by leading banks in London that they would be charged for what they borrow from other banks. It is usually abbreviated to BBA LIBOR (for British Bankers' Association Libor). LIBOR is the primary benchmark, along with EURIBOR, which is responsible for short term interest rates around the world. Most of the financial institutions, mortgage lenders, and credit card agencies set their own rates based on it.

UK Financial Conduct Authority in 2017 said it would abandon Libor by the end of 2021 due to the rigging scandal of 2012, which led to billions in fines levied on banks for attempting to manipulate the LIBOR which affected the credibility of the major benchmark.

Mumbai Interbank Offered Rate (MIBOR)

NSE developed and launched the NSE Mumbai Interbank Bid Rate (MIBID) and NSE Mumbai Interbank Offered Rate (MIBOR) for the overnight money market in 1998. The MIBID/MIBOR rate is used as a benchmark rate for majority of deals.

Money Market Reforms

On the recommendations of the Sukhmoy Chakravarty Committee on the Review of the Working of the Monetary System, 1985 and the Narasimham Committee Report on the Working of the Financial System in India, 1991, the RBI initiated a series of money market reforms basically directed towards the efficient discharge of its objectives.

Reforms made in the Indian Money Market are:

- Deregulation of the Interest Rate.
- Money Market Mutual Funds (MMMFs) can sell units to corporates and individuals.
- Discount and Finance House of India (DFHI) was set up in 1988 to impart liquidity in the money market. It was set up jointly by the RBI, Public sector Banks and Financial Institutions.
- Liquidity Adjustment Facility (LAF): LAF adjusts liquidity in the market through absorption and or injection of financial resources by the RBI.
- In order to impart transparency and efficiency in the money market transaction on the electronic dealing system has been started.
- Development of New Market Instruments like CMBs and MSS since 2004 that was useful in 2016 (post-demonetization).
- Standing Deposit Facility (SDF).

Capital Market

It refers to market for funds with a maturity of 1 year and above called as Term Funds that include medium and long-term funds. The demand for these funds comes from both the government for its investment purposes and the private sector. Banks, public financial institutions like LIC and GIC, development financial institutions and mutual funds are the main participants in the market. The components of the capital market in India are the following:

- Government securities/bonds
- Securities that include the shares and debentures of Indian companies-both the primary and secondary market.
- Development Financial Institutions (DFIs)
- Merchant banks
- Angel investors
- Private equity
- Venture capital
- Mutual funds

Government Securities/Bonds

Government bonds or dated securities with original maturity of one year or more issued by the Central Government or the State Governments (State Development Loans—SDLs) called gilt-edged instruments—gilt edged because the original ones issued by the British government had golden border. They are issued and marketed by RBI. Government of India also issues savings instruments (Savings Bonds, National Saving Certificates (NSCs, etc.) or special securities (oil bonds, Food Corporation of India bonds, fertiliser bonds, power bonds, recapitalization bonds, etc.). They may not be tradable and are not eligible to be SLR securities. They are not issued through the RBI.

Dated Government Securities

Bonds carry either a fixed or a floating coupon (interest rate) which is paid on the face value, and is payable at fixed time periods (usually half-yearly). The tenure of these dated securities can be up to 30 years. GOI-Dated Security can be held by any person, firm, company, corporate body or institution, State Governments, Provident Funds and Trusts. People who are eligible to invest in the government stocks are: Non-Resident Indians (NRIs, viz., Indian citizens and Individuals of Indian origin), Overseas corporate bodies predominantly owned by NRIs and Foreign Institutional Investors registered with SEBI and approved by the RBI. The minimum investment in G-Secs is `10,000. G-Secs could be of the following types:

Dated Securities: Dated securities are the ones that have fixed maturity and fixed coupon rates payable half yearly. They are identified by their year of maturity.

Floating Rate Bonds: Floating rate bonds are the bonds with variable interest rates and fixed percentage over a benchmark rate. There may also be a cap and a floor rate attached, thereby fixing a maximum and minimum interest rate payable on it.

Capital Indexed Bonds: Capital Indexed bonds are bonds where the interest rate is a fixed percentage over the inflation rate: WPI or CPI depending on the terms.

Foreign Portfolio Investors (FPI): They are allowed to buy the government bonds, but the RBI sets limits to FPI investment in GOI securities, State Development Loans (SDLs) and corporate bonds.

State Development Loan (SDL)

State Governments raise loans from the market through the RBI. SDLs are dated securities issued through an auction like the auctions conducted for dated securities (bonds) issued by the Central Government. Interest is computed at half-yearly intervals and the principal is paid on the date of maturity. SDLs qualify for SLR. They are also eligible as collaterals for borrowing through market repo as well and borrowing by eligible entities from the RBI under the Liquidity Adjustment Facility (LAF).

Development Finance Institution (DFIs) or Development Banks

Financial institutions assume a critical role in the provision of long-term credit. A Development Finance Institution (DFI) can be broadly categorised as All-India or State/regional level institutions depending on their geographical coverage of operation. Functionally, All-India institutions can be classified as follows:

- Term-lending institutions (IFCI Ltd. etc.) extending long-term finance to different industrial sectors.
- Refinancing institutions (NABARD, SIDBI, NHB) extending refinance to banking as well as non-banking intermediaries for finance to agriculture, SSIs and housing sector, respectively.
- Sector-specific/specialized institutions (EXIM Bank, HUDCO Ltd., IREDA Ltd., PFC Ltd., IRFC Ltd.)
- Investment institutions (LIC, UTI, GIC, etc.)

State/regional level institutions are various State Finance Corporations (SFCs), State Industrial Development Corporations (SIDCs), etc.
Historically, low-cost funds were made available to DFIs to ensure that the profits on their lending operations did not come under pressure. DFIs had access to soft window of Long Term Operation (LTO) funds from RBI at concessional rates. However, with the onset of Indian economic reforms in 1991 when capital markets opened for equity both within and outside the country, DFIs like ICICI, IDBI, etc., were largely bypassed and so on the basis of Khan Committee report in 1998, many of them became universal banks.

Merchant Banks/Investment Banks

They essentially deal with companies and not with the retail public. Merchant Banks man- age and underwrite. Underwriting means to guarantee purchasing of any share in a new issue (IPO) or rights issue not fully subscribed by the public. New public issues are floated by the companies to raise funds from public. They advise corporate clients on fund raising. They are called investment banks in the US.

Lehman Brothers (bankrupt since 2008), Goldman Sachs and Morgan Stanley are some global examples doing business in investment banking, equity, trading (especially U.S. Treasury securities), research, investment management, private equity and private banking. They exist in India too.

Nidhi Company

A Nidhi company is a type of company in the Indian non-banking finance sector, recognized under Section 406 of the Companies Act, 2013. Their core business is borrowing and lending money among their members. They are also known as Permanent Fund, Benefit Funds, Mutual Benefit Funds and Mutual Benefit Company. They are regulated by Ministry of Corporate Affairs. The RBI has the power to issue directions in matters related to their deposit acceptance activities. Nidhi companies are more popular in South India, and 80 per cent of them are located in Tamil Nadu.

Collective Investment Scheme (CIS)

A Collective Investment Scheme (CIS) is an investment scheme in which several individuals come together to pool their money for investing in assets and share the returns from that investment. They exclude mutual funds and are regulated by the Securities and Exchange Board of India (SEBI).

Alternative Investment Funds

Alternative Investment Funds (AIFs) is a newly created class of pooled-in investment vehicles for real estate, private equity and hedge funds. Angels are the new category of AIFs by SEBI. Alternative Investment Funds are basically established or incorporated for the purpose of pooling in capital from Indian and foreign investors in India.

Real Estate Investment Trusts (REITs)

SEBI regulates Real Estate Investment Trusts (REITs). Like mutual funds, REITs pool-in money from investors and issue units in exchange. Money so collected is invested in commercial properties which are completed and generate income. The REIT has to first get registered and raise funds through an initial public offer or IPO. The minimum requirement for asset sizes permitted to be listed in India is `500 crore. The minimum issue size of the initial public offer shouldn't be less than `250 crore. Therefore, like stocks, investors will be able to buy units of REITs from both primary and secondary markets which are based on commercial real estate without having to buy those assets.

Mutual Funds

Mutual funds raise money from public and invest them in stock market securities, bonds, etc., SEBI regulates mutual funds.

Hedge Fund

A hedge fund is like a Mutual Fund (MFs)—both are investment vehicles which pool investors' money and invest as per the fund's mandate and returns are distributed among unit holders for a commission. However, hedge funds use strategies far more complex than MFs. Hedge funds are less transparent. SEBI regulates them under Alternative Investment Fund (AIF).

Venture Capital

Venture capital is money provided by financial institutions who invest in startups generally that have the potential to develop into significant economic contributors. The name comes from the fact that the enterprise has certain risk built into it.

Angel Investors

An angel investor or angel is a wealthy individual or firm that provides capital for a business start-up, usually in exchange for convertible debt or ownership equity. They invest their own money unlike a venture capitalist who invests public money. They became popular after the web-based enterprises came up in the 1990's. With an aim to encourage entrepreneurship in the country by financing small start-ups, SEBI in 2013 notified norms for angel investors who are allowed to be registered as Alternative Investment Funds (AIFs).

In order to ensure investment by angel funds is genuine, SEBI restricted investment by such funds. Among other norms included, angel funds can make investments only in those companies which are incorporated in India, the funds need to be invested in a firm for at least three years and investment is done in companies not older than 3 years. Angel funds are required to have a corpus of at least `10 crore, and minimum investment of `25 lakh by an investor. The regulator also stipulated that the fund must not have any family connection with the investee company.

The new norms would help in encouraging entrepreneurship in the country by financing small start-ups at a stage where such start-ups find it difficult to obtain funds from traditional sources of funding such as banks and financial institutions among others.

In 2016, GOI introduced a start-up policy which can get a stimulus from the angels.

Private Equity

Shares are sold privately, and not through an IPO to a firm. The quantum of equity thus issued is substantial. The PE firm stays invested for only a limited period (few years or so). PE firm also takes part in the management of the company. The aim is to boost the company for which the PE firm has the skills and experience. The company may be listed or not. It generally has a lock in period during which they are not publicly traded on a stock exchange.

Hundi

A Hundi is a written order made by a person directing another to pay a certain sum of money to a person named in the order—bearer of the communication. Hundis were legal financial instruments and evolved in India. When banking did not develop so extensively, they were used in trade and credit transactions; as remittance instruments for the purpose of transfer of funds from one place to another. Hundis then served as travellers' cheques. They were also used as credit instruments for borrowing and as bills of exchange for trade transactions. Being a part of an informal system, hundis now have no legal status and were not covered under the Negotiable Instruments Act, 1881.

Chit Funds

A group of people save together and the fund that develops is used for investments to generate returns. From the fund, members who want to borrow can do so. It is a kind of savings scheme. There are chit fund schemes organized by registered financial firms and informally among friends and relatives. These schemes are very popular in tier II and III towns in India and even in rural India, because of under-penetration of banking services, as they are a way of raising quick money or catering for sudden liquidity needs or even a planned expenditure. They thrive as bank loans are very cumbersome and many are not eligible. Chit funds are governed by state or central laws. There is a central Chit Funds Act of 1982, apart from several state chit fund Acts. There is an office of 'Registrar of Chit Funds' in every state that monitors operations which are quite stringent. Securities Laws (Amendment) Act, 2014 provides SEBI with new powers to effectively pursue fraudulent investment schemes (Ponzi schemes) and gives guidelines for the formation of special fast trial courts.

Non-Banking Financial Company (NBFC)

NBFC means Non-Banking Financial Company. NBFC is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, housing finance, acquisition of shares / stock / bonds / debentures / securities issued by government or local authority or other securities, chit business, but does not include any institution whose principal business is that of agriculture and industrial activity. NBFCs are like banks; how- ever, they do not accept demand deposits. CRR does not apply to them. They are however required to keep a portion of their deposits (time deposits) in the form of government securities.

Some microfinance companies are registered as NBFCs and are regulated by the RBI while other MFIs are either registered as money lenders or Societies. A RBI-appointed panel headed by Y H Malegam had recommended setting up of a special category of NBFCs operating in the microfinance sector in 2011. These are called Non-Banking Financial Company-Micro Finance Institution (NBFC-MFI).

The RBI introduced a new category called Non-Banking Financial Company-Factors. Factoring is the business of selling invoices (receivables) to a factoring company (Factor) at a discount. Consequently, the selling corporate can get cash quickly and avoid risk in collecting debt. Factoring can be of two types: domestic and export oriented, the latter being called forfaiting. Forfaiting is the purchasing of an exporter's receivables (the amount importers owe the exporter) at a discount by paying cash. The forfaiter, the purchaser of the receivables, becomes the entity to whom the importer is obliged to pay its debt.

The Reserve Bank of India (RBI) in 2019 merged three categories of NBFCs — asset finance, loan companies and investment companies — into one new category called NBFC-investment and credit company (NBFC-ICC) to ease operational flexibility of these institutions. The aim is to replace entity-based regulations with activity-based ones.

Credit Default Swap (CDS)

It is a form of insurance against debt default. When an investor buys corporate (or government) bonds he/she faces the risks of default on the part of the issuing agent. The investor can insure the investment in such bonds against default through a third party. The investor pays a premium to the party providing insurance. In the event of default by the bond issuer, the insurer would step in and pay the investor. A CDS is just like insurance, which is bought by those who fear default.

Infrastructure Debt Funds (IDFs)

IDFs are investment vehicles which can be sponsored by commercial banks and NBFCs in India in which domestic/offshore institutional investors, specially insurance and pension funds can invest through units and bonds issued by the IDFs. They can be set up either as a Trust or as a Company. A trust based IDF would normally be a Mutual Fund (MF), regulated by SEBI, while a company based IDF would normally be a NBFC regulated by the Reserve Bank. Only banks and Infrastructure Finance companies can sponsor IDF-NBFCs.

FIIs Investment in Debt

FIIs can invest in government and corporate debt in both the primary and secondary market. These limits and the rules are relaxed from time to time depending on the needs of the economy. FII debt is rupee debt.

Take-out Financing (TOF)

Banks collect deposits whose maturity essentially is 3–5 years but the infrastructure funding for roads, ports, etc., is for much longer periods. There is thus a mismatch and thus, came ToF. It came into effect in 2010. Take-out financing is a method of providing finance for longer duration projects, for example, 15 years, by the banks, which they do by sanctioning medium-term loans (like 5–7 years). The understanding is that the loan will be taken out of books of the financing bank within pre-fixed period, by another institution thus preventing any possible asset-liability mismatch.

Under this process, the institutions engaged in long term financing such as IDFC, agree to take out the loan from books of the banks financing such projects after the fixed time period when the project reaches certain previously defined milestones. Based on such understanding, the bank concerned agrees to provide a medium-term loan (5–7 years). At the end of the period, the bank could sell the loans to the institution and get it off its books. This ensures that the project gets long-term funding through various participants. Banks otherwise cannot lend for infrastructure as their deposits are for a short-period and the loans are for a long-period.

External Sources of Finance for India

- Foreign Stock exchanges for ADRs and GDRs
- ECB
- IBRD, IDA, IFC, IMF, AIIB, NDB, CRA (explained in respective Chapters)
- Bilateral loans by foreign Governments
- Masala bonds
- Foreign Portfolio Investment or FPI (explained in a separate Chapter)

External Commercial Borrowings (ECBs)

ECB (External Commercial Borrowings) is an instrument used to facilitate the access to foreign currency by Indian corporations and PSUs. The ECBs include commercial bank loans, credit from official export credit agencies, buyers' credit, and commercial borrowings from the private sector window of Multilateral Financial Institutions, such as International Finance Corporation (Washington), ADB and investment by Foreign Institutional Investors (FIIs) in dedicated debt funds. ECBs cannot be used for investment in stock market or speculation in real estate. The DEA (Department of Economic Affairs), Ministry of Finance, Government of India along with Reserve Bank of India, monitors and regulates ECB guidelines and policies. External Commercial Borrowings provide an additional source of funds to Indian corporates and PSUs for financing expansion of existing capacity and as well as for fresh investment, to augment the resources available domestically. External Commercial Borrowings can be used for any purpose (be it rupee-related expenditure as well as imports). The exception can only be stock market investment and speculation in real estate. Applicants are free to raise ECB from any internationally recognized source such as banks, export credit agencies, suppliers of equipment and international capital markets among others. ECBs help diversify risk for the companies. Also, the interest rates are softer abroad. They help Indian companies with foreign funds. Country benefits as it has access to forex.

ECBs can be Raised through Two Routes: Automatic Route and the Approval Route. The former does not require permit from the regulator whereas the latter requires. The RBI policy allows corporates registered under the Companies Act, 1956, except financial intermediaries such as banks, Financial Institutions (FIs), housing finance companies and Non-Banking Finance Companies (NBFCs) to access ECBs. NGOs engaged in microfinance activities have been permitted to raise ECB up to certain limits. Financial institutions dealing exclusively with infrastructure or export finance such as IDFC, IL&FS, Power Finance Corporation, Power Trading Corporation, IRCON and EXIM Bank are considered on a case-by-case basis. ECB Policy helps source loans cheap, domestic easing liquidity constraints, the country get forex, contain the rupee slide and provides infrastructural benefits.

Euro Issues

They are shares (receipts) and bonds issued to raise foreign currency. The issue is listed on a European stock exchange.

Chapter - 9
Stock Market

Introduction

Companies need finance for their investment and operations. They can either source it from their own reserves (profits) or borrow or raise share capital. Share capital is raised by issue of shares. The entire worth of the company is made up of the value of all the shares put together. The person who starts the company is called the promoter. He retains majority of shares generally and sells the rest to public—individuals and institutions; domestic and foreign.

The company may be a private limited company or a public limited company. The number of shareholders in a private limited company is limited to a maximum of two hundred (Indian Companies Act 2013) and a minimum is 2 persons. Public limited company is one where the company issues shares to the public at large—individuals and institutions through an Initial Public Offering (IPO). The word 'limited' means that the liability of the company in case of winding up is limited to the assets of the company and not that of any other company of the group or the personal wealth of the promoters and other shareholders.
In the case of the public limited company, the company is listed on a stock exchange where its shares are traded.

Stock Exchange

A stock exchange is an organization which provides a platform for trading shares. In a stock exchange, investors through stockbrokers buy and sell shares and other financial products in a wide range of listed companies. Thus, not only shares but also mutual funds, debentures, government securities and other financial products are traded on the stock exchanges.

Stock is the capital raised by a corporation, through the sale of shares or bonds or debentures or a similar product. All of them have one feature in common—they are listed on a stock exchange. Shares are listed compulsorily if they are issued to public and others may be listed. In common language, stocks and shares are used interchangeably.

A shareholder is any person or organization which owns one or more shares issued by a company. Owning a share of a company is owning to that extent the company itself. A stockbroker buys and sells for an investor as officially only the broker can do it. The origin of the stock market dates to the year 1494, when the Amsterdam Stock Exchange was first set up.

Importance of Stock Exchanges

- 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 investment thus helping the company and the country.
- Exercise discipline on companies and make them strive to be profitable.
- Investment in backward regions for job generation.
- Another vehicle for investors' savings.
- Enables the government to divest and mobilize finances for its budget.

Primary Market

The primary market is that part of the capital markets that deals with the issuance of new shares directly by the company to the investors by 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 Follow on Public Offer (FPO). At times, listed companies want to raise money by the issue of shares and opt for a rights issue where the existing shareholders are first offered additional shares at a good price. They may accept or not.

Secondary Market

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

Stock Exchanges in India

The first company that issued shares was the VOC or Dutch East India Company in the early 17th century (1602). India has millions of shareholders, thousands of companies listed on the stock exchanges and thousands of stockbrokers. The Indian capital market is globally significant in terms of the degree of development and volume of trading and its tremendous growth potential.

There are five stock exchanges in the country, as follows:

- Bombay Stock Exchange (BSE)
- National Stock Exchange (NSE)
- United Stock Exchange (USE)
- Metropolitan Stock Exchange of India (MSE)
- India International Exchange (INX)

Bombay Stock Exchange (BSE)

BSE is Asia's first stock exchange and the world's 11th largest stock exchange with an overall market capitalization of $2.3 trillion (2018). More than 5000 companies are listed on the BSE.

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).

BSE's automatic online trading system is known as BOLT. BSE went for an IPO in 2017 and got listed on the National Stock Exchange (NSE).

National Stock Exchange (NSE)

It is stock exchange located in Mumbai, India. National Stock Exchange (NSE) was established in 1992. NSE played a critical role in reforming the Indian securities market and in bringing transparency, efficiency and market integrity. NSE has a market capitalization almost equal to BSE though the number of companies listed is less than half of BSE. About 1600 companies are listed on it.

National Stock Exchange was set up by a group of leading Indian financial institutions to bring transparency to the Indian capital market. This was done at the behest of the government of India. Many domestic and global institutions and companies hold stake in the exchange. Some of the domestic investors are: LIC, GIC, State Bank of India and IDFC Ltd. Foreign investors include Citigroup.

The Standard and Poor's CRISIL NSE Index 50 or S&P CNX Nifty or Nifty 50 or sim- ply 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 leading 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 sec- ond tier of stocks in terms of market capitalization (value of all the shares of a company added up at the latest price of the share).

NSE and the Bombay Stock Exchange are the two most significant stock exchanges in India, and between them are responsible for majority share transactions.

Metropolitan Stock Exchange of India (MSE)
It was earlier known as MCX-SX. It commenced operations in 2008 but became a full- fledged exchange with equity trading in 2013. It went for an IPO in 2012.

United Stock Exchange of India (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's shareholders include 21 Indian public sector banks, private banks, international banks (Standard Chartered) and corporate houses. USE launched its operations in 2010 and deals in currency futures.

India International Exchange (INX 2017)
India International Exchange (INX) is India's first international stock exchange, opened in 2017. It is located at the International Financial Services Centre (IFSC), Gujarat International Finance Tec-City (GIFT City) in Gujarat. It is a wholly owned subsidiary of the Bombay Stock Exchange (BSE).

INX is one of the world's most advanced technology platforms with a turn-around-time of 4 microseconds which operates for 22 hours a day, allowing international investors and NRIs to trade from anywhere across the globe. INX offers equity, currency, commodity and interest rate derivatives and proposes to offer depository receipts and bonds once the infrastructure is in place.

BSE SME and NSE Emerge
BSE and NSE in 2012 launched their Small and Medium-sized Enterprises (SMEs) exchange platforms to enable small and medium enterprises to raise funds and get listed as public entities. While BSE started its SME platform under the brand name of BSE SME Exchange, NSE platform called it 'Emerge'. The exchange provides an opportunity to small entrepreneurs to raise equity capital for growth and expansion. It also provides opportunity for investors to identify and invest in good SMEs at early stage. SMEs have huge listing potential but had only debt-financing options, without any access to equity options. There is a general lack of awareness among SMEs about equity capital, stock markets and funding options, other than banks.

Sensex
Sensex is a portmanteau of the words Sensitive and Index. The base period of S&P BSE SENSEX is 1978–79 and the base value is 100 index points. This is often indicated by the notation 1978–79 = 100. It consists of the 30 largest and most actively traded blue chip stocks (profit making), representative of various sectors, on the BSE. Inclusion of the company is based on market capitalization. Thirty companies in the index are periodically revised—some companies 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. The counterpart of BSE Sensex is NSE Nifty (NSE fifty).

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 through a Parliamentary Act (SEBI Act 1992). SEBI regulates the working of stock exchanges and intermediaries such as stockbrokers, accords approval for mutual funds and registers Foreign Institutional Investors (FII) who wish to trade in Indian stocks. 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 investors' education and training of intermediaries of securities markets like brokers, credit rating agencies, underwriters like the investment banks, etc. SEBI prohibits unfair and fraudulent trade practices related to securities markets, and insider trading in securities, with imposed monetary penalties, on erring market intermediaries. It also regulates substantial acquisition of shares (for example, the shares of IDBI bank bought by Life Insurance Corporation of India in 2018) and takeover of companies along with calling for information from, carrying out inspection, conducting inquiries and audits of the stock exchanges and intermediaries and self-regulatory organisations in the securities market.

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

SEBI's powers were enhanced in 2002 and 2014—strengthened the board, more full- time directors and given enhanced powers to conduct search and seizure, etc. SEBI also regulates credit rating agencies.

Securities Laws (Amendment) Act 2014

Securities Laws (Amendment) Act 2014 is a legislation in India which provided the securities market regulator SEBI with new powers to effectively pursue fraudulent investment schemes, especially Ponzi schemes. It also provides guidelines for the formation of special fast trial courts.

SEBI's Role as Protector of Investors

Investors are the pillar of the financial and securities market putting the money in funds and stocks. If they are protected, the stock market's credibility grows, there is higher investment, millions more add to the investing public strength and so on. It is thus very important to protect the interests of the investors. Investor protection involves prevention of malpractices. SEBI is responsible for safeguarding the interests of the investors. SEBI published various directives, conducted many investor awareness programmes and set up an Investor Protection Fund (IPF) to compensate the investors. Other measures are as follows:

- Registering and regulating intermediaries such as brokers, portfolio managers, merchant bankers, etc.
- Recording and monitoring the work of credit rating agencies, etc.
- Registering investment schemes like mutual fund and venture capital funds, and regulating their functioning.
- Keeping a check on frauds and unfair trading methods related to the securities market.
- Observing and regulating major transactions and take-over of companies.
- Carry out investor awareness and education programme.
- Inspecting and auditing the exchanges (SEs)
- Assessment of fees and other charges
- Banning insider trading
- Strengthening of corporate governance in the listed companies.

The Investor protection measures taken up by the SEBI has a slogan 'An informed investor is a safe investor'. SEBI launched the Securities Market Awareness Campaign which covers major subjects like portfolio management, Mutual Funds, tax provisions, Investor Protection Fund and Investors' Grievance Redressal.

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.
- FIIs are permitted since 1992.
- Settlement guarantee funds at all stock exchanges.
- Compulsory dematerialization of share certificates to remove problems associated with paper trading and speed up the transfer.
- Clause 49 of the listing agreement for corporate governance. It mandates that all listed companies should have half the Directors on the Board as Independent Directors.
- Making it mandatory to have anchor investors (one who is allotted substantial number of shares in an IPO and cannot sell them on listing as his responsibility is to ensure that the listing is smooth, and price is not manipulated).

- Restrictions on Participatory notes.
- Platform for MSMEs.
- Law in 2014 strengthens SEBI.
- Merger of FMC with SEBI rules for credit rating agencies.

Demutualization

Mutualizationreferstoownershipandmanagementoftheexchangebeingcombinedin thesame hands. Brokers were the owners and the management of the BSE. There is a conflict of interest in these two functions. Demutualization is when management and ownership are separated. Ownership is divested partly from the brokers and the shares are sold to others. All stock exchanges are to be demutualized according to the Government law made in 2004. Demutualization thus means that ownership, management and trading rights are separated in a stock exchange.

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 derivatives.

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 for which a small part of payment has been paid at the time of signing the contract.

Futures are different from forwards as the former are traded on exchange while the latter may be signed as a contract between two parties over the Counter (OTC), that is, outside the commodities or stock exchange.

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 company's repurchase of stock it has issued. It takes place at a price that is usually higher than the market price. In the case of stocks, this reduces the number of shares outstanding, giving each remaining shareholder a larger percentage of 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.

Reasons for buyback include:
- Boosting the share price
- Giving shareholders an exit at a relatively attractive price in a dull market.
- Putting unused cash to use

Shares bought back need to be cancelled (extinguished) and thus the total equity shrinks and the shareholders benefit. Companies can buy back with the reserves but cannot borrow to buyback. It is allowed in India since 1998. The government has encouraged cash-surplus PSUs to go for share buybacks to meet its disinvestment target. GOI benefited from the buyback operations of Coal India Ltd. (CIL) and many other PSUs.

Anchor Investor

Anchor investors or cornerstone investors (as they are called globally) are institutional investors like sovereign wealth funds, mutual funds and pension funds that are invited to subscribe for shares ahead of the IPO to boost the popularity of the issue and provide confidence to potential IPO investors. The benefit for institutional investors applying in anchor quota is that they get guaranteed allotment. Anchor investors, however, can- not sell their shares for a period of 30 days from the date of allotment as against IPO investors who can sell on listing day.

Global Depository Receipts (GDR)

Indian companies can raise equity capital in the international market through the issue of Global Depository Receipt (GDRs). Indian companies can raise share capital in the inter- national market through the issue of Global Depository Receipt (GDRs). They are called receipts and not shares as an Indian company is not allowed to raise share capital in any country other than India. Therefore, the procedure is marginally changed, and the name is changed but the process is substantively the same.

GDRs are issued in foreign currency. GDRs are beneficial in multiple ways: The proceeds of the Global Depository Receipts (GDRs) can be used like any other form of corporate reserves. For example, to acquire a foreign company. Nation benefits as foreign currency adds to its forex stock. Currency stabilises. GDRs are listed on London Stock Exchange or Luxembourg or elsewhere. They are also called euro-issues in a general sense.

American Depository Receipts (ADRs)

American depository receipts are like GDRs, but the investors are from the United States and the listing is on an American stock exchange like NASDAQ or the New York Stock Exchange. They are issued to the US retail and institutional investors. They are entitled like the shares to bonus, stock split and dividend. Like GDRs, they help raise equity capital in forex for various benefits like expansion, acquisition, etc. ADR route is taken as non-US companies are not allowed to list on the US stock exchanges by issuing shares. For almost all purposes, ADRs are like shares. Similarly, Indian Depository Receipts (IDRs), are issued by non-Indian companies to Indians in India in rupees.

Foreign Portfolio Investor (FPI)

In 2012, SEBI had constituted K. M. Chandrasekhar committee to rationalize/harmonize various foreign portfolio investment routes and to establish a unified, simple regulatory framework. Based on the Chandrasekhar Committee report, in 2014, the new FPI Regime came into effect.

FIIs, Sub-Accounts and QFIs are brought together to form the new investor class, Foreign Portfolio Investors. Since 2018, FPIs are permitted to invest in corporate bonds, Central Government securities (G-secs) including treasury bills and State Development Loans(SDLs) without any minimum residual maturity requirement.

Foreign Institutional Investor (FIIs)

Foreign Institutional Investor (FII) is an institution established or incorporated outside India which proposes to make investment in securities in India. They are registered as FIIs with SEBI. FIIs include mutual funds. FIIs can invest in 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.

Difference Between FDI and FPI

FDI is involved in setting up firms to produce goods and services. That is why it is called 'direct' institution. FPI on the other hand buys financial assets for profits. In order to remove the ambiguity that prevails on what is Foreign Direct Investment (FDI) and what is Foreign Institutional Investment (FII), it was decided to follow the international practice and lay down a broad principle that, where an investor has a stake of 10 percent or less in a company, it will be treated as FII and, where an investor has a stake of more than 10 percent, it will be treated as FDI.

Since the source of funds is not revealed, the PNs are potentially unsafe. Therefore, SEBI imposed certain conditions like limits on the PNs that a single FII can issue, etc. SEBI wants the PN holders to register with 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 over time to about 2000.
The SEBI action aims at ensuring that the quality of flows into stock markets and Indian forex market is clean.

Clearing House

An organisation which registers, monitors, matches and guarantees the trade of its members and carries out the final settlement of all transactions on the stock exchanges. The central counterparty steps in between the buyer and the seller and acts as a buyer to every seller and a seller to every buyer guaranteeing settlement of trades. This process is called novation. Clearing corporations maintain funds for guaranteeing trades, settlement and in case of a default by a buyer or a seller.

National Securities Clearing Corporation Ltd. (NSCCL), Indian Clearing Corporation Ltd. (ICCL) and MCX-SX Clearing Corporation Ltd. (MCX-SXCCL) are examples. The three corporations clear and settle trades in securities or other instruments/ products traded on the stock exchanges.

Clearing Corporations are designated as Market Infrastructure Institutions for oversight considering its systemic importance in securities markets regulated by the SEBI. They are also subject to rules and regulations that are based on the International Organisation of Securities Commissions' (IOSCO) Principles.

Commodity Exchanges

Commodity exchanges are institutions which provide a platform for trading in 'commodity futures' like stock exchanges provide space for trading in equities. They 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, SEBI allows futures trading in over 120 commodities.
Currently there are six national exchanges, viz., Multi Commodity Exchange, Mumbai (MCX), National Commodity and Derivatives Exchange, Mumbai (NCDEX), National Multi Commodity Exchange, Ahmedabad (NMCE), Indian Commodity Exchange Ltd., Mumbai (ICEX), ACE Derivatives and Commodity Exchange, Mumbai (ACE) and Universal Commodity Exchange Ltd., Mumbai (UCX), that operate forward trading in commodities.

Besides, there are 11 Commodity-specific exchanges recognized for trading in various commodities approved by the Commission under the Forward Contracts (Regulation) Act, 1952.
Gold, Crude oil, Silver, Copper, Natural Gas, Lead, Soy Oil, Zinc, Soybean and Castor seed are the prominently traded commodities.

Forward Markets Commission (FMC)

Forward Markets Commission (FMC) was a regulatory authority, which was overseen by the Ministry of Consumer Affairs and Public Distribution, Govt. of India. It was merged with SEBI in 2015. The Forward Contracts Regulation Act (FCRA) stands repealed, and the regulation of the commodity derivatives market shifts to SEBI under the Securities Contracts Regulation Act (SCRA), 1956. SCRA is a stronger law and gives more powers to SEBI than FCRA offered to FMC. The aim is to have commodity markets that are better regulated, with more stringent processes—and thus evoke greater confidence. The FMC only regulated the exchanges and had no direct control over brokers. SEBI has a far superior surveillance, risk-monitoring and enforcement mechanism that will give more confidence to investors and may help businesses grow.

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 paper- work involved in transfer of securities and reduction in transaction cost.

National Securities Depository Limited (NSDL)

In the depository system, securities are held in depository accounts, which is similar to holding funds in bank accounts. Transfer of ownership of securities is done through simple account transfers. NSDL is the first depository in India. NSDL offers facilities like dematerialization, i.e., converting physical share certificates to electronic form; dematerialization, i.e., conversion of securities in DEMAT form into physical certificates, etc.

Stock Markets and Macroeconomy

It can be argued that stock markets reflect the larger economy. Following points can be presented in favour:

- When the economy does well, companies make profits, give bonuses and dividends and thus shareholders benefit. Based on this logic, there is demand for shares and thus markets will go up and vice versa.

- When the recession took place in 2008, stock markets crashed all over the world.
- It is said that all companies are not listed. But it does not diminish the mirror effect as the companies that are listed are a fair cross section of the whole economy.
- It is further said that agriculture is not represented. But the fact is some agro-companies are listed and the performance of the macro-economy is based on agriculture as well. Thus, the dynamics of agriculture are factored in.
- Liquidity—the money that is chasing stocks—exaggerates the valuations.
- Political factors also have an impact by way of stability and the priorities.
- However, stock markets are influenced by psychological factors like greed and fear and that partly distorts the valuations, but the trend is not violated.

Stock Market Crash of 2020

Pre COVID-19, market capitalisation of BSE and NSE each was about $2.16 trillion. At the beginning of the year, there were close to 30 companies that were expected to file IPO's. The market conditions were generally favourable as there were high expectations from Indian economy. NSE and BSE reached peaks of 12,362 and 42,273 respectively.

But the pandemic of COVID 19 led to crash in the stock markets like during the Global Financial Crisis of 2008. The total market cap lost 27.5% from the start of the year, at its worst, reflecting the economic losses due to the Depression-like conditions with huge unemployment, factory shutdowns, bank losses, drastic fall in demand and consumption, supply side being damaged due to lockdown and social distancing, global trade having crashed, government finances being hit and so on. FIIs looked for a safe haven and so sold their holdings in the Indian stock market.
In response to current turmoil, RBI and the Government came up with a slew of reforms such as reductions of repo rate, interest on loans being given moratorium, measures to boost liquidity in the system through LTRO etc; GOI gave direct benefit transfer(DBT). As a result, market recovered to some extent.

Indian Stock Market Performance

Reasons for the Indian stocks to do well are both global and domestic:

- Sound Economic growth and potential
- Large market
- Under-tapped in the sense that a large section of society is yet to enter the market
- World-class infrastructure for trading
- Credible regulation by SEBI

- Market-friendly policies
- Allowing QFIs, sub-accounts and PNs
- Global liquidity flows due to loose money policies like QE

International Financial Services Centre (IFSC)

Gujarat International Finance Tech-city (GIFT City) SEZ is India's first International Financial Services Centre (IFSC) under Special Economic Zone Act, 2005. It is being developed as a global financial services hub. GIFT City IFSC is a Multi Services Special Economic Zone and commenced its business in 2015.

It is being developed as the country's first International Financial Services Centre (IFSC). IFSC is a jurisdiction that provides financial services to resident and non-resident Indians in foreign currencies. Such centres deal with flows of finance, financial products and services across borders. London, New York and Singapore global financial centres.

The services it offers are:

- Fund-raising services for individuals, corporations and governments
- Asset management
- Wealth management
- Global tax management and cross-border tax liability optimization, which provides a business opportunity for financial intermediaries, accountants and law firms.
- Global and regional corporate treasury management operations that involve fund- raising.
- Risk management operations such as insurance.
- Merger and acquisition activities among trans-national corporations.

The SEZ Act 2005 allows setting up an IFSC in a SEZ or as a SEZ after approval from the central government.

GIFT City Co. Ltd., which is implementing the GIFT City project in Gandhinagar, is a 50:50 joint venture between Infrastructure Leasing and Financial Services Ltd (IL and FS) and state government owned Gujarat Urban Development Company Ltd.

The aim is to develop a world class smart city that becomes a global financial hub with the development of an International Financial Services Centre. The government is also trying to bring back the financial services and transactions that are currently carried out in offshore financial centres by Indian corporate entities and overseas branches or subsidiaries of Financial Institutions (FIs) to India.

Entities regulated by RBI, Securities & Exchange Board of India and the Insurance Regulatory and Development Authority of India can set up offices in IFSC. For instance, banks, insurance companies, stock broking firms, alternate investment funds and investment advisors, etc.

Since India has many restrictions on the financial sector, such as partial capital account convertibility, high SLR (Statutory Liquidity Ratio) requirements and foreign investment restrictions, a SEZ can serve as a testing ground for financial sector reforms before they are extended the entire nation. Apart from SEZ-related incentives there is an exemption from the securities transaction tax.

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. Following are the important indices:

- NASDAQ
- American Dow Jones Industrial Average
- American S and P 500 Index
- British FTSE 100: It is a share index of the 100 most highly capitalized companies listed on the London Stock Exchange. 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
- Ibex for Spain
- Japanese Nikkei
- 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

NASDAQ stands for the National Association of Securities Dealers Automated Quotation Sys- tem. 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. Currently there are three Dow Jones Indices—The Dow Jones Industrial Average (DJIA), the Dow Jones Transport Average (DJTA) and the DJUA (Dow Jones Utility Average).

In recent years, broader indices such as the Standard and 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.

Sustainable Stock Exchanges (SSE)

The Sustainable Stock Exchanges (SSE) initiative is a project of the United Nations (UN). Other key stakeholders include the World Federation of Exchanges (WFE) and the International Organization of Securities Commissions (IOSCO).

The SSE provides a multi-stakeholder learning platform for stock exchanges, investors, regulators and companies to adopt best practices in promoting corporate sustainability. In collaboration with investors, regulators and companies, they strive to encourage sustainable investment.

International Organization of Securities Commissions (IOSCO)

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

Members are the Securities Commission like SEBI or the main financial regulator from each country. IOSCO has members from over 100 different countries, who regulate more than 90 per cent 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 has a permanent secretariat based in Madrid.

BRICS Cooperation Among Exchanges

In 2011 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, BOVESPA from Brazil, MICEX from Russia, BSE from India, Hong Kong Exchanges and Clearing Limited (HKEx) from China and JSE Limited from South Africa, announced the formation of the alliance. 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.

Social Stock Exchange

In the 2019–20 Union Budget it was proposed to set up a social stock exchange (SSE) under the regulatory ambit of the Securities Exchange Board of India (SEBI) to support social enterprises in raising funds. SSEs can be helpful in bringing in significant additional capital to support entrepreneurs working to improve the lives of under-served social groups like farmers, informal sectors, health and education fields in rural areas and so on, thereby enabling inclusive growth.

Some Terms

Mutual Fund

A financial intermediary that collects money from several investors, to invest in capital market to generate returns for the investors. Mutual fund does it for a fee. There are two types of MFs, viz., Open-ended Funds and Closed-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 from the fund office itself and not on the stock market.

Closed-ended means only a fixed number of shares (units) 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).

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. It can be split if the price is too high to make everyone afford it. If the company does well, there may be bonus shares issued to existing holders.

Bond
A secured debt instrument issued for a specific period at a fixed or floating rate of interest for raising capital by borrowing.

Debenture
Debenture is an unsecured debt instrument carrying interest. It is a corporate financial instrument. 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 part of the amount converted into shares.

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

Bull
Bull is an investor who believes that the market will go up—an optimist.

Bear Market
A prolonged period of falling stock prices usually preceding or accompanied by a period of poor economic performance known as recession or slowdown.

Bull Market
A stock market that is characterized by rising prices over a long period of time. It represents a period of investor optimism, lower interest rates and economic growth. The opposite of a bear market.

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 demand for them in the market.

Largecap, Midcap or Small Cap 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 down and vary from institution to institution.

Retail Investor

A retail investor is one who applies for shares worth less than `2 lakh in any IPO, according to SEBI. SEBI allows price discount for retail investors. This discount is offered to attract retail investors into the market and broad base ownership.

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

It is the latest price of the share of the company multiplied by the total number of shares of the company.

MPS Norms

SEBI mandated that there should be 25 per cent Minimum Public Shareholding (MPS) by all listed companies. In the 2019-20 Union Budget, it was proposed that Securities and Exchanges Board of India (SEBI) should consider increasing the minimum public share- holding norms to 35 per cent.

Sweat Equity

It is the large number of shares that the Directors of a company are issued for their contribution to the intellectual property of a company that is locked in for some time and may be sold later.

Insider Trading

Insider trading occurs when anyone with information related to strategic and price-influencing information purchases or sells stocks to make speculative profits. SEBI punishes those who are involved in insider trading.

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 have their stock markets collapse beyond a point. India, for example grew 6.7 per cent (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 its 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.

Shariah Index

Bombay Stock Exchange (BSE) launched its Shariah Index in 2010. The index 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. The new index attracts 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.

Types of Shares

There are essentially two types of shares: common stock and preferred stock. Preferred stock is generally issued to investors like banks and others 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 stockholders are not.
- When the company is to be closed, preference stockholders are given money first from the proceeds of the sale of the assets of the companies and come immediately after the creditors.
- 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).

Power Exchanges

A power exchange is an institution that is responsible for conducting auctions to sell power at competitive market prices. Central Electricity Regulatory Commission (CERC) permitted trading of electricity through Power Exchange in 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.

Fintech in India: Promise, Progress, Innovation and Regulation

In general, FinTech stands for financial technology and describes technologically enabled financial innovations. It is an emerging industry that uses technology to improve activities in finance. The use of smartphones for mobile banking, investing, borrowing services, and cryptocurrency are examples of technologies aiming to make financial services more accessible to the general public. Financial technology companies consist of both startups and established financial institutions and technology companies trying to replace or enhance the usage of financial services provided by existing financial companies. Fintech aims to provide agile, efficient and differentiated experiences to the end- user.

Fintech has the potential to transform the financial sector where consumers can choose from a larger set of options at competitive prices and financial institutions could improve efficiency through lower operational costs. As a country that is determined to achieve universal financial inclusion at affordable costs, this is a defining moment for us.

FinTech in India

India has been at the forefront of this revolution. India is amongst the fastest growing FinTech markets in the world. India ranked the highest globally in the FinTech adoption rate with China. Digital payments value of $65 bn in 2019 is expected to grow at a CAGR of 20% till 2023.The overall transaction value in the Indian FinTech market is estimated to jump from approximately $65 bn in 2019 to $140 bn in 2023.

It is reported that there are as many as 1250 FinTech firms operating in India which have created a large number of jobs. They are also generating a healthy appetite for investment.

The Reserve Bank has over the years encouraged greater use of electronic payments so as to achieve a "less-cash" society. The objective has been to provide a payment system that combines the attributes of

- safety,
- enhanced convenience,
- accessibility,
- leveraging technological solutions that enable faster processing,
- affordability,
- interoperability, and
- customer awareness and protection.

New technology

Banks have been the traditional gateway to payment services. However, with the fast pace of technological changes, this domain is no longer the monopoly of banks. Non-bank entities are cooperating as well as competing with banks, either as technology service providers to banks or by directly providing retail electronic payment services. The regulatory framework has also encouraged this enhanced participation of non-bank entities in the payments domain.

Cash to Digital: Facilitators

In India, like in many parts of the world, cash is the well-established and widely used payment instrument. Cash is all pervasive, easy to use and store and offers great convenience. It is, however, reassuring that non-cash payments, especially those using electronic or digital modes are rapidly increasing. The digital revolution is taking the world by storm and no other area has witnessed such metamorphosis as payment and settlement systems, resulting in a myriad of digital options for the common man. Consumers now have a range of options to choose from when selecting a payment method to complete a transaction.

As at end November 2019, India had over 115.5 crore wireless telephone subscribers resulting in a tele-density of 88.90%. The urban tele-density and rural tele-density was 157.33% and 56.69%, respectively. The increase in smartphones has helped to accelerate the adoption of digital payments. Further, it has led to numerous innovations in payment mechanisms, such as tokenisation and scanning of QR code for making payments using smartphones.

These have facilitated the shift from cash to non-cash payments. (Tokenisation, which aims at improving safety and security of the payment system, refers to replacement of actual card details with an unique alternate code called the 'token', which shall be unique for a combination of card, token requestor and identified device. Instead of using actual card details, this token is used to perform card transactions in contactless mode.)

Internet usage is on the rise in India. While the average Indian until 2013 used to spend more on voice services than on mobile data services, the majority of an average mobile bill now pertains to data charges according to a report by the Internet and Mobile Association of India (IAMAI). By November 2019, there were over 64.2 crore and 1.9 crore wireless and wireline broadband subscribers, respectively across the country. The increase in internet penetration has ensured adoption of digital modes of payments across the country.
The growth of infrastructure in India has been phenomenal over the past six years, especially with reference to availability of Mobile Cellular Subscriptions. With increased penetration of 3G and 4G even in remote areas, the internet network is rapidly expanding in India and provides a threshold of "Digital Revolution."

Institutional Innovation and Regulation

In recent years, a focussed effort has been made to develop a state of the art national payments infrastructure and technology platforms, be it Immediate Payments Service (IMPS), Unified Payments Interface (UPI), Bharat Interface for Money (BHIM), Bharat Bill PaySystem (BBPS), or Aadhaar-enabled Payment System (AePS). This has changed the retail payments scenario of the country. The total volume of retail electronic payments witnessed manifold increase over the last few years.

The settlement data of volume and value of transactions undertaken in the payment systems by the Reserve Bank (Neft and RTGS) and the facilities provided by National Payments Corporation of India (AePS, CTS, IMPS, and UPI) shows major leaps.

Numbers with regard to digital modes of payment are as follows: The NEFT system handled 195 crore transactions valued at around Rs.172 lakh crore in 2017-18 growing many times in terms of volume and value. Similarly, the number of transactions carried out through credit and debit cards in 2017-18 was 141 crore and 334 crore, respectively. Prepaid payment instruments (PPIs) recorded a volume of about 346 crore transactions, valued at Rs.1.4 lakh crore. Thus, the total card payments, in volume terms, stood at 52 percent of the total retail payments during the year 2017-18.

Alternative Models

Developments in the spheres of banking technology and trade finance have been commendable as well. Alternative models of lending and capital raising are coming up and have the potential to change the market dynamics of traditional lenders and the role of traditional intermediaries. Crowd-funding, which entails raising external finance from a large group of investors, is at a very nascent stage in India. The peer-to-peer (P2P) lending has the potential to improve access to finance for small and medium enterprises. Eleven entities have been licensed to operate P2P platform. The Reserve Bank has also granted licenses and permitted seven purely digital loan companies (NBFCs) to commence operations. Although they are purely digital players operating through mobile applications, RBI ensured that they have at least one physical presence for customers to reach out to in case of need.

Furthermore, seven payment banks have commenced operations. These technology-led banks use FinTech, both while onboarding customers as well as while carrying out operations.

Invoice trading is another nascent area of FinTech application in India. It assists MSMEs which often have working capital and cash flow problems due to delayed payments.

The Reserve Bank has set up the Trade Receivables Discounting System (TReDs), which is an innovative financing arrangement where technology is leveraged for discounting bills and invoices. Three entities have been authorised for this purpose and the volumes are slowly gaining traction.

Another initiative has been laying down a regulatory framework for Account Aggregators (AA). A total of five entities have been given in- principle approval as NBFC-AA and are expected to commence their operations during 2019-20. It is a new form of NBFC.

To further deepen digital payments and enhance financial inclusion through FinTech, the Reserve Bank of India (RBI) has also appointed a five-member committee under the chairmanship of Shri Nandan Nilekani.

While opening a new world of opportunities, the FinTech revolution has its own share of risks and challenges for the regulators and supervisors. Early recognition of these risks and initiating action to mitigate the related regulatory and supervisory challenges is key to harnessing the full potential of these developments.

Risks

RegTech and SupTech

Designing suitable financial products that cater to specific needs of the financially excluded population, digital onboarding and boosting the quantum of investments are vital in achieving the first objective. Effective utilisation of Aadhaar eco-system may provide incentives for the people to adopt digital platforms as it is happening in the case of direct benefits transfer (DBT). The central KYC registry is a significant step in this regard – about 100 million KYC records have already been uploaded onto this platform. We also need to ensure multi-lingual financial literacy and a robust grievance redressal machinery to effectively handle inter-regional disparities and to offer online dispute resolutions.

As regards potential risks and their mitigation, RegTech and SupTech have an important role. RegTech is an application or platform which makes regulatory compliance more efficient through automated processes and lowers the costs of compliance. RegTech focuses on technologies that facilitate the delivery of regulatory requirements more efficiently and effectively. Suptech is a short form of Supervisory technology. SupTech refers to the technology that supports supervisors. The Bank for International Settlements (BIS) defines Suptech as the use of innovative technology by supervisory agencies to support supervision". Supervisory agencies lay down the rules and regulations. They need technology to check compliance by the constituents. The objectives of SupTech are seamless and straight-through data collection / reporting, data analysis and decision making, streamlined licencing, market monitoring and surveillance, cybersecurity data or evidence based policy making.

Both the technologies aim at improving efficiency through the use of automation, introducing new capabilities and streamlining workflows. Reserve Bank has been using SupTech for data collection and analysis. The examples are Import Data Processing and Monitoring System (IDPMS), Export Data Processing and Monitoring System (EDPMS) and Central Repository of Information on Large Credits (CRILC), to name a few. Also, the risk-based supervision of banks is extensively data-driven and is an example of SupTech. The future of RegTech and SupTech technologies, however, lie in big data analytics, artificial intelligence, machine learning, cloud computing, geographic information system (GIS) mapping, data transfer protocols, biometrics, etc.

This also brings in the need for a transparent, technology and data-driven approach.

A strong risk culture - in which risk detection, assessment and mitigation are part of the daily job of bank staff - will be central to the success of managing the emerging risks. Similarly, systemic risks may arise from unsustainable credit growth, increased interconnectedness, procyclicality (lending recklessly while the growth is good without factoring in for the slowdown/recession), development of new activities beyond the supervisory framework and financial risks associated with lower profitability.

Data confidentiality and customer protection are major areas that also need to be addressed.

The Reserve Bank has encouraged banks to explore the possibility of establishing new alliances with FinTech firms as it could be pivotal in accelerating the agenda of financial inclusion through innovation. It is essential that flow of investments to this sector is unimpeded to realise its full potential. It is imperative to create an ecosystem which promotes collaboration while carefully paying attention to the implications that it has for the macroeconomy.

Sandbox

In order to ensure an orderly development of FinTech, to streamline their influence into the financial system, to protect the customers and to safeguard the interest of all the stakeholders, we need to have appropriate regulatory and supervisory frameworks. Such frameworks should address associated risks while keeping in mind the growth requirements of this sector. The Reserve Bank's working group on FinTech and digital banking in 2017 suggested the introduction of a 'regulatory sandbox/innovation hub' within a well-defined space and duration to experiment with FinTech solutions, where the consequences of failure can be contained and reasons for failure analysed. A 'Regulatory Sandbox' would benefit FinTech companies by way of reduced time to launch innovative products at a lower cost. Going forward, the Reserve Bank will set up a regulatory sandbox, for which guidelines will be issued in the next two months.

We have to strike a subtle balance between effectively utilising FinTech while minimising its systemic impacts. By enabling technologies and managing risks, we can help create a new financial system which is more inclusive, cost-effective and resilient.

Chapter - 10
Inflation: Concepts, Facts and Policy

Introduction

Inflation means a persistent rise in the average price of goods and services. If prices rise moderately, it is a positive development as it shows there is growth in the economy. How- ever, if prices rise steeply, it hurts almost the entire economy without any benefits—growth, budgetary balance, welfare, reduces the purchasing power of money, impoverishes the poor disproportionately more as a greater proportion of their incomes are needed to pay for their consumption, reduces savings, pushes interest rates up, dampens investment and leads to depreciation of currency thus making imports costlier which feeds into inflation further. In other words, the entire macroeconomic stability rests on inflation if it reaches unsustainable levels. Therefore, the government policies aim at growth with price stability, which is moderate inflation on a long-term basis.

Inflation and its Types

Depending on the rate of growth of prices, inflation can be of the following types:

Creeping Inflation is a rate of general price increase of up to 4 per cent a year. It is largely positive from a systemic perspective as it shows there is growth and so is referred to as price stability. It is a deterrent to deflation. It is considered good for the economy as producers and traders make reasonable profits encouraging them to invest.

Trotting inflation is when creeping inflation increases. If not controlled, trotting inflation may accelerate into a galloping inflation which may be around 8-10 per cent a year. If it aggravates, galloping inflation can spiral to runaway inflation which may change into a hyperinflation.

Hyperinflation is when prices are out of control. That is, a monthly inflation rate of 20 or 30 per cent or more— 'an inflationary cycle without any tendency toward equilibrium'. Hyperinflation is the result of reckless fiscal policy that creates excess money through deficit financing. It may also be caused due to war when fiscal resources and civilian production bases are diverted for military purposes. Social upheavals also can destabilize production to cause abnormal increases in prices. If it aggravates, it leads to monetary collapse—money loses its value and either barter (exchange of goods and services without money mediating) may become popular or a foreign currency will become the dominant medium of exchange.

It must be noted that rates of growth of prices that are attached to the aforementioned terms are not of universal application. The tolerance levels differ from country to country. Developed countries have far lower tolerance levels compared to developing countries.

Other related concepts are as follows:

Deflation: When prices grow at a rate that is less than zero. That is, if an item that was sold for `10 is being sold for less than `10 on a persistent basis. Deflation increases the value of money which allows one to buy more goods and services than before with the same amount of currency.

Disinflation: It is the reduction of rate of inflation. It is the rate of growth of prices that is slowing but prices are increasing. Reasons for disinflation can be many: money supply may be reducing; economy may be slowing; supplies may be increasing and becoming cheaper, etc. Disinflation is desirable if it brings about price stability but not if it is poised towards deflation.

Stagflation: It is a combination of inflation and rising unemployment due to recession. It comes from the two words—stagnation and inflation. It is a macroeconomic condition when the inflation rate is high, the economic growth rate slows, or economy goes into de-growth (recession) and unemployment rises. Standard policy interventions will not work. For example, if rates are lowered to boost growth, inflation will rise even more eating into growth and causing unemployment. In the 1970's, US economy went into stagflation as global oil prices shot up. In 2018, there are comments indicating that due to rising oil prices, there could be stagflation.

Reflation: Which is when inflation returns after a spell of deflation and recession thus showing that growth is back—US and EU after the great recession (2007–09) when growth was revived.

Open Inflation: One of the primary responsibilities of the government is to ensure affordability of goods and services. Governments subsidize goods and services to keep them inexpensive. For example, kerosene, food, transport, etc. The inflation that results when the government does not suppress it with subsidies and monetary policy is called open inflation.

Suppressed Inflation: Inflation is too big a risk for the economy for the government to allow it to continue unchecked. Therefore, fiscal and monetary actions are taken to man- age it at a moderate level. That is called suppressed inflation. It is named so because, the problem of inflation is only managed and not resolved. It may re-emerge if fiscal policies change—reduce subsidies, etc.

Headline Inflation: Headline inflation is a measure of the total inflation. It is an unadjusted number. It is the overall inflation as it is reported. Headline inflation is what consumers experience. It is best understood when contrasted with core inflation (explained ahead).

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 base inflation. For this purpose, certain items are excluded from the computation of core inflation. These items include changes in the price of fuel and food and the processed food part of manufacturing. The reason is they are volatile, being subject to short-term fluctuations and are seasonal in nature like food items. Thus, core inflation eliminates transitory effects. The main argument here is that the central bank should effectively respond 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. Headline inflation on the other hand includes the official rate of increase in prices that excludes no item in the basket. Headline and core inflation are calculated both at the wholesale and consumer levels. CPI (Combined, that is rural and urban) headline inflation is considered when inflation is being targeted in the country by the RBI since 2015.

Measures of Inflation

GDP Deflator

It is the most comprehensive measure of inflation as it reports the change in prices of all domestically produced final goods and services in an economy. The GDP deflator is not based on a fixed basket of goods and services but applies to all goods and services domestically produced and thus is the most useful. It is not used for decision making in the short term as the statistics are available with a long-time lag.

Cost of living Index

A certain standard of living requiring a specific set of goods and services (basket) is defined and the basket is tracked for price changes in relation to affordability. The cost of living is the cost of maintaining such predefined standard of living.

Producer Price Index (PPI)

In India, we have a price index to measure changes in prices at the consumer and wholesale levels. But we do not measure the changes in prices that producers receive. Wholesalers buy from producers in bulk. If producer prices are measured, it becomes clear as to whether the wholesale price changes are justified or not. If wholesale prices are going up and producer prices are not, the problem is with the excessive margins of the wholesalers and can thus be addressed. In the absence of knowledge of movements of producer prices, price management becomes difficult and undue gains continue. Hence, the need for PPI. Within the PPI, there are two aspects

- price a producer receives for his goods/services called Output PPI and
- price a producer pays for the goods/services called Input PPI.

The difference between the two also reveals whether the producer prices are justified or not. Margins can be controlled and it will positively impact inflation. Producer prices can be tracked as basic prices (without indirect taxes) or market prices.

Department for Promotion of Industry and Internal Trade (DPIIT) under the Ministry of Commerce and Industry set up a working group on the PPI in 2014 under the chairmanship of B.N. Goldar to outline the timeline for launch of the PPI series and it submitted the report in 2017.

Wholesale Price Index (WPI)

Wholesale is sale of goods in bulk. Retailers buy from wholesale market to sell to consumers. There may be a chain of retailers before the consumer buys the product. Wholesale price index tracks price changes at the wholesale level.

PPI and WPI differ since WPI includes logistics, cost of credit, warehousing costs, transportation costs, margins, risk considerations, etc.

Consumer Price Index (CPI)

CPI measures the changes in prices paid by the consumer at the retail level. It can be for the whole economy or specific to a group. For example, CPI for industrial workers, etc., as in India.

Causes of Inflation

Demand-Pull Inflation

Rising demand in the economy pushes prices. Demand may rise due to

- growth and income increases; or
- monetary easing; or
- excess of foreign inflows; or
- fiscal expansion by the government

Cost-Push Inflation

When inputs that go into production cost more, the inflation that results is cost-push inflation. For example, if foodgrain production falls in India due to bad monsoon, grains cost more and it has an overall inflationary impact. If global oil prices go up, the supply shocks that result push up 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 and remains unproductive, inefficient distribution and storage facilities leading to artificial shortages of goods, backward technology and the resulting under-productivity is also a structural source of inflation. Infrastructural bottlenecks–roads, ports, etc., causing wastage of goods and creating shortages. Food inflation witnessed for a decade in India till mid–2010s was structural in nature as the preference for protein foods is far ahead of its supplies and this is a phenomenon driven by income rise.

Other Causes

- Speculation in the commodity exchanges.
- **Cartelization of Producers:** When producers come together and manipulate the prices in the market for the goods or services that they produce for their own profits. For example, Competition Commission of India (CCI) had imposed penalties in 2016 on Cement Manufacturers Association (CMA) for cartelization in the cement industry that drove up prices through manipulation.
- **Hoarding:** Accumulation of huge quantities of goods and releasing them into the market in conditions of scarcity at higher prices is also a cause of inflation. From time to time government raids wholesale traders and forces them to release their hoarded stocks to ease prices. For example, major onion traders in Lasalgaon and surrounding areas in Nashik district of Maharashtra, one of the largest onion markets in the country. Essential Commodities Act, 1955 aims to check hoarding, among other things. In 2014, GOI included onions and potatoes for one year under the ECA to curb hoarding. GOI imposed limits on the quantity of onions and potatoes that individuals and wholesale traders could stockpile. This empowered state governments to take measures to prevent hoarding.
- **Imported Inflation:** When a country that depends on imports of goods sees inflation due to international prices rising or due to exchange rate depreciating. For example, crude price rise in 2019.

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 receiving scholarships) will be worse-off in real terms due to higher prices and same income as before.
- Impact of inflation on exports depends on many factors and the sector. It may discourage exports as domestic sales are attractive due to higher prices. Inflation may erode the external competitiveness of our products if it leads to higher production costs such as wage increases, and higher interest rate. It may also stimulate exports if the rupee depreciates as a result of domestic inflation being relatively high. However, if exports are import-intensive, advantage of depreciation may be neutralized.
- Inflation can drag down growth as investment climate turns unfriendly due to low savings rate and high interest rates that deter consumption.
- Not only does inflation discourage saving and thus hit investment, it also skews savings pattern in favour of unproductive assets like gold and commodities as inflation may be higher than interest rates and yield is negative.
- Inflation tax is a hidden tax. It is the financial loss in the value of money incurred by holders of cash. Another way of seeing it is that when the government wants to tax people, they resist it. But the government needs the money And so it prints and releases the money into market and that inflates the economy which means people pay more for the goods and services they consume. The result is that the tax that they did not pay is paid as prices rise.
- Government fiscal deficit may go up as the need to subsidize is more to make goods and services affordable which can create macroeconomic instability.

Inflation usually is associated with growth because when there is growth, there is rise of incomes and demand for goods and services which causes inflation. Supply generally lags demand as investors must make sure that the demand is sustainable as otherwise underutilization of capacities hurts profits. There is thus inevitable inflation in a growing economy. However, as has been mentioned before, inflation can result without growth as well.

It can be argued that a low level of inflation 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.'

Losers: Everyone loses when prices rise beyond the zone of tolerance—more than 4 per cent generally. Individuals on fixed incomes, retirees and all creditors (who lent at fixed rate of interest), to name a few.

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

Deflation

Deflation is invariably associated with recession when economic growth is negative. That is, economy is producing less than what it produced earlier.

When an economy experiences deflation, demand from businesses and consumers to buy products goes down because they expect to pay less later as prices fall further. With crashing demand, producers cannot sell and go bankrupt, unemployment rises reducing demand further. That aggravates deflation further. It makes it more expensive to service existing debts. As debt becomes unserviceable, the risk of default and bankruptcy rises too, and banks become reluctant to lend as their own NPAs rise.

The way to deal with deflation is by pump priming the economy in the Keynesian way. There are fiscal and monetary responses. Fiscal remedies to deflation:

- Tax cuts to boost demand from consumers and businesses.
- Increase government spending on infrastructure projects that boost the return on private investment.

Monetary response is:

- Lowering interest rates to encourage demand for credit.
- Printing more currency to boost money supply.

India did not ever face deflation at the retail level but in 2014 and 2015, for 14 consecutive months, Wholesale Price Index (WPI) inflation was in the negative. WPI inflation had remained negative for four months -April - July 2020 as coronavirus induced lockdown crashed economic activity. However, headline CPI inflation remained high during the COVID-19 induced lockdown period and subsequently, due to the persistence of supply side disruptions.

Price Stability and Optimal Inflation

All consumers want lower prices. Price stability according to the Monetary Policy Framework Agreement 2015 is inflation rates at 4 per cent, plus or minus 2 per cent on a medium-term basis. That will help public to have clear expectations of prices for the future and behave predictably. When there is clear guidance to inflation expectations, there is no panic buying that inflates more by creating scarcities nor in selling that can deflate.

Low levels of prices and negative inflation (deflation) may be of short-term comfort to the consumer but are not desirable from a longer-term view.

Consumer may want negative inflation as it helps him afford goods and even save. That is possible when supplies outstrip demand on a sustainable basis which is not possible as the producer incurs losses.

Hypothetically, negative inflation is also possible if government subsidizes goods and services steeply but producers would object to that. Besides, that is also not possible fiscally as deflation hurts fiscal receipts and on top of it, subsidies bill will damage the fiscal position even more.

Lastly, consumer will not be benefited if prices fall due to recession-driven deflation as it may hurt his own job and business prospects in the medium run. Therefore, we can aim at inflation that is in the positive territory that augurs well for economic wellbeing for all—producers and consumers alike. Too much inflation hurts from all sides and too little has no incentive for growth. There must be price stability at a moderate level of inflation. However, the question remains how much inflation will be good for the economy in terms of growth, welfare and stability. In India, the RBI and the GoI signed a Monetary Policy Framework Agreement in 2015 which says that the objective of monetary policy framework is mainly to maintain price stability, while keeping in mind the objective of growth; and contain consumer price inflation within 4 per cent with a band of 2 per cent. This level of inflation is considered optimal from growth, stability, fiscal consolidation, foreign trade and welfare perspectives.

GDP, Potential GDP and Inflation

Potential output ('natural gross domestic product') can be linked to inflation. Potential GDP is the highest level of real gross domestic product that can be sustained over the long term without creating instability. If GDP exceeds its potential, inflation will accelerate and if GDP falls below its potential level, inflation will decelerate as suppliers attempt to utilize the existing idle capacity by cutting prices.

Inflation and Corruption

The link is as follows:

- Through black money, demand rises and so do prices.
- Hoarding not being checked will create artificial scarcities.

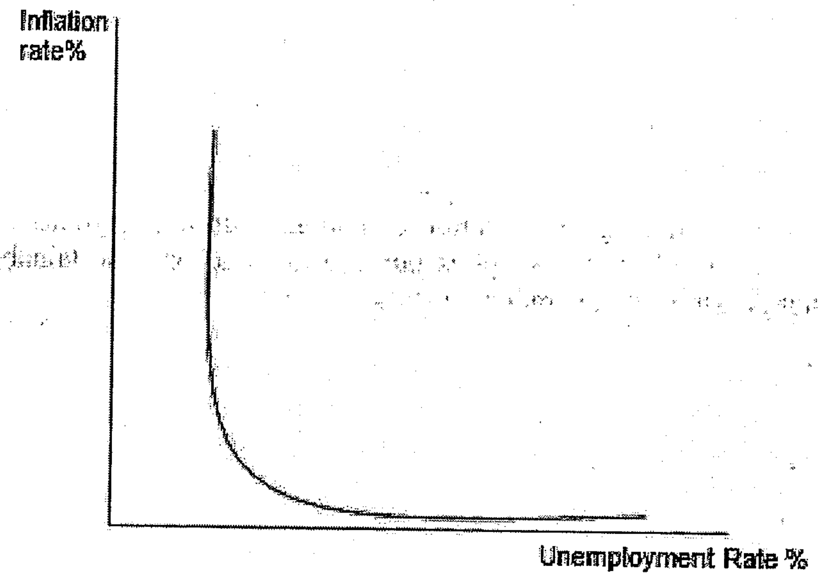


Figure: Phillips Curve

- Commodity prices being manipulated through speculation in commodity exchanges.
- Tax evasion limits government capacity to subsidize and stabilize prices.

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.

Inflation Targeting

Inflation targeting focuses mainly on achieving price stability as the predominant objective of monetary policy. Under it, a number or range is set to be achieved by the central bank. The RBI and the GoI signed a Monetary Policy Framework Agreement in 2015 where the Preamble of the RBI Act, 1934 was amended to make it the statutory responsibility of the RBI to maintain price stability through inflation targeting. A new Chapter was added in the RBI Act, with the details of the operation of a Monetary Policy Committee (MPC), as the institutional framework through which the RBI acts for targeting inflation.

The advantages of inflation targeting are:

- Promotes transparency in the conduct of monetary policy as the objective is clear.
- Increases the accountability of monetary authorities because the benchmark is a statutory fact.

- Inflation expectations are managed well. When we choose a range of price level for the RBI to achieve (called flexible inflation targeting framework), it is helpful because it increases chances of effectiveness.

Critics however argue that in pursuit of price stability, growth and credit supply are unduly being compromised with. Also, due to the targeting, Reserve Bank of India does not cut rates when it should do so for growth; It is believed that higher inflation would support or enable higher growth.

GOI notified the consumer inflation target of 4% for RBI until March 31, 2021, with an upper tolerance level of 6% and lower limit of 2% that was finalised in consultation with the RBI.

Inflation Indices

Inflation as we have already learned, is measured at the producer, wholesale and consumer (retail) levels. It is measured at the sectoral (food) and general economic level. It may be used for a specific group (industrial workers) or the whole country. Changes in the price levels at the wholesale and retail level are tracked by various price indices in India—WPI and CPI. Different CPIs exist for different consumer groups.

All price indices use a particular year as a base year and measure price movements from that year. Base year used for the Wholesale Price Index is 2011 -12. Wholesale prices of a large representative sample of goods make up a basket. Each good has a different weightage. The weights of all goods at their respective prices in the base year add to 100. If sugar is the only commodity in the WPI basket in the base year and its wholesale price in the base year is Rs.10 a kg and rose in the next year to Rs.15, it will be reflected in the WPI in the next year as 100 will become 150.

But WPI basket has hundreds of goods and the average price movement of all the goods in a given period is shown in the movement of the wholesale price index.

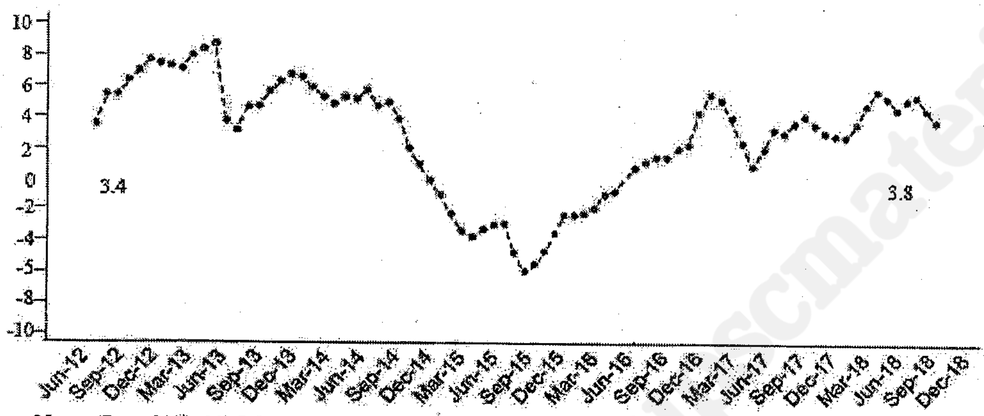
Ideally the same base year should be used for all indices, but data availability, logistics, etc., are the constraints. Ideally the same base year should be used for all indices, but different base years are used for different price indices due to convenience, data availability, logistics, etc.

Wholesale Price Index (WPI)

WPI provides estimates of inflation at the wholesale transactions level for the economy. This helps in timely intervention by the Government to check inflation, particularly in essential commodities, before the price increase spills over to retail prices. WPI is used as deflator for many sectors of the economy for estimating GDP by CSO. It is also used to deflate nominal values of production in Index of Industrial Production (IIP). Global and domestic investors track WPI for their investment decisions.

The WPI is published by the Economic Advisor in the Ministry of Commerce and Industry (with a month lag). The various commodities taken into consideration for computing the WPI can be categorized into primary articles, fuel and power and manufactured goods. Primary articles include food articles, non-food articles and minerals. In fuel, power, light and lubricants, electricity, coal mining and mineral oil are included. The manufactured goods category encompasses food products, beverages, tobacco and tobacco products, wood and wood products, textiles, paper and paper products, basic metals and alloys, rubber and rubber products and many others.

Indian WPI (per cent)



Notes: (Base: 2011-12) I Data of latest 2 months is provisional
Source: RBI

Figure: Wholesale Price Index-based Inflation

WPI has an all-India character. The inflation rate is calculated on point to point basis, i.e., the price of a good at one point of time in the year is compared to the same point of time in the previous year. It thus respects seasonality factor. For example, October prices of a year with October prices of another year.

There are several 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 seasonal item is not available in the market and its prices are not quoted, its weight is distributed over the remaining items and new seasonal items, if any, in the concerned sub-group.

The accuracy of WPI is unsatisfactory even after the introduction of the revised series in 2017. Services such as education, telecom, 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 unorganized 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.

New Wholesale Price Index (WPI)

The Government periodically reviews and revises the base year of the macroeconomic indicators to capture structural changes in the economy and improve the quality, cover- age and representativeness of the indices. The base year of All-India WPI was revised from 2004–05 to 2011–12 by the Office of Economic Advisor (OEA), Department of Industrial Policy and Promotion and the Ministry of Commerce and Industry to align it with the base year of the CSO for Gross Domestic Product (GDP) and Index of Indus- trial Production (IIP). The revision entails changing the commodities in the basket and assigning new weights to the commodities. For the new series with base 2011–12 = 100, the working group was chaired by Late Dr. Saumitra Chaudhuri. WPI basket does not cover services.

In the new WPI basket, the number of items was increased from 676 to 697. It enhanced the number of quotations from 5482 to 8331(shops from where price information was collected). New definition of WPI does not include Indirect taxes so that productivity and scale are better captured. This also brings new WPI series closer to the concept of Producer Price Index and is in consonance with the global practices. Further for the first time a Technical Review Committee has been set up to recommend appropriate methodological intervention to continuously improve coverage, quality and timeliness of the WPI.

The new series also present separate 'WPI Food Index' which along with CPI Food Price Index published by CSO would help monitor the food inflation effectively. The seasonality chart of the Fruits and Vegetables Sub-group under Food Articles has been updated in the new series. For example, tomato price index will now be available around the year as against eight months in the earlier series. Cauliflower was earlier available only for six months but now it will be available for eight months in year.

Consumer Price Index (CPI)

Consumer Price Index (CPI) measures changes in the prices of goods and services purchased by households. The CPI measures price changes by comparing, on a point to point basis, the cost of a fixed basket of commodities like the WPI. Sub-indexes are computed for different categories and sub-categories of goods and services, being combined to produce the overall index with weights reflecting their shares in the total of the consumer expenditures covered by the index. CPI can be used to index (i.e., adjust for the effect of inflation) the real value of wages, salaries, pensions, for regulating prices, etc.

The dearness allowance of Government employees and wage contracts between labour and employer are based on this index.

Over the years, CPIs have been widely used as a macroeconomic indicator of inflation and as a tool by Government and Central Bank for targeting inflation and monitoring price stability. CPI is also used as deflators in the National Accounts along with WPI.

CPI numbers were known as 'Cost of Living Index Numbers' prior to 1955. Cost of living index is a broader term which includes not only changes in prices but several other factors like change in consumption habits and standard of living.

Presently, the consumer price indices compiled in India are:
- CPI for Industrial workers CPI (IW)
- CPI for Agricultural Labourers CPI (AL)
- Rural Labourers CPI (RL)
- CPI All India (Urban)
- CPI All India (Rural)
- CPI All India (Combined)

There was another CPI called the Urban Non-Manual Employees (UNME) but was discontinued.

For Industrial Workers (CPI-IW), a basket of 370 commodities is tracked; for Agricultural Labourers (CPI-AL), it is a basket of 60 commodities. The baskets and the weightages to each item have been determined based on surveys of consumption patterns. All-India figures declared are averages.

Each commodity is given a specific weightage, which differs from one index to another index. For example, the CPI-AL gives greater weightage to food grains since a greater proportion of the agricultural labourer's expenditure would go toward food grains.

In the organized sector, CPI-IW is used as a cost of living index. 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/agricultural labourers.

The base years for the above CPIs are:

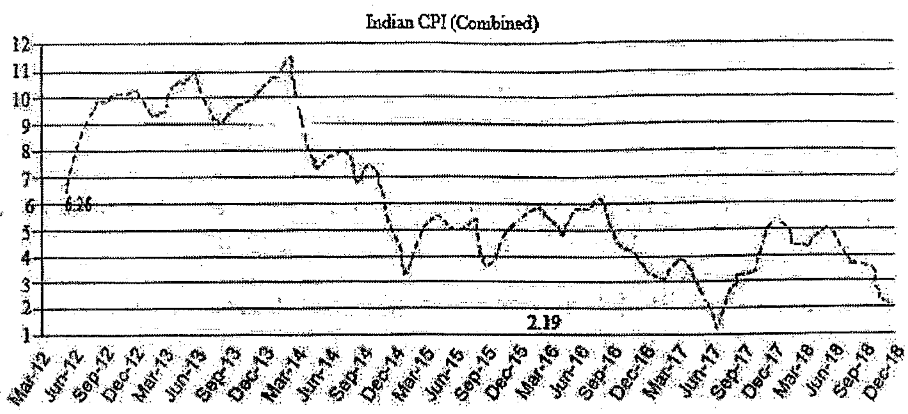
- Consumer Price Index Numbers for Industrial Workers on base 2016 = 100.
- Consumer Price Index Numbers for Agricultural Labourer on base 1986–87 = 100.
- Consumer Price Index Numbers for Rural Labourer on base 1986–87 = 100.

New CPI Series 2015

The Central Statistics Office (CSO), Ministry of Statistics and Programme Implementation in 2015 revised the Base Year of the Consumer Price Index (CPI) from 2010 = 100 to 2012 = 100 and brought in many methodological changes due to change in the consumption pattern from 2004–05 to 2011–12. Changes are the following in the weighing diagram (groups, items and weights): The number of Groups, which was five in the old series, has now been increased to six. 'Pan, tobacco and intoxicants', which was a Sub-group under the Group 'Food, beverages and Tobacco', has now been made separate. Accordingly, the Group 'Food, beverages and Tobacco' has been changed to 'Food and beverages'.

- Egg, which was part of the sub-group 'egg, fish and meat' in the old series, has now been made a separate sub-group. Accordingly, the earlier Sub-group has been modified as 'Meat and fish'.
- Sample size for collection of house-rent data for compilation of House Rent Index, which was 6,684 rented dwellings in the old series, has now been doubled to 13,368 rented dwellings in the revised series.

In the new CPI index, weight of food and beverages is 45.86 per cent and weight of fuel and light segment is 6.84 per cent. Price data are collected from selected towns by the NSSO and from selected villages by the Department of Posts.



Base: 2012
Notes: Dec-18 data is provisional
Source: RBI

Figure: Consumer Price Index (Combined)-based Inflation

New CPI reflects the realistic picture of the prices of consumer goods and services because of the following reasons:

- CPI (Rural): Prices are collected from 1,181 selected village markets covering all districts of the country for rural areas and from 1,114 urban markets of 310 selected towns of urban areas. From each district, at least two villages were selected.
- These markets are equally distributed over different weeks of a month to capture price variations during the month. Only transaction prices, that is prices actually paid by the consumers, are collected for compilation of indices. The items having significant share in the overall consumption expenditure of the households, including the Public Distribution System (PDS) items and the items consumed by majority of the households are included in the basket.
- CPI (Urban): All cities/towns having population (2001 Population Census) of more than 9 lakhs and all state/UT capitals not covered therein were selected and other towns were selected randomly.

The entire process of data validation is carried out using electronic mode of communication. Two independent web portals for Rural and Urban Price Data have been developed by the National Informatics Center (NIC).

The Consumer Price Index is released every month on the 12th day. The RBI started using CPI combined as the sole inflation measure for the purpose of inflation targeting.

Difference Between WPI and CPI

WPI measures price change at the wholesale level. CPI on the other hand measures price change at the retail level. There is a difference between the two in terms of prices. The difference is due to several factors:

- Two indices are calculated with different baskets, commodities and weights.
- Food inflation is reflected more in CPI as its weight is more in CPI than in WPI.
- Services are not part of the WPI basket.
- A substantial portion of the difference is due to the middlemen between the wholesaler and the consumer. Each one has his own margins to make.
- While wholesale prices are about the same throughout the country, consumer prices vary from region to region; and rural to urban due to the change in consumer preferences for certain products, supplies and purchasing power.
- Taxes levied by states comprise an important component of the variation in prices of many products.
- Logistics also adds to the consumer price.

Why the two diverge is because of the number and nature of ingredients of the baskets, weights attached, taxes add to the CPI, logistical and other extra costs and middlemen. Take the food group for example. CPI Food group has a weight of 39.1 per cent as com- pared to the combined weight of 24.4 per cent (Food articles and Manufactured Food products) in the WPI basket. Similarly weights of the major petroleum products such as petroleum and High-Speed Diesel also vary significantly. The CPI basket consists of services like housing, education, medical care, recreation, etc., which are not part of the WPI basket.

A sizeable proportion of WPI basket represents manufacturing inputs and intermediate goods like minerals, basic metals, machinery, etc., whose prices are influenced by global factors, but these are not directly consumed by the consumers and are not covered by the CPI basket. Thus, when the prices of these goods change, CPI need not capture them except with an extended time lag in a reduced manner. The divergence is greater with the new WPI series as it excludes indirect taxes.

Consumer Price Index for Industrial Workers (CPI-IW)

The CPI-IW is compiled and disseminated by the Labour Bureau on a monthly basis. It measures changes in the retail prices of a fixed basket of goods and services being consumed by an average working-class family. Apart from serving as a guide for policy formulations, these index numbers are utilized for fixing/revising wages, regulating the dearness allowances paid to large number of manual workers and Central/ State Govt. employees. To capture the latest consumption pattern of working-class family, Labour Bureau has revised the base year of the existing CPI-IW series 2001=100 to a more recent base year 2016=100.

- The new series of CPI-IW covers the industrial workers from the existing seven sectors viz. Factories, Mines, Plantation, Railways, Public Motor Transport Undertakings, Electricity Generating & Distributing Establishments and Ports & Docks. The new series has a wider coverage in terms of sample size, number of centres, markets/outlets, items etc.
- A total of 88 centers have been covered in the 2016 series as against 78 centers in the 2001 series.
- The sample size for the conduct of Working Class Family Income and Expenditure Survey, on the basis of which weighting diagrams have been derived, was increased to 48384 families from 41040 in the 2001 series.
- The number of selected markets for collection of retail price data has also been increased to 317 markets under the 2016 series as against 289 markets covered in the 2001 series.
- The number of items directly retained in the index basket has increased to 463 items as against 392 items in the 2001 series.
- The number of States/UTs has increased to 28 under 2016 series as against 25 in the 2001 series.

The group level weights under newseries has changed in comparison to earlier series (1982 and 2001). The weight of Food & Beverages has declined over time whereas the weight of Miscellaneous group (Health; Education & Recreation; Transport & Communication; Personal Care & Effects; Household Goods & Services etc.) has increased substantially under 2016 series vis-à-vis earlier series. The weight of Housing Group has reported an increasing share over period of time.

Base Effect

When changes in the CPI/WPI in the base month have a considerable effect on changes in Year on Year(YoY) inflation, this is referred to as base effect. Base effects are therefore the contribution to changes in the annual rate of measured inflation from abnormal changes in the price index in the base period. Hence, we need to distinguish whether changes in inflation are caused by price changes in the current month, or by extreme price changes in the base period. For example, the WPI deflation in April-July 2020 will provide a relative low base for the index numbers in the same months in 2021 that will show the WPI inflation to be higher than what the ground level prices actually indicate.

Base effect applies to growth rates and other similar comparative rates.

Relevance of the two Indices of WPI and CPI

The WPI is useful for industrialists as they purchase commodities whose presence in the WPI is significant. They also purchase at the wholesale price. The CPI basket does not include machinery, chemicals, and so on. Secondly, the price of electricity in the CPI is the consumer tariffs, not the industrial tariffs.

CPI All India (Combined) is the most dependable index for the consumer and RBI uses it for inflation targeting.

Price Index for Services

In India, the services sector accounts for about 55 per cent of the GDP. However, the WPI does not include services and CPI does. Certain services such as medical care, education, recreation and amusement, transport and communication are included in the new CPI series. However, some major services such as trade, hotels, financing, insurance, real estate and business services are not covered.

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

Food Price Indices

Before we understand food prices, two important laws need to be noted:

- Engel's Law on Family Expenditure and
- Bennett's Law

Engel's Law on Family Expenditure

Every family has to spend money on necessaries of life, education, health, clothing, house rent, light and fuel, recreation and so on. A list containing expenditure by a family on each of these items is called 'Family Budget'. Earnest Engel (1857) made an investigation on family budgets. For that purpose, he studied three groups of people viz., poor, middle and rich. From his study, he derived the conclusions which is known as 'Engel's Law on Family Expenditure'. It states that as the family income increases, the percentage of income spent on food decreases, although the actual amount increases.

Bennett's Law

It states that as income increases, the proportion of the budget spent on 'starchy-staples' decreases. Bennett's Law reflects a desire for dietary diversity that includes more of protein food.

The above two laws have relevance in India as in India protein food inflation was seen as the income levels of India rose steeply since 2005.

There are food indices for WPI and CPI as aforementioned.

CFPI

The Central Statistics Office (CSO) first released Consumer Food Price Indices (CFPI) for three categories—rural, urban and combined—separately on an all India basis with effect from 2014. It is a part of the statistics released by the CSO in new CPI series—rural, urban and combined. Consumer Food Price Index (CFPI) covers food products consumed by a specified population group in a given area with reference to a base year which is 2012.

FAO Food Price Index

Globally, the food price index is released by Food and Agriculture Organization (FAO) of the United Nations. The FAO Food Price Index is a measure of the monthly change in international prices of a basket of food commodities. It consists of the average of five commodity group price indices (Cereal, Vegetable Oil, Dairy, Meat and Sugar) weighted with the average export shares of each of the groups for 2002–2004 which is the base year with a value of 100.

Residex

RESIDEX, the country's first official Housing Price Index (HPI) was launched in 2007 by National Housing Bank and was revamped in 2015 and expanded to 50 cities spread over 18 States and UTs. NHB RESIDEX enables the policy makers, banks, housing finance companies, builders, developers, investors, individuals, etc., to track the movement of housing prices across different cities in India on quarterly basis. NHB RESIDEX helps buyers and sellers to check and compare prices before entering a transaction. They can also analyse the price trends across different cities. The base year is 2012–13 and data sources are data from banks and home finance companies and market surveys.

House Price Index (HPI) of the RBI

The RBI compiles Quarterly House Price index (HPI) (base: 2010–11 = 100) for ten major cities. Based on these city indices, an average house price index representing all-India house price movement is compiled. These indices are based on the official data of property price transactions collected from registration authorities of respective state governments.

Collection of Statistics Act, 2008

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

Under the new Act the Government is given power to levy higher penalty for not sharing data and tougher punishment will be imposed in cases where manipulation of data is involved. 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 willful manipulation or omission of data a criminal offence. 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 determine the method to collect and disseminate the same. Core statistics generally include national income, money and banking, demography, social and environment sectors.

Growth-Inflation Trade Off

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

As prices rise, the central bank intervenes and raises rates to cool investment and consumption demand and so price rise is moderated. Repo rate—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 dis- proportionately and partly because high rate of 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.

The primary official goal of the RBI is to moderate and stabilize prices as the inflation targeting framework of 2015 February mandates.

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

As prices stabilize, rates are lowered, demand and growth resume and a new and higher base is set for the growth process. Growth and inflation do have a tradeoff 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.

Government Steps to Control Inflation

The Government has taken several short-term and medium-term measures to improve domestic availability of essential commodities and moderate inflation. It has procured record food grains and kept food grain buffer stock 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 in the open market when prices are high. This is in addition to the buffer stock built by the FCI for food security through the fair price shops.
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
- Subsidizing food under the Food Security Act 2013
- Reducing indirect taxes: GST adjustments

Administrative Measures

- Ban on exports of food items
- De-hoarding
- Jan Aushadi shops for cheaper medicines
- Ayushman Bharat for free medical and health services
- Monetary Measures Repo rates were kept high to make credit dearer

Other Measures Taken to Control Inflation

- Advising states to allow free movement of fruits and vegetables by delisting them from the APMC Act
- Banning of export of all pulses
- Zero import duty on pulses and onion
- Empowering States/UTs to impose stock limits in respect of onion, pulses, edible oil, and edible oilseeds under the Essential Commodities Act

Inflation risks 2021

Inflation risks to the economy in 2021 stem from:

- Return of economic growth
- Global crude prices rising
- Rupee depreciation, in case the USD strengthens
- Higher MSP announced by the government

- Fiscal deficit being high
- Supply side shocks due to various agitations

Thalinomics

"Thalinomics: The economics of a plate of food in India" is an attempt in the Economic Survey 2020 to quantify what a common person pays for a 'thali' across India. Prices data from the Consumer Price Index for Industrial Workers (CPI-IW) for around 80 centres in 25 States/UTs from April 2006 to October 2019 have been used for the analysis.

Analysing this data, the Survey found that since 2015-16, there was a change in the dynamics of 'thali' prices. Using the annual earnings of an average industrial worker, the survey found that the affordability of vegetarian 'thali' improved 29% from 2006-07 to 2019-20, while that of non-vegetarian thali improved by 18%. Affordability of 'thali' in relation to a worker's daily pay has improved over time, indicating improved welfare of the common person. The moderation in inflation actually contributed to gains for a common man eating two thalis a day.

Survey claims that the reforms undertaken since 2014-15 to enhance agricultural productivity as well as efficiency and effectiveness of agricultural markets for better and more transparent price discovery led to the change in prices of thali. The document lists schemes like per drop more crop, crop insurance, soil card, etc. for gains for a common man in getting a thali meal.

While the case is broadly correct, there are gaps in the analysis:

- Only the organised sector has its wages linked to Consumer Price Index for Industrial Workers (CPI-IW). Wages of 90% of the work force are not so linked to inflation and raised along with it.
- The country started an inflation targeting regime in 2016 by setting up a six-member monetary policy committee (MPC) to decide the policy rates. This new regime also contributed to lower inflation. Survey however does not mention it.
- The prices of education and health care increased steeply but the Survey confines itself to the Thaali prices only.

Dosanomics

When former RBI Governor Raghuram Rajan wanted to reduce interest rates reflecting the price levels in the economy, there was criticism that the post-retirement public that depends on interest income for their sustenance would suffer. Raghuram Rajan wanted price stability for sustainable economic growth and the multiplier that it produces. Price stability necessarily moderates interest rates. To communicate the point, Rajan gave the example of the price of Dosa.

Rajan explained that retirees should ask for lower prices and not higher rates because lower prices in the economy safeguard their incomes and savings more than lower rates. The medium to long term effect of price stability is such that supplies improvc and quality of goods also will, thus having all round economic welfare. The example of Dosa around which the economic case for lower rates was made brought the point the name Dosanomics. Basically, Dosanomics is about high growth with price stability.

Chapter - 11
Taxation

Introduction

The core of the government's fiscal policy is the power to collect taxes and use them for public purposes. The power of the fiscal policy to generate economic growth and equity comes from the privilege to tax and spend.

Tax

Tax is a payment compulsorily collected from individuals or firms by the government. Taxes are of two types, essentially

- Direct taxes, and
- Indirect taxes

A direct tax is one in which the payment is made directly to the government by the one on whom the burden of payment falls. The individual or the company paying the tax cannot pass the liability on to anybody else. For example, income tax, corporate tax, wealth tax, etc.

An indirect tax is levied on manufacturing, importing or 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., are examples. Goods and Services Tax (GST), for example, an indirect tax is paid by the consumer to the seller and the seller in turn pays it to the government.

Importance of Taxation for the Government, Economy and Society

Taxation has revenue and non-revenue aims. The revenue it fetches helps government in meeting its growth goals through investment. Taxes provide funds that can accomplish the following:

- Provision of public goods
- National security
- Enforcement of law and order
- Redistribution of wealth through progressive taxation system
- Economic infrastructure—roads, ports, etc.
- Social infrastructure like education, health, etc.
- Social security measures like insurance, pensions, unemployment benefits
- Reduction of economic inequality

- Provide basic minimum income to all through a scheme like Universal Basic Income (UBI) if tax collections are adequate.
- If tax collections show buoyancy, the government's need to borrow is reduced and thus macroeconomic stability can come about.
- To modernize the economic system with things like GST
- Promote savings
- Promote micro, small and medium enterprises (MSME)
- Boost exports by making exports free of the GST burden
- Protect domestic production by raising the import duties selectively.

Taxation in India

India has an elaborate federal constitutional scheme for imposition, collection and appropriation of taxes. The central government levies direct taxes such as personal income tax and corporate tax, and indirect taxes like customs and excise duties and service tax. In 2017, most excise duties and all service taxes were integrated into the Goods and Services Tax (GST) for most products. States are a part of GST. They have power to levy value added tax (VAT) on petroleum products, liquor, etc., which are outside GST. States also have the power to levy direct taxes like tax on agricultural income.

Tax Reforms in India: The Need

Since 1991, the tax system in India has undergone substantial rationalization—reduced rates and slabs and better administration. Tax system has been simplified also to boost 'Ease of doing business.' Some of the tax reforms made are:

- Broadening the tax base to include services, fringe benefits, stock and commodity mar- ket transactions, google tax, angel tax, etc.
- Reduction in customs and excise duties. Peak customs rate is today 10 per cent which is imposed on 90 per centof non-agricultural industrial goods.
- Lowering of corporate tax rates to 25 per cent over a four-year period from 2015.
- Wealth tax was abolished in the Union Budget (2016–2017) and integrated into the highest income tax bracket.
- Rationalizing the personal income tax rates and slabs starting from the 1997 'dream budget'.
- GST from 2017
- Use of technology for quicker processes
- Simpler procedures for greater compliance
- Safe harbour rules on transfer pricing
- Revamping the double tax avoidance treaties with many countries like Mauritius to prevent base erosion and profit shifting (BEPS).

- Clear-cut general anti-avoidance rules (GAAR)
- Stringent action against black money holders through disclosure schemes which have a very small amnesty component, for example, Income Disclosure Scheme (IDS) 2016 and severe monetary penalty as in Pradhan Mantri Garib Kalyan Yojana, 2016 (PMGKY), so that they pay adequate tax.

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 following:

- Tax resources must be 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 and investment flows.

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

- Goods and Services Tax (GST) to create a common market within the country which will step up investment.
- To tax speculation so as to deter excess of it.
- Google tax on internet advertisements to create horizontal equity with the print advertisements.
- Angel tax to check tax evasion.
- To reduce the cash in the economy with a bank cash withdrawal tax in 2019.
- Bring multinationals into tax base.
- Withdraw tax exemptions to corporates.
- Promote financial savings by concessional taxation on investments in mutual funds, infrastructure bonds, etc.

Tax Reforms in 2020 and 2021

Introduction of 'Honoring the Honest' platform. The platform for 'Transparent taxation- Honoring the Honest' was launched in August 2020 with an objective to impart greater efficiency, transparency and accountability, and to eliminate physical interface between taxpayers and tax officers.

The key features of the platform are

- Usage of technology, data analytics and Artificial Intelligence and
- Recognizing taxpayers as partners in nation-building.

The Platform stands on 3 pillars of tax administration reforms :

- Faceless assessment,
- Faceless appeal, and
- Taxpayers' charter.

The platform is designed to ensure fairness by adopting measures like random selection through system using data analytics and Artificial Intelligence, automated random allocation of cases, team based assessment/ review and no requirement of physical interface between taxpayers and the Income Tax department.

Faceless Assessment Scheme 2020

The Faceless Assessment Scheme, 2019 (earlier called the e-assessment Scheme and renamed in August 2020) was based on the idea that automated random allocation of cases across Income Tax teams with dynamic jurisdiction and elimination of face-to-face contact between the income-tax authorities and the taxpayer can lead to an efficient, non-discretionary, unbiased single window system of assessment.

Faceless Appeals Scheme 2020

Under Faceless Appeals Scheme, 2020, all Income Tax appeals will be finalised in a faceless manner under the faceless ecosystem with the exception of appeals relating to serious frauds, major tax evasion, sensitive & search matters, International tax and Black Money Act.

Taxpayers' Charter

The third pillar of Honoring the Honest platform is the introduction of taxpayers' charter.

Finance Act 2020 incorporated Section 119A in the Income Tax Act to empower the CBDT to issue orders, instructions and stipulate guidelines to supervise and regulate the adoption of Taxpayers' Charter.

Traditionally tax administrations paid limited attention to taxpayer service while performing the functions of regulator and enforcer of tax laws. However, due to an increased demand for better services to the tax payers, there has been a worldwide recognition of the rights of the tax payers, by publishing formal 'taxpayers' charters.'

The introduction of taxpayer charter by Government of India as a part of the 'Honoring the Honest' platform is, thus, an important step in this direction, as it emphasizes the importance of fair, courteous and reasonable treatment to taxpayer.

Tax Ombudsman

In India, the institution of Income Tax Ombudsman was created in 2003 and Indirect Tax Ombudsman came to existence in 2011. The institutions of Ombudsman for direct and indirect taxes were, therefore, abolished in February 2019.

Direct and Indirect Tax Ratio

Examples of direct taxes are Income Tax, Corporate Tax, Minimum Alternative Tax (MAT), Fringe Benefit Tax (FBT), Dividend Distribution Tax (DDT), Securities Transaction Tax (STT), Capital Gains Tax, Angel Tax, Cash Withdrawal Tax, Property Tax, etc.
Examples of indirect taxes are Goods and Services Tax (GST), Central Excise Duty, Customs Duty, Value Added Tax (VAT) of States, Entertainment Tax, Stamp Duty, etc.

Temporary levy called cess or surcharge can be levied on both.

The total tax revenue of the Government of India includes both direct and indirect taxes. Direct taxes come from the relatively well off as it is a progressive tax in which the richer a person/firm, the more he/it has to pay. It has equity built into it.

Indirect taxes, on the other hand, largely do not differentiate between the rich and the poor though there is a progressive element there due to exemptions and hierarchy of slabs; and luxury goods attracting a higher tax under the GST custom duty, etc. But on many essential goods, there is tax and the poor pay it. Indirect taxes also contribute to inflation and may dent savings and demand. Thus, they are relatively anti-growth and anti-equity. In India, the relative contribution has been evolving as described below as mentioned in the Reserve Bank of India (RBI) Handbook of Statistics on Indian Economy.

In 1985–1986, the indirect tax revenue was four times more than that of the direct tax revenue. The share of indirect taxes in the total tax revenue was 83 per cent compared to the 17 per cent share of direct taxes in 1985–1986. The reason was that the rich were very few in the country and government needed money for which indirect taxes were easy to collect. In the 30 years since then, the share of both has more or less become equal. But it got reversed in 2018–2019 with direct taxes fetching more.

Budget 2020-21 estimated the Gross Tax Revenue (GTR) to be ` 24.23 lakh crore. The direct taxes constitute around 55 per cent of GTR.

In this context, it should be noted that when the overall tax collections of both the centre and the states are taken into account, the majority of the total tax collected is accounted for by indirect taxes, implying that the tax structure in the country continues to be regressive.

The reasons for the surge in indirect taxes are as follows:

- Service tax base increased and also the rate. With GST in force since 2017, there are different service tax rates going up to 28 per cent basic and steep cess, while in the pre- GST model, service tax was collected at 15 per cent.
- With better compliance with GST, more firms are registering and paying taxes.
- There was also a temporary reason related to global crude prices falling when GOI found an opportunity and need to increase the excise duties on petroleum products steeply. The trend became more conspicuous since 2020 when global crude prices crashed due to the pandemic. During 2020-21, there was negative growth in all direct taxes and GST, except excise duties as they include duties on petroleum products.

Tax to GDP Ratio

When the economy grows, personal incomes rise and so do corporate profits and consumption of goods and services. All of them add to tax collections and thus the tax: GDP ratio increases. It is called tax buoyancy. GOI's gross tax collections (total amount that it collects, which includes the share of states and UTs) reached its highest level of 11.6 per cent in 2017–2018. The gross tax to GDP ratio declined to 10.9 per cent in 2018 and slid further in FY20 to a 10-year low of less than 10% per cent, driven by a decline in collections from customs duties and corporation tax, while excise duty posted marginal growth. The crash was on account of a slump in economic activity.

When we add the taxes and duties of states and local bodies, India's tax to GDP ratio becomes 16.6 per cent. Gross tax collections of GOI have statistically come down from 2017–2018 as states are collecting their own GST.

Following are the relevant variables in this regard:

- Centre's gross tax collections.
- Centre's tax collections after the share of states is transferred as recommended by the Finance Commission.
- States' own tax collections

Other Countries have Different Ratios—In 2015, tax revenue (including social contributions) in the EU-28 stood at 40.0 per cent

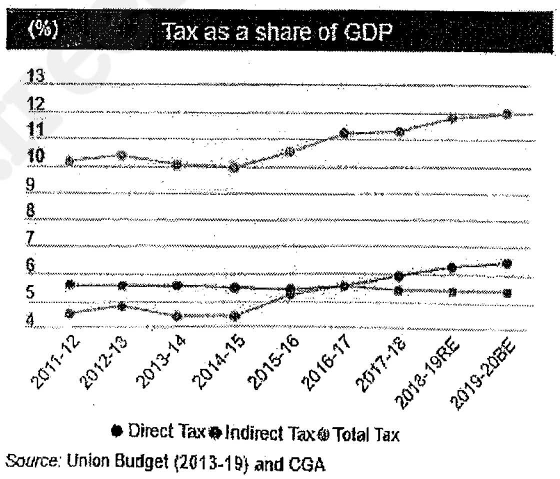


Figure: Tax as a Share of GDP

of the GDP and accounted for around 89 per cent of the total government revenue. Tax to GDP ratio in BRICS countries was—Brazil (35.6 per cent), South Africa (28.8 per cent), Russia (23 per cent), and China (19.4 per cent). Some countries, like Sweden, have a high tax to GDP ratio (as high as 54 per cent). USA's is 25.4 per cent. France has a tax to GDP ratio of 45 per cent while Denmark's is at 48.6 per cent. Most developed countries have a higher per capita income and therefore the ability to pay higher taxes.

The relatively low ratio in India is because of the following:
- We are a developing country.
- There is a large informal sector.
- Agricultural income is exempt.
- There are so many other tax exemptions (tax expenditure).
- Parallel economy.
- Tax machinery does not have sufficient capacity.

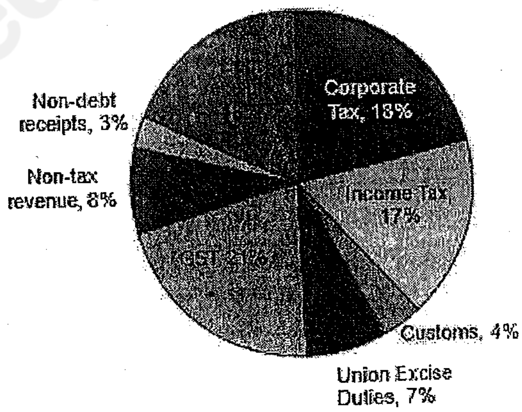
While the ratio determines the extent to which the government is able to finance its expenditure from tax collections, it is also an indicator of tax compliance.

A low ratio handicaps the government from spending on the social sector and infrastructure. India spends on an average about 3.4 percentage points less vis-a-vis comparable countries on health and education.

Since 2016–2017, the formalization of the economy has gathered momentum with demonetization and GST. There are more people filing tax returns, more digital payments, those who evaded taxes earlier cannot do so any more as the government relies on big data garnered from demonetization. GST makes compliance higher due to input tax set off.

Due to demonetization, as many as 1.26 crore new taxpayers were added in 2016–2017.

The IT department launched Operation Clean Money to clamp down unaccounted money funnelled into bank accounts, post demonetization.



Source: Union Budget (2013-19) and CGA

Figure: Indian Gross Tax Revenue

Thus, the rising tax-GDP ratio, except in the panedemic year of 2020-21, can be attributed to:

- Rationalization of the tax rates
- More economic activity (GDP growth)
- Broadening tax base (more taxable economic actions)
- Better enforcement
- Better compliance

Number of Taxpayers

The number is relatively small but is rising. In India, a large section of people come from agriculture, BPL and micro and small enterprises who are not liable to pay tax as their income falls below the exemption limit. Due to Tax Deduction at Source (TDS), many more people are paying tax even though many of them may not be filing their tax returns. That is, not everyone who pays tax files returns. Similarly, not everyone who files returns pays tax. Many file returns to show that they have no taxable income.

The government added millions of new taxpayers in recent years. The number of income tax return filers has increased to 6.48 crores in 2021 from 3.48 crores in 2014.The effective number of taxpayers (taxpayers among filers and those who did not file returns but paid tax by tax deduction at source, TDS, essentially employees) increased in the same period. This is expected to significantly boost the government's tax revenue. Similarly, with GST, more firms are registering and paying taxes. GST was implemented from 1st July 2017. In the first year, the number of registered assesses increased by 72.5 per cent. The original 66.17 lakh assesses has increased to 114.17 lakhs. It has a collateral benefit for direct tax collections also.

Broadening Tax Base

Tax base encompasses all that is taxed—incomes, profits, manufacture, sale, import, etc. While vertical equity demands that rich are taxed more and luxury goods as well, horizontal equity demands that all transactions except the very essential ones be taxed. The greater the number of transactions taxed, the larger will be the base. Since 1991, the government has been broadening the base; in 1994, the service tax was introduced. Following have been the steps:

- STT
- CTT
- Fringe benefit tax
- MAT
- GAAR

- Limitation of benefit clause in the DTAAs
- Demonetization
- Transfer pricing and APAs
- GST
- Expanding the coverage of provisions relating to TDS to more transactions
- Quoting of Permanent Account Number (PAN) made compulsory for many transactions so more people can be brought under the tax net.
- Google tax
- Angel tax

Tax Amnesty Schemes

There are people who do not comply with the tax laws, that is, they evade taxes. Governments make amnesty schemes for them to come clean by paying taxes at the current rates or any other rate which is beneficial to the assessee as the government collects tax revenue that can be used for the socio-economic development of the country. It is called tax amnesty scheme. Those who comply with such a scheme are not charged with crime. Some schemes do not have any penalty whereas some have it. The schemes that were launched in 2016 are mainly disclosure schemes: IDS 2016 and PMGKY.

Income Declaration Scheme (IDS 2016)

Income Declaration Scheme, 2016 was an amnesty scheme that was a part of the 2016 union budget to unearth black money and bring it back into the system. It provided an opportunity to income tax and wealth tax defaulters to avoid litigation and become compliant by declaring their assets, paying the tax on them and a penalty.

Pradhan Mantri Garib Kalyan Yojana, 2016 (PMGKY)

It is an amnesty scheme launched by the GOI in December 2016 on the lines of the IDS, launched earlier in the year. It provided an opportunity to declare unaccounted wealth and black money in a confidential manner and avoid prosecution after paying tax, interest and a fine.

Sabka Vishwas–Legacy Dispute Resolution Scheme

It has been operational from 1st September 2019 and was announced in the 2019–2020 Union Budget. There were tax disputes about service tax and excise duty before the GST came into force. GST subsumed them. The scheme aims to free a large segment of the taxpayers from such legacy taxes. Amnesty and dispute resolution are the two main components of this scheme. It provides relief in the tax dues with full waiver of interest, fine and penalty. Also, there is a complete amnesty from prosecution. The scheme offers relief of varying amounts on tax depending on the nature of the case.

Operation Clean Money 1 and 2

Income Tax Department (ITD) initiated Operation Clean Money 1 and 2 in the year 2017. It involved e-verification of large cash deposits made post-demonetization in 2016. Data analytics were used for comparing the demonetization data with information in Income Tax Department databases. People who were identified for tax collection were those with cash transactions that did not appear to be in line with the taxpayer's profile. The IT department used information received from banks to identify persons whose tax profiles were found to be inconsistent with the cash deposits made by them during the demonetization period.

Vivad se Vishwas

Under the scheme that was introduced in the 2020-21 union budget, a taxpayer who paid the disputed tax within a specified period will get complete waiver of interest and penalty.

While the rationale behind the amnesty schemes is appealing for the amnesty schemes, they carry a moral hazard: those who do not pay, continue not to pay and those who did, may be demotivated.

Direct Taxes Code (DTC)

The Direct Taxes Code (DTC) is a proposal by the Government of India (GOI) to simplify and rationalise the direct tax laws in India. DTC aims to introduce new provisions and revise, consolidate and simplify the structure of direct tax laws in India into a single legislation. DTC is expected to replace the Income Tax Act, 1961 and other direct tax legislations.

Many changes have already been brought about in the direct tax regime in the country in the last few years:

- Wealth tax was abolished.
- In 2018–2019, long-term capital gains tax (LTCG) was introduced on certain equity gains.
- GOI presented a plan to reduce the corporate tax rate from 30 per cent to 25 per cent in four years to make India's tax rates globally competitive.
- Reduction in corporate tax rate for MSMEs from 30 per cent to 25 per cent to make them more competitive.
- General Anti Avoidance Rules (GAAR).
- Place of Effective Management (PoEM) rule as a test to determine residency for tax benefit purposes.

- Changes in DTAAs.
- reduced the time limit for reopening of income tax assessment cases to three years from six years, while for serious tax fraud cases where concealment of income is Rs 50 lakh or more it would be 10 years in the 2021-22 Union Budget.

Government set up a panel headed by Akhilesh Ranjan for overhauling the five-decade-old Income Tax Act of 1961. The panel submitted the report in 2019.

Capital Gains Tax

It is a 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 years (one year for shares and mutual funds), it is called Long-Term Capital Gains (LTCG) and taxed. Short-Term Capital Gains tax is always more to encourage investment as distinct from speculation. Till 2018–2019, LTCG arising from transfer of listed equity shares were exempt from tax. Union Budget 2018–2019 reintroduced the LTCG tax on equity investments shares and related. The budget legislated taxing long-term capital gains exceeding 1 lakh at the rate of 10 per cent without allowing the benefit of any indexation. All gains up to 31st January 2018, however, are grandfathered (Grandfathering means new laws will not apply.). The gains from equity shares held up to one year will continue to be taxed at the rate of 15 per cent on short-term capital gains.

Cost Inflation Index (CII) is the index for the inflation rate in the country. The Central Board of Direct Taxes (CBDT) issues this index every year. If indexation benefit is given for LTCG, the inflation cost is added to the purchase price and the resulting amount is deducted from the sale price to get the amount on which the tax is calculated. Put differently, the inflation cost is deducted from the gains and the rest is taxed.

Inverted Duty Structure

Normally, there should be lower tax on import of raw material so that it can be imported and processed (value added) to produce the final product that can be sold at home or exported. That helps 'Make in India'. It also promotes exports. Higher import duty, likewise, on finished products discourages their import, thus protecting domestic manufacturers, saving the country precious foreign currency and creating employment in the country. It is clear that the inverted duty structure imposes higher import duties on the raw materials and intermediates than on the finished product. It puts the domestic manufacturers at a disadvantage, making them uncompetitive within the domestic market and in global markets.

The examples are—India levies one of the highest duties on import of raw materials and one of the lowest duties on import of finished rubber goods. This inverted duty structure is leading to a surge in import of finished goods. Of the total import of finished goods, 80–90 per cent is avoidable as domestic rubber manufacturing units have the capability to meet the demand. Low import duties on rubber products rendered mandatory under the negotiated Free Trade Agreements (FTAs) have led to indiscriminate imports in the country.

Reducing the customs duty on raw material for the pharmaceutical, electronic and auto- mobile sectors is important for the same reason.

FTAs may lead to inverted duty structure. It is due to negotiations that involve thousands of tariff lines and the give and take involved. The government remedied many such anomalies through subsequent orders when it is brought to the notice of government.

Tax Expenditure

Tax expenditure refers to revenue forgone as a result of exemptions and concessions (direct and indirect tax). The government has been presenting a statement on tax expenditure in the parliament since 2006–2007 union budget. The revenue foregone due to tax incentives in 2015–2016 was estimated at nearly 6 lakh crores. Such exemptions have been justified for promoting balanced regional growth, dispersal of industries, neutralization of disadvantages on account of location, and incentives to priority sectors, including infrastructure. They are also given to the middle class to build houses, senior citizens for their relief, women for buying houses, etc.

Since the amount is large and so many of the incentives may have lost their utility and need, it is suggested that some should be dropped. They should be subject to a sunset clause (should operate for a limited time) as tax exemptions often create pressure groups for their perpetuation. While some may be justified as they enhance investment and generate more taxes for the government, others cannot be.

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 infrastructure and also help reduce the fiscal deficit.

However, some such incentives are necessary. For example, the Start-Up policy that gives breaks for such firms.

Tax Havens

There are countries or states within countries where tax rates are either zero or very low for some items like income or capital gains, etc. They are called tax havens. Individuals and firms find them attractive for that reason. Such low/nil rates are a result of global competition to attract capital and is a sovereign decision and so is legal. For firms and persons to do business with such countries may also be equally legal if the respective laws permit.

The important features of a tax haven are:

- Nil or nominal taxes;
- Tax information is not shared with foreign tax authorities
- No requirement for a substantive local presence.

But the problem that arises is as follows: Most countries either tax at normal rates or high rates so that they can spend on infrastructure and the poor. If capital flies from such countries, their tax base shifts and their governments cannot spend on public and merit goods.

Bermuda, Panama, Ireland, Singapore, the Cayman Islands, Monaco, Luxembourg and Hong Kong are among 45 territories blacklisted by the Organization for Economic Co-operation and Development (OECD) and threatened with punitive financial retaliation for being tax havens.

Base Erosion and Profit Shifting (BEPS)

As seen above, there are many wealthy individuals global firms that undertake financial activities by registering in countries or states where there are enormous tax advantages. There are two types of BEPS:

1. Some companies that shift base by registering in tax havens are globally renowned ones like Apple, Facebook, Amazon, Nike, Uber. It is called BEPS which refers to tax planning strategies that exploit gaps in tax rules of some countries to artificially shift profits to low or no-tax locations with little or no real economic activity. It means, a company shifts to a jurisdiction like Mauritius or Ireland where tax rates are low, just to 'avoid' taxes. It thus represents a case in which the tax base is eroded when profits of firms are shifted to havens. Hundreds of billions of dollars of tax revenue is lost by the governments of the countries where these companies actually carry out their economic activity. It can mean a moral hazard: when taxpayers see MNCs legally avoiding taxes, it weakens voluntary compliance by all taxpayers.
2. The other type is through shell companies. A shell company is one that does not have any real business and exists only on paper to show profits and losses that are fictitious. It may be used to launder black money into white. It, however, shows business on paper. It may be legal or illegal money that is invested. Most of the companies through which money is invested and

laundered are shell companies that have no real business and exist only on paper to show profits and losses that are fictitious.

Tax abuse not only weakens efforts to fight poverty but also weakens the fiscal base needed for sustainable economic development. OECD has a BEPS inclusive framework in which many countries are participants, including India.

The United States Foreign Account Tax Compliance Act (FATCA) is a similar example. The Foreign Account Tax Compliance Act (FATCA) is a 2010 United States federal law requiring all non-U.S. (foreign) financial institutions (FFIs) to search their records for customers from U.S. and to report the assets and identities of such persons to the U.S. government. India agrees with it.

G20 also discussed and devised strategies for common fiscal laws and practices. India suffers from BEPS due to the misuse of double taxation avoidance agreements (DTAA), transfer pricing issues, etc. India modified its DTAA with Mauritius to tackle BEPS issues.

Double Taxation Avoidance Agreement (DTAA)

In the age of globalization when investors from one country go to every other country where profits can be made, there is a need to ensure that there is no double taxation. That is, if profits made by the investor of one country in another country are taxed in both the countries, it is a disincentive to financial integration and also spells unfairness. Double taxation internationally is the collection of tax by two or more countries on the same declared income or profit or sale. DTAAs are signed between countries affected to avoid double taxation. DTAAs are fair and boost investment and growth.

For instance, when shares are traded by firms and gains are made, there is no tax in India for capital gains. Many of India's DTAAs also have lower tax rates for royalty, etc.

Favourable tax treatment for capital gains under certain DTAAs such as the one with Mauritius encouraged substantial foreign investment into India. Mauritius accounted for $93.65 billion or one-third of the total FDI flows into India between 2000 and 2016. It was also a preferred route for foreign portfolio investors.

But the problem is DTAAs led to round tripping: Indian money goes out to return through the DTAA countries to avoid paying taxes. Even foreign companies which are not genuinely resident companies take the DTAA route for their investments only for tax avoidance purposes. They are called 'mailbox companies'. They have no businesses in Mauritius or any other DTAA country. This leads to loss of tax revenue for the country. India has DTAAs with about 88 countries.

Rationalization of DTAA

The three DTAAs were amended to ensure that no misuse was done. It can be exemplified with the Mauritius case. In 2016, India and Mauritius signed a Protocol to amend the 1982 India-Mauritius. It applies equally to the India-Singapore DTAA. The 2016 protocol says that India has the right to tax the capital gains in India for investments coming from Mauritius from 2017. Investments made before 1 April 2017 have been grandfathered (investors continue to enjoy the benefits) and will not be subject to capital gains taxation in India. Where such capital gains arise during the transition period from 1 April 2017 to 31 March 2019, the tax rate was limited to 50 per cent of the domestic tax rate of India. However, the benefit of 50 per cent reduction in tax rate during the transition period shall be subject to the Limitation of Benefits Article, that is, only genuine investors can avail of them. Taxation in India at full domestic tax rate will take place from the financial year 2019–2020 onwards.

Limitation of Benefits

DTAAs should be used for the right purposes. Therefore, DTAAs contain an article intended to prevent 'treaty shopping'. Treaty shopping is when different DTAAs have different levels of concessions, choosing the DTAA that offers the best terms for maximum gains. Those who are not genuine residents of the country in the DTAA benefit thus. The limitation of benefits articles deny the benefits of the tax treaty to those who are not genuine residents based on certain tests.

Under the India-Mauritius Limitation of Benefits (LOB) rules, the benefit of 50 per cent reduction in tax rate during the transition period from 1st April 2017 to 31st March 2019 shall be subject to LOB Article, whereby a resident of Mauritius will not be entitled to benefits of 50 per cent reduction in tax rate, if it is a shell company, that is, if its total expenditure on operations in Mauritius is less than `27,00,000 in the immediately preceding 12 months. Otherwise, DTAAs can lead to round-tripping and money laundering activities.

This LOB clause will have the effect of bringing substance to companies which want to be tax resident in Mauritius.

General Anti Avoidance Rules (GAAR)

There are firms and individuals who either minimize tax payment or completely avoid it by taking advantage of the rules in the book. But the government says that it is not acceptable as the entire event is planned only to avoid taxes as was done by Vodafone when it signed the deal outside the country with Hutch and put up a corporate veil for the operation just to avoid paying taxes. Even though on the face of it, it is legal, GOI applied the doctrine of 'look through' and not 'look at' and ordered them to pay tax, as tax avoidance in this case was tax evasion and not tax planning. There were no clear rules for the GOI order, and it was criticised as being arbitrary. There was a demand that there be clear GAAR rules.

As a result, the GOI made rules framed by the Department of Revenue under the Ministry of Finance.

GAAR is an anti-tax avoidance rule. It came into operation on 1 April 2017. It allows tax officials to deny tax benefits if a deal is found to be without any commercial purpose other than tax avoidance. Thus, it seeks to prevent tax evasion under the guise of tax planning.

The GAAR that are operating in the country are:

- Investments made till March 31, 2017 were not subjected to GAAR.
- It is to be applied on those claiming tax benefit of over Rs 3 crore.
- The proposal to apply GAAR will be vetted first by the Principal Commissioner/Commissioner of IT and at the second stage by an Approving Panel headed by a high court judge.

Adequate procedural safeguards are in place to ensure that GAAR is invoked in a uniform, fair and rational manner.

The rules are aimed at improving transparency in tax matters and help curb tax evasion.

Place of Effective Management (PoEM)

To determine the residential status of foreign companies, the Finance Act 2015 introduced the concept of place of effective management or PoEM. If a company's place of effective management is India, it will be treated as an Indian resident and its global income will be taxable in India. The aim of PoEM is to target shell companies.

OECD Digital Tax

OECD proposed in 2019 that large and highly profitable multinational enterprises (MNE), mainly digital companies should pay tax wherever they have significant amount of business, sales and generate their profits. The proposal would re-allocate some profits and corresponding taxing rights to countries and jurisdictions where MNEs have their markets. It mainly aims to tax global digital companies like Google, Facebook, LinkedIn and so on.

Tax Information Exchange Agreements (TIEA)

A TIEA is a mutual agreement between countries to exchange information relevant to the administration and enforcement of the domestic tax laws of the contracting parties.

This information generally relates to the determination, assessment, and collection of taxes; the recovery and enforcement of tax claims; and investigations, including prosecutions.

The purpose TIEA is to promote international cooperation in tax matters. By 2019 India entered into 21 TIEA arrangements.

Convention on Mutual Administrative Assistance in Tax Matters

It was developed jointly by the OECD and the Council of Europe. The Convention is the most comprehensive multilateral instrument available for all forms of tax cooperation to tackle tax evasion and avoidance. It facilitates entrance into bilateral tax information exchange agreements between state parties who are members. G20 favours it. About 126 countries and parties, including India, joined the Convention. It represents a wide range of countries including all G20 countries, all BRICS, all OECD countries, and an increasing number of developing countries.

Transfer Pricing and APA

Transfer pricing has become an important part in the BEPS issue. If a subsidiary company sells goods to a parent company or vice-versa, the price of those goods paid by the parent to the subsidiary or the opposite within the country or internationally, is the transfer price.

India adopted Transfer Pricing Code recently. The need for the Code is because of the profit shifting practices followed by the MNCs. For example, an MNC has a subsidiary in India and elsewhere. It sources from and supplies to the subsidiaries in all the countries. The goods and services are same, but the prices are shown differently depending upon the tax rates in the countries. The corporate tax rates are high in India. Therefore, the price of goods sold by the MNC to the Indian subsidiary is shown higher in India to project less profit and thus less tax outgo. Thus, transfer pricing is generally done in a way so 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 need to be rationalized so that the tax revenues due to the government are not eroded. Tax evasion and money laundering has to be checked by tightening the transfer pricing regime. The solution is advance pricing agreements (APA).

The Indian code prescribes that income arising from international transactions or specified domestic transactions between associated enterprises should be computed based on the arm's length price and not 'sweetheart' price (a price that is unfair because it gives an advantage to one side) that can mean base erosion. An arm's length price for a transaction is what the price of that transaction would be in the open market.

An APA refers to an agreement between the taxpayer and the tax authorities on the pricing of an existing or proposed transaction between related parties. APA enables the taxpayers and the revenue authorities to interact, negotiate and come to a conclusion on the pricing of the transaction in question. If the taxpayer and the revenue authorities agree to a particular price, they may enter into an agreement, which would be valid for a period of 5 years. If, however, for some reason, they do not reach a consensus, they may not sign the agreement. It helps avoid disputes with the tax authorities over transfer pricing. The APA scheme, which was introduced in 2012, tries to provide certainty to taxpayers in transfer pricing by specifying the method of pricing and setting the prices of international transactions in advance. It applies to foreign MNCs and Indian companies as well.

Tobin Tax

James Tobin, an economist, proposed in 1972 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 FPIs.

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 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 partly attributed to the 'dynamics of hot money' (portfolio investments or FPI flows). That gave further justification for the Tobin tax.

Tobin tax can be imposed only if all the countries accept the proposition. Otherwise, FPIs can go to countries where the tax is not imposed, if they are attractive enough.

India does not prefer it as we need foreign inflows as we are a Current Account Deficit (CAD) country and do not have a surplus. If the Tobin tax is resented by the FPIs, not only will they leave the country, but no new investors will come. It will precipitate into a macro economic crisis.

Tobin tax is also used in a general sense when all financial speculations are sought to be taxed for stability. In the European Monetary Union (EMU), there is a proposal to see a micro tax levied at 0.1 per cent on share and bond transactions and 0.01 per cent 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. India has a similar tax—securities transaction tax (STT) and commodities transaction tax.

Due to currency volatility and stock market shocks in China in 2015–2016, there was a proposal that Tobin tax be imposed. China may be able to afford such a tax as FPI exposure is limited in China and it has a huge surpluses of forex reserves.
India cannot afford Tobin tax as we need foreign currency. We need to contain volatility by other means like encouraging FDI and relatively limiting FPI, though FPI is also very important for liquidity in capital market.

Pigovian Tax

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

Carbon tax (called Clean Environment Cess from 2017) is levied in India since 2010 at the rate of `400 per tonne on coal, lignite and peat in order to finance and promote clean environment initiatives, funding research in the area of clean environment, or for any such related purposes. It is imposed on coal produced in India or imported into India. This is in line with the principle of 'polluter pays'.
In many countries, carbon taxes are levied also on other fossil fuels like petroleum, natural gas, etc.

Goods and Services Tax (GST)

India's indirect tax system has been transformed with the introduction of the Goods and Services Tax (GST) in 2017. It removed many defects in the earlier system, which was characterized by:

- Multiplicity of taxes and duties
- Cascading effect
- Steep inter-state variations
- Irrational exemptions
- Too many slabs
- Tax evasion
- Inefficient use of resources due to the above.

Short History of GST

The earliest form of Value Added Tax (VAT) was introduced in 1986 in the form of MOD- VAT, modified VAT, that applied to a few commodities only and was confined to excise duties. In 2002, union excise duties were renamed as Central Vat (CENVAT) when value added became the base for tax. VAT was introduced (earlier name was sales tax) at the state level in 2005. When states called their sales tax VAT, the centre reverted to the earlier name of excise duty to prevent confusion. The Constitution was amended to usher in the GST in 2016.

The Need for GST

GST is needed to:

- form a common domestic market and attract investment
- eliminate multiplicity of existing indirect taxes which will make it far less cumbersome
- simplify the tax structure
- bring more firms under the 'tax net' as there is incentive to pay taxes due to the attraction of input tax credits
- create tax buoyancy to enable government to consolidate the fiscal system and provide greater resources for the social sector
- lower business costs and transaction costs to boost economic growth and bring India in line with practices in many developed economies
- reduce production costs to make exporters more competitive
- reduce black money and evasion as GST is transparent

Nature of GST

GST is a comprehensive, multi-stage, destination- based tax that is levied on value addition. It provides set off for tax paid on inputs which removes cascading (tax on tax). The total burden of the tax is exclusively borne by the domestic consumer. Exports are not subject to GST.

The term multi-stage requires elaboration. Each final commodity is produced through a process of many steps of value addition from the raw material stage to the final sale to reaching the consumer. Value addition is not only physical but also includes storage, distribution and sale. At every stage, tax is paid and under GST that is returned (credited) when it is shown, that value is further added and the good sold. Every purchaser of a good or service has to pay tax, but if they are purchased for production and can show that it is an input for value addition, they can claim they paid back the tax. Only the consumer pays tax. All others have it credited to them. That is how the cascading effect is removed.

Destination based means that goods are taxed where they are sold to the consumer and not where they are made, i.e., if goods are made in Gujarat and sold in Telangana, they are taxed in Telangana where the consumer pays for it.

The manufacturing state gains by its prosperity which creates a big market for goods made within its own geography, and from outside.

Both the centre and states simultaneously levy GST on the same value added. The amount is also the same. The centre would levy and collect Central Goods and Services Tax (CGST), and states would levy and collect the State Goods and Services Tax (SGST) on all transactions within a state.

The centre would levy and collect the Integrated Goods and Services Tax (IGST) on all inter-state supply of goods and services and also imports. IGST is a mechanism to monitor the inter-State trade of Goods and services and further to ensure that the SGST component accrues to the destination / consuming State. The principle is: any indirect tax, by definition is a consumption tax, the incidence of which is borne by the consumer. Logically, the tax should accrue to the destination State having jurisdiction over such consumer. The IGST rate is equal to CGST rate plus SGST/UTGST rate. IGST is levied by the Central Government on all inter-State transactions of taxable goods or services.
With the 101 CAA 2016 in place, the centre passed laws to levy CGST and IGST. Similarly, all states passed laws on SGST. These laws specify the rates of the GST to be levied, the goods and services that will be exempted and included and so on.

GST and Centre-State Financial Relations

Pre-GST Position

Fiscal powers between the centre and the states are clearly demarcated in the Constitution with almost no overlap between the respective domains. The centre has the powers to levy tax on the manufacture of goods (except liquor for human consumption, opium, narcotics, etc.) while the states have the powers to levy tax on the sale of goods.

In case of inter-states sales, the centre has the powers to levy a tax (the Central Sales Tax), but the tax is collected and retained entirely by the originating states. As for services, it is the centre alone that is empowered to levy service tax.

Since the states are not empowered to levy any tax on the goods and services traded with other countries import or export, the centre levies and collects the customs duty. All taxes and duties that the centre imposed and collected were shared with the states on the basis of Finance Commission recommendations.

The introduction of GST required amendments in the Constitution to empower the centre and the states jointly to levy and collect GST.

It required a unique institutional mechanism that would ensure that decisions about the structure, design and operation of GST are taken jointly by the two. GST Council has been assigned that role as we shall see.

GST Council

Goods and Services Tax Council is a constitutional body. Article 279A (1) of the Constitution mandates that the GST Council should be set up by the President within 60 days of the commencement of Article 279A. All aspects of GST Council are contained in Art. 279A and its clauses. GST council examines issues relating to goods, services tax and make recommendations to the Union, and the States on parameters like rates, exemption list and threshold limits.
The GST Constitution Amendment Act does not state categorically about whether the recommendations made by the GST Council are binding on the Union and the State Governments.

The GST Council is to consist of the following three types of members:
- The Union Finance Minister (as Chairman).
- The Union Minister of State in charge of Revenue.
- State Finance Ministers, including from Delhi and Puducherry.

Constitution (101st) Amendment Act, 2016

To address all the above issues, the Constitution (101st Amendment) 2016 Act was made. The Act amended the Constitution to introduce the goods and services tax (GST).

It inserts a new Article 246A in the Constitution to give the central and state governments equal and parallel powers to make laws on the taxation of goods and services.

The tax shall be levied as Dual GST separately, equally and parallelly by the Union (CGST) and the states (SGST).

However, only the centre can levy and collect GST on supplies in the course of inter-state trade or commerce and imports called the Integrated GST (IGST). The IGST would be divided between the centre and the states in a manner to be decided by the parliament, by law, on the recommendations of the GST Council.

Main Constitutional Changes

1. Art.246A
2. GST Constitution Amendment Act omits Entry 92 and 92C from the Union List and Entry 52 and 55 of the State List of the Seventh Schedule.

- 92 of Union list—Taxes on the sale or purchase of newspapers and on advertisements published therein.
- 92C of Union List—Taxes on services
- 52 of State List—Taxes on the entry of goods into a local area
- 55 of State List—Taxes on advertisements other than advertisements published in the newspapers and advertisements broadcast by radio or television.

All the above four are now a part of GST.
Art. 246A had to be introduced as GST is a unique subject and cannot be accommodated in the existing 3 lists in the Seventh Schedule.
Facilitating GST council

Voting in the GST Council

The decisions of the Council are taken by a certain voting process unless there is unanimity.

The GST Council comprises of 28 State Finance Ministers (J and K is no longer a State since 2019) and 3 Finance Ministers of Delhi and Puducherry and J and K).

Union Government is represented by the Finance Minister and the Union Minister of State for Finance (Revenue). Each State Finance Minister is entitled to one vote and equal vote.

In a GST Council meeting, vote of the Central Government has a weightage of one-third of the total votes cast. Votes of all State Governments taken together have a weightage of two-thirds of the total votes cast in any meeting. Meeting of the GST Council requires a quorum of half of the members.

Every decision of the GST Council shall be taken by not less than three-fourths of the weighted votes of all members.

Functions of the GST Council include making recommendations on:

- taxes, cess and surcharges levied by the centre, states and local bodies which may be subsumed in the GST;
- goods and services which may be subjected to or exempted from GST;
- model GST laws, principles of levy, apportionment of IGST and principles that govern the place of supply;
- the threshold limit of turnover below which goods and services may be exempted from GST;
- rates including floor rates with bands of GST;
- special rates to raise additional resources during any natural calamity;
- special provision with respect to Arunachal Pradesh, Jammu and Kashmir, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim, Tripura, Himachal Pradesh and Uttarakhand; and
- Any other matters relating to the goods and services tax, as the Council may decide.

The GST Council shall recommend the date on which GST will be levied on petroleum crude, high speed diesel, motor spirit (commonly known as petrol), natural gas and aviation turbine fuel.

Resolution of Disputes: The GST Council may decide upon the modalities for the resolution of disputes arising out of its recommendations.
Compensation to States: Parliament shall, by law, provide compensation to states for any loss of revenues, for a period which may extend up to 5 years or less. This would be based on the recommendations of the GST Council.

Goods and Services Tax (GST) Council met 36 times till mid-2019.

Tax Slabs Under the GST

The government has categorised items under 5 major slabs for different goods and ser- vices—0 per cent, 5 per cent, 12 per cent, 18 per cent and 28 per cent. Cesses may be imposed on the items under the highest slab of 28 per cent and they are used only for com- pensating the states for falling below the guaranteed level of GST collection.

Taxes Merged into GST

GST subsumed various central indirect taxes including the central excise duty, additional excise duties, service tax, additional customs duty (CVD) and special additional duty of customs (SAD), etc. It also subsumed State Value Added Tax (VAT)/sales tax, central sales tax, entertainment tax, octroi and entry tax, purchase tax and luxury tax, etc.

Alcohol, petroleum products, real estate and electricity do not come under GST.

GST and Revenue Neutral Rate

An important issue in GST was the rates of central and state GSTs to be levied. Tax rates should be 'revenue neutral'. This implies that the rates set under the new GST regime are such that they get the same revenue as the pre-GST regime. That is, the rates are not meant to lead to revenue loss or gain. However, over time, the revenue productivity is expected to increase due to better compliance, higher levels of efficiency, and increased productivity of the economy due to its rationality and transparency.

Estimation of revenue-neutral rate requires consensus on the exemption list, number of tax rates to be levied and the list of goods and services to be included in different rate categories.

There are three terms in this field:

- The standard rate is what applies to most goods and services.
- Fitment rate is the rate that applies to each class of goods and services (which is the tax bracket in which a good or a service falls).
- Revenue neutral rate is the rate that brings the same revenue as the pre-GST regime, ceteris paribus (other conditions remaining constant).

Dual GST

India adopted a dual GST model, meaning that taxation is imposed by both the union and state governments. Being a federal country, both the centre and the states have been assigned the powers to levy and collect taxes through the appropriate legislation. A dual system satisfies the urge for autonomy for both the centre and states.

GST (Compensation to States) Act, 2017

One of the apprehensions of some states from the beginning was that they might make losses when GST comes into force, at least initially. The grounds are clear.

It is a destination-based tax, so is viewed as being advantageous for the consuming states and detrimental for the producing states like Maharashtra, Tamil Nadu, Gujarat, Haryana, and Karnataka. The latter wanted a suitable compensation formula. States demanded full compensation for five years and the centre agreed.

Constitution Amendment Act says that parliament shall, on the recommendation of the GST Council, provide for compensation to the States for loss of revenue arising on account of implementation of the GST for a period of five years. As per the GST (Compensation to States) Act, 2017, the loss of revenue to the states on account of the implementation of GST is payable during the transition period of five years. The same Act says that the financial year 2015–2016 is to be taken as the base year for calculating the compensation amount. The projected nominal growth rate of revenue subsumed for a state during the transition period shall be 14 per cent per annum.

The government needs extra revenue to compensate the states, and so the GST Council allowed the centre to impose additional cesses for five years on certain goods over and above the highest tax bracket of 28 per cent. These goods on which cess will be levied include tobacco products, coal, motor vehicles, which include all types of cars, personal aircraft, and yachts. These additional cesses, however, will be removed after 5 years and the states incurring losses would have to find alternative sources of revenue.

The percentage of the additional cess changes from good to good. Both intra-state and inter-state supplies of goods or services would attract GST cess over and above the applicable CGST, SGST, and IGST rates.

Constitution Amendment Act says that parliament shall on the recommendation of the GST Council, provide for compensation to the States for loss of revenue arising on account of plementation of the GST for a period of five years. As per the GST (Compensation to States) Act, 2017, the loss of revenue to the states on account of the implementation of GST is payable during the transition period of five years.

Pandemic

The total GST revenue shortfall due to pandemic for the 2020-21 fiscal was estimated at Rs 3 lakh crore, of which compensation cess collection was estimated at Rs 65,000 crore, leaving a compensation deficit of Rs 2.35 lakh crore. Of this Rs 2.35 lakh crore, Rs 1.1 lakh crore has been estimated as shortfall on account of GST implementation, while the rest is being estimated as the impact of the pandemic.

Centre gave two options to the states — either borrow Rs 1.10 lakh crore from a special window facilitated by the RBI, or borrow Rs 1.8 lakh crore from the market. Almost all states chose the former as under it the Centre will borrow through the RBI and pass it on to the states. The interest rate is relatively low and the debt is not reflected in the FRBM Act of the centre.

It is a formula for the 2020-21 fiscal only. The moot point is what will happen once the five-year window expires in 2022.

GST and Cross-Empowerment

The cross-empowerment model allows taxpayers to restrict their interaction to a single tax authority for central GST, state GST and integrated or IGST. The division of GST taxpayers between the centre and states will be done horizontally with states getting to administer and control 90 per cent of the asseesses below Rs 1.5 crore annual turnover and the remaining 10 per cent coming under the centre. The centre and states will share control of assessees with annual turnover of over Rs 1.5 crore in 50:50 ratio and thus each taxpayer will be assessed only once and by only one authority.

Anti-Profiteering Clause of GST

The GST Act provides that it is mandatory to pass on the benefit due to reduction in rate of tax or from input tax credit to the consumer by way of commensurate reduction in prices. If the firms do not pass it on, they are liable for penal action. GST rules prevent entities from making excessive profits by not passing on such reliefs.

Since the GST, along with the input tax credit, is eventually expected to bring down prices, a National Anti-profiteering Authority (NAA) is set up to ensure that the benefits that accrue to entities due to reduction in costs are passed on to the consumers. Also, entities that hike rates inordinately, citing GST as the reason, will be checked by this body.

Once the registered entity, which has profiteered illegally, is identified, it can be asked to reduce prices if it has hiked prices too much. If price reduction due to GST rate relief has not been passed on to customers, the firm can be told to return to the customer the sum equivalent to the price reduction along with 18 per cent interest from the date the higher sum was collected. It can impose penalty on the profiteer or cancel its registration.

National Anti-Profiteering Authority (NAA)

The National Anti-Profiteering Authority is a five-member body consisting of a Chairman and four technical members from states or centre. The Authority sets the method and procedure for determining whether the reduction in GST rate or the benefit of input tax credit has been passed on by the seller to the buyer by reducing the prices. The Authority was to initially exist for 2 years till 2019 but its term was extended by another 2 years till 2021.

Goods and Services Tax Network (GSTN)

Goods and Services Tax Network (GSTN) is a Section 8 (under new companies Act, not- for-profit companies are governed under section 8) company. It was incorporated in 2013.

Initially, the GOI held 24.5 per cent equity in GSTN and all states of the Indian Union, including NCT of Delhi and Puducherry, and the Empowered Committee of State Finance Ministers (EC), together held another 24.5 per cent. The balance 51 per cent equity was with non-government financial institutions. However, the 27th meeting of the GST Council in 2018 decided that the GSTN will be a 100 per cent government company with central and state governments holding a 50 per cent stake each in the entity, by acquiring the 51 per cent stake held by private entities. The GSTN was set up primarily to provide IT infrastructure and services to the central and state governments, taxpayers and other stakeholders for the implementation of GST. The Authorised Capital of the company is `10 crores. Besides, since GST is a destination-based tax, the inter-state trade of goods and services (IGST) would need a robust settlement mechanism amongst the states and the centre. This is possible only when there is a strong IT Infrastructure and service backbone which enables capture, processing and exchange of information among the stakeholders (including taxpayers, states and central governments, accounting offices, banks and RBI).

GST and Petro-Products

Petroleum products are not included in GST–taxes paid on them are not treated as eligible for input tax credit and set off.

Taxes constitute more than 50 per cent of the price consumers pay for petrol and diesel. States which charge VAT are reluctant to move away from the present tax regime unless the centre promises compensation. Different states have different rates of VAT. It is the GST Council, the highest decision-making body of the indirect tax regime, that has the final word on the inclusion of petroleum products.

Under GST, even if petrol and diesel are charged at the highest slab of 28 per cent, states will stand to lose, considering they will only get 14 per cent of it–

much lower than the present rate of VAT. Today, states have the freedom to change the VAT on petrol and diesel. But under the GST, this flexibility will go.

Article 279A(5) of the Constitution provides that GST council shall recommend the date on which GST shall be levied on petroleum crude, high speed diesel, motor spirit, natural gas and aviation turbine fuel (ATF).

GST Benefits Small Entrepreneurs and Small Traders

Under the provisions of the GST, traders with an annual turnover of less than Rs.40 lakh are exempt from GST. For the North-East, it is Rs.20 lakh. The high threshold of exemption will protect the interest of small traders. A uniform GST threshold across states is a positive. A composition scheme for small traders and businesses has also been introduced under GST. The Composition Scheme is a simple and easy scheme under GST for small taxpayers who can avoid tedious GST formalities and pay GST at a fixed rate if the turnover is less than a certain specified of small traders is very high in comparison to the tax paid by them.

- The compliance cost and compliance effort would be saved for such small traders.
- Small traders get relative advantage over large enterprises on account of lower tax incidence.

Harmonized System of Nomenclature (HSN) Code in GST

The Harmonized System of Nomenclature (HSN) was developed by the World Customs Organization (WCO) with the vision of classifying goods from all over the world in a systematic and logical manner. It is a six-digit uniform code that classifies more than 5,000 products and is accepted worldwide. These defined rules are used for taxation purposes in identifying the rate of tax applicable to a product in a country. It is also used to determine the quantity of products exported or imported in and out of a country. It is a crucial feature to analyse the movement of goods across the world. HSN has been adopted in more than 200 countries, covering 98 per cent of the goods in the world.

GST and Composition Scheme

Composition scheme is a scheme under GST for small businesses belonging to the unorganized sector with aggregate turnover of less than `1.5 crore (less than 75 lakhs for North-Eastern states). For a service provider, it is Rs.50 lakhs. The firms pay tax at a lesser rate and have fewer returns to file.

Electronic Way Bill (E-Way Bill)

It is basically a compliance mechanism, wherein, by way of a digital interface, the person causing the movement of goods uploads the relevant information prior to the commencement of the movement of goods and generates an e-way bill on the GST portal.

It applies to goods of value exceeding `50,000 when they are shipped inter-state or intra- state. The e-way bill must be raised before the goods are transported and should include details of the goods, their consignor, recipient and transporter. The transporter has to carry the invoice and the copy of the e-way bill as support documents for the movement of goods. They can also carry the e-way bill number, mapped to an Radio Frequency Identification Device (RFID).

Though check-posts have been abolished under GST, a consignment can be intercepted at any point for the verification of its e-way bill for all inter-state and intra-state movement of goods. If a consignment is found without an e-way bill, a penalty or tax sought to be evaded, whichever is greater, can be levied.

GST laws flexibly allow any of the parties to a transaction, the consignor or the recipient, to generate the e-way bill, provided they are registered.

GST and Federalism

GST is a classical instance of cooperative federalism. Both the centre and states had to forego some of their earlier constitutional powers for the historic compromise.

The Empowered Committee of State Finance Ministers headed by a state finance minister led the states while negotiating the GST since the beginning of the year 2000. Gradually, CENVAT and Vat were introduced, and later, GST came about. Under the GST regime, the Centre and states will act on the recommendations of the GST Council for harmonization of GST laws across the country. The composition, quorum, weights for members are all indicative of cooperative federalism. The very fact that Art 246A was added to the constitution shows the issue's sensitivity for federalism.

GST and Fiscal Autonomy Issues

The Constitution was amended to usher in the GST. It was also done 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 cannot impose tax on the manufacturing of goods. The centre cannot levy sales tax.
States feel that their fiscal autonomy is being eroded because of the following reasons:

- They are surrendering the power to tax sales on most goods.
- They cannot change rates according to their fiscal needs as was acutely felt in Kerala when floods ravaged the state and the state needed additional financial resources in 2018.

- All states cannot have the same rates as it violates respect for federal diversity.
- The centre may not compensate the states fully.

The position of states is not maintainable for the following reasons:
- The 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 petroleum products.
- The GST Council takes all decisions in which the states are in majority; vote of each state has the same value.

Thus, there is mutual surrender of powers to a uniform national taxation system in which both gain. Apprehensions of loss of fiscal autonomy by states and central dominance were eliminated. This is a standard case of cooperative federalism and is an example of pooled (shared) sovereignty.

GST so far

The experience has been mixed. Initially, there were problems, but it settled down to relatively smooth functioning.

Advantages:
1. 97.5 per cent articles covered by 18 per cent or lower GST slab
2. Under the previous regime of taxation, rates were much higher.
3. Traders do not have to comply with many rates of many taxes.

Disadvantages:
1. 5 rates are too many.
2. Alignment with computer systems has been costly for many small traders.
3. GSTN operations have glitches.
4. rates change too often.
5. refunds are time-taking.

The compensation issue has been the most conspicuous challenge so far but that is largely due to the pandemic.

Laffer Curve

Developed by Arthur Laffer, this curve shows the relationship between tax rates and tax revenue collected by governments. The Laffer curve has been debated in the country since 1997–1998 when the union budget reduced rates and slabs in the income tax regime in the country. The curve shows the optimal rates for sustained collection of taxes in which compliance rates are the highest.

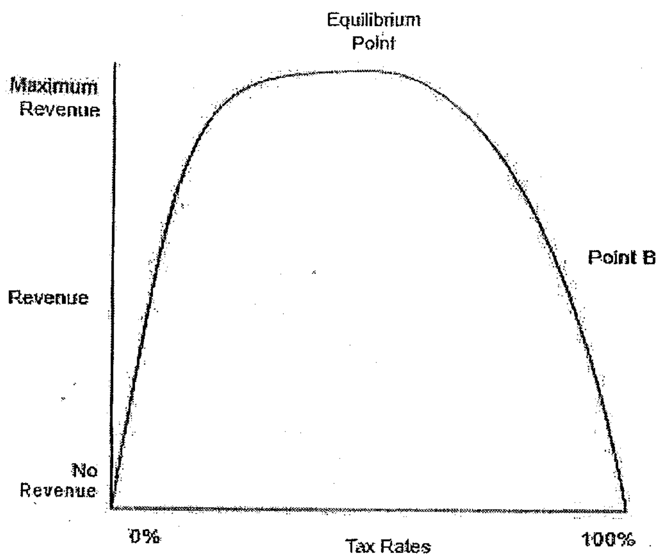


Figure: Laffer Curve

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 the provisions of the Companies Act. There was a large number of companies who showed book profits according to their profit and loss account (according to the Companies Act) but do not pay any tax by showing no taxable income as per the provisions of the Income Tax Act. Although the companies show book profits and may have even declared dividends to the shareholders, they were not paying any corporate 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 18.5 per cent of the book profit.

Book profit is profit which is notional—when assets appreciate, their value in the book goes up, but the same is not realized as they are not sold. This is also known as unrealized gain or unrealized profit or paper gain or paper profit.

Rajaswa Gyan Sangam

The Central Board of Direct Taxes (CBDT) and the Central Board of Indirect Taxes and Customs (CBIC) have been holding annual conferences of senior officers for a number of years. In 2016, for the first time, a joint conference of the two boards was held under the umbrella of 'Rajaswa Gyan Sangam'. The same was held in 2017 too.

The objective of the conference was to enable two-way communication between the policymakers and senior officers in the field offices with the view to increase revenue collection and facilitate effective implementation of law and policies. Issues arising in the implementation of policies and strategies to achieve targets in core functional areas are discussed. Such issues inter alia include HR issues, litigation management, strategies for revenue maximization, tax evasion, taxpayer services, GST and reforms and modernization.

Some Tax Related Terms

Dividend Distribution Tax: Companies giving dividend have to pay tax on the amount distributed as dividend.

Withholding Tax: It means withholding tax from certain payments including interest, salaries paid to employees, professional fee, payments to contractors, etc., at the time of making the payment. It is the same as TDS.

Presumptive Tax: Small businesses find it expensive to comply with book keeping norms of tax rules. In order to incentivise them to pay tax, tax laws allow them to declare income at a certain rate of turnover and pay tax on it. He is relieved from tedious job of maintenance of books of account. Composition scheme in the GST for small businesses is another example.

Wealth Tax: When income accumulates into wealth, it gets taxed after a point. Union Budget 2015–2016 abolished wealth tax and instead levied an additional surcharge to the individuals with a taxable income of ` 1 crore and above.

Securities Transaction Tax (STT): 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.

Commodities Transaction Tax (CTT): It is a tax similar to Securities Transaction Tax (STT). CTT aims at discouraging excessive speculation of commodities.

Fringe Benefit Tax (FBT): Fringe benefits are usually enjoyed collectively by the employees and cannot be attributed to individual employees singly. They are taxed in the hands of the employer who may or may not pass it on to the employee. Examples are transport services for workers and staff, gym, club, etc. Consequent to the abolition of fringe benefit tax in 2009, certain benefits taxed earlier as fringe benefits in the hands of the employer would now be taxable as perquisites in the hands of the employees.

Perquisites: They are benefits in addition to normal salary to which an employee has a right by virtue of their employment. 'Perks' as they are called colloquially, are benefits generally given in cash/kind, received by an employee by virtue of his/her employment. Perks arc taxable as a part of salary as per the India income tax laws and includes:

- The value of rent-free accommodation
- The value of any concession in the matter of rent respecting any accommodation provided, etc.
- Car
- Club membership
- Travel

Tax-Incidence: It shows the entity on which tax is imposed. It is different from tax burden as the latter refers to the one who actually bears it, the consumer in the case of indirect taxes. For direct taxes, both fall on the same entity. Tax on petrol is paid by the consumer while the seller is officially responsible to deposit it with the government.

Tax Base: The value of goods, services and incomes on which tax is imposed. When we speak of the tax base being broadened, it means 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 Shelters: When money is invested in certain permitted financial and other products, tax rebates are allowed. These products are called tax shelters. For example: mutual funds, infrastructure bonds, Post Office savings instruments, etc. It reduces tax liability.

Tax Planning, 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 reducing tax liability, it is called tax avoidance. It is lawful to take all available tax deductions. It is the same as tax planning. It is lawful to take all available tax deductions. It is the same as tax mitigation. It may be called tax avoidance also. But there is a difference to be made. Certain types of tax avoidance can be considered evasion as in the case of Vodafone. Lacking in commercial substance can make tax avoidance into tax evasion.

Tax evasion is a punishable offence. Tax evasion involves failing to report income, or improperly claiming deductions that are not authorized. It creates black money.

Hidden Taxes: These 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.

Consumption Tax: It is a tax on spending on goods and services. Consumption taxes are indirect, such as a sales tax or a value added tax.

Proportional, Progressive and Regressive Tax: An important feature of tax systems is whether they are proportional (the tax as a percentage of income is constant over all income levels), progressive (the tax as a percentage of income rises as income rises and also taxes at a higher rate on luxury goods), or regressive (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 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. Value means price. Luxury goods attract ad valorem tax. A bottle of water and perfume may measure the same but the price differs steeply. Water is essential while perfume is not. Therefore, if tax is a percent of price, more tax can be collected from the sale of a bottle of perfume. If it is flat rate (specific duty), either water costs much more or perfume becomes cheap. Both are avoidable. Government also loses potential revenue.
Excise Duty: Excise duty is a tax on manufacturing and is levied on the manufacture of goods within a 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 per cent.

Negative Income Tax: Subsidy is a negative income tax. Tax is what the government collects and subsidy is what it gives. For example, universal basic income (UBI).

Tax Buoyancy: It refers to the percentage change in tax revenue with the growth of national income, that is, growth-based change 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. It is unlike tax buoyancy which is growth-linked.

Tax Stability: It means no frequent changes and there is 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.

Chapter - 12
Public Sector: Evolution, Reforms and Performance

Introduction

Public sector units, also called enterprises or undertakings, are owned by the government, central or state, either wholly or at least a majority of shares in each. A public sector enterprise usually has forms of organizational structures like departmental undertakings (Railways), statutory corporations set up by an Act of Parliament (Oil and Natural Gas Corporation Limited), and companies registered under Companies Act, 2013 (Bharat Heavy Electricals Limited or BHEL and so on).

Departmental undertakings like the railways are not formed by or with the consent of the legislative authority. These are set up by executive decisions of the government (for example, cabinet ministers) and carry out specially defined commercial functions. These undertakings are a part of the government and managed by civil servants. They do not have separate finances, but their receipts go into and their expenditure comes from the Consolidated Fund of India, unlike the other forms of PSEs. That is, they are financed by annual budgets. A departmental undertaking is the best-suited, where the primary purpose is to collect revenues for the state and provide public utilities and services at fair prices in larger public interest. Some examples of departmental undertakings are the Railways and the Postal Department.

Statutory corporations are enterprises normally engaged in economic or manufacturing activities, and are set up by an act of legislature. These corporations are legal entities, which are separate from the government and also from the people who conduct their affairs. ONGC and IOC are some examples of the same. Statutory corporations are the ones which enjoy extensive legal autonomy, and their rules, objectives, functions and duties are defined and specified in the Parliamentary Act. Financing statutory corporations is not a part of the annual budget, and therefore, they can retain their revenues and also spend as per the rules laid down by the statute.

Control Boards are set up to manage government projects, for example, the river valley project by the Bhakra Management Board.

As per the Companies Act, 2013, government company is the one in which the government owns 50 per cent plus one or more of the paid-up capital.

Rarely, a PSE can be in the form of a cooperative society that supports cooperative movements, such as the Indian Farmers Fertilizer Cooperative Ltd (IFFCO), Krishi Bharati Cooperative Ltd (KRIBHCO) and so on. They are registered under the Multi State Cooperative Societies Act. In India, we have all these types of PSEs.

Since the beginning of socio-economic planning after Independence, the public sector played a preeminent role in India. Commanding the heights of the economy were to be in the hands of the public sector—basically, infrastructure and basic industries such as heavy engineering, power, metals and so on. PSEs dominated the Industrial Policy Statement, 1948, and Industrial Policy Resolution of 1956. They were opted for by the government partly as the government wanted to steer the economy towards planning goals rapidly and also because of pragmatic compulsions, like the negligible presence of the private sector in manufacturing and their unwillingness to take up the unprofitable work of investing in infrastructure.

The objectives of the PSUs are to:

- Build a self-reliant economy.
- Prevent/reduce concentration of private economic power.
- Establish sound economic infrastructure.
- Set up industries in the backward regions, thus helping bring about balanced regional development.
- Assist in ancillarization, thus spreading the benefits of industrialization.
- Create sufficient levels of employment and set standards of labour welfare.
- Selling goods and services at reasonable prices so as to serve consumers, keeping prices affordable and helping non-inflationary growth process.
- Invest in areas where the private sector would not invest, such as in roads, transport and so on.

Performance

Since planning began in 1951, the public sector has been the main engine of inclusive growth.

The Department of Public Enterprises (DPE), Ministry of Heavy Industries & Public Enterprises, Government of India brings out the Public Sector Enterprises Survey on the performance of Central Public Sector Enterprises (CPSEs) every year. The Public Enterprises Survey -2018-19 that was tabled in both the Houses of Parliament in 2020 is the latest.

As per the Survey 2018-19, there were total 348 CPSEs as on 31st March,2019 out of which 249 were operational. Remaining 86 CPSEs were under construction and 13 CPSEs were under closure or liquidation.
The highlights of the performance of CPSEs, during 2018-19 are:

- Profit of 178 profit making CPSEs stood at Rs. 1,75,000 crore during 2018-19.
- Loss of 70 loss making CPSEs stood at Rs.31,635 crore in 2018-19 .
- Overall net profit of operating CPSEs during 2018-19 stood at Rs. 1,43,000 crore.
- Net worth of all CPSEs was 12,00,000 crore.
- Contribution of CPSEs to Central Exchequer by way of excise duty, customs duty, GST, corporate tax, interest on Central Government loans, dividend and other duties and taxes stood at Rs. 3,69,000 crore.
- Foreign exchange earnings of 79 CPSEs through exports of goods and services stood at Rs. 1,43,000 crore
- Foreign exchange expenditure of 144 CPSEs on imports and royalty, know-how, consultancy, interest and other expenditure stood at Rs.6,65,000 crore.

The CPSEs have thus been making a substantial contribution to the central government through the payment of dividend, interest, corporate taxes, excise duties and so on. The survey excludes insurance, finance and other companies.
PSEs are important since:

- The record of the PSUs in supplying many goods and services, such as coal, transport, power, irrigation and so on, is commendable.
- The PSUs are a model employer, providing various facilities such as education, housing and so on.
- On establishing industries in MP, Rajasthan, Bihar and so on, the efforts of the PSUs to reduce regional economic imbalances are not insignificant.
- Non-inflationary growth process is facilitated because of the PSEs, as the prices of their goods and services can be administered.

A large number of CPSEs have been set up as greenfield (new) projects consequent to the initiatives taken during the Five-Year Plans. CPSEs such as the National Textile Corporation, Coal India Ltd. (and its subsidiaries) have, however, been taken over from the private sector following their nationalization. Industrial companies such as the Indian Petrochemicals Corporation Ltd., Modern Food Industries Ltd., Hindustan Zinc Ltd., Bharat Aluminum Company and Maruti Udyog Ltd., on the other hand, which had been CPSEs earlier, ceased to be CPSEs after privatization.

Along with other public sector majors such as the Indian Railways in transportation, CPSEs are the leading companies of India, with significant market shares in sectors such as petroleum (e.g., Coal India Ltd. and NMDC), power generation (e.g., NTPC and NHPC), power transmission (e.g., Power Grid Corporation of India Ltd.), heavy engineering (e.g., BHEL), aviation industry (e.g., Hindustan Aeronautics Ltd. and Air India Ltd.), storage and public distribution system (e.g., Food Corporation of India and Central Warehousing Corporation), shipping and trading (e.g., Shipping Corporation of India Ltd. and State Trading Corporation Ltd.) and telecommunications (e.g., BSNL and MTNL).

With economic liberalization post 1991, sectors that had been the exclusive preserve of the public sector enterprises were opened to the private sector with extensive LPG reforms. The CPSEs, therefore, are faced with competition from both domestic private sector companies (some of which have grown very fast) and large multinational corporations (MNCs).

While considering the performance of PSUs, it must be recognized that most of them had locational disadvantage, sold the product at administered prices (government-fixed prices), did not have access to the best of technology, had an excess of manpower, operated in areas not meant for profit making, such as the railways, were subject to multiple controls and excess of accountability and so on. Even though sick PSEs are reducing in number, the problems are compounded by resource crunch, erosion of net worth due to continuous losses incurred by the PSUs, reluctance of financial institutions to provide funds for the revival of PSUs, heavy interest burden, old and obsolete plants and machineries, outdated technology, low capacity utilization, excess manpower, weak marketing strategy, and so on. Inadequate autonomy is another reason. Populism and the absence of rational pricing of goods and services is yet another reason for the low efficiency levels in PSUs.

Public Sector and Economic Reforms

Economic reforms were made necessary to make the economy competitive through market forces. It was expected to post higher growth rates and make industries yield higher productivity, where profits and taxes could contribute to poverty alleviation. Public sector was in need of competition to unlock its value. Therefore, domestic and foreign capital was invited to force the PSEs to compete and perform. The government recognized the need for PSE reforms during the 7th FYP (1985–1990).

The New Industrial Policy 1991 made significant changes like the de-reserving of many areas, with only 3 areas being reserved today; equity disinvestment; managerial revamp with greater autonomy; and so on. The reforms made to the PSUs are the following:

The list of industries reserved for the public sector has been pruned down and they stood at only three by 2019:

1. Atomic Energy
2. Minerals specified in the Schedule to the Atomic Energy (Control of Production and Use) Order, 1953.
3. Railway passenger transport.

However, a new classification and policy emerged in 2020 as a part of the Atma Nirbhar policy and has been crystallised in the Union Budget in 2021-22 Union Budget.

New Public Sector Policy 2021

In May 2020, during the height of the pandemic, the government announced the new Public Sector Enterprise(PSE) policy as a part of Atma Nirbhar Bharat. It classifies public sector commercial enterprises as strategic and non-strategic sectors.

There are 18 sectors in the strategic category.

The remaining companies are in non-strategic sectors.

In the strategic class, Government will retain only a limited presence. That is, there will be a maximum of four public sector units and a minimum of one unit operating.

In the Union Budget 2021-22, it was announced that the government will maintain a bare minimum presence in only four strategic sectors. The four sectors are

- atomic energy, space and defence;
- transport and telecommunications;
- power, petroleum, coal and other minerals; and
- banking, insurance and financial services.

Other sectors are non-strategic and units in the non-strategic sector will be put up for privatization.

The firms that will be privatised in 2021-22 include Bharat Petroleum Corp Ltd, Air India, Shipping Corporation of India, Container Corporation of India, IDBI Bank, Bharat Earth Movers Ltd, and Pawan Hans.

NITI Aayog will make representations with respect to CPSEs under strategic sectors. NITI Aayog's recommendations will be considered by a core group of secretaries on divestment. Finally, the alternative mechanism for strategic divestment will approve action on CPSEs. An alternative mechanism for strategic divestment will decide if CPSEs will be retained under government control or subjected to privation/merger/closure.

This initiative is expected to bring healthy competition in sectors and will also assist the government to focus extensively on 'strategic sectors'

This is the first time since 1956 that the government has said it will not have state-owned companies in the non-strategic sector — and that the number in the strategic sectors too, would be reduced.

The period since 1991, when reforms were launched, saw many reforms in the way PSEs should function:

- The government must withdraw from commercial and other areas like hotels, bakeries, cycles and so on.
- Disinvest a portion of the PSU equity in favour of retail public, employees, domestic and foreign financial institutions, for a variety of purposes.
- Strategic sale, where a PSE is sold to a strategic partner who buys majority equity and takes over the management and which may extend to complete ownership in due course.
- Increasingly, they are being subjected to market discipline, primarily by listing on the stock exchanges, which is the direct outcome of divestment.
- Globalization—liberal FDI norms and import of capital goods are compelling PSUs to perform.
- The MoU system is being improved with greater weightage given to the criterion of financial performance.
- Navaratnas (1997) are granted financial and managerial autonomy for global competitiveness (Read ahead).
- Miniratnas were taken up for similar reforms.
- Maharatnas have been recognized since 2011.
- Professionalization of boards
- ETF (Bharat-22), 2017

As mentioned above, the reforms have paid off and performance has improved.

Disinvestment and Privatization

The New Industrial Policy, 1991, as mentioned above, spoke of disinvestment, and the Finance Minister's Budget Speech in 1999–2000 talked of privatization for the first time.

Definitions

Disinvestment is the sale of shares of the government to the retail public or employees or mutual funds or the domestic financial institutions or FPIs. In other words, Government continues to own more than 50% of equity and thus the unit remains in government hands. Shares are sold to various individuals and institutions in limited quantities only for raising capital. None of the buyers of shares holds enough to have a substantial say in the management. It is essentially a money-raising exercise with some accompanying benefits.

If the Government sells a chunk of equity to a single buyer—26 per cent or 51 per cent or more—to whom the management is also handed over, it is termed a strategic sale, and the buyer is called a strategic partner. It is usually in the case of privatization. The buyer is one who has presence in the sector and can add value to the unit. For example, IPCL was sold to Reliance Industries Ltd (RIL) and BALCO was sold to Sterlite. The government may also sell off a unit to a strategic buyer—the entire equity.

A strategic buyer is one who not only buys the chunk of entire equity—in one tranche or more—but also takes over the management, that is, the strategic part of the sale. It is unlike usual disinvestment, where the sale of shares is unaccompanied by the transfer of management control. The strategic partner gives a higher price for the shares as he gets management control along with it (management premium). Also, the running of the unit improves.

Privatization and strategic sale are the same if the sale of equity and transfer of management takes place in favour of a private owner. Take the following examples: sale of Hindustan Petroleum Corporation (HPCL) to Oil and Natural Gas Corporation Limited (ONGC); Power Finance Corporation (PFC) to Rural Electrification Corporation (REC); and IDBI Bank to Life Insurance Corporation of India (LIC).

They are strategically sold to another PSU. But it is not privatization as the strategic partner is not a private entity.

The advantages of a strategic sale (privatization) are that it receives investment; the strategic partner with management control will invest further for diversification and technological improvement; market perception will improve as it is no longer a government company; and shareholder value will increase. With the improvement of the functioning of the company, workers' protection will also be guaranteed.

Corporatization is a related term. It means that government units are reorganized along business lines. Typically, they are required to pay taxes, raise capital from the market (with no government backing, explicit or implicit), and operate according to commercial principles. Even government corporations should focus on maximizing profits and achieving a favourable return on investment. They have to operate on a level playing field along with the private sector without any special advantages, more or less.

Advantages of Disinvestment/Privatization

- Raises finances for the government that can be spent on restructuring the PSEs.
- Makes additional finances available for social sector priorities.
- Exposes the enterprises to market discipline, thereby forcing them to become more efficient and survive on their own financial and economic strength.
- When units become more professionalized and profitable, budgetary support for them can be minimized, freeing resources for social and infrastructural needs.
- Results in wider distribution of wealth through the offering of shares to small investors and employees.
- Beneficial effects are seen in the capital market; the increase in floating stock gives the market more depth and liquidity and facilitates the raising of funds by the PSEs for their future projects or expansion.
- Opening up the public sector to appropriate private investment increases economic activity and benefits the economy, employment and tax revenues in the medium to long term.
- Reduces the public debt that threatens to assume unmanageable proportions.
- In many areas, e.g., the telecom sector, the end of public sector monopoly brought relief to consumers by way of more choices and cheaper and better quality of products and services. Competition made PSEs perform better, as outlined above.

Criticism of Divestment

While the advantages are convincing, the criticism is not to be dismissed either:

- PSEs constitute family silver and should not be liquidated.
- PSEs check the private sector in the wider marketplace and so are crucial to economy. For example, if PSEs are absent, private enterprises may cartelize and so on.

- PSEs contribute by way of dividends and profits and thus are important sources of public finance.
- The exercise is essentially meant to garner resources for filling the revenue deficit. A prudent middle path needs to be adopted by way of extent of divestment, units chosen, pace of the process, method adopted (IPO, strategic sale, etc.), valuation debate and so on.

Disinvestments worth about 4.5 lakh crore have taken place since 1991 till 2019, and the government has set a target of `1.05 lakh crore of disinvestments for 2019–20.

Valuation of Shares

Fixing the price of shares for PSEs is done on the basis of the discounted cash flow (DCF) model. The DCF model is a method of valuing a business today based on the stream of its future profits or cash flows. It is said to be the best of the given methods.

Net asset valuation is not adopted, as it applies only to the units that are being wound up and not for running businesses.

Government Policy on Disinvestment/Privatization

As a part of reforming the PSEs, the government's policy on disinvestment and privatization has been evolving since the beginning of the reforms in 1991.
Its main elements are:

- Divest to raise money and for other advantages.
- List all unlisted public sector enterprises and sell a minimum of 25 per cent of equity to the public, as mandated by SEBI.
- Buyback of shares, for example, CIL and EIL.
- Restructure and revive potentially viable PSUs.
- Close down PSUs that cannot be revived or sold.
- Fully protect the interest of workers.

NITI Aayog recommended strategic disinvestment of many sick and other public sector units.

Strategic and Non-strategic Classification

Government classified the Public Sector Enterprises into strategic and non-strategic areas for the purpose of disinvestment. It was decided that the Strategic Public Sector Enterprises would be those in the areas of:

- Arms and ammunitions and the allied items of defence equipment, defence aircrafts and warships.

- Atomic energy (except in the areas related to the generation of nuclear power and applications of radiation and radioisotopes to agriculture, medicine and non-strategic industries).
- Railway transport.

All other PSEs were to be considered non-strategic.

Buyback of Shares

Buyback is a corporate action where a company buys back its own shares from the existing shareholders usually at a price higher than the market price. When it buys back, the number of shares outstanding in the market reduces.

A buyback allows companies to gain name and also material advantages. By reducing the number of shares outstanding on the market, buybacks increase the proportion of shares a company owns, which is in percentage terms. Companies buy back shares in the open market over an extended period of time.
The advantages of buyback are that it:

- provides an additional exit route to shareholders when shares are undervalued or are thinly traded.
- enhances consolidation of stake in the company.
- returns surplus cash to shareholders.
- supports share price during periods of sluggish market conditions. The government encouraged cash surplus PSUs to go for share buybacks to meet its disinvestment tar- get. The funds for the buyback were met out of internally generated cash resources of the company. The government was the largest beneficiary, as it sold its shares in the companies. Indian Oil Corporation (IOC), ONGC, BHEL, NLC, Oil India, Coal India, NMDC, HEG, NHPC, EIL and National Aluminium Corporation (Nalco) are some pub- lic sector companies that took up buyback.

Crossholdings

State-owned companies like Coal India, NTPC and NHPC have significant cash on their balance sheets, which can be used to buy shares of one another as the companies are related and have synergies. Similarly, oil for companies, when they buy shares of one another in bulk, they can guide each other and work with a common purpose. The government benefits as such purchase is done from the promoter.

PSE- Exchange Traded Fund (ETF)

An ETF is a mutual fund. In 2014, the GOI sold some of its equity to a private fund man- ager in 10 PSEs. The company that bought the equity issued units of the same to subscribers just like shares. Unlike shares from a single company, the fund as a whole with shares in 10 PSEs got listed on the stock exchange. Its value can go up and down. When the units of the fund issued to the public are traded in the stock market, the buyer gets shares of all ten together. The advantage is that the average valuation of 10 PSEs is reflected, and thus, the risk is less and so is the reward. It is called an exchange traded fund (ETF).

Bharat 22

Bharat 22 is an ETF that was launched by the GOI in 2017, comprising 22 stocks of the CPSEs, public sector banks and private companies of Strategic Holding of Specified Under- taking of Unit Trust of India (SUUTI). These 22 stocks are spread across six sectors, which are Basic Materials, Finance, Energy, FMCG, Industrials and Utilities.

SUTTI

UTI Mutual Fund was carved out of the erstwhile Unit Trust of India (UTI) as a SEBI-registered mutual fund. The Unit Trust of India went through bifurcation into Specified Under- taking of Unit Trust of India (SUUTI) and UTI Mutual Fund (UTIMF). SUUTI holds shares in many companies, including the three companies ITC, Axis Bank (erstwhile UTI Bank) and Larsen and Toubro. The government can sell the shares for its disinvestment purposes.

Methods of Disinvestment of Minority Stake in CPSEs

- Initial Public Offering (IPO) is the offer of shares in an unlisted CPSE by the government to the public for subscription for the first time.
- Further Public Offering (FPO) is the offer of more shares of a listed CPSE by the government to the public for subscription.
- Offer for sale (OFS) of shares by promoters through the stock exchange mechanism is made to institutional investors by auction on the platform provided by the stock exchange and has been extensively used by the government since 2012.
- Strategic sale, as explained above.
- CPSE Exchange Traded Fund (ETF)
- Cross holdings

Use of Disinvestment Proceeds

The proceeds of disinvestment are credited to the National Investment Fund (NIF) in the Public Account constituted in 2005 and are used for the approved purpose, as decided from time to time. The NIF is utilized for the following purposes:

- Subscribing of shares being issued by the CPSEs on rights basis, so as to ensure that 51 per cent ownership of the government in CPSEs is not diluted.
- Preferential allotment of shares of the CPSE to promoters so that government shareholding does not go down below 51 per cent in all cases where the CPSE is going to raise fresh equity to meet their capex (capital expansion) program.
- Recapitalization of public sector banks and public sector insurance companies to strengthen them through further capital infusion towards achieving the Basel-III norms.
- Investment by the government in RRBs/IIFCL/NABARD/Exim Bank.
- Equity infusion in various metro projects.
- Investment in Bharatiya Nabhikiya Vidyut Nigam Limited and Uranium Corporation of India Ltd.
- Investment in Indian Railways towards capital expenditure.

Department of Investment and Public Asset Management (DIPAM)

The Department of Disinvestment was set up as a separate department in 1999 and was later upgraded to Ministry of Disinvestment in 2001. From 2004, it again became a department and was placed under the Ministry of Finance. The Department of Disinvestment has been renamed as Department of Investment and Public Asset Management (DIPAM) in 2016. Its functions are:

1. All matters relating to the management of central government investments in equity, including disinvestment of equity in CPSEs.
2. Decisions on the recommendations of administrative ministries, NITI Aayog, etc, for disinvestment, including strategic disinvestment.
3. a. Decisions in matters related to CPSEs for purposes of government investment in equity, like capital restructuring, bonus, dividends, disinvestment of government equity and other related issues.

   b. Advise the Government in matters of financial restructuring of the CPSEs and for attracting investment in the said enterprises through capital market.

Maharatna, Navaratna and Miniratna Companies

Maharatnas

The Government introduced the Maharatna Scheme in 2010 with the objective of delegating enhanced powers to the boards of identified large-sized Navratna CPSEs, to facilitate expansion of their operations, both in domestic as well as global markets.

The eligibility criteria for the grant of Maharatna status are as follows. The CPSEs fulfilling the following criteria are eligible to be considered for granting of Maharatna status:

- Having Navratna status
- Listed on an Indian stock exchange
- An average annual turnover during the last 3 years of more than `25,000 crore
- An average annual net worth during the last 3 years of more than `15,000 crore
- An average annual net profit after tax during the last 3 years of more than `5,000 crore
- Significant global presence or international operations.

Delegation of powers to Maharatna CPSEs: The Maharatna CPSEs, in addition to hav- ing Navratna powers, have been delegated additional powers in the area of investment in joint ventures/subsidiaries and human resources development. Maharatna CPSEs can invest 5,000 crore in one project (1,000 crore for Navratna CPSEs).

The Government has granted Maharatna status to ten CPSEs:

1. Bharat Heavy Electricals Limited (BHEL)
2. Bharat Petroleum Corporation Limited (BPCL)
3. Coal India Limited
4. GAIL (India) Limited
5. Hindustan Petroleum Corporation Limited (HPCL)
6. Indian Oil Corporation Limited (IOC)
7. NTPC Limited
8. Oil & Natural Gas Corporation Limited (ONGC)
9. Power Grid Corporation of India Limited (PGCIL)
10. Steel Authority of India Limited(SAIL)

Of the ten, Hindustan Petroleum and Power Grid Corporation were granted the status in 2019 October by Department of Public Enterprises, under the Ministry of Heavy Industry and Public Enterprises.

Navaratnas

Economic reforms subject PSEs to market competition from domestic players, imports and MNCs. Globalization makes the competition more intense. To perform in such conditions, PSEs need a level playing field to compete with private players. GOI introduced the Navaratna concept in 1997 to grant enhanced autonomy to eligible PSEs referred to as Navaratnas. There are 14 navaratnas by the end of 2019.

Navaratnas (CPSE)

1. Bharat Electronics Limited
2. Container Corporation of India Limited
3. Engineers India Limited
4. Hindustan Aeronautics Limited
5. Mahanagar Telephone Nigam Limited
6. National Aluminium Company Limited
7. NBCC (India) Limited
8. NMDC Limited
9. NLC India Limited
10. Oil India Limited
11. Power Finance Corporation Limited
12. Rashtriya Ispat Nigam Limited
13. Rural Electrification Corporation Limited
14. Shipping Corporation of India Limited

The government has a quantitative system to confer the status of Navaratna to PSEs. According to the system, every PSE is rated on the following parameters:

- Net profit to net worth
- Total manpower cost as a percentage of total cost of production
- Profit before depreciation, interest and taxes (PBDIT) on capital employed
- PBDIT on turnover
- Earnings per share
- Inter-sectoral performance

To gain the Navaratna status, a PSE must score at least 60 out of 100 based on these param- eters. Additionally, a company must first be a miniratna and have four independent directors on its board before it can be made a navaratna.

The Navaratnas, subject to certain guidelines, have autonomy to:

- incur capital expenditure
- decide upon joint ventures
- set up subsidiaries/offices abroad
- enter into technological and strategic alliances
- raise funds from capital markets (international and domestic)
- enjoy substantial operational and managerial autonomy

The boards of these PSEs have been broad-based with the induction of nonofficial part-time professional directors.

Miniratna Companies

There are over 70 Miniratna companies. Miniratnas can also enter into joint ventures, set subsidiary companies and overseas offices but on a lesser scale as compared to Navratnas and with certain conditions.

Autonomy for PSEs

Managerial and financial autonomy is important for the PSEs to function well in a market economy, where there is severe competition and companies are listed on the stock exchanges. Steps for rendering autonomy to the PSEs are as follows:

- Maharatnas, Navaratna and miniratna status
- MoU
- Disinvestment
- Professionalization of boards

Professionalization of PSU Boards

- Outside professionals should be inducted in the boards of PSUs in the form of non- official directors, whose number should be at least a third of the actual strength of the board.
- Under the Navratna/Miniratna package, the board of select PSUs have been professionalized by inducting a minimum of four non-official directors in case of Navratnas and three in case of Miniratnas.
- The number of government directors on the board should not be more than two.

Memorandum of Understanding (MoU)

The beginning of the policy of Memorandum of Understanding can be traced to the report of the Arjun Sengupta Committee in the mid–eighties. One of the recommendations of this committee was for the introduction of the a system of MoU for measurement of performance of public enterprises. The MoU system was introduced on an experimental basis in 1987–88. It means the unit accepts to achieve results for which it is given autonomy. It is ranked on its performance as per the obligations and commitments under the MoU. Good ranking brings more autonomy.

The MoU system has been adopted as it was felt that PSEs are unable to perform at efficient levels because of multi-point accountability. Also, there was no clarity of objectives. The absence of functional autonomy also hampered their performance. The MoU covers both financial performance as well as non-financial performance. Under this system, per- formance of the company is categorized into five categories, namely: excellent, very good, good, fair, and poor.

The objectives of the MoU system are to improve the performance of public enterprises by increasing autonomy and accountability of the management through clearly laid down performance targets at the beginning of the year, enable the evaluation of managerial performance through objective criteria and provide a mechanism to reward good performance through performance incentives to stimulate improved performance.

Challenges for PSUs

Article12

Article 12 of the Constitution of India defines State, and PSEs constitute a part of it. The State, under the Constitution, has certain obligations towards the welfare of citizens as well as employees of PSEs. Thus, the autonomy of the management is curtailed in HR policies. This provision requires suitable amendment to make the PSEs dynamic.

Tenure of the CEO and Board of Directors

The managerial problems in the PSU can be effectively dealt with if the tenure of the CEO and the Board of Directors is assured. The selection, service conditions and the tenure of the Board of Directors is subject to government rules and regulations. Unlike the corporate sector, where the CEO has almost a decade to manage the company, in PSUs, management focus is on short-term strategies—co-terminus with the CEO's tenure. There is, thus, a need to provide continuity in the management by appointing CEO and other members in the Board of Directors for longer tenures with representation of shareholders other than GOI.

Multiple Audit

The business decision in PSUs gets influenced by a number of agencies, such as the Admin- istrative Ministry like Railways, steel, etc., parliamentary committees, CAG, CVC, CBI and courts. The end result of this is recourse to a risk-averse approach to business. PSU leadership loses its entrepreneurial dynamism.

Role of Administrative Ministry

The role of the administrative ministry needs to change. Like shareholders of any other company, the ministry's role should be limited to contributing as a shareholder in the AGM/ EGM of the companies and providing it the requisite support. The role of the ministry in day-to-day management (micromanagement) should be avoided.

Non-Commercial Activities

PSUs like other companies should function commercially but there are limitations. Some PSUs are sick or potentially sick units taken over by the government for social reasons which results in lack of autonomy to reorganize its business on profitable lines. Regularization of contract labour under Article.12 of the Constitution mandates PSUs to absorb excess labour. PSUs are unable to spin-off loss-making units or close operations in those units leaving them unviable.

Ad-hoc Group of Experts (AGE) Report

Ad-hoc Group of Experts (AGE) on Empowerment of Central Public Sector Enterprises was set up in 2004. It was headed by Arjun Sengupta. It recommended in 2006

- Greater autonomy for public sector units.
- Central PSUs should have truly independent boards. It recommended empowering the PSU boards in order to take decisions on mergers, joint ventures, pricing, exports, appointments, selection of dealers, promotion and transfer of employees, and so on. The ministry concerned should not review the PSU more than twice a year. Supervision should be done by sector-specific supervisory boards.
- Ministries should not interfere with the functioning of the PSUs under them. Their managements should be accountable to the board and not to the ministry.
- Supplementary audit by the Comptroller and Auditor General of India of the PSEs should be an exception rather than a rule, as it delays the publishing of audited accounts as required by SEBI.
- Reworking of the accountability of the PSEs to the parliament so that the questions raised on their functioning do not compromise sensitive trade data and work as an impediment in functioning as commercial enterprises.

Government accepted some of the recommendations of AGE Report related to the enhancement of financial powers of Navratna, Miniratna and other profit-making CPSEs. The remaining recommendations relating to ownership issues, audit of government companies, Article 12 of the Constitution, parliamentary accountability, vigilance, management in CPSEs, and so on are under examination.

Purchase Preference Policy

The government gives purchase preference in supply of goods and services to government departments and autonomous bodies and other PSEs if the price quoted by the supplying CPSE is within 10 per cent of the lowest valid bid price, other things being equal. This helps support the PSEs.

Chapter - 13
Balance of Payment

Introduction

Balance of Payments (BOP) is the overall statement of a country's economic and financial transactions with the rest of the world over a specific period—usually one year. It includes all outflows and inflows (payments and receipts). If financial outflows are more, it is a BOP deficit and if inflows are more it is a surplus. All global financial transactions of a country consist of two types:

- Capital account (investment and borrowing)
- Current account (rest of external transactions which includes the balance of trade)

Current Account and Capital Account

Capital account deals with investment and borrowings and the rest of the BOP is the current account. Trade account consisting of exports and imports are a part of the current account.

Balance of payments covers a vast number of transactions from trade, remittances by foreign workers to loans and investment. All these transactions of a country with the rest of the world are classified broadly into current and capital accounts as indicated before.

Current account includes foreign trade in physical goods (merchandise) and invisibles. Invisibles are:

- Foreign currency flows in services, like software, knowledge process outsourcing based earnings, consulting services, shipping services, tourism, and royalty on patents.
- 'Remittances' which are transfer of money by a foreign worker to an individual in their home country. For example, NRIs of India.
- Factors payments that include incomes from wage, interest, profit or rent.

Capital account transactions in the BOP are investment and borrowing. For example, FDI, FPI, ECBs, Masala Bonds and so on. We will see the details ahead.

India's Balance of Payments (BOP) Crisis in 1991

The beginning of 1990s saw major BOP crisis due to many factors like the Gulf war and cumulative problems of the Indian economy. India has been dependent on crude imports. International crude prices are very crucial for our BOP condition. When there was geopolitical disturbance due to Iraq crisis, crude prices shot up as did our import bill. Tour- ism dropped. It depleted our foreign exchange reserves. International rating agencies downgraded India. This fuelled the crisis further as India's credit worthiness plunged and there were no ready international lenders. A substantial outflow of deposits held by Non-resident Indians during 1990–91 added to the crisis. Reserves declined to a low of $0.9 billion in January 1991. India had to pledge gold in May 1991 and again in July 1991 to avoid a default on its short-term debt servicing obligations. India borrowed foreign currency through India Development Bonds issued by the State Bank of India and Foreign Exchange Immunity Scheme of the Government of India. The scheme was aimed at attracting back the illegal foreign currency stashed abroad by resident Indians.

India came out of the crisis with an IMF-sponsored bail out. In course of time, Indian economy recovered, exports grew as rupee was devalued, foreign inflows started to pick up and we overcame the BOP pressures.

The rupee was devalued and brought closer to the market value as earlier it was artificially overvalued. International investors saw in this reform progress towards market orientation. Indian exporters felt encouraged as their earnings in foreign currency would fetch them more rupees. Devaluation was a precursor to rupee convertibility.

Structural reforms were taken up so that the economy is put on a competitive path—opening the economy to globalization and so on.

Balance of Payments and Invisibles

Invisibles in international trade are 'services', remittances and factor income transfers. Visibles in international trade stand for 'physical goods' (merchandise). Invisibles are in three parts, viz., Services, transfers and income.

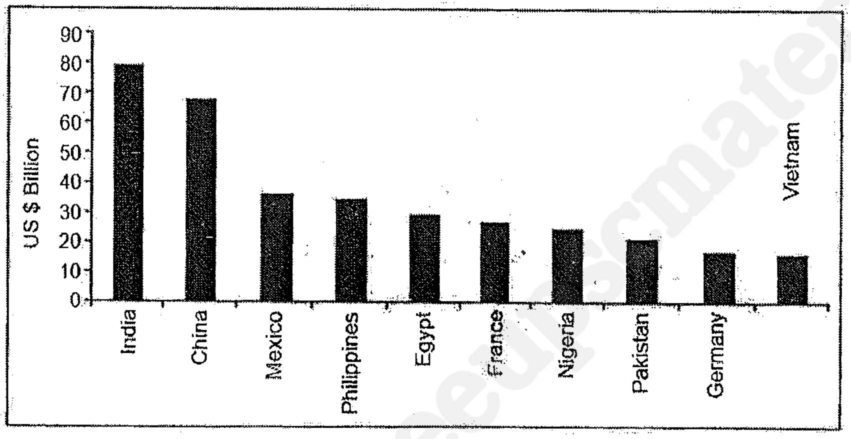
Services include transportation, financial services, travel, telecommunications, computer services and professional services. Transfers include remittances from Indians working abroad.

Income receipts are the income earned (as profits, interest and dividends) from owner- ship of overseas assets by Indian companies, government and individuals.

Remittances

India, for some years, has been the largest remittances receiving country. It received about $83 billion in 2019 and is followed by China. In 2020, remittances to India were expected to fall this year by nine per cent to USD 76 billion due to the ongoing coronavirus pandemic and global economic recession of the total $69 billion in 2017, about 58.7 per cent was received by four states—Kerala, Karnataka, Maharashtra and Tamil Nadu. After Kerala, Maharashtra had the largest chunk of remittances at 16.7 per cent (11.52 billion), followed by Karnataka 15 per cent (about $10.35 billion), Tamil Nadu 8 per cent and New Delhi 5.9 per cent. Southern states of Kerala, Karnataka, Tamil Nadu and Andhra Pradesh had a share of about 46 per cent or $31.74 billion.

In terms of countries, 82 per cent of the total remittances came from seven countries— UAE, the US, Saudi Arabia, Qatar, Kuwait, the UK and Oman. Indians working in The Gulf Cooperation Council (GCC) countries—mostly semi-skilled and unskilled workers—sent more than 50 per cent of the total remittances in the financial year 2016–17.



Data Source: Record High Remittances Sent Globally in 2018, www.worldbank.org, accessed 18 Nov 2019

Figure: Top Remittance Receiving Countries in 2018

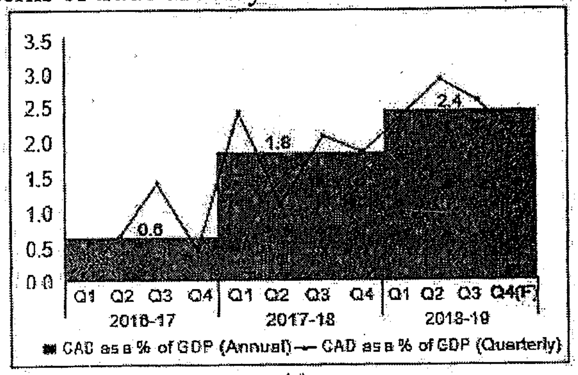
Indian diaspora which is one of the most prosperous in the world is sending money home. Controls are lifted and so there are greater inflows. The government has progressively reduced red tape. Interest rates are high. The RBI has increased the amount that can be remitted home. In recent months, the rupee has weakened considerably vis-à-vis the dollar, and a surge in remittances is expected as non-resident Indians take advantage of it. Due to remittances, India's current account is stabilizing.

The Covid pandemic led to global economic contraction resulting in unemployment and return of lakhs of Indians working abroad. Remittances fell as mentioned above.

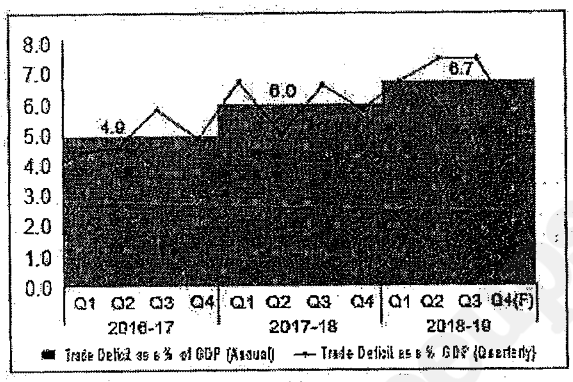
Current Account Deficit

The current account of the balance of payments is the sum of the balance of trade (exports minus imports of goods and services), net factor income (such as royalty, interest and dividends) and net transfer payments (such as remittances). Both government and private payments are included in the calculation.

Trade is the most important part of the current account. This means that changes in the patterns of trade are key drivers of the current account.



(a)



(b)

Data Source: World Bank Organization; Statistics (2016–2019)

Figure: Current account deficit and trade deficit as per cent of GDP

Deficit on the current account means a net outflow of foreign currency and depletion of forex reserves. In India's case, this means a dollar outgo. India's merchandise trade deficit is large and is covered up largely by remittances and the surpluses on service trade. But still there is a CAD. Therefore, India relies on attracting capital inflows, which could be in the form of FDI/NRI deposits/FPI, etc., to meet the shortfall. But when capital flows cited before are dwindling and the country must then borrow to meet the current account gap, the country's currency starts to depreciate as its outflows are more. Its capacity to defend its currency weakens. It has limited forex to meet debt servicing obligations as neither is it exporting enough nor is it attracting foreign investment. It runs into a sovereign debt crisis thus. Therefore, a current account deficit in excess of 2.5 per cent of GDP is seen as worrisome in the case of India.

To act against CAD, India needs to promote exports and slow down consumption imports such as fuel, electronic items and gold. Reduction of fuel subsidies will also reduce the demand for imported fuel and thus balance trade.

CAD is said to be good up to a limit as the country uses foreign savings which are imports for its development. However, following points must be made to qualify the same:

1. It should be financed from dependable inflows like FDI,
2. It should be within limits.
3. Foreign portfolio investments to cover the CAD is advisable only to some extent because they are volatile.

Some steps to cover the CAD that government took over decades are:

- Liberalize FDI/FPI.
- Liberalizing long-term external commercial borrowings (ECBs).
- Asking state-run companies to raise funds from overseas markets, etc.
- Open to sovereign wealth funds and pension funds to get them to invest in India.
- Promote exports.
- Measures to reduce imports, especially non-essential ones.
- Floating dollar bonds.

Current Account Surplus

The Economic Survey 2020-21 projected India's current account to register a surplus of 2 percent of the Gross Domestic Product (GDP) in FY21 after a gap of 17 years.

India's current account balance turned into surplus (0.1 percent of GDP) in fourth-quarter 2019-20 because of a lower trade deficit and a sharp rise in net invisible receipts.

This quarterly surplus has been followed by successive current account surpluses in the first and second quarters of the 2020-21 fiscal.

In the first half of 2020-21, steep contraction in merchandise imports and lower outgo for travel services led to a sharper fall in current payments than current receipts leading to a current account surplus. Survey says: Given the trend in imports of both goods and services, it is expected that India will end with an annual current account surplus of at least 2 percent of GDP – after a period of 17 years.

India, being a developing and emerging market economy, typically runs a deficit on the current account to supplement domestic savings with foreign savings to fund higher investment.

Currency Convertibility

Convertibility of a currency means giving freedom to the holders of the currency to convert them freely into other currencies at the prevailing market rate and vice versa. For example, one who has Indian rupees can convert them into foreign currencies if rupee is convertible and reconvert.

Convertibility can be permitted on both current and capital account transactions in a limited manner or more liberally. Limitation is by way of depth—in terms of amount and range in terms of purpose like trade, travel, investment, loans, etc. If 100 per cent FDI is allowed in a sector, it refers to depth on capital account. If more sectors are opened for FDI it refers to range or spread. In other words, former is vertical and the latter horizontal.

Convertibility has many advantages as we will see when discussing the Tarapore Committee.

No country grants full convertibility—they open for some sectors and restrict it for certain purposes. For example, the trade account convertibility is confined to exports and imports and certain associated aspects like remittances (what Indians living abroad send to their friends and relatives in India), tourism, etc. Even here, restrictions are imposed after a point. The larger the scope of convertibility that is permitted by a country, the stronger and the more resilient its economy is said to be, according to its advocates.

Rupee Convertibility

The rupee's external value was regulated by the RBI till 1992. Unlike the developed countries where market forces dictate the exchange rate of the currency, the rupee was artificially valued by the RBI because the country did not have a policy that is pro-exports or pro-FDI.

Devaluation of the rupee was done by the RBI in 1991 to set the stage for convertibility. The rupee was made partially convertible in 1992, under which 40 per cent of the foreign exchange earnings were to be traded at the official exchange rate and the remaining 60 per cent could be converted at market determined exchange rates. It was the dual exchange rate system of 40:60 and was known as Partial Convertibility of Rupee (PCR) and was a part of Liberalized Exchange Rate Management System (LERMS) that was introduced in 1992. Rupee was made fully convertible on the trade account in 1993 and it was further extended to current account in 1994. Thus, India assumed obligations under Article VIII of the International Monetary Fund and as a result of which, India is committed to adopt current account convertibility. The measures helped in international investors reposing faith in Indian economy.

On the capital account, foreign institutional investments (investments into financial assets like shares, bonds, etc.) were permitted and Indian companies were permitted to raise resources in the international capital markets in the form of Global Depository Receipts. Norms for foreign direct investments were liberalized and multinational companies were wooed by the central/state governments to invest in white goods (consumer durables), infrastructure and other projects. The dramatic change in the external economic policy environment led to a surge in capital flows.

Current account convertibility is relatively risk free as it does not involve external debt. It refers to freedom to convert domestic currency into foreign currency and vice versa for the following purposes:

- Exports and imports in goods
- Export and import of services
- Remittances, including factor incomes
- Travel

Capital Account convertibility is a major structural reform. It means FDI/FPI being allowed into India. Similarly, allowing capital outflows from India for Indian entities to invest abroad. Indian entities can borrow from foreign countries.
It is a challenge and needs to be sequenced well depending on the ability of the economy to absorb it. For example, 51 per cent FDI is allowed in multi-brand retail in India since 2012 on the approval route, i.e., with permission from the government. It is a structural reform which has impact on more than half the population directly. Thus, it is done 20 years after economic reforms had begun and results were appreciated.

Full Convertibility

Full convertibility means freedom to convert rupee into foreign currency and vice versa for both current and capital account purposes with least restrictions.

That means, in the capital account, there should be close to 100 per cent FDI and FPI allowed across as many sectors as possible (except security related areas). Similarly, there should be very liberal regime for outflows, i.e., Indians can invest and borrow from overseas. There should be very few controls on current account transactions also.

Full convertibility is not practiced anywhere in the world, but many advanced countries aim for it. India has a large measure of capital account convertibility for foreigners and NRIs for investing in India and taking out profits relating to FDI, portfolio investment and NRI bank deposits in India. For Indian residents and corporates, some limits still exist on how much they can invest abroad. Indian companies also need the RBI's permission to borrow funds from overseas for some designated purposes. The controls are being relaxed.
Full convertibility has the following dimensions:

- Liberalization of financial flows in and out of the country.
- Convertibility for more purposes (like FDI in retail).
- Higher or no caps on existing foreign investment regime.
- More of automatic than approval route.
- Liberalization of outflows from India. Indians being allowed greater freedom to take their money abroad.

The fuller the convertibility, more the relaxations.

Benefits of Full Convertibility

- India needs huge FDI and other financial resources, especially to upgrade its infrastructure. Domestic savings alone are not enough. More foreign funds would come in only if they are sure of free entry and exit.
- Indian businesses (especially, the established companies) would be able to access cheaper foreign funds that would improve their international cost competitiveness.
- Indian banks would be able to borrow foreign funds at lower rates which would, in turn, enable them to lend at a lesser rate to Indian small and medium enterprises which may not otherwise be able to borrow directly from the international capital market.
- Access to foreign funds would facilitate Indian companies taking over firms abroad and developing more Indian MNCs in the process. For example, the Tatas acquiring Jaguar.
- It exerts macroeconomic discipline.
- Ordinary Indian investors would be able to further diversify their asset portfolios as they are allowed to invest abroad. Outflows are necessary to

balance the inflows, or the problem of appreciation will plague the economy. Otherwise Dutch disease may be the result.

- All advantages of FDI will be available—technology, investment and trade accrue. However, the fears are as follows:
- As the east Asian financial crisis (1997) and the global financial crisis (2008) show, adoption of fuller convertibility should be calibrated, or it can be quite destabilizing.
- Domestic interests are hurt as it can create unemployment. For example, FDI in retail.
- Rupee still not being a hard currency (globally strong), can be subject to volatility with serious effects as we have seen in 2018.
- FDI hike in defence has effects on national security.

In order to minimize the ill effects of full convertibility the following prerequisites need to be ensured according to the Tarapore Committee (1997):

- Fiscal deficit should be minimal
- Forex reserves should be adequate
- NPAs of banks should be minimal
- Inflation and interest rates should be moderate

Unless these conditions are met, steps towards fuller convertibility should be kept on hold.

Tarapore Committee on Capital Account Convertibility (CAC)

Committee on Capital Account Convertibility or Tarapore Committee, was an experts' committee formed by the RBI in 1997 to study the feasibility of capital account convertibility in India. The objective of the committee was to study economies that had implemented capital account convertibility and understand the prerequisites for it. They had to make recommendations on the measures to be taken and the time frame to achieve full capital account convertibility. They also had to suggest changes in the domestic financial policy to achieve the objective. It gave the report on the benefits, preconditions and risks regarding the capital account convertibility adoption.

The report said that the time was appropriate for India to take some steps towards it, but it should be done only when the prerequisites are met as otherwise the CAC is a double-edged sword. The report said that the adoption should be phased. The transition from one phase to the next should be made, only if certain preconditions are met. The preconditions were reduction of fiscal deficit, keeping the inflation in a 3–5 per cent range and reforming the financial sector, including reduction of non-performing assets as mentioned above.

Second Tarapore Committee 2006

Committee on Fuller Capital Account Convertibility, the second Tarapore Committee, was set up by the Reserve Bank of India in 2006 to study the status of capital account convertibility in India and make recommendations for future changes. The committee was set up to explore the need and feasibility and the cautions to be observed about opening convertibility further. It recommended that:

- India should make the rupee more freely convertible over the next five years to realize the country's 'maximum' economic potential.
- In view of the huge investment needs of the country and the inadequacy of domestic savings, inflows of foreign capital become imperative.
- The shift towards fuller convertibility should be phased.
- Before making the rupee more freely tradeable, India must improve regulatory and supervisory standards across the banking system.
- Ban participatory notes as a mode of investment in Indian equities and ease the direct investment routes for foreigners.
- Foreign individual investors should be brought at par with non-resident Indian investors.
- Restrictions on overseas borrowings by Indian firms and banks be eased.
- Limits on outbound remittances by Indian citizens should be increased.
- Fiscal deficit be brought under control otherwise a large deficit will make India's economy vulnerable to shocks.
- It proposed the formation of a monetary policy committee (MPC) which has since been set up and is in operation.

Capital account convertibility relaxations so far:

- Capital account transactions continue to be regulated under FEMA which is a highly liberalized version of the earlier FERA.
- Foreign direct investment, barring a few strategic industries is put on automatic route, with most of the sectors permitted to have ever increasing foreign equity participation.
- The foreign portfolio investment by FPIs is allowed liberally.
- The External Commercial Borrowings (ECB) no longer require the RBI or Ministry approval up to a value.
- Masala bonds are being issued abroad.
- Inflows are liberalized far more than outflows for reasons of deterring capital flight and ensuring BOP security.
- Overseas investment limit for Indian companies enhanced.

- Ceiling on overseas investment by mutual funds enhanced.
- An Indian citizen can invest up to $2,50,000 per year in foreign markets.
- Union Budget 2019–20 proposes to issue sovereign bonds abroad.

FEMA and FERA

The Foreign Exchange Management Act, 1999 (FEMA) was enacted 'to consolidate and amend the law relating to foreign exchange with the objective of facilitating external trade and payments and for promoting the orderly development and maintenance of foreign exchange market in India'. It replaced the Foreign Exchange Regulation Act (FERA). FEMA makes offences related to foreign exchange civil offenses. FEMA was rendered possible as India accumulated forex reserves post–1991 reforms.

The Foreign Exchange Regulation Act (FERA) 1973 imposed strict regulations on the dealings in Foreign Exchange (FOREX) and the transactions which had an indirect impact on the foreign exchange.

Internationalization of Rupee

Internationalization of rupee means the following:

- When Indian firms import, they should be able to pay for the imports in rupees.
- When Indian firms export, they should accept payments in rupees.
- When Indian firms issue bonds globally, they should be able to repay in rupee regardless of the currency in which the debt was contracted.
- All over the world individuals, companies and central banks should accumulate
- Indian rupee as a reserve currency because of its global demand.

US Dollar, Euro, Japanese Yen, British Pound, Swiss Franc and Chinese Yuan make the grade and are international currencies.
An international currency is traded actively in global markets. It is accepted for international trade transactions.

Benefits of Internationalization of Rupee

- Greater degree of integration of Indian economy with rest of the world in terms of foreign trade and international capital flows.
- Savings on foreign exchange transactions for Indian residents—we can pay in rupee for external transactions and need not route them through any foreign currency.
- Reduction in dependence on foreign exchange reserves for balance of payment stability.

International Currency: Pre–requisites

First, the economy should be fully integrated into the global economy. Second, it is linked to macro economic fundamentals like strength of the economy, growth rates, economic productivity, exports, FDI, resilience, etc.
Third, it should be a global hard currency. It means currency should be stable and liquid. Being liquid means there are ready buyers and sellers all the time at the market price for any quantity.

IndianRupee

Indian rupee is steadily becoming internationalised:
- Masala bonds were floated in 2014.
- The Indo-Japanese currency swap (US$ 75 billion) deal of 2018 may be called another step in that direction.
- Currency swap deal between India and the UAE of 2018 is one more example.

There are challenges on the road to internationalisation. Firstly, one of the important drivers for internationalization of a currency is the country's share in global trade. India's percentage share in the global trade is still on the lower side.
Secondly, internationalization of Indian currency would also require full capital account convertibility, though China is an exception. The capital account is being progressively liberalized in accordance with the evolving macroeconomic conditions and requirements.

Currency Swap Agreements

A bilateral currency swap is a credit line from one country to another at a fixed exchange rate. It is an agreement between two central banks to exchange currencies. These swaps involve two transactions.
- the borrowing central bank sells its domestic currency to the other central bank to buy a hard foreign currency like dollars at the prevailing market exchange rate.
- borrowing central bank buys back its currency on a specified future date at the same exchange rate.

The borrowing central bank pays interest, at an agreed rate to the lending central bank. In 2018, India and Japan signed a currency swap agreement. This currency swap arrangement will allow the Indian central bank to draw up to $75 billion worth of yen or dollars as a loan from the Japanese government whenever it needs this money. The RBI can use it for any purpose for which it uses its own forex reserves such as:
- Pay for imports
- Service foreign currency loans

The RBI may even keep them for external account stability and fight off speculators on rupee exchange rate.

If the Japanese central bank wants the RBI to lend it up to $75–billion loan, the RBI is obliged to provide it out of its own reserves.

Uses of it for India are:
- Stave off speculators of currency
- Signal to investors that the forex front is stable
- Boosts foreign inflows

India's Currency Swap Agreements
- India-Japan currency swap agreements 2018.
- India and the UAE signed currency swap agreement in 2018 worth $500m. It allows the two countries to pay for their imports in their respective national currencies at a pre-agreed exchange rate. There is no need to pay in another currency like US$. It will reduce the impact of volatility in exchange rate arising from the dependency on a third currency.
- India has a Currency Swap Arrangement for SAARC Member Countries with a Standby amount of $400 million operated within the overall size of the facility of $2 billion.

Rupee Depreciation in 2020: Case Study

The historic low of nearly Rs.77 for a US dollar in 2020 April had both global and domestic reasons. They are:
1. global pandemic and the economic contraction that was taking place meant that the optimism about global economy in general and Indian economy in particular declined. Capital flight to a safe haven like the US Dollar took place
2. US-China trade tensions worsened, thus threatening global trade
3. Global crude prices crashed driving speculative money to the US Dollar. It meant, that FIIs sold rupee holdings and converted it into dollar.
4. Investors sold off rupee as they felt that in future it would be costlier to do so due to further depreciation.

Government took some steps to correct the fall and liberalized ECBs and FPI.

Exchange rate is the price of one currency in terms of another currency. For example, approximately 75 rupees are exchanged for $1 US in mid–2020. That is the exchange rate of rupee. In 1991, it was less than 20 rupees. The difference is largely because at that time the exchange rate was set by the RBI arbitrarily and today it is left to market forces.

The exchange rate depends upon many factors:

- Growth rate of the economy
- Future potential
- Foreign trade profile which includes import dependency
- Inflation
- Forex reserves with the RBI
- Interest rates in the country
- Monetary policy of countries like USA
- Currency manipulation by a large country like China that forces India to also weaken its currency to some extent to retain its exports
- International commodity prices
- External debt levels, particularly the short-term commercial debt level
- Twin deficits--fiscal and external current account
- Political stability

Rupee is completely floated. The RBI buys and sells foreign currency only to facilitate normal operations for foreign trade, debt servicing, etc. We can thus say that the rupee exchange rate is not 'managed' by the RBI. It is not even semi-managed (dirty float). The RBI's forex market intervention is only to neutralise manipulation of forex market that can create instability (internally and externally). The Forex reserves of about $585 b have been built up as war chest primarily for this reason by 2021.

Devaluation and Depreciation

Exchange rate of a currency is defined as the price of one currency in terms of another currency. It may be fixed by the central bank or left to the market forces of demand and supply or a mix of the two. Indian rupee had a fixed rate till 1992.
When the external value of the currency is changed by the central bank, it is called devaluation if it is made cheaper and revaluation if it is made stronger. Weaker means more of rupees for a dollar and stronger means less of rupees for a dollar. Thus, loss or gain of value due to central bank decision is called devaluation or revaluation.

If market forces bring down the value due to demand falling behind supply of the currency, it is called depreciation. Depreciation and Devaluation have the same effect but the method is different—the former is driven by market forces and the latter is administered by the central bank (the RBI).

Increase in external value taking place as a result of market forces of demand and supply is called appreciation.

When central bank fixes the rate, it is called fixed rate. When market forces operate to change the rate, it is called floating exchange rate.

Devaluation/Depreciation and Its Effects

It is argued that when a currency depreciates due to market forces of supply and demand or is devalued by the Central bank, exports go up. The reason is: If a dollar can get more rupees, it can buy more Indian goods and services. Therefore, depreciation helps sell more internationally. In fact, in India's case, since the beginning of reforms in 1991 one of the reasons for the growth in exports in dollar terms was the depreciation of rupees. With a weaker rupee:

- Exports pick up
- FPIs flow in
- Remittances increase
- Inessential imports reduce
- More money in rupee terms is realized for the loans in foreign currency that Indian firms take

However, when rupee loses its value externally:

- Debt servicing becomes costlier
- Inflation rises as imports become costlier
- Government's subsidy bill and fiscal deficit rise as it must make costlier imported goods like petroleum products and food affordable to the general public.

At the same time, a cheaper rupee making the imports costly may drive the domestic importdependent firms to become either import-substituting or cut corners and raise productivity. The result can be innovation and indigenous production.

To boost exports, pricing the external value of the rupee low is not the right strategy beyond a point. Scale, quality, reliability, packaging and more factors matter. Price- elasticity of our exports is also to be considered before depreciation is advocated. That is, if imports make up a significant part of exports, the export competitiveness due to depreciation is eroded as import costs also rise. Import intensity of Indian exports—about 50 per cent exports like engineering goods, gems and jewellery, etc., is high, and thus depreciation hurts them.

J-Curve

J-curve effect is a theory stating that a country's trade deficit will initially worsen after the depreciation of its currency. This is because imports will cost more and initially imports in quantitative terms will not reduce significantly. On the export front, initially, the export pick-up is not much. Thus, the outgo will increase, and earnings will not improve much. Thus, there is pressure on BoP. Over time, when exports become price-competitive and inessential imports are reduced due to high cost, the BOP turns positive. The trajectory described thus gives it the shape of an umbrella stick or J.

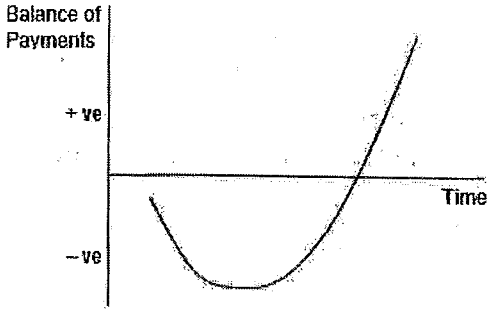


Figure: J–Curve

Currency Appreciation and its effects

Normally, currencies appreciate when the economy does well. An appreciating currency is the result of a booming economy unless the central bank keeps it weak for certain macro- economic goals (such as exports among others). Performance of economy brings in huge foreign inflows, exports do well and add to the foreign currency reserves and help the currency quote higher.

The resentment is among exporters while importers, those who borrowed from overseas and generally the consumers are gainers. Those who already borrowed gain as their repayment costs are lower. Borrowing through Masala bond does not make any difference to the borrowers as the borrowers pay exactly what they borrowed in rupee terms with interest, that is, they do not take exchange rate risk nor enjoy the reward if the rupee strengthens. Masala bond issues help the country however gain foreign currency and thus rupee will appreciate.

The Indian consumer is a beneficiary too, as costs of a host of imported goods—from petro-products to electronic, electrical and consumer items—would be cheaper.

Appreciation is suggested for the following reasons:

- Helps manage inflation.
- Puts pressure on the export sector to scale up value chain and export niche products.
- Forces the industry to cut costs and be competitive on quality terms.

Currency Mechanisms

There are many ways a currency's exchange rate is arrived at for practical financial transactions. They are:

- Fixed exchange rate is one in which the central bank artificially and arbitrarily fixes the exchange rate which may not have any relation to market forces. India had this system till 1992 before trade account convertibility was introduced. India had the system as it did not need any FDI or exports.
- Floating rate means the forces of demand and supply in the market determine the valuation and the role of monetary authority is indirect like changes it makes in the interest rates, cash reserves ratio, etc. The central bank has no direct role in regulating the rate but in a marginal way, its buying and selling foreign currency in the market, it does influence the rate though imperceptibly.
- Dirty float exchange rate is largely market determined, but the central bank manages the rate in a specific band that suits certain national goals like export promotion, import management, debt servicing, remittances, etc. Management of the currency valuation is within a band called the target zone and is declared by the central bank. It is also called managed float.
- In the pegged system the currency is pegged to the international hard currency like dollar or to a group of such currencies to signal the commitment of the central bank to stability. Its movements may or may not be determined by the hard currency because the valuations that suit the local economy are independent of the hard currency. It is essentially meant for imparting stability and credibility to the domestic currency in its exchange rate to invite investors. The stability, however, depends on the ability of the country to manage the rate that is necessary for its exports and gain other benefits. For that, the central bank should have sufficient forex reserves to intervene whenever necessary. Otherwise, there will be speculative attacks and currency meltdowns. China is an example of currency peg. Crawling peg means that the Government accepts that the currency will crawl up or down gradually by a certain annual rate.

Currency Board

Like a central bank, a currency board is a country's monetary authority that issues currency notes and coins and controls money supply. That is its only function and is performed in line with the fixed currency exchange rate.

In recent times, currency board came into international headlines when Argentina adopted it to flush out its extra currency that was losing its value due to fiscal profligacy. When foreign investors were leaving the country and the exchange rate of Argentine Peso was plunging, the decision was taken to adopt the currency board mechanism. It set a fixed exchange rate to US dollar. It ruled that the country should print so many Argentine Pesos as it had dollars—the ratio between the two being fixed at a certain level. Thus, the country retrieved its financial stability and FDI and FII resumed.

Currency Board may exist in countries irrespective of any fiscal or currency crises.

Real Value of the Rupee

Since 1991 when 1 US fetched 16 rupees, rupee depreciated to more than Rs.73 per US dollar by early 2021. Erosion is caused by market forces according to demand and supply in the market. The factors that influence value are listed earlier in the chapter.

There are three ways of seeing the value of a currency:

- The prevailing official exchange rate is called the Nominal Effective Exchange Rate (NEER).
- Adjustment—upward or downward—according to inflation shows Real Effective Exchange Rate (REER). REER is an inflation adjusted exchange rate—the differential between the inflation in India and India's trading partners is factored to arrive at the REER. NEER always tends towards REER even though there may be a time lag to suit the macro-requirements of the economy. The RBI uses its 36-country REER as an indicator to understand whether the rupee is overvalued or undervalued. REER is notional.
- Purchasing Power Parity (PPP) method that we discussed in Chapter 1.

Any currency may be overvalued or undervalued. Overvaluation of the rupee means that its price in terms of foreign currencies is too high. That means, strong rupee. This makes our exports expensive in foreign markets and our imports cheap in the home market.
Undervaluation of the rupee means the opposite. Its price in terms of foreign currencies is too low, so that it discriminates against imports and favours exports. Currency wars are waged to cheapen the currencies to boost exports.

Forex Reserves

The RBI holds foreign exchange reserves which are made up of:

- Foreign currency held in US Dollars, Euro, British Pound, Japanese Yen, etc.
- Gold reserves
- Special Drawing Rights of International Monetary Fund
- IMF reserve tranche position

Each member of the IMF is assigned a quota, part of which is payable in SDRs or specified usable currencies called reserve assets which are global hard currencies, and part in the member's own currency. What the member pays in foreign currency as a part of the membership fee (quota) is technically called Reserve Tranche Position (RTP). RTP is accounted among a country's foreign-exchange reserves. It can be withdrawn from IMF any time with- out any interest during critical situations of a country such a BOP crisis.

Forex Reserves 2021

The country's foreign exchange reserves stood at USD 583.945 billion in the first week of February 2021.

The break up is as follows:
Foreign currency assets (FCAs), a major component of the overall reserves were USD 542.338 billion. xpressed in dollar terms, the foreign currency assets include the effect of appreciation or depreciation of non-US units like the euro, pound and yen held in the foreign exchange reserves.

The gold reserves were USD 34.967 billion.

The special drawing rights (SDRs) with the International Monetary Fund (IMF) were USD 1.503 billion.

The country's reserve position with the IMF was USD 5.138 billion.

RBI is diversifying the reserves into SDR and gold since the US-centered global recession in 2008 so as to be relatively secure.

FCAs are kept in the form of deposits with central banks of other countries and also as government securities of US, Japan, etc. The returns are low, but it is safe.

Market value of foreign currencies, expressed in US dollar terms, changes. The FCAs include the effect of appreciation or depreciation of non-US dollar currencies, such as the Euro, the Pound and the Yen held in the reserves. When assets are valued at current levels, the gains that may be made are known as revaluation gains. For example, 1 US$ may have been bought with about 45 but current value is more than 70 and thus yields revaluation gains. If RBI holds Euros and Euro loses to US$, the revaluation gains expressed in US$ are negative relatively.

These are reserves and not resources and cannot be used for infrastructure, etc., as suggested by some as the investors want to see the country hold enough of these reserves to give them confidence to come and leave without uncertainties.

The RBI accumulated the forex reserves for the following reasons:
- To gain external account security
- To import essentials for economic and social security—energy and food security
- To defend the rupee against manipulators
- To enjoy favourable rating by sovereign credit rating agencies which in turn will confer advantages like borrowing cheap from offshore currency market, etc.
- To enable the country to globalize further

Adequacy or otherwise of forex reserves is measured with reference to the:
- Composition of the reserves—whether they are made up of exports and FDI earnings or FPIs and loans
- Level of foreign debt (particularly short-term debt)
- Import dependence
- Export buoyancy
- CAD
- Sovereign credit rating, etc.

There is a notion called import cover of reserves which is the traditional trade-based indicator of foreign exchange reserve adequacy. It tells us how long imports can be sustained in the event of a shock. According to the IMF, traditionally, the import coverage measure has been based on months of prospective imports, with three months' coverage used as a benchmark. It is not an indicator of adequacy of forex reserves which is based on an aforementioned comprehensive list of criteria.

However, there are problems with huge forex reserves. They are:
- High cost of acquisition.
- Low returns as they are invested in government securities of foreign central banks in the USA, Japan, etc., and also as deposits with the central banks earning very low.
- High sterilization costs, that is, when rupees are printed to buy dollars, rupees that go into the market have to be absorbed by floating government securities carrying significant interest cost through MSBs (discussed in the chapter on Monetary Policy).
- Market risks associated with their deployment in US securities are evident since 2008.

China, Japan, Switzerland, Saudi Arabia, Taiwan, Russia, Hong Kong and India are the top eight countries in terms of forex reserves that their central banks hold—in the descending order.

Currency War

Brazil's Finance Minister Guido Mantega, in 2010, coined the term while describing the competition between the United States and China to cheapen their currencies. While countries cheapened their currencies to gain undue export advantage for many decades, China in contemporary times is known for it. Its export-led economy depended on weak exchange rate that is set by its central bank—People's Bank of China. When other nations join the race of devaluation to withstand the competition and win, it becomes competitive devaluation for which another name is currency war.

Currency cheapening is made possible by the central bank following an expansionary monetary policy to lower the value of its money. It may also be done by the central bank by fixing the exchange rate low in countries like China where there is no capital account convertibility as the central bank administers the exchange rate.

Other countries may not be able to join as their currencies are not fixed but are floated. Also, not all countries can afford such devaluation as they may be import dependent like India as:

- Imports will be costlier
- Inflation will shoot up
- Growth will suffer
- Jobs will be lost
- Financial sector may be destabilized as banks may accumulate Non-Performing Assets (NPA).

A central bank has many tools to weaken the currency: increase the money supply by expanding credit. It can lower interest rates.

The US undertook Quantitative Easing for many reasons, one important reason being joining currency war to boost exports.

Governments can also aid in currency losing its value through expansionary fiscal pol- icy: by spending more. But its effects can be severely destabilizing and anti-growth unless the entire ecosystem is in place to take relative advantage of the weak currency from the global market. Example: Large scale export capacity.

Currency Manipulation

Currency manipulation is to weaken the currency to gain unfair global advantages. It is the crux of currency wars. A country depends on the price of its currency in overseas markets—the exchange rate, for a variety of its macroeconomic objectives. Some want it weak so as to export more, etc., and some want it balanced if they also have a need to import substantially. China is in the former category and India in the latter. China keeps its exchange rate weak by having the Yuan (Renminbi) fixed (pegged) to a basket of currencies. By artificially keeping it devalued, it has posed a threat to other countries that also want to export but cannot weaken the currency so much. For example, India. When a country damages its competitors through a weak currency, it is called a 'beggar thy neighbor policy.' The decline of India's exports and the huge trade deficit that India runs with China may be cited as an example of such policies. It is the result of currency manipulation. The United States accused China of keeping the yuan artificially low by massively accumulating foreign reserves, in order to give Chinese exports an advantage over competitors.

The US wants to have Chinese Yuan to move freely in foreign exchange markets and find its value.

President Trump's 'America First' is also a response to it. Protectionism is spreading across the world as a result. Trade wars of imposing higher tariffs and quantitative restrictions on one another are get- ting worse and are becoming currency wars. In case of USA-China trade war of 2018, China pegged its currency weaker and thus made up for the tariff hikes by the US. It had an impact on many other currencies that also had to let their currencies slip to be able to withstand the competition from China.

On August 5, 2019 the US officially named China as a currency manipulator. The two countries meet to address the charge. The US will also work with the IMF to address its concerns.

The next most popular reserve currency is the Euro. About 20 per cent of central bank foreign currency reserves are in Euros. Japanese Yen, British Pound, Swiss Franc and Chinese Yuan are also in global reserve currencies.

Most of the other currencies are only used inside their own countries. Whether a currency becomes a reserve currency or not does not depend on the size of the economy of the currency. Swiss economy is worth only $660 billion in 2018 but Swiss Franc has been a global reserve currency for many years. China was worth more than $5 trillion in 2010 and was not.

The reasons for any national currency to emerge as a global currency are that:

- It should have strength and performed well for decades.
- It should be liquid, that is, should have buyers and sellers in any amount at any time.
- It should be stable which the central bank should be able to ensure.

If a currency satisfies these features, it can be accepted across the world. If a currency is held by others, it has a great advantage: when other countries hold it, they do not hold it as currency as it does not fetch returns and so they buy government bonds with it which most often happen to be the bonds of the country whose currency is held as reserve. For example, when the US dollar is held, it is invested as US government security which fetches some returns. It means, world will give US the dollars that they hold, and the US will in return give them US government securities. These securities carry an interest rate that is negligible because there is great demand for them. It means that the rate at which the US raises loans is very cheap. That reflects on the global trust in these bonds. The US spends the money for its own growth and consumption. When the bonds mature, US prints currency and returns the money. That is the list of incredible advantages that the US has as its currency is the foremost global reserve.

Global Reserve Currency

There are some national currencies that are held by central banks around the world as a part of their foreign exchange reserves as they are accepted in the international markets for all types of transactions like payment for imports, debt servicing, etc. For example, US dollar, Japanese Yen, Euro, etc. It is held not only by the central banks but also firms and individuals as it is considered a safe-haven currency. U.S. dollar is the most preferred and makes up two-thirds of all known central bank foreign exchange reserves. More than 85 per cent of forex trading involves the U.S. dollar and 40 per cent of the world's debt is issued in dollars.

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Hard and Soft Currency

In line with the explanation of global reserve currency, hard currency is any globally traded currency that is liquid (adequate supply) and stable (does not fluctuate much). Such currency is in global demand as a store of value. Long-term stability, fiscal and economic policies of the country, strength of the economy, etc., are the relevant factors behind the emergence as a hard currency. It becomes a safe haven currency. Soft currency exhibits the opposite features.

Flight of Capital

When domestic currency is converted into foreign currency in large amounts and rapidly leaves the country, it is called capital flight. It may be due to:

- The perception that the economy is not doing well.
- Imposing of controls that will mean losses.
- Because of policies that are inimical for investments.
- The government facing sovereign debt crisis defaulting on its external debt.

Any of these events will cause loss of confidence in the economy. When flight of capital takes place, exchange rate drops thus causing even greater flight and harm to the economy. The country's currency will lose value and the purchasing power. Forex crisis will ensue. High inflation will result. The problem is worse if the country is import dependent. Country's creditworthiness in the global markets will erode.

In such a situation the country will resort to capital controls.

Capital Controls

Capital controls are any measure taken by a government, central bank or other regulatory body to limit the flow of foreign capital in and out of the domestic economy. These controls include taxes (Tobin tax), quantitative restrictions, etc. These controls can be economy-wide or specific to either a sector or industry. Capital controls are temporary and are aimed at stabilization. In the long run they limit economic progress and efficiency.

Dollarization

When a country uses the currency of another country informally or by official substitution, it is called Dollarization. Currency substitution can be in complete replacement of domestic currency or along with it. Nepal and Bhutan hold Indian rupee along with their own official currencies (Nepalese Rupee and Bhutanese Ngultrum respectively) for financial security and for trade across the border. Similarly, residents of Zimbabwe hold British Pound or South African Rand along with Zimbabwe dollar.

Sovereign Wealth Fund

It is a fund of foreign currency that is meant to be invested in global assets. It is set up and managed by the central bank or a special body (special purpose vehicle) of the government. It is commonly seen in countries that have substantial foreign currency assets earned by them from exports or by foreign investors like MNCs. The fund is invested in shares, bonds, property or other areas of potential growth (energy assets such as oil and gas fields, uranium and agricultural fields). It may also be used to acquire foreign companies. The main reason for it is to earn more for their foreign currency reserves than making investments in government bonds of foreign central banks for paltry returns.

India has not set up an SWF because our reserves are not adequate for our needs and contingencies. Besides, forex held by the RBI is not earned through exports or FDI but is essentially 'borrowed resources'. Our external debt is about $550 billion and our forex reserves are $430 billion.

Dutch Disease

Netherlands discovered huge reserves of oil and related fuels in 1960s. Netherlands exported large amounts of it. The foreign exchange inflows led to the Guilder appreciating so much that exports of other sectors suffered; imports shot up and the competitiveness of Dutch industry was affected adversely. Deindustrialization was the result.

It is known as Dutch disease. Essentially it means appreciation of currency due to the export of certain commodity so much so that imports shoot up and economy declines. The Economist magazine in 1977 coined the term to describe the decline of the manufacturing industry in the Netherlands.