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ECONOMICS : AN INTRODUCTION

Definition of Economics

There are three representative definitions of economics, which encompass major dimensions of the subject. They are as follows:

- Adam Smith defined economics as the 'Science of Wealth'. (Material Definition)
- Economics is a study of mankind in the ordinary business of life; it examines that part of individual and social action which is most closely connected with the attainment and with the use of material requisites of well being'. (Welfare Definition)
- Professor Robbins in his 'Nature and Significance of Economic Science (1932)' defined economics as 'the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses.' (Behavioral Definition)

Macro and Micro Economics

Ranger Frisch used the terms macro and micro economics first in 1953. The subject matter of economics and its various concepts can be classified either in 'microeconomics' or 'macroeconomics' for the sake of convenience of study. Microeconomics is the study of units whereas macroeconomics is the study of aggregates. As its name implies, microeconomics is concerned mainly with small segments of the total economy, i.e., behaviour and decision of individual consumer or producer or group of consumers and producers that form a market unit. Microeconomics is about production or consumption of an individual unit, demand and supply of an individual unit, price and output determination of an individual unit, etc. On the other hand Macroeconomics is the study of 'whole' or 'aggregate' such as national income, aggregate saving, aggregate demand, aggregate supply, etc.

Positive versus Normative economics

In Economics, mainly there are two types of approaches- positive and normative; the former

approach deals with "what is" and the latter with "what should be". In positive economics we describe, explain and understand the economic phenomena "as they are" while in normative economics we study "what should be" and we conjecture, suggest and do value judgments to take certain stands on various issues and judge the worth of economic policies and stances as good or bad, desirable or undesirable. So, normative approach is which deals with "what should be" or "if" and "then" conditions.

Fundamental Questions for an Economy

Economics broadly deals with anything, which has a price or monetary value. This monetary value arises out of two factors:

1. Unlimited wants and desires of the people.
2. Limited/Scarce availability of resources.

Since unlimited needs and wants of the masses have to be satisfied out of the scarce and limited resources available, Economics tries to find out the most efficient allocation of the scarce resources so that the needs and desires are satisfied to the best possible extent. The answers of three fundamental questions of economics determine the allocation of scarce resources among its alternative uses. The three fundamental questions are as follows:

1. What to produce?
2. How to produce?
3. For whom to produce?

The three fundamental questions of economics are resolved differently in different economic systems. The more important economic systems are Socialism, Capitalism and Mixed Economy. Under a Socialist regime, all the resources are collectively owned. Under Socialism, the questions, what, how and for whom to produce are decided by the central planners keeping in view various factors, such as the priorities of the economy and supply and demand conditions. They assign different quantity of resources to different products depending on expected

demand and hence let the economy work in a centrally planned fashion. The socialist economy, therefore, do not allow the free play of market forces. Government intervention is the hallmark of socialist economies.

On the other hand capitalism tries to answer all these fundamental questions through market mechanism. It explains that the invisible hand of free market forces will determine the above answers to questions. Prices of factors of production and commodities together with purchasing power of different consumer groups will determine what to produce, how to produce and for whom to produce. Thus market mechanism brings all the commodities and factor markets in equilibrium.

Mixed Economy involves ownership of factor resources by private as well as public sector. Whereas strategic and core sectors are generally owned by public sector, non-strategic, capital and consumer goods are open to private sector to compete.

Main Features of Capitalism:

- Laissez faire or free market.
- Private property.
- Capital owned by capitalists.
- Production done by hired labour.
- Market mechanism (invisible forces of market) determines prices of commodities and factors of production as well as distribution of products and income.
- Modern day capitalism accepts limited state intervention.

Market Economy

The term market economy is not identical to capitalism where a corporation hires workers as a labour commodity to produce material wealth and boost shareholders profits. A "market economy" is an economy in which individuals make economic decisions according to the principle of supply and demand. A market economy is a realized social system based on the division of labour in which the prices of goods and services are determined in a free price system set by supply and demand. This is often contrasted with a planned economy, in which the central government determines the price of goods and services using a fixed price system. Market economies are contrasted with mixed economy where there the price system

is not entirely free but under some government control that is not extensive enough to constitute a planned economy. In the real world, market economies are regulated by society.

Laissez-faire

Laissez-faire is a French phrase literally meaning Let do ("allow to do"). From the French dictum first used by the eighteenth century physiocrats as an injunction against government interference with trade, it became used as an economic ideology which advocates minimal state intervention in the economy. Many writers suggest that laissez-faire capitalism never existed. It is generally understood to be a doctrine that maintains that private initiative and production are best allowed a minimal of economic interventionism and taxation by the state beyond what is necessary to maintain individual liberty, peace, security, and property rights.

Crony capitalism

Crony capitalism is a pejorative term describing an allegedly capitalist economy in which success in business depends on close relationships between businessmen and government officials. It may be exhibited by favoritism in the distribution of legal permits, government grants, special tax breaks, and so forth. Crony capitalism is believed to arise when political cronyism spills over into the business world; self-serving friendships and family ties between businessmen and the government influence the economy and society to the extent that it corrupts public-serving economic and political ideals. In its lightest form, crony capitalism consists of collusion among market players.

Socialism

Socialism refers to a broad set of economic theories of social organization advocating state or collective ownership and administration of the means of production and distribution of goods. Modern socialism originated in the late nineteenth-century working class political movement. Karl Marx posited that socialism would be achieved via class struggle and a proletarian revolution, it being the transitional stage between capitalism and communism.

Features of classical form of socialism

- Productive resources owned by states.

- No private property.
- State intervention.
- State employed workers.
- Centrally planned economies.
- Production and distribution decisions taken by a central agency.
- Administered prices.

Socialism is not a discrete philosophy of fixed doctrine and program; its branches advocate a degree of social interventionism and economic interventionism, sometimes opposing each other - especially the reformists and the revolutionaries. Some advocate complete nationalization of the means of production, distribution, and exchange; social democrats propose selective nationalization of key national industries in mixed economies combined with tax-funded welfare programs; libertarian socialists advocate co-operative worker ownership of the means of production; most Marxists (some inspired by the Soviet economic model), advocate centrally-planned economies. By contrast, Social-Anarchists, Luxemburgists, the U.S. New Left and various forms of libertarian socialism favor decentralized ownership via co-operative workers' councils and participatory planning.

Market socialism

Market socialism is a term used to denote two different economic system(s) based in socialism which operate according to market principles. The first term relates to an economy directed and guided by socialist planners on either a local or state level. The earliest models of this form of market socialism were developed by Enrico Barone (1908) and Oskar R. Lange (1936). Lange and Fred M. Taylor proposed that central planning boards set prices through "trial and error," making adjustments as shortages and surpluses occurred rather than relying on a free price mechanism. If there were shortages, prices would be raised; if there were surpluses, prices would be lowered. Raising the prices would encourage businesses to increase production, driven by their desire to increase their profits, and in doing so eliminate the shortage. Lowering the prices would encourage businesses to curtail production in order to prevent losses, which would eliminate the surplus. Therefore, it would be a simulation of the market mechanism, which Lange thought would be capable of effectively managing supply and demand. There are a few examples of

market socialism in the contemporary world. Market mechanisms have been utilized in a handful of socialist states, such as Yugoslavia and even Cuba to a very limited extent. The People's Republic of China is run by the Communist Party, but its economy involves considerable private enterprise and market forces in both private and public sectors.

Communism

Communism is a socioeconomic structure that promotes the establishment of an egalitarian, classless, stateless society based on common ownership of the means of production and property in general. It is usually considered to be a branch of socialism, a broad group of social and political ideologies, which draws on the various political and intellectual movements with origins in the work of theorists of the Industrial Revolution and the French Revolution, although socialist historians say they are older. Communism attempts to offer an alternative to the problems believed to be inherent with capitalist economies and the legacy of imperialism and nationalism. Communism states that the only way to solve these problems would be for the working class, or proletariat, to replace the wealthy bourgeoisie, which is currently the ruling class, in order to establish a peaceful, free society, without classes, or government. The dominant forms of communism, such as Leninism, Stalinism, Maoism and Trotskyism are based on Marxism, but non-Marxist versions of communism (such as Christian communism and anarchist communism) also exist and are growing in importance since the fall of the Soviet Union Planned economy or Directed economy or Command economy.

Planned Economy: A planned economy or directed economy is an economic system in which the state or government manages the economy. Its most extensive form is referred to as a command economy, centrally planned economy, or command and control economy. In such economies, the state or government controls all major sectors of the economy and formulates all decisions about their use and about the distribution of income, much like a communist state. The planners decide what should be produced and direct enterprises to produce those goods.

Unplanned Economy: Planned economies are in contrast to unplanned economies, such as a market economy, where production, distribu-

tion, pricing, and investment decisions are made by the private owners of the factors of production based upon their own and their customers' interests rather than upon furthering some overarching macroeconomic plan.

Mixed Economy

A mixed economy is an economic system that incorporates aspects of more than one economic system. This usually means an economy that contains both privately-owned and state-owned enterprises or that combines elements of capitalism and socialism, or a mix of market economy and planned economy characteristics. There is not one single definition for a mixed economy, but relevant aspects include: a degree of private economic freedom (including privately owned industry) intermingled with centralized economic planning (which may include intervention for environmentalism and social welfare, or state ownership of some of the means of production). The term "mixed economy" arose in the context of political de-

bate in the United Kingdom in the postwar period, although the set of policies later associated with the term had been advocated from at least the 1930s. Supporters of the mixed economy, including R.H. Tawney, Anthony Crosland and Andrew Shonfield were mostly associated with the British Labour Party, although similar views were expressed by Conservatives, including Harold Macmillan. India and France are examples of mixed economies. With varying degrees all contemporary economies are mixed economies because pure capitalism or pure communism are a misnomer.

Features of a Mixed Economy

- Elements of both socialism and capitalism.
- Both public and private investment.
- Freedom to buy, sell, and profit.
- Economic planning by the state.
- Significant regulations (e.g. wage or price controls) combined with, including taxes, tariffs, and state-directed investment.

STATE OF THE INDIAN ECONOMY

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State of the Indian Economy

With 1.2 billion people and the world's fourth largest economy, India's recent growth and development has been one of the most significant achievements. Over the six and half decades since independence, the country has brought about a landmark agricultural revolution that has transformed the nation from chronic dependence on grain imports into a global agricultural powerhouse that is now a net exporter of food. Life expectancy has more than doubled, literacy rates have quadrupled, health conditions have improved, and a sizeable middle class has emerged. India is now home to globally- recognized companies in pharmaceuticals and steel and information and space technologies, and a growing voice on the international stage that is more in keeping with its enormous size and potential. At the same time, the country is in the midst of a massive wave of poverty and unemployment.

The foremost reason for slowing growth rate in India during the first half of 2012-13 is weakening industrial growth in the context of tight monetary policy followed by the Reserve Bank of India (RBI) through most of 2011-12, and continued uncertainty in the global economy.

The other reasons are listed below:

1. The slowdown in growth in advanced economies and near recessionary conditions prevailing in Europe resulted in decrement of exports along with poor inflows of foreign investments in the country.
2. As India is an energy deficient nation, thus, it is mainly dependent on import of crude oil. This is leading to higher current account deficit.
3. Rainfall in the monsoon season of 2012-13 has been below normal, particularly in the key months of June and July. This affected sowing and resulted in a lower growth rate of agriculture and allied sectors.

4. The Reserve Bank of India followed a tight monetary policy to control inflation, although there has been some relaxation in the recent months in the Statutory Liquidity Ratio (SLR) as well as Cash Reserve Requirement (CRR).

5. Poor implementation of infrastructure projects failed to provide proper boost to the economy. Further delay in passage of projects due to red-tapism has reduced the investments in infrastructure.

6. The service sector declined due to a reduction in the growth rate of 'Trade, hotels, transport and communications' sector as these are demand driven sector and high inflation is forcing people to invest less in these sector.

However India is expected to record 6.1 per cent gross domestic product (GDP) growth in the current fiscal. The growth is expected to increase further to 6.7 per cent in 2014-15, according to the World Bank's latest India Development Update. While, the Prime Minister's Economic Advisory Panel expects the economic growth rate to increase to 6.4 per cent in 2013-14 from 5 per cent during 2012-13, on back of improvement in performance of agriculture and manufacturing sectors.

PRESENT STATUS OF INDIAN ECONOMY

Agriculture Sector

As per the National Accounts Statistics, the agriculture and allied sector registered a growth of 2.1 per cent during the first half of 2012-13 which is lower than the growth rate of 3.4 per cent in the first half of 2011-12.

Further average annual growth of the agriculture and allied sector during the Eleventh Five year Plan at 3.6 per cent fell short of the 4 per cent growth target. Realized growth, however, has been much higher than the

average annual growth of 2.5 and 2.4 per cent achieved during the Ninth and Tenth Plans, respectively.

Growth has also been reasonably stable despite large weather shocks during 2009 (deficient south west monsoon), 2010-11 (drought/deficient rainfall in some states), and 2012-13 (delayed and deficient monsoon). An important reason for this dynamism was step-up in the gross capital formation (GCF) in this sector relative to GDP of this sector, which has consistently been improving from 16.1 per cent in 2007-8 to 19.8 per cent in 2011-12 (at constant 2004-5 prices)

Overall GCF in agriculture (including the allied sector) almost doubled in last 10 years and registered a compound average annual growth of 8.1 per cent. Rate of growth of GCF accelerated to 9.7 per cent in the Eleventh Plan (2007-12) compared to a growth of 2.7 per cent during the Tenth Plan (2002-07). Average annual growth of private investment at 12.5 per cent during Eleventh Plan (first four years) was significantly higher as against nearly stagnant investment during the Tenth Plan.

But there has been a decline in overall area under foodgrains during 2011-12 (2nd Advance Estimates) as compared to 2010-11. The area coverage under foodgrains during 2011-12 stood at 1254.92 lakh ha compared to 1267.65 lakh ha last year. The lower area under foodgrains has been due to a shortfall in the area under jowar in Maharashtra, Rajasthan and Gujarat; bajra in Maharashtra, Gujarat and Haryana; and in pulses in Maharashtra, Uttar Pradesh, Andhra Pradesh, and Rajasthan. However the area under coarse cereals and oilseeds has also come down as compared to the previous year. The area coverage under rice during 2011-12 is around 444.06 lakh ha which 15.44 lakh is ha more than the previous year. The area coverage under sugarcane during the current year has slightly improved to 50.81 lakh ha, higher by about 1.96 lakh hectares as compared to the previous year, and the area under cotton has increased significantly to 121.78 lakh ha as compared to 112.35 lakh ha during 2010-11

The agriculture, including allied activities, accounted for only 14.1 per cent of the GDP at constant (2004-5) prices in 2011-12, its role in the country's economy as its share in total employment according to the 2001 census is

58.2 per cent. The declining share of the agriculture and allied sector in the country's GDP is consistent with normal development trajectory of any economy, but fast agricultural growth remains vital for jobs, incomes, and the food security. The growth target for agriculture in the Twelfth Five Year Plan remains at 4 per cent, as in the Eleventh Five Year Plan.

Agricultural production in the country is greatly influenced by policies such as pricing, procurement, storage, etc. The Minimum Support Prices (MSPs) for major crops have been raised substantially by the Government in 2012, in line with the objective of ensuring remunerative prices to farmers for their produce and with a view to encouraging higher investment and production in the sector. This policy also resulted in higher procurement of foodgrains by Food Corporation of India (FCI) and the State agencies. The procured foodgrains are being made available to the consumers under the targeted public distribution system (TPDS) at central issue prices (CIPs) that are much less than the economic costs to the procuring agencies.

Reasons for slow growth in agriculture sector:

1. Slowdown in agriculture growth.
2. Weak Framework for Sustainable Water Management and Irrigation.
3. Stringent land regulations discourage rural investments.
4. Rural poor have little access to credit.
5. Weak Natural Resources Management.
6. Excessive use of chemical inputs are decreasing rate of fertility of soil.
7. Frequent floods and droughts.
8. Irregular monsoon.

Industrial Sector

As per the IIP, industrial output growth rate during April-September 2012-13 was 0.1 per cent as compared to 5.1 per cent in April-September 2011-12. The Mining sector production has contracted in the last six quarters. The contraction in the current year was largely because of decline in natural gas and crude petroleum output. Manufacturing, which is the dominant sector in industry, also witnessed deceleration in growth, as did the electricity sector. There was, however, a sharp pick-up in growth in October 2012 with

manufacturing growth improving to 9.8 per cent, the highest recorded since June, 2011. Growth, however, turned negative in November and December, 2012 and was placed at (-) 0.8 per cent and (-) 0.6 per cent, respectively. Gross capital formation (GCF) in the industrial sector comprising mining, manufacturing, electricity and construction recorded negative during 2008-09 and again in 2011-12.

The major cause of manufacturing sluggishness are:

1. Drop of investment in new projects due to the slower rate of growth in disbursement of bank credit. Further adverse business sentiment is also leading to lower investment.
2. Decline in capital goods, natural gas, crude petroleum, and fertilizers output.
3. Infrastructure bottlenecks has impinged on the performance of the mining and electricity sectors.
4. High inflation and high interest rates which has made borrowing costs higher.
5. The global economic slowdown.
6. Supply-side bottlenecks such as inadequate infrastructure, inadequacy of fuel supply linkages and delays in project clearances of large manufacturing and infrastructure projects

However as per the survey by HSBC Indian manufacturing and services sectors expanded more than China in February 2013. The HSBC composite index for India for manufacturing and services stood at 54.8 in February 2013, whereas it was 51.4 for China.

The Government has been taking confidence building measures for improving the industrial climate and manufacturing in the country. Three important initiatives taken in this regard are announcement of National Manufacturing Policy (NMP), implementation of Delhi Mumbai Industrial Corridor (DMIC) Project and policy reforms to promote Foreign Direct Investment (FDI).

In addition, the Government has initiated implementation of the e-Biz Project, a Mission Mode Project under the National e-Governance Plan (NeGP) for promoting an online single window at the national level for business users. The objectives of setting up of the e-Biz Portal are to provide a number of services to business

users, covering the entire life cycle on their operation. The project aims at enhancing India's business competitiveness through a service oriented, event-driven G2B interaction.

Service Sector

The share of services in India's GDP at factor cost (at current prices) increased from 33.3 per cent in 1950-51 to 56.5 per cent in 2012-13. With an 18.0 per cent share, trade, hotels, and restaurants as a group is the largest contributor to GDP among the various services sub-sectors, followed by financing, insurance, real estate, and business services with a 16.6 per cent share. Both these services showed perceptible improvement in their shares over the years. Community, social, and personal services with a share of 14.0 per cent is in third place. Construction, a borderline services inclusion, is at fourth place with an 8.2 per cent share.

The HSBC Markit services Purchasing Managers' Index (PMI), which gauges business activity from a survey of over 400 companies ranging from banks to hospitals, stood at 50.7 in April 2013

Indian service sector enjoyed foreign direct investment (FDI) inflows amounting to US\$ 4.75 billion during April-February 2012-13, according to the recent statistics released by the Department of Industrial Policy and Promotion (DIPP).

As the Indian economy is gaining due to growth in service sector, government has taken many new initiatives to boost service industry in India.

The initiatives are as follows:

1. Liberalized the FDI policy for the services sector. These include liberalising the policy on foreign investment for companies operating in the broadcasting sector, like increasing the foreign investment limit from 49 per cent to 74 per cent in teleports (setting up up-linking HUBs/teleports) and direct to home (DTH) and cable networks, and permitting foreign investment of up to 74 per cent in mobile TV. Foreign airlines have also been permitted to make investment up to 49 per cent in scheduled and non-scheduled air transport services. FDI, up to 51 per

cent, in multi-brand retail trading and amended the existing policy on FDI in single-brand product retail trading.

2. The insurance sector could invest in the capital markets and other than traditional insurance products, various market link insurance products were available to the end customer to choose from.
3. Rajiv Gandhi Equity Saving Scheme: to allow income tax deduction to retail investors on investing in equities.
4. Insurance companies has been empowered to open branches in Tier II cities and below without prior approval of IRDA.
5. All towns of India with a population of 10,000 or more will have an office of LIC and an office of at least one public sector general insurance company.
6. An ambitious IT driven project to modernise the postal network at a cost of Rs. 4,909 crore. Post offices to become part of the core banking solution and offer real time banking services.

Price Indices and Inflation

The headline inflation measured in terms of Wholesale Price Index (WPI) in 2012-13 (April-December) averaged 7.55 per cent as compared to 9.44 per cent during the corresponding period in 2011-12. Inflation has been in the range of 7-8 per cent in the last twelve months. Overall WPI food inflation comprising primary food articles and manufactured food products, with a weight of 24.31 per cent, averaged 9.08 per cent in 2012-13 (April-December) as compared to 7.91 per cent during the corresponding period in 2011-12. In December 2012, food inflation was 10.39 per cent as compared to 2.70 per cent during December 2011.

The persistently elevated prices for animal products (eggs, meat and fish), the rise in the prices of cereals and vegetables, along with the increase in international prices of fertilizers (non-urea) and the increase in administered prices of diesel have contributed to inflation to differing degrees over time.

The Consumer Price inflation for major indices generally followed a similar trend. The CPI-IW inflation in 2012-13 (April-December) averaged 10.0 per cent as compared to 8.82 per cent in the same period last year. The Central Statistics Office (CSO) launched a new

series of Consumer Price indices from January 2011. All India general inflation for CPI-NS averaged 10.04 per cent in 2012-13 (April-December) and was placed at 10.56 per cent in December 2012. Inflation based on other group specific CPIs (CPI for Agricultural Labourers and CPI for Rural Labourers) also remained in double digit in December 2012. While part of the higher CPI inflation reflects the high weight of food in the consumption basket (46 – 69 per cent), price pressures have persisted in services and housing, which are included in the CPI basket.

The reasons behind persistent inflation are (a) higher international prices of crude, precious metals, edible oil etc. (b) change in dietary pattern leading to structural demand supply mismatch for protein rich items (c) revision in MSP prices for some of the essential commodities (d) revision in petroleum prices in September 2012 among others. Inflation has been a major cause of concern for both the Government and Reserve Bank of India who are taking a number of measures to contain it as indicated.

1. RBI has reduced the policy repo rate under the liquidity adjustment facility (LAF) by 25 basis points from 7.5 per cent to 7.25 per cent with immediate effect.
2. The reverse repo rate under the LAF, determined with a spread of 100 basis points below the repo rate, stands adjusted to 6.25 per cent with immediate effect.
3. The Bank Rate stands adjusted to 8.25 per cent with immediate effect.
4. The cash reserve ratio (CRR) of scheduled banks has been retained at 4.0 per cent of their net demand and time liabilities (NDTL).

Trade

India is the 19th largest merchandise exporter and 12th largest importer in the world with shares of 1.7 per cent and 2.5 per cent in world exports and imports respectively in 2011, as per the World Trade Organization (WTO). In commercial services, India is the 8th largest exporter and 7th largest importer in the world with shares of 3.3 per cent and 3.1 per cent in world exports and imports respectively.

The rate of growth of India's exports was 40.5 per cent in 2010-11. It decelerated in 2011-12 to 21.3 per cent. During 2012-13 (April-

December), exports were valued at US\$ 214.1 billion, registering a negative growth of 5.5 per cent over the level of US\$ 226.5 billion in 2011-12 (April-December). Value of imports during this period was US\$ 361.3 billion, which was marginally lower by 0.7 per cent than the level of US\$ 363.9 billion in the corresponding period of 2011-12. Rising crude oil prices, along with increase in gold and silver prices have contributed significantly to the import bill. Of the total imports, Petrol oil and lubricants imports accounted for US\$ 124.5 billion (34.5 per cent of total import) in April-December 2012. This was 12.2 per cent higher than the level of US\$ 111.0 billion in 2011-12 (April-December). Non-Petrol oil and lubricants imports during 2012-13 (April-December) valued at US\$ 236.7 billion, were 6.4 per cent lower than the level of US\$ 252.9 billion in 2011-12 (April-December). Consequently, trade deficit for 2012-13 (April-December) increased to US\$ 147.2 billion vis-a-vis US\$ 137.3 billion in 2011-12 (April-December).

Thus the biggest risk to the economy stems from the CAD which was historically the highest and well above the sustainable level of 2.5 per cent of GDP as estimated by the Reserve Bank. The priority has therefore been to reduce CAD through improving trade balances. Efforts have been made to promote exports by diversifying the export commodity basket and export destinations.

Recent Measures taken by the government to boost exports

The Union Minister for Commerce, Industry and Textiles has recently announced additional incentives to boost exports. These incentives came in the backdrop of the Annual Supplement of the Foreign Trade Policy announced on June 5, 2012. According to the new guidelines the 2% Interest Subvention Scheme on rupee export credit which is available to certain specific sectors including handicrafts, carpets, handloom, readymade garments, processed agriculture products, sports goods and toys, has been given an extension up to March 31, 2014. At present, the Scheme is scheduled to end on 31st March 2013. Along with this, Small and Medium Enterprises (SMEs) for all sectors will now be able to avail the benefits of the Scheme.

The scheme has been extended to certain specific sub-sectors of the engineering sector.

Government has also announced the introduction of a "pilot scheme" of 2% Interest Subvention for Project Exports through EXIM Bank for countries of SAARC region, Africa and Myanmar. The interest subvention would be linked to the Buyer's Credit Scheme which was introduced in the last financial year being implemented through EXIM Bank, ECGC and the National Export Insurance Account. The "objective of the scheme is to boost India's exports in these countries by providing long term concessional credit through EXIM Bank, as co-financing in infrastructure sectors such as drinking water, housing, irrigation, road projects, renewable energy, etc.

Apart from these, five new countries have been added under the Focus Market Scheme while Eritrea has been added under the Special Focus Market Scheme. The five countries being added under FMS are New Zealand, Cayman Islands, Latvia, Lithuania and Bulgaria. Under FMS Duty Credit of 3 per cent is given on the FoB value of exports. Sixty new products which include Engineering, Rubber, Textiles, Drugs & Pharmaceuticals products among others, and three countries (Taiwan, Thailand and Czech Republic) have been incorporated under the Market Linked Focus Product Scheme.

Banking Sector

Banks as financial intermediaries collect deposits from savers and on-lend these to investors and others. The deposits of banks form the basis of their lending operations. Aggregate deposits of the banking sector increased from an average of Rs. 48,019.8 billion in 2010-11 to Rs. 64,362.3 billion during Q3 of 2012-13. Year-on-year growth of aggregate deposits, however, moderated from an average of 17.9 per cent in Q1 of 2011-12 to 12.87 in Q3 of 2012-13.

Money supply (M3) growth was around 14.0 per cent during Q1 of 2012-13 but decelerated thereafter to 11.2 per cent by end-December as time deposit growth slowed down. There was some pick up in deposit mobilization in Q4, taking deposit growth to 14.3 per cent by end-March. Consequently, M3 growth reached 13.3 per cent by end-March 2013, slightly above the revised indicative trajectory of 13.0 per cent.

NATIONAL INCOME CONCEPT AND ACCOUNTING

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National income accounting is a branch of macroeconomics of which estimation of national income and related aggregates is a part.

Some definitions used in national income concept:

a) What is Economic territory?

Economic territory is the geographical territory administered by a government within which persons, goods and capital circulate freely.

Those parts of the political frontiers of a country where the government of India, does not enjoy the above "freedom" are not to be included in economic territory of that country. One example is embassies. Government of India does not enjoy the above freedom in the foreign embassies located within India. So, these are not treated as a part of economic territory of India. They are treated as part of the economic territories of their respective countries.

For example the U.S. embassy in India is a part of economic territory of the U.S.A. Similarly, the Indian embassy in Washington is a part of economic territory of India.

Based on 'freedom' criterion, the scope of economic territory is defined to cover:

- Political frontiers including territorial waters and air space.
- Embassies, consulates, military bases, etc located abroad, but excluding those located within the political frontiers.
- Ships, aircrafts etc, operated by the residents between two or more countries.
- Fishing vessels, oil and natural gas rigs, etc operated by the residents in the international waters or other areas over which the country enjoys the exclusive rights or jurisdiction.

b) What is the difference between citizen and resident?

Citizenship is basically a legal concept based on the place of birth of the person or some legal provisions allowing a person to become a citizen. On the other hand residentship is basically an economic concept based on the basic economic activities performed by a person.

A resident, whether a person or an institution, is one whose centre of economic interest lies in the economic territory of the country in which he lives. That is NRI are the citizens of India but their economic interest lies in other countries (a engineer working in US thus its economic interest in US) thus NRI are known as Non Resident Indian.

c) What is the difference between National and Domestic Product?

National income and related aggregates are basically measures of production activity. There are two categories of national income aggregates: domestic and national, or domestic product and national product.

Production activity of the production units located within the economic territory is domestic product irrespective of whether carried out by the residents or non-residents i.e. irrespective of whether performed by citizen of India or not.

National product includes production activities of residents irrespective of whether performed within the economic territory or outside it (such as workers working in Gulf countries).

National product is derived in the following way:

National product = Domestic product + residents contribution to production outside the economic Territory - non-residents contribution to production inside the economic territory.

In practical estimates the resident's contribution outside the economic territory is called "factor income received from abroad". The non-residents' contribution inside the economic territory is called "factor income paid to residents".

Therefore, National product = Domestic product + Factor income received from abroad - Factor income paid to abroad.

d) What is the difference between Gross and Net?

Gross means total value of products received from the buyer i.e. if I bought a laptop and pay 1000 rupees then it is gross and net is what is received by company after deducting the depreciation cost, excise duty, taxes etc i.e. finally company may receive 600 rupees after deducting all this. Then it is known as Net.

e) What is the difference between market price and Factor cost?

If, I buy a bike of 50000 rupees this is the Gross amount (as discussed above) and when taxes and depreciation are deducted it becomes Net.

Some companies even get subsidies for their products.

Thus Market price is 50000 rupees and Factor cost is market price - indirect taxes + Subsidies.

This is what is actually available to production units for distribution of income among the owners of production house.

Thus National income is defines as the Net National Product at Factor Cost.

Methods for estimation of National Income

The flow of production, income and expenditure never stops. It is a circular flow without a beginning or an end. Production generates income; income generates demand for goods and services. And demand leads to expenditure on the goods and services produced, so that, the circle of production, income and expenditure always continues. Production aspects point to the flow of goods and services in the economy or the process of value adding. Income or distribution aspects points to the generation of income in terms of the wages, interest, rent and profit and,

expenditure or disposition aspect indicates disposal of income in terms of consumption expenditure or investment expenditure.

National income of a country is measured at three different levels:

1. Output or Production Method: This method is also called the value-added method. This method approaches national income from the output side. Under this method, the economy is divided into different sectors such as agriculture, fishing, mining, construction, manufacturing, trade and commerce, transport, communication and other services. Then, the gross product is found out by adding up the net values of all the production that has taken place in these sectors during a given year.

In order to arrive at the net value of production of a given industry, intermediate goods purchased by the producers of this industry are deducted from the gross value of production of that industry. The aggregate or net values of production of all the industry and sectors of the economy plus the net factor income from abroad will give us the GNP. If we deduct depreciation from the GNP we get NNP at market price. NNP at market price - indirect taxes + subsidies will give us NNP at factor cost or National Income.

The output method can be used where a census of production for the year is calculated. The advantage of this method is that it reveals the contributions and relative importance and of the different sectors of the economy.

2. Income Method: This method approaches national income from the distribution side. According to this method, national income is obtained by summing up of the incomes of all individuals in the country. Thus, national income is calculated by adding up the rent of land, wages and salaries of employees, interest on capital, profits of entrepreneurs and income of self-employed people.

This method of estimating national income has the great advantage of indicating the distribution of national income among different income groups such as landlords, capitalists, workers, etc.

3. **Expenditure Method:** This method arrives at the national income by adding up all the expenditure made on goods and services during a year. Thus, the national income is found by adding up the following types of expenditure by households, private business enterprises and the government: -

- a) Expenditure on consumer goods and services by individuals and households denoted by C. This is called personal consumption expenditure denoted by C.
 - b) Expenditure by private business enterprises on capital goods and on making additions to inventories or stocks in a year. This is called gross domestic private investment denoted by I.
 - c) Government's expenditure on goods and services i.e. government purchases denoted by G.
 - d) Expenditure made by foreigners on goods and services of the national economy over and above what this economy spends on the output of the foreign countries i.e. exports - imports denoted by (X - M).
- Thus, $GDP = C + I + G + (X - M)$.

Limitations of National Income Estimation in India

There are limitations in the estimation of National Income in India. These are:

- a) The output of the non-monetized sector is totally excluded. A difficulty arises in

finding out the imputed value of the produce of the non-monetized sector.

- b) Non-availability of data about the income of small producers or household enterprises.
- c) Lack of differentiation in economic functions.
- d) Absence of data on income distribution.
- e) The illegal income remains unreported.

Brief history of National income concept

In 1876, DadaBhai Naoroji was the first person to prepare estimates of national income and per capita income for the year 1867-68. DadaBhai Naoroji estimated national income at Rs 340 crore and per capita income of Rs 20. Professor V.K.R.V. Rao estimated National Income for the year 1931-32 at Rs 1689 crore and per capita income at Rs 62. Ministry of Commerce (Govt. of India) estimated national income at Rs 6234 crore and per capita income at Rs 198 for the year 1945-46. Presently Central Statistical Organization measures the national income of the country.

According to UN "an under developed country is one in which per capita real income is low when compared to that of US, Canada, Australia and western Europe.

But a comprehensive measure of development must take into account the potential of an economy to use its human, natural and capital resources to raise the level of living of its population.



Overview of Indian planning

When India became independent in 1947, it was gripped by mass poverty, literacy, unemployment, low industrial development, etc. After the independence the leaders of independent India had to decide on the type of economic system most suitable for our nation based on the principles guided by the Directive Principles i.e. a system which would promote the welfare of all rather than a few.

The Directive Principles of the Constitution lays down that: the State will direct its policy towards securing that a) all citizens, men and women equally have a right to an adequate means of livelihood; b) the ownership and control of the resources of community are so distributed as best to achieve common good; c) economic development should not lead to concentration of wealth.

There were mainly two types of economic systems: **Capitalist and Socialist** and among them, socialism has been chosen by Jawaharlal Nehru however not in toto. Nehru, and many other leaders and thinkers of the newly independent India, sought an alternative to the extreme versions of capitalism and socialism i.e. a mixed economy where private and public entities will collaborate together to achieve a suitable economic development. Thus Indian government after being formally declared republic in January 1950, embarked on a strategy of five year plans which spells some general goals as well as specific objectives which are to be achieved within a specified period of time. (Planning means a systematic utilization of the available resources at a progressive rate so as to secure an increase in output, national dividend, employment and social welfare of people).

Economic planning refers to any directing or planning of economic activity by the state, in an attempt to achieve specific economic or social outcomes. Planning is an economic mechanism for resource allocation and decision-making in contrast with the market

mechanism. Most economies are mixed economies, incorporating elements of market mechanisms and planning for distributing inputs and outputs and India is one of them.

India adopted planning in the 1950s as a vehicle of its development. Planning derives its objectives and social promises from the Directive Principles of State Policy enshrined in the Constitution. The country has completed ten Five Year Plans and is currently engaged in implementing the Eleventh Plan.

Each Plan registers gains—and some inadequacies. The succeeding Plan should take full cognizance of all these changes, no less than their implications. The broad goals and objectives of the State Plan are generally in conformity with the National Plan although the strategies, thrust areas and programmes may vary.

Issues in Development

The immediate goal for achievement was to increase living standard, decrease in poverty, increase in agricultural and industrial production, employment, savings and capital formation and improvements in infrastructure. Apart from the overall development, achieving some social objectives was also given prime importance as India followed Soviet model of socialist form of production. Among social objectives reducing income inequalities and reaching benefits of development to deprived sections of population were considered of prime importance.

Achievement of the fore mentioned goal was not an easy task as the state of infrastructure was awry, low availability of capitals, unskilled and ill equipped labour force and low productivities in most of the sectors. Along with these problems the other factors that hindered development were reaching of the benefits of the developments to the lowest strata of society, translating investment into production. Similarly, translation of the savings into

productive investments, increasing savings to finance capitals, financing of current and capital consumption were some other problems that were encountered in the process of development. The inadequate financial infrastructure and absence of well developed financial market entailed the problem of such fruitful conversion of whatever little savings were available for finance.

Other structural backwardness relate to major obstacle to development of the economy. These structural backwardness pertained mainly due to acute deficiency of capital, low rate of capital accumulation due to low capacity to save and inadequacies in converting the domestic savings into productive investment due to lack of infrastructure. Also, agriculture sector was marked with underemployed labourers, reducing productivities and diminishing returns due to fragmentation of holdings.

Another problem faced by the formulators was the limited choices available in the form of trade off between present and future consumption. Policy formulators faced with the problem of financing current consumption at the cost of foregoing capital formation with small availability of limited finance and budgetary provisions to increase expenditure. The other major policy dilemma was bringing the social justice by reducing the inequalities in income, on the other hand allowing some inequalities to foster to create new class of entrepreneurs in the society.

Technical Approach for Planning in India

The techniques that are applied in economic planning can be broadly classified under overall regulation of economic activities through fiscal and monetary measures and the other is through sectoral policies to regulate the economic activities. The sectoral policies were based on the objectives to have a balanced regional growth. The Indian planners followed expansionist fiscal and monetary measures as would have done by any of the developing countries to increase the income and spending.

Demand and supply management became a major concern with the growing economy as the structure became more complicated. Later on persistent inflationary pressures build up limited the scope of monetary policies. Initially

it was assumed that in process this could get corrected with the passage of time by itself given unlimited supply of foreign exchange that can be utilized to finance imports. The imports would also help in augmenting the domestic supplies that would help in controlling demand.

Initially the fiscal policies that was sought to be expansionist was sought through deficit financing, which later on could get controlled by controlling and curtailing government expenditures. But later on large government deficit became a major problem as most of the revenues from the taxes were utilized in deficit financing. It left little scope for social sector development finance.

Among different sectors agricultural output and development were sought to be augmented by developing suitable developmental programmes and providing assistance to the farmers to help bridge the credit gap. Subsequently, government also resorted to providing subsidy to provide agricultural assistance for inputs. Also industries like chemicals and fertilizers were also subsidized for many years and are still being done so to develop agricultural. However in subsidization of the industries and the sectors it became a major hurdle in germinating inefficiencies and uncompetitiveness of these industries that became a burden rather than of any help.

In absence of free market the price mechanism fell into sole and whole purview of the government. Various price policies were formulated that helped regulate the supply and demand in different sectors. Thus industries and agriculture were subjected to various price control mechanism. Industrial pricing were introduced. In the sixties agricultural price commission was also established to control the agricultural prices of important food grains and commodities. Apart from the price control mechanism these sectors were also subjected to various qualitative and quantitative controls.

In agricultural sector pricing public distribution system and procurement policies played an important role. Building infrastructure like public distribution system would help the government in directly influencing the market price. This would help government in controlling the agricultural prices and checking inflationary pressures due to increases in food prices. In case of inflationary

pressures the government through increasing its market intervention can augment the market supply of commodities.

PLANNING HISTORY

The planning history can be discussed as a constituent of two phases. First phase constituting of sustained growth phase for the years from 1950–51 to 1964–65. Second phase constituting since 1964–65 till date has been termed as slowing down phase. The growth phase constituted for the first three plans i.e. 1st, 2nd, 3rd plan periods, country's output or production, per-capita income, infrastructural developments in terms of establishing institutions and industrial as well as financial infrastructure, all grew at phenomenal rate however rate was slower than projected in plan. However the growth rates trailed behind as per the projections in the plan documents. In discussing the plan history it is most important to discuss the second plan as it marks the turning point for Indian economy as the growth trajectory was based on the basis of Mahalanobis formulation.

The economic growth was expected to take place through modern industrialization, thus expected to be replica of industrialization in advanced countries. But in the Mahalanobis strategy stress were placed on import substitution by developing the countries capabilities in producing capital goods. It was on this line that during the second plan there were substantial public sector investment in infrastructure and industries that produced intermediate goods like steel, coal, power and heavy electrical machinery. The cottage and small scale industries expanded only to the extent that it provided large scale employment to labour. Thus the phase recorded 8 to 10 per cent growth in industrial output, 3–3.5 per cent growth in agricultural output and 1.75% growth in per capita income.

During **First Plan Year** that is in 1951–56 was a reflection of basically reconstructing the tattered economy and establishing infrastructure and institution to enable the country run on its own. Initially the planners formulated policies based on supply side of the economy ignoring any deficiencies in aggregate demand. Also the public investment in the areas in sectors that had large gestation lag, public utilities and

sectors that required heavy investment were taken to be of prime importance. Thus in the initial plan document investment in public sector unit that were of importance to the country's defence like arms and ammunitions, artilleries, infrastructure like power, road transport and railways were undertaken. Also developing heavy industries like electrical industries, iron and steel, aluminium, etc. were undertaken. Apart from this public investment in agriculture sector were also undertaken to increase the production as well as the productivities.

Second plan for the growth of economy was given the prime importance. During this plan investments were increased to promote industrial development thus taking industrialization as the impetus for growth. Industrialization based on Mahalanobis model was unveiled. Import substitution and enlarged public sector investment with focus on establishing PSUs in the areas that required huge investment were given importance.

Third Plan and Fourth Plan were resultants of repercussion of first and second plans when the formulators realized that industrialization alone without giving adequate attention to other sector growth resulted in failure of 1st & 2nd Plan. Thus the need to develop agriculture sector and infrastructure was paid attention to in these plans. It was during these years that Green Revolution was undertaken to boost agricultural production with the help of increase in yield. Thus, taking the country back to growth strategies with overall development taking place in almost all the sectors of the economy. It was during this time period that the government formulated suitable agricultural price policy and came up with public distribution system concept. These two policies helped the government in getting the control of the market where it enabled the government on playing a more proactive role in dealing with situations of price rise and food security. Also it helped the government in addressing the issues of poverty where it tried to provide the people living below poverty with food grains through rationing.

During **Fifth and Sixth five year plan** a shift in strategies were warranted as the population growth rate became very high making all the plan formulation fail. Thus these two plans

were based on assessment of the economic situation. Though during these two plans the prime concern remained increasing GDP growth rate with focus on overall development along with increasing the per capita income. In the back drop the population control became major concern of the formulators. With growth in population above the natural rate some other issues became pertinent like issues of growing unemployment, decrease in productivities, inefficient use of capital, issues of growing demand for food and other items, increasing urbanization leading to migration, increasing landless laborers, decrease in agricultural productivities even after experiencing initial spurt of green revolution due to lack of infrastructure and inputs, building up of inflationary pressures and illiteracy. These factors were supposed to form the basis of seventh plan.

Increasing population and growing demands led to increasing need to improve the agricultural production not only to make the economy self reliant but also to meet the other impending factors arising out of it like enhanced need to achieve a food security system. Though improving the existing pds and procurement system played an important role, however increasing agricultural productivities by expanding green revolution to other crops like rice and other cereals did form the original basis to achieve the goal. Apart from this improving agricultural infrastructure increasing irrigation and extension of credit assistance, these issues were also addressed.

Besides agriculture sectors manufacturing and other secondary sector industrial problems were also scrutinized and addressed. Basic issues that were identified were low productivities in secondary sector, low capacity utilization of existing capital resources and incompetetiveness in terms of cost and scale of operations of some of the public sector units came up. Some other factors that contributed to these inefficiencies in running were excessive protection provided to these organizations. Thus the **seventh plan** was targeted to address these issues. There was shift in focus of planning for industry away from getting in any new investment to existing optimum capacity utilization and productivity enhancement.

In the external sector appropriate export policies were also postulated to improve the

countries balance of payment position. Shrinking external assistance was also one of the factors that compelled the policy makers to look for export sectors as an alternative. Thus the seventh plan postulates the integration of export policy with all policies and programmes that affected productivity and costs.

Growing unemployment, lack of skilled laborers, increasing illiteracy, increasing migration of rural laborers to the urban areas as effect of urbanization led to developing new policies to increase employment and education. Thus the policies focused on universalisation of education, increasing educational infrastructure and skill formation. Also issues related to unemployment were addressed. Apart from stress on cottage and small scale, other government programmes that assisted in addressing the unemployment issuses in rural and urban areas were also undertaken. Thus many of the government programmes like integrated development programmes, trysem etc were launched that had inbuilt and integrated component directed to increase employment. Some of the poverty alleviation programmes were also launched to address the issue of increasing poverty like Minimum Needs Programmes.

Eighth Plan and Liberalization in India

During seventh and eighth plan many factors emerged for non performance of the economy on the whole with industrial sector registering almost negligible growth and the GDP growth rates hovering around 3.5 per cent. Thus addressing these major issues were given prime importance in Eighth plan. The collapse of Rupee Trade area and failure of the economic off take to targeted growth path led to a series of reforms in many sectors. The Eighth plan is also popularly known as 'Liberalization' of the economy. The liberalization policies were unveiled by then Finance Minister Dr Manmohan Singh in the year 1991-92. This was accompanied with substantial opening of the economy.

The frame work for the eighth plan encompassed four important macroeconomic aspect related to liberalization. These were the policy regime governing the trade, technology and trans-border capital flows; industrial deregulation and administered price policy; financial sector reforms; and effective monetary

and fiscal policies enactment to regulate aggregate demand in the economy. These policies are discussed briefly in the following sections.

- **Trade, technology and capital flows**

Series of trade reforms were carried that included lowering of customs duties on import and exports, reducing the negative list items, lowering of tariff rates applicable and enacting liberal trade policies. In liberal trade policies incentives were announced to promote exports and imports and capital inflows in EXIM policies. There were substantial reductions in the import duties from 300 to 150, reducing tariffs on export to 110 per cent. Also partial convertibility of rupees was introduced in order to increase the incentives for exporters. Under the system exporters or the foreign exchange earned through the remitters could get converted to rupees with 40 per cent at the official exchange rate and 60 per cent of it at market determined prices.

In order to integrate the economy with external world a series of capital flows policies were also unveiled to increase the foreign direct flow in the economy. The regulation that was liberalized for FDI included technology transfer through automatic route. The technology collaboration and equity participation under automatic route were also allowed up to 51 per cent in almost 31 areas.

- **Deregulation and Price Policies**

Opening of the economy to external sector formed one of the parts of liberalization; along with it privatization of industrial sector formed another significant part. This was done mainly by reducing the bureaucratic interference in industrial operation by liberalizing entry and exit of the private firms, delicensing of many of the industrial units, reducing government stake in industrial sick units either through selling its stake to other private players or closing down of the non performing units. However, disinvestments in large public sector units were strongly opposed and were carried out cautiously in phased manner.

Policies on small sector units that were non-performing were to assist in technological upgradation and modernization. These units were not shut as these were labour intensive and provided employment to millions.

Price policy reforms were also introduced to allow the private players to play dominant role. Many of the products that were tradable and the sector in which competition due to presence of private players was subjected to market determined prices. Whereas for the units that were non- tradable goods and services the government followed long run marginal cost pricing of the production.

- **Financial Sector Reform**

Another integral component of the liberalization policies were financial sector reforms. Under credit lending and interest policies were reformed. Increasing role of the development financial institutions can be witnessed in this period and was duly recognized by the government. Under this regime the lending rates could not be fixed by these DFIs. Also the interest rates charged could not be fixed on the basis of the market conditions by these DFIs.

The banking sector was also subjected to series of reforms. The interest rate structure for the commercial banks was fixed upward. Lending credit limits were raised. Besides giving the banks flexibility to charge credit and lending rates, partial deregulation of term deposit rates of the commercial banks were also carried.

Many other reform policies that suited the new capital market structure where the private sector companies could also raise funds from the market through equity participation were also introduced. Apart from regulations that controlled foreign exchange operations of the market were also liberalized. India also adopted floating system of exchange rate during this time. Many new forms of financial institutions like merchant banking, mutual funds, leasing companies, venture capital companies and factoring companies also came up. However regulatory framework for many of these institutions was developed later.

Credit policies related to lending were based on prioritization. Thus the sectors that were in the priorities for development by the government were given easier access to credit. This helped in developing not only the lagging sectors but also the lagging regions. Extension of banking system and culture through extension services and regional rural banks to

remote places of India were also carried. Earlier the post offices were the only form that helped in reaching the rural India. Thus it helped not only in mass mobilization of capital from rural savings; at the same time it also helped the agricultural sector to avail the facilities of priority lending.

The reforms were also marked by substantial dilution of government stake ownership in the banks and credit lending agencies. This happened mainly on account to the redefining of capital adequacy norms for the banks. The commercial banks that operated internationally had to subsume to a capital adequacy ratio of 8 per cent by March 1994 whereas domestic bank had to accede to a ratio of 4 per cent by March 1993. In case of the banks failing these ratio norms had to tap the capital market for raising funds in the form of loan and equity participation. This led to decrease of government ownership stake in many of the commercial banks.

• Monetary and Fiscal Policies

Monetary and fiscal policies were targeted to regulate and manage the aggregate demand in balance with the increasing aggregate supply so that it would curtail building up of any inflationary pressures. Prior to eighth plan the fiscal deficit had grown disastrously at 11 per cent of the GDP. The eighth plan tried to achieve a 7 per cent deficit. This was done mainly by increasing the revenue base by reforming the tax structure prevalent in the economy. Also prudent government expenditure management by pruning the excess expenditure was sought. The government expenditure had increased from 19 per cent of GDP in seventies to 31 per cent of GDP in 1990-91. This was done by decreasing the non plan expenditure of the states, controlling consumption expenditure and reducing subsidization.

The consumption expenditure of the government rose on account of two variables defence expenditure and increased administrative cost. Government tried to reduce both these cost by reforming the bureaucratic structures and deregulating the large public sector units.

The subsidy element had increased the expenditure of the government by 4 per cent in

the year 1990-91. This accounted mainly for the fertilizer subsidy, food subsidy and interest rate subsidy. Also other subsidization programme like rural subsidy for electrification and others also accounted. Thus government pruned its expenditure by revising its policies and withdrawing subsidy given to many of these units. Subsidy on account of Public distribution system also formed a major chunk thus government reduced its PDS operation and also by reforming the procurement and price policies followed by the government.

The government also tried to increase its revenue resources by substantially improving the tax structure. In it, apart from broadening the tax base the direct tax structure like income tax, corporate tax structures were also modified. Besides improving internal tax, external tariff structures were improved by reducing the external tariff to 110 per cent to increase exports. Lowering of custom duties and other non tariff barriers helped in expanding the foreign trade that helped generate revenue in return. Indirect taxes like sales and excise taxes were also subjected to reform regulations. MODVAT and value added taxes were introduced to reduce the tax distortions in the economy. The Chelliah Committee recommendations for taxes and Official Committee of the government were the two main instrumental forces in introducing the tax reforms in the country. It was on their suggestion that government reformed the system that helped in increasing the revenue from tax.

Ninth Five Year Plan India ran through the period from 1997 to 2002 with the main aim of attaining objectives like speedy industrialization, human development, full-scale employment, poverty reduction, and self-reliance on domestic resources.

The main feature of the Ninth Five Year Plan India is that at its onset our nation crossed the fifty years of independence and this called for a whole new set of development measures. There was a fresh need felt for increasing the social and economic developmental measures. The government felt that the full economic potentiality of the country, yet to be explored, should be utilized for an overall growth in the next five years. As a result in the Ninth Five Year Plan India, the emphasis was on human

development, increase in the growth rate and adoption of a full scale employment scheme for all. For such development one needs to promote the social sectors of the nation and to give utmost importance to the eradication of poverty.

The Ninth Five Year Plan of India looks through the past weaknesses in order to frame the new measures for the overall socio-economic development of the country. However, for a well-planned economy of any country, there should be a combined participation of the governmental agencies along with the general population of that nation. A combined effort of public, private, and all levels of government are essential for ensuring the growth of India's economy.

Objectives of Ninth Five Year Plan:

The main objectives of the Ninth Five Year Plan were:

- To prioritize agricultural sector and emphasize on the rural development.
- To generate adequate employment opportunities and promote poverty reduction.
- To stabilize the prices in order to accelerate the growth rate of the economy.
- To ensure food and nutritional security.
- To provide for the basic infrastructural facilities like education for all, safe drinking water, primary health care, transport, energy.
- To check the growing population increase.
- To encourage social issues like women empowerment, conservation of certain benefits for the Special Groups of the society.
- To create a liberal market for increase in private investments.

The **Tenth Five Year Plan** India (2002-2007) aims to transform the country into the fastest growing economy of the world and targeted an annual economic growth of 10%. This was decided after India registered a 7% GDP growth consistently over the last decade.

This GDP growth of 7% is much higher than the world's average GDP growth rate. Thus, the Planning Commission of India sought

to stretch the limit and set targets which would propel India to the super league of industrially developed countries.

In a nutshell, the Tenth Five Year Plan envisaged:

- More investor friendly flexible economic reforms.
- Creation of congenial investment environment.
- Encourage private sector involvement
- Setting up state-of-the-art infrastructure.
- Capacity building in industry.
- Corporate transparency.
- Mobilizing and optimizing all financial resources.
- Implementation of friendly industrial policy instruments.

Eleventh plan vision included overall improvements of quality of life and welfare of the deprived section of the population. This included Scheduled Castes, Scheduled Tribes, other backward castes, minorities and women. Thus the eleventh plan termed such developmental growth as inclusive growth of the country. Also the plan visualised to integrate the country with global economy, increasing employment opportunities at home, reducing poverty, spread of education and skill development. On numerical front a target of 9 per cent GDP growth every year was targeted and 7.6 per cent annual growth rate of per capita income.

The focus in this plan shifted from increasing the income to improving the livelihood conditions of the population. Until now the manufacturing sector growth and tertiary sector formed the core of planning structure of the five year plan. However in eleventh plan though the manufacturing and tertiary sectors were given attention but the focus shifted to improvement in social and human capital, including agricultural development. The budgetary outlay on improving educational infrastructure and universalisation of education increased from meagre 8 per cent in tenth plan to almost 19 per cent. Apart from this the agriculture, health and rural development expenditure also tripled.

Another prime importance given was on infrastructure where the expenditure is likely to go up to 9 per cent of GDP. The public sector investments also focused on developing the social capital and addressing the equity issues in society. Thus many of the government programmes that strengthened these objectives were given priorities. Also the existing programmes were redefined and many new programmes launched to meet the goal.

Schemes under national rural employment guarantee act (NAREGA) that mainly helped creation of rural employment and rural assets was extended to 330 districts more. Agricultural development under the government programmes like Accelerated Irrigation Benefits, Bharat Nirman, Rashtriya Krishi Vikas Yojna and National Rainfed Area Authority were extended. National food security mission to address the food crisis in India and especially among rural poor was launched. Government also launched national rural health mission scheme to improve the country's health expenditure.

The economic development for the eleventh plan was based on series of model of the economy. A broad framework which represented an indicative planning was prepared. Under this different growth targets for different sectors were fixed to achieve overall 9 per cent annual growth rate for the GDP. There was an increase in investment and saving target though the increased planned for achievement was modest with ICOR remaining more or less the same. However in quantitative terms even the same amount of ICOR (capital output ratio) amounted to a substantial amount. Agricultural growth target was fixed at 4 per cent, industry at 10-11 per cent and services at 9-11 per cent.

Among the industrial growth core sector growth formed the basis of the industrial growth model. This was likely to be achieved with an increase in overall investment to 37-38 per cent on average throughout the plan period. The major structural change in the investment pattern was decrease in share of the public investment in total investment. The private sector investment now accounts for almost 77 per cent in total investment in the economy. Competitive environment was sought to be increased by policy enactment such that the

market mechanism to would play dominant role in reaching equilibrium, also the government role was reduced to minimum. This was furthered by reducing quantitative and qualitative restrictions both for internal private investors and external investors to boost economic growth. Infrastructural development however was left for the public sector investment as government increased its investment in agriculture, irrigation and water management. Thus public sector investment was targeted to increase from 4.1 per cent in 2006-07 to 6.8 per cent in 2011-12.

The increased investment is projected to be most likely to be funded by increasing equivalent increase in savings. Further stress is put on the increase in domestic savings. Whereas the main factors identified for increasing the domestic savings was household savings and corporate savings, the public sector savings played lesser role in it. Though during the seventh plan the public sector savings improved as compared to previous plan on account of the impact of the Fifth Pay Commission's recommendations worked itself out in the system, the implementation of the Fiscal Responsibility and Budget Management (FRBM) Act, and the fiscal and revenue deficit targets for 2008-09 established thereby helped introduce an element of discipline, and the buoyancy in tax revenues arising out of the high growth rate recorded in the Tenth Plan combined with improvements in tax administration contributed to improved savings.

Apart from internal savings and investment identity policies to balance of payment from external account were also unveiled. In the globalised market where the financial system was complicated the role of external factors are important. Thus a series of policies were announced to help the economy not only integrate with globalized market but also avail the opportunities from it. The merchandise trade was further liberalized by reducing the quantitative and qualitative restrictions. Also many new export promoting incentives were announced. To increase both foreign direct investment that were long term and institutional investment that are short term the government reformed its financial and capital markets. For example apart from allowing 51 percent FDI in most of the sectors appropriate special economic zone policies conducive for

direct investment were also enacted during this plan. Direct investment in many of the sectors now flow through automatic route.

APPROACH PAPER TO THE TWELFTH PLAN (2012-2017)

Indian planning has travelled a long distance since its inception in March 1950. The planning has been a mixed experience. On the one hand India has overcome the bottlenecks existing in the form of low saving, low investment, food scarcity, etc. On the other still Indian economy 'tryst with destiny' is far from true realization as socio-economic and human development indicators has been the biggest obstacle for the realization of an egalitarian society.

So far eleven plans have been formulated and implemented. The approach paper to the 12th Plan has been approved by the Cabinet in September. It would be prudent to analyse the performance of the Eleventh Plan as given by the Mid-Term Appraisal of the 11th Plan in brief and then the issues that has been identified by the 12th Plan that need to be overcome.

Eleventh Plan Performance

GDP growth for the 11th Plan is likely to be 8.2%, which is less than the target of 9%, but is a remarkable achievement given the worst drought in 30 years and the global recession. There has also been progress on various aspects of inclusiveness, though the progress has been less than what was targeted. Agricultural growth has improved from 2% in the Tenth Plan to 3%, but this is below the 4% target. There has also been progress in poverty reduction and in the areas of health, education and in upliftment of SC/STs. However, trends reveal that we are likely to miss the Millennium Development Goals (MDGs) in several of the targets, especially those relating to health.

Inflation has accelerated in the past two years and is now an area of concern. The global environment is also highly uncertain, both in terms of the strength of recovery in the developed countries and also the volatility in commodity prices, especially oil. International financial markets are yet to stabilize, and the extraordinary easing of global money supply has yet to play itself out.

Planning Commission has undertaken extensive consultations with a wide range of organizations and individuals, which reveals that citizen groups support the broad objectives of existing government programmes, but they have little faith in the design of these programmes and the manner of execution. There is a perception that government programmes, especially Centrally Sponsored Schemes, are not sensitive enough to local needs. Also, Government works in silos with little effort to achieve convergence and co-ordination across Ministries and between Centre and States, even though most problems require inter-Governmental and inter-Ministerial co-ordination.

Twelfth Plan Objectives

The basic objective for the Twelfth Plan must be faster, more inclusive and sustainable growth.

A key issue is what the Growth target should be. The target of 10% is being mentioned, but assessment of the 11th Plan and uncertain global environment indicates that even 9% will be difficult to achieve. In the short to medium run, the main constraints relate to insufficient agricultural growth leading to inflation, growing skill shortages, and the unsettled global economy. In the longer run, the environment and natural resources, particularly energy and water, pose serious challenges. Therefore 12TH Plan has proposed a target range of GDP growth of 9 to 9.5%.

An inclusive growth strategy is essential to address some of the main growth constraints outlined above, and to make the target growth rate feasible. The following are the key instruments for making growth more inclusive:

- Better performance in agriculture (at least 4% growth).
- Faster creation of jobs in manufacturing through spreading industrial growth more widely.
- Both agricultural and manufacturing growth will depend upon the creation of appropriate infrastructural facilities in a widely dispersed manner. Rural connectivity is particularly important in this regard, especially in the backward areas and the north-east.

- There must be a much stronger effort at health, education and skill development
- Reforming the implementation of flagship programmes to increase their effectiveness in achieving the objective of greater inclusion.
- Special challenges focused by vulnerable groups and backward regions. The need for a special focus on backward regions has particularly become urgent.

Agriculture and Rural Development

Moving forward on the estimated agriculture growth of 3-3.2% in the 11th Plan, 12th Plan has aimed a target of 4% agricultural growth. It is further estimated that cereals will grow only at 1.5 to 2.0%. However, other food (horticulture, dairying, fisheries etc.) need to grow at more than 5%. This calls for a change in agricultural strategy as these are all perishable products, and therefore subject to much higher degree of market risk than food-grains, oil seeds or natural fibres. In the case of these products, which are all relatively high value, investments and institutional development are more important than subsidies or price support systems.

In order to achieve the agriculture growth of 4% 12th Plan has emphasized on raising land productivity and water use efficiency. State specific strategies are emphasised. Dry areas need to focus on livestock. Most importantly, markets must be reformed. An important beginning has been made by granting statutory status to warehouse receipts. However, the real benefits from this measure can accrue only when the appropriate warehouse infrastructure and supporting backward linkages have been created and a nationwide trading platform has been put in place. Consideration should be given to extending infrastructure status to a wider range of agricultural market facilities in the same manner as for warehouses. States must modify the Essential Commodities Act (ECA) and the APMC Act (perhaps exclude horticulture and perishables entirely from the ambit of APMC), rebuild the extension system, increase the involvement of private sector in marketing, and also facilitate leasing in/out of land by farmers. State agricultural universities and extension networks are in a bad shape and need strengthening.

MGNREGS has helped generate employment and income in rural areas but it can do much more to increase land productivity, particularly in rainfed areas. This calls for redesign of the programme in the Twelfth Plan. In addition, MGNREGA has transformed rural labour relations, which is bound to affect the production decisions of farmers, both in terms of crops as well as technologies. The Agricultural support systems must facilitate this transition, which requires greater flexibility and responsiveness. Forest economies and tribal societies need greater protection and promotion. Steps need to be taken to make PESA and FRA more effective. This can be in conjunction with schemes for increasing resources directed to the backward regions.

Water

Water is emerging as a major problem, both for drinking as well as for irrigation. Urban and industrial demand for water is going up rapidly, without commensurate augmentation of supply. To address this critical problem, need is to put an integrated strategy in place immediately. The elements of this strategy could be:

- Re-estimate India's water balance basin-wise. All aquifers must be mapped over the next five years and aquifer management plans put in place.
- AIBP must be restructured to incentivize irrigation reform and efficiency of water use. Setting up Water Regulatory Authority should be made a precondition for AIBP approvals. Some States are already doing this.
- Watershed management must be given higher priority, with convergence of programmes and better technical support.
- Separation of electrical feeders for agriculture with high-quality assured, even if rationed, power supply can potentially reduce ground water use.
- Water recycling in urban areas and by industries should be enforced to protect water levels and water quality in both surface and ground water sources.
- The legal and policy framework needs to be improved. In this direction 12th Plan has considered promulgating a new Groundwater Law reflecting the principles

of Public Trust Doctrine, and a new Water Framework Law along the lines of the one that exists in the European Union.

- A National Water Commission may be put in place to monitor compliance with conditionalities imposed in clearance of important projects.
- Since water is primarily a State subject, we will need to evolve a political consensus along the lines of what was done in the case of power. Perhaps a special National Development Council meeting could be convened for this purpose.

Industry

Manufacturing performance is weak. Growth of manufacturing in the 11th Plan is likely to be only 8%. We need to raise this to 11-12% per year in the 12th Plan to create the jobs for our growing labour force. This has become a particularly urgent need since it is now clear that agriculture will no longer absorb more workers, and may indeed release some of the existing work-force. As per the 12th Plan estimation, the manufacturing sector will have to create around 3 to 4 million jobs over and above the pace of job creation in the recent past.

To achieve the desired growth in manufacturing 12th Plan emphasizes on effectively harnessing the abundance of abundance of entrepreneurial talent in the country. The corporate sector has largely been unfettered, and has demonstrated its dynamism. There are, however, limits to which it can grow. A large part of the additional growth will have to come from the MSME sector, which continues to face a plethora of hurdles in realizing its true potential. The Twelfth Plan will need to focus on this.

For accelerating manufacturing growth, therefore, we need a strategy to:

- Achieve greater domestic value addition and technological depth in Indian industry to cater to growing domestic demand and to improve our trade position.
- Attract investment, including FDI, in critical areas where manufacturing capacity should modernised and developed.
- Improve the business environment and reduce the cost of doing business. This is

largely an agenda item for state governments. (Procedural wrangles and corruption affect small business the most.)

- Land and infrastructure constraints must be addressed effectively. Again, this is largely in the domain of the State, but the Centre can incentivise.
- Promoting “clusters” is a very effective way of helping manufacturing and promoting MSMEs. State Governments should be incentivized to support clusters

Education

Education has received less funds in the Eleventh Plan than was envisaged. This is partly because the sector made a slow start, but also because of resource constraints. The Twelfth Plan has to correct this.

Eleventh Plan focused on quantity in school expansion. In this regard significant success has been recorded with enrolment rates going up rapidly, especially in primary education. However, scholastic achievement tests show that learning achievements of the students are well below desired levels. Twelfth Plan must focus on quality. This includes teacher training and evaluation, and also measures to enforce accountability.

There is need to rapidly build capacity in secondary schools to absorb the graduates from expanded primary enrolments. States must facilitate PPP in secondary education. States are keen to do this, and Planning Commission is collaborating with them on this. The drop-out rates between primary and secondary education continue to be extremely high, which raises questions regarding the perceptions of the utility of secondary education among the people. This will need to be changed through introducing higher skill content at the secondary schools level. Vocational education will need to be given greater emphasis and made more attractive.

The gross enrolment ratio (GER) in higher education must be targeted to increase from nearly 18% today to say 25% by 2016-17 and perhaps 30% by 2020. Private universities and colleges have played a major role in increasing enrolment in higher education in recent years, but there are concerns regarding both equity and quality. Measures will need to be taken to

further promote private initiatives in higher education while addressing the concerns that have arisen. Skill Development needs a major focus at all levels. To ensure that the skills developed also lead to employability, the emphasis in the Approach Paper is on promoting PPP.

Health

The quality of health services needs to be improved through NRHM. Besides, the need is to focus on preventive aspects of health care, particularly drinking water, sanitation, nutrition, better maternal and child services and immunisation.

Shortage of qualified medical personnel at all levels is a major hurdle in improving the outreach of the healthcare system, especially the public health facilities. This needs to be corrected expeditiously. Efforts are already underway to increase the out-turn of doctors. This will have to be accelerated, and similar efforts have to be put in place for nurses and medical technicians. However, such efforts will take time to have sufficient impact. In the meanwhile, systems will need to be put in place for more effective PPP models in primary health care.

Role of PPP in secondary and tertiary health care must be explored with greater vigour. Planning Commission needs to evolve appropriate concession models to facilitate this. Planning Commission is in touch with states to study their experiments, and best practices will need to be propagated in the country.

Expenditure on health by the Centre and States needs to be increased from 1.3 percent of GDP at present to 2.0 percent (and perhaps even 2.5 percent) by the end of 12th Plan.

Energy

GDP growth of 9% requires commercial energy growth of 7%. The likely achievement in 11th Plan is 5.5%. Unless adequate growth in commercial energy availability is ensured the GDP growth target cannot be achieved.

The following policy issues have to be addressed.

- The need to create 100,000 MW of new power capacity in the Twelfth Plan. The ability to do so is seriously undermined by

persisting large losses in the discoms, estimated at Rs.70, 000 crore per year. These losses are being sustained only because banks continue to lend to what are effectively bankrupt discoms. State Governments have to be incentivised to implement distribution reforms which reduce ATC losses. Some states are succeeding but in general the progress is too slow. Better performing states should be rewarded.

- Forest and environment clearance procedures are hindering both coal availability and hydro-power development. State governments with coal and hydro resources have been complaining strongly about the costs being borne by them.
- The implementation of past policy initiatives is incomplete. Prices of electricity are not sufficiently flexible and regulators are being restrained from allowing periodic price increases. Open access is still not a reality, and needs to be incentivized.
- At present, petroleum, gas and coal prices all three are out of line with world prices and world energy prices are unlikely to soften. Domestic prices need to be better aligned to give the right signals to both consumers and investors. The need is to adopt a time-bound programme to achieve this alignment over three years.
- Coal production will be a major constraint partly due to weak performance of Coal India and partly environmental constraints. Because coal production cannot be increased sufficiently, we must plan now for coal imports to rise from 80 million tonnes to 250 million tonnes by the end of the 12th Plan. This will require corresponding expansion of rail and port capacity.
- Coal India must become a coal supplier and not just a mining company. It should plan to import coal and carry out price pooling and blending to meet the needs of the users.
- In the petroleum and natural gas sector, need is to further expansion of new NELP blocks and a clear policy for exploration of shale gas, integrated development of oil and gas blocks. Bidding in various oil exploration rounds in the past has not

attracted oil majors. Term of PSCs should perhaps be clear to attract investment. This is an area where foreign participation in exploration also brings in up-to-date technology.

- Nuclear power programme must continue, with necessary safety review. Active efforts need to be made to allay the apprehensions of people regarding the safety of nuclear power plants.
- Solar mission is seriously underfunded and requires more support. It is also not clear whether the current bidding process is sufficiently competitive and provides appropriate incentives for improving efficiency. Wind power too requires greater support, especially for off-shore locations which have not been sufficiently explored.
- Demand side management of energy is as important as action on the supply side. Realistic pricing will help. However, we also need more pro-active standard setting for appliances, vehicles and buildings.

Transport

GDP growth at 9% or more will need to be supported by much faster expansion in transport infrastructure than we have seen in the past. The requirements of energy efficiency also require a shift from road to rail in freight.

The following are some of the important issues that arise:

- The Dedicated Freight Corridor project is a major capacity enhancing investment for the Railways. It must be put on a monitoring system such that both corridors are completed before the end of the Twelfth Plan. For this purpose, milestone must be clearly fixed, and responsibility assigned.
- The Railways have to undertake an ambitious programme of modernisation and technical upgradation which increases their freight carrying capacity. Unless this is done they will not be capable of facilitating the shift from road to rail transport which is crucial for energy efficiency. This can only be achieved if (a) the Railways desist from diverting resources to gauge conversion and uneconomic passenger lines and (b) Railways financing is improved to be able to support medium term expansion.

- Improved Railway financing requires rationalisation of freight: passenger fares in the Railways. If this is not done, the Railways will simply not achieve financial viability.
- The Railways must move speedily to implement the PPP projects that are pending in diesel and electric locomotives.
- Rail and road linkages to ports must have top priority.
- The NHAI programme needs to be put on a track where monitorable milestones targets are set for the 12th Plan with maximum emphasis on viable BOT projects to reduce the demand for Government resources.
- The port expansion programme has been seriously delayed. PPP in ports should be exploited. Much more needs to be done to deepen ports.

Plan Size and Resources

In this regard, as in the past, a Working Group has been set up under the Chairmanship of the Chief Economic Adviser. The size will depend upon:

- the buoyancy in revenues
- the tolerable level of the fiscal deficit
- the extent to which we can control non-Plan expenditure including subsidies.

A tentative picture available at present suggests that the Centre's GBS could increase from 4.9% of GDP in 2011-12 to 6.2% of GDP in 2016-17. Most of this increase will be in the last two years of the Plan since in the first three years the fiscal deficit will have to be compressed from 4.6% in 2011-12 (the base year) to 4.1%, 3.5% and finally 3.0% in 2014-15.

A key assumption affecting the resource projection is that non-Plan expenditure growth can be contained below GDP growth. The absence of a Pay Commission in this period will help. However, critical to this projection is the assumption that subsidies will grow by only 5% per year. It may be difficult to contain food subsidy within that limit, depending on the outcome of the Food Security Act. However, strong action will be needed in containing fertiliser subsidy and petroleum subsidies.

Allocation Priorities in the 12th Plan

The increase in the GBS as a percentage of GDP between 2011-12 and 2017-18 is therefore only 1.3 percentage point. However, the need is to provide a significant increase for health, education, and infrastructure as a percentage of GDP.

Health and Education received only about 60% of the planned allocation in the 11th Plan as against an over-all realization of 87%. This was partly on account of major new schemes being launched during the Plan and partly due to limitations in the absorptive capacity in these sectors. The preparatory work done during the 11th Plan has led to significant improvement in absorptive capacities, and these sectors both require and are ready for significant increases in allocations. It is estimated that the GBS allocated to these two sectors, including skill development initiatives, will need to be increased by at least 1.2 percentage point of GDP.

Infrastructure investments have seen significant improvement during the 11th Plan, but the pace of infrastructure development needs further acceleration if the glaring infrastructure gaps are to be bridged within a reasonable time-frame. Although PPPs have been successful in a number of infrastructure sectors, and efforts will need to be continued in further encouraging private sector involvement, it is felt that public investment in infrastructure, particularly irrigation, watershed development and urban infrastructure, will need an additional 0.7 percentage points of GDP increase over the next five years.

These sectors will therefore need an increase of 1.9 percentage points of GDP as GBS during the 12th Plan. The GBS for the other sectors as a percentage of GDP must therefore go down. The allocation of these sectors will increase in absolute terms, but more slowly than real GDP. This reprioritisation must be accepted.

The above situation emphasises the importance of resorting to PPP as much as possible. This is particularly important in the social sectors, where only tentative beginnings have been made. Several states have initiated interesting models of PPP in social service delivery. These experiments need to be evaluated and best practices up-scaled to the national level.

The innovations made at the state level in a range of sectors make a compelling reason for reconsideration of the Centrally Sponsored Schemes (CSS). The States have consistently argued that the CSS are structured too rigidly to permit innovations and to meet local specificities. There is merit in this argument. It is, therefore, proposed to reduce the number of CSS to only a few major schemes which are of a national character and dictated by the rights and entitlements of citizens. For all the rest, it is proposed to create flexi-funds in the concerned Ministries which can be used to support state-level innovations and/or up-scaling of successful experiments. The success of the Rashtriya Krishi Vikas Yojana (RKVY), which is in effect a flexi-fund scheme, as compared to the other CSS lends further credibility to this approach.

A compelling argument has also been made regarding the lack of ownership of the CSS by the States, and its consequent effect in terms of poor implementation. It has been proposed therefore that the model used in the new APDRP should be extended to all other CSS as well. In this model, central funds are initially provided as loans to the state governments, which are subsequently converted to grants on achievement of pre-specified outcome or output targets.

Governance and Empowerment

Citizen feedback reveals general unhappiness with governance and public service delivery. Four important dimensions have been pointed out: (i) programmes and schemes are often designed without adequate understanding of the desires and limitations of the beneficiaries, especially the most disadvantaged; (ii) systems for informing the people of their rights and entitlements are very poor and often exclusionary; (iii) the service delivery personnel, apart from issues of corruption, are inadequately informed of their duties and responsibilities and take little pride in their work; and (iv) complaint redressal systems are not independent of the delivery mechanism resulting in non-responsive behavior.

People should be active agents of change and this can be achieved only if flagship programmes provide human and financial resources for social mobilization, capacity

building and an information strategy. The involvement of civil society organizations (CSOs) in programme design through wide consultations should become a norm. Delivery and policy functions, the latter including concurrent evaluation, need to be separated in Government Ministries in order to introduce objectivity in programme design and redesign. Consideration needs to be given to setting up professionally managed delivery organizations with clear mandates and accountability.

Information dissemination methodologies need to be entirely recast. The poorest and most disadvantaged need to be targeted specifically. It is also felt that women and the youth are the most effective agents of change, and advantage should be taken of organizations which work closely with them to spread relevant programme information through formal and informal channels.

Total Quality Management needs to be introduced at all levels in service delivery organisations. Training of service delivery personnel and periodic review of performance are essential.

Complaint recording and redressal systems have to be created at an arm's length from the delivery system, and these should be empowered to enforce and monitor compliance. Advantage can be taken of IT systems to increase transparency and responsiveness.

Government departments engaged in related areas tend to work in silos. The need is for much better mechanism for converging the activity of these departments. In many areas there is need for effective mechanisms for resolution of inter-Ministerial and inter-departmental differences. This is particularly true in the field where the Collector is potentially the only possible focus of convergence but is actually far too overburdened.

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PUBLIC FINANCE IN INDIA

CHRONICLE
IAS ACADEMY
A CIVIL SERVICES CHRONICLE INITIATIVE

PUBLIC FINANCE

It is that branch of economics that studies about government finances. Government finances have two main components-(1) Public Revenue and (2) Public Expenditure.

PUBLIC REVENUE

Public revenue refers to revenue of the government from tax and non-tax sources. There are two broad sources of public revenue- Tax and non-tax sources. Taxes are compulsory levies, which every citizen is legally obliged to pay to the government. Taxes are broadly categorised as direct and indirect taxes. The non-tax sources of public revenue are mobilised from a variety of sources. The non-tax sources include, among others, the surplus and profit generated in the commercial undertakings of the government, the savings and profits of the Public sector undertakings, market borrowings, interest, repayment of principal by the debtors, the disinvestment proceeds of Public sector undertakings, signoirage, etc.

Tax Base

Tax base refers to the base on which a tax is levied. Some taxes are levied on income (income tax, corporate tax, profit tax, presumptive tax, etc.) whereas some other taxes are levied on commodity production and sale (excise duty and sales tax). Taxes are also levied on cross border transactions or movements of commodities (customs duty).

Direct and Indirect Taxes

All taxes have been broadly categorized as direct and indirect taxes.

Direct Taxes: In the colloquial sense, a direct tax is one paid directly to the government by the persons (juristic or natural) on whom it is imposed (often accompanied by a tax return filed by the taxpayer). Examples include some income taxes, some corporate taxes, Property Tax, Wealth Tax, Expenditure Tax and transfertaxes such as estate (inheritance) tax and gift tax.

Indirect Taxes: An indirect tax or "collected" tax is one (such as excise duty, customs duty, sales tax or value added tax or VAT) which is collected by intermediaries who turn over the proceeds to the government and file the related tax return. Some examples of indirect taxes are-Excise Duty, Customs Duty, Sales Tax, etc.

Impact and Incidence of Taxes

The impact of a tax refers to the first point of levy of a tax whereas the incidence of a tax refers to the final resting point of a tax. Now, the taxes in which the impact and incidence lie at the same point are not shiftable, hence, they are direct taxes. On the other hand taxes in which impact of taxes is at one point and the incidence is on another point, they are shiftable, hence, they are indirect taxes.

Canons of a Good Tax

Adam Smith has prescribed four canons of a good tax. They are:

- (i) **Canon of Equality:** According to this canon, taxes should be in proportion to the ability of tax payers of different economic classes.
- (ii) **Canon of Certainty:** A good tax must be certain and not arbitray in terms of time and mode and manner of payment, the rate of taxes to be paid, etc.
- (iii) **Canon of Convenience:** The mode and timing of tax payment should be convenient to the tax payer.
- (iv) **Canon of Economy:** The cost of collection of taxes should be minimum. Some more canons of a good tax were added later by public finance experts. The important among them are:
- (v) **Canon of Productivity:** It is called the canon of fiscal adequacy as well. According to this canon, a tax must be able to garner sufficient public revenue for the treasury so that the government can avoid deficit financing.

- (vi) **Canon of Buoyancy:** The tax revenue should have an inherent tendency to increase along with the increase in national income, even if the rates and coverage are not revised.
- (vii) **Canon of Flexibility:** The taxes should be flexible enough so that tax authorities can revise the tax rate or its coverage or both as per need of the hour.
- (viii) **Canon of Simplicity:** The taxes should be simple to understand and administer.
- (ix) **Canon of Diversity:** A tax system should permit diversity and variety of taxes rather than relying on a few taxes.

Constitutional Provisions to Levy and Collect Taxes

The central and state governments need funds to meet various socio-economic obligations. The constitution has clearly mentioned about the powers of centre and the states with regard to levy and collection of taxes. Among the taxes levied and collected by the central government the most important are the central excise duty and customs duties, apart from income and corporation taxes. But the centre is required to share the proceeds of excise and income taxes with the states. The state governments have the sole authority to levy taxes on land and agriculture. There is provision of some local taxes such as property taxes, octroi, profession tax, etc. that local bodies can levy.

Till 1st April 2005, every state had its own sales tax system, wherein they levied and collected it with their own machinery. From 1st April onwards, 21 states have shifted to a system of unified VAT.

The Union taxes as laid down in List-I of the Seventh Schedule of the Constitution are as follows:

1. Taxes on income and other than agricultural income;
2. Corporation tax;
3. Customs duties;
4. Excise duties except on alcoholic liquors and narcotics not contained in medical or toilet preparations;
5. Estate and succession duties other than on agricultural land;
6. Taxes on capital, value of assets, except agricultural land, of individuals and companies;

7. Rates of stamp duties on financial documents;
8. Taxes other than stamp duties on transactions in stock exchanges and future markets;
9. Taxes on sale and purchase of newspapers and on advertisements therein;
10. Taxes on railway freight and fares;
11. Terminal taxes on goods or passengers carried by railways, sea or air and
12. Taxes on the sale and purchase of goods in the case of interstate trade.

The taxes under State List as given in the List- II of the Seventh Schedule of Indian Constitution are as follows:

1. Land revenue;
2. Taxes on the sale and purchase of goods, except newspapers;
3. Taxes on agricultural income;
4. Taxes on land and buildings;
5. Succession and estate duties on agricultural land;
6. Excise on alcohol liquor and narcotics;
7. Taxes on the entry of goods into a local area;
8. Taxes on mineral rights, subject to any limitation imposed by parliament;
9. Taxes on the consumption and sale of electricity;
10. Taxes on vehicles, animals and boats;
11. Stamp duties except those on financial documents;
12. Taxes on goods and passengers carried by board or inland waterways;
13. Taxes on luxuries including entertainments, betting and gambling;
14. Tolls;
15. Taxes on professions, trades, callings and employment;
16. Capitation taxes, and
17. Taxes on advertisements other than those contained in newspapers.

The Concurrent List of Taxes Include:

1. Taxes on Motor vehicles
2. Stamp duties on non-judicial stamps

Duties levied by the Union and collected and appropriated by States:

1. Stamp Duties

2. Excise duties on medical preparations containing alcohol or narcotics

Taxes levied and collected by the Union and fully appropriated by the States:

In this case although taxes are levied and collected by the Union government, the entire proceeds are assigned to states in proportion determined by the Parliament.

1. Succession and estate duties;
2. Terminal taxes on goods and passengers;
3. Taxes on railway freight and fares;
4. Taxes on transaction in stock exchanges and future markets;
5. Taxes on the sale and purchase of newspapers and advertisements therein.
6. Proceeds of additional excise duties on mill-made textiles, sugar and tobacco. These taxes were levied in 1957 by the Union in lieu of states' sales taxes on these commodities, are wholly distributed among the states in a manner that ensures their past income from the same intact.

Taxes levied and collected by the Union and Proceeds partially shared with States:

1. Income Tax
2. Union excise duties

Some other notable points:

- The union government has exclusive power to impose taxes, which are not specifically mentioned in the State or Concurrent List.
- The property of the Union is exempted from state taxation and the property and income of the states are exempt from Union taxes.
- The Parliament may pass legislation for taxation by the Union of any trading or business activities of a state, which are not part of the ordinary functions of the Government.
- States may delegate part of their taxation powers to the central government. The provision has been applied in the case of agricultural land, which has been included in the purview of Estate duties in many states.
- Parliament has exclusive powers to tax

sales or purchases of goods in the course of the inter-state trade.

- In view of increased role of state governments and limited sources of revenue, the Constitution of India has provided for the devolution of resources from the Center to the States.
- For devolution of certain central taxes' proceeds to the states, the Article 280 of Indian Constitution provides for the setting up of a Finance Commission by the President every five years or earlier.

NEW TAXES IN INDIA

The Fringe Benefit Tax

The Budget 2005-06 has imposed what it calls a 'fringe benefit' tax on certain expenses incurred by corporates. These expenses are deemed to be in the nature of fringe benefits extended to employees. The specified expenses when incurred on employees are 'deemed' to be 'fringe benefits,' and hence, attract a tax even though the employee may not derive any benefit from it. The budget 2005-06 contains the definition of 'fringe benefits' as "any privilege, service, facility or amenity, directly or indirectly, provided by an employer to his employees (including former employee or employees) by reason of their employment; or any reimbursement, directly or indirectly, made by the employer to his employees for any purpose; any free or concessional ticket provided by the employer for private journeys of the employees and their family members; and any contribution by the employer to an approved superannuation fund. Some of the most common fringe benefits include car, computer services, hotel and tour expenses, etc. which generally becomes a fringe benefit when it is owned or leased by an employer and made available for the private use of an employee. This tax was scrapped in the budget 2009-10.

Banking Cash Transaction Tax

The budget 2005-06 has introduced a tax on cash withdrawal from banks, called Banking Cash Transaction Tax or Banking Cash Withdrawal Tax. The new banking cash transaction tax, introduced for the first time in the Indian Budget was meant to keep a tax trail on blackmoney. The savings accounts were totally exempted from 0.1 per cent tax on cash withdrawal from banks following criticism from trade, industry and political parties. The tax

was applicable for withdrawals of Rs 25,000 and above on a single day from current and other non-savings accounts in the banks for individuals and Hindu Undivided Families. For business accounts, the 0.1 per cent tax was applicable for any withdrawal beyond Rs 1 lakh on a single day. The central board of direct taxes through a notification in this regard (June 1, 1996), made it clear that if the total withdrawal exceeds Rs 25,000 by individuals or Rs 1 lakh by businesses on a single day even through multi transactions, the tax would be effective. Originally proposed to levy transaction tax of Rs 10,000 and above, Finance Minister P. Chidambaram later scaled up the limit to Rs 25,000 after it evoked wide-spread criticism from industry and political parties. The budget 2008-09 announced that Banking Cash Transaction Tax (BCTT) would be withdrawn with effect from April 1, 2009.

Minimum Alternate Tax (MAT)

In almost all the economies of the world, income tax laws provide a number of concessions in their income tax laws. A profit making clever company may conduct its business and accounting affairs in such a manner that the cumulative effect of all such concessions is to reduce its income declared in the tax returns to zero. The Minimum Alternate Tax is a device to keep a zero tax company within the tax net.

In the 1996-97 budgets, an effort was made to tackle the phenomenon of zero tax companies, which despite having substantial book profits paid zero tax. The government brought the zero tax companies under the tax net. Thus, where the total income of a company after availing all eligible deductions was less than 30 per cent of the book profit, the total income of such companies was deemed to be 30 per cent of the book profit and they were charged a minimum tax which works out to be 12 per cent of the book profit. Some sectors such as power, infrastructure and exports were exempt from the MAT.

Value-Added Tax (VAT) and GST

VAT (Value Added Tax) was introduced to avoid cascading of taxes (tax being levied upon a price that includes one or more elements of tax) as a product passes through different

stages of production/value addition. The tax is based on the difference between the value of the output and the value of the inputs used to produce it. The aim is to tax a firm only for the value added by it to the inputs it is using for manufacturing its output and not the entire input cost. VAT brings in transparency to commodity taxation: right now, only the final tax paid by the consumer is apparent to her, while with value added tax generalised to a goods and services tax (GST) that subsumes both central and state level taxation, the entire element of tax borne by a good (or a service) would be represented by the GST paid on it. A GST of 20% might seem high, but it would be about half the actual incidence of tax in most goods at present.

CENVAT

Central value Added Tax is the rechristened MODVAT. The Government introduced CENVAT in lieu of central excise taxes in 2000-01 budget and it plans to extend the CENVAT to the customs duties in due course. Initially the CENVAT was introduced as an experiment on a limited basis, but later it was extended to all sectors of the economy.

State VAT

State level VAT became operational from April 1, 2005 to replace sales tax that varied over states. Now we have a harmonized system of state VAT. Here are some the main features of state VAT.

- Introduction of VAT would help avoid cascading nature of sales tax.
- Present multiple rates and taxes can converge into a few rates and a single VAT.
- Transparency in the system of tax administration through simple self-assessments and departmental audit.
- Rationalisation of taxes to result in lower tax burden and higher tax revenues.
- To avoid tax competition, the design of State VAT needs to be harmonized even as the distinctive needs of individual States are recognized.
- State VAT to have two basic rates of 4 per cent and 12.5 per cent and to cover 550 commodities. About 270 commodities will be under 4 per cent rate.
- 46 items, comprising of natural and unproc-

essed products in unorganized sector, items legally barred from taxation and items having social implications, are exempt from VAT.

- Gold and silver ornaments subject to a special VAT rate of 1 per cent and other commodities to attract a general VAT rate of 12.5 per cent.

Finance Bill

The proposals of government for levy of new taxes, modification of the existing tax structure or continuance of the existing tax structure beyond the period approved by Parliament are submitted to Parliament through this bill. It is the key document as far as taxes are concerned.

Budget

Budget (from originating from french word 'bougette') generally refers to a list of all planned expenses and revenues of government. An annual proposal that outlines anticipated Federal revenue and designates program expenditures for the upcoming fiscal year. Thus budget is a statement of the State's program plan, the resources necessary to support that plan, a description of how and for what purposes the resources are to be used, and a projection of the effects of the programs on people and the environment. The Union Budget is the annual report of India as a country. It contains the government of India's revenue and expenditure for the end of a particular fiscal year, which runs from April 1 to March 31. The Union Budget is the most extensive account of the government's finances, in which revenues from all sources and expenses of all activities undertaken are aggregated.

Fiscal Year

A fiscal year (or financial year, or sometimes budget year) is a period used for calculating annual ("yearly") financial statements in businesses and other organizations. In many jurisdictions, regulatory laws regarding accounting and taxation require such reports once per twelve months, but do not require that the period reported on constitutes a calendar year (i.e., January through December). Fiscal years vary between businesses and countries. In New Zealand, India, Hong Kong, the government's financial year runs from April 1 to March 31. The U.S. government's fiscal year begins on October 1 of the previous calendar year and

ends on September 30 of the year with which it is numbered. The Australian government's fiscal year begins on July 1 and concludes on June 30 of the following year. The United Kingdom's fiscal year runs from April 6 to April 5. Japan's income tax year runs from January 1 to December 31, but corporate tax is charged by their own one year period.

Performance and Programme Budgeting System

Programme Budgeting: The formulation of the budget proposals should be directly related to the extent to which they can be implemented. The implementation of a budget involves making programmes, setting agencies that will implement it and the modus operandi for the same.

Performance Based Budgeting (PBB): Tests have been devised for comparing actual with the expected results and thereby assessing the efficiency of the project in terms of its performance. This aspect of budgeting is referred to as the performance budgeting. Performance budget, as stated by the Hoover Commission (USA), is based upon activities, functions and projects of the government.

Performance and Programme Budgeting System (PPBS): A budget, which includes both the aspects of budgeting viz. programme budgeting and performance budgeting may be termed Performance and Programme Budgeting System (PPBS).

The PPBS is an outcome of efforts aimed at improving the formulation and execution of expenditure policy of the government at the executors (not legislative) level. It incorporates rules of managerial efficiency and flexibility in both formulation and execution of expenditure policy of the government.

Revenue and Capital Budgets

A budget has two accounts, namely, (1) revenue account and (2) capital account. Revenue account includes all receipts and expenditure, which are of recurring nature and which do not pertain to sale and purchase of assets. The capital account includes the heads which pertain to receipts and expenditures of long term nature and sale and purchase of assets. The former is often called revenue budget whereas the latter is called capital budget.

Revenue Budget

Revenue accounts cover those items, which

are of recurring nature. Current expenses are equivalent to consumption. Revenue Budget consists of the revenue receipts - both tax - revenue and non - tax revenue and revenue expenditure. The tax revenue includes revenue from direct and indirect taxes. The non-tax revenue receipts include revenue from currency, Coinage and mint, interest receipts, dividends, profits, revenue from general services (such as police, jails, supplies and disposal, and public works), revenue from social and community services (such as education, health, housing, broadcasting and so on) and revenue from other services (such as agriculture and allied services, industry and mines, transport and communications).

Capital Budget (or Capital Account)

Capital Budget or Capital Account of the budget covers those items, which are in the nature of acquiring and disposing of capital assets. Capital budget includes capital receipts and capital disbursements. Capital account receipts include market loans, borrowings from Reserve Bank of India and others through the sale of treasury bills and loans from foreign governments and others to the central government. Capital disbursements would include expenditure on acquisition of various physical assets like land, buildings, machinery and equipment, investments in shares and debentures and loans to state governments and other bodies. The capital budget also incorporates the transactions in the Public Account.

The division between revenue and capital account for state budgets is similar to that of the government of India. In India, till mid 1980s, in addition to the division of the budget into Revenue and Capital Accounts, the Plan Budget was also prepared.

The Plan Budget was a document, which showed the budgetary provisions for important projects, programs and schemes included in the central plan. It gave the details of the budgetary support for the Central Plan by sectors of development, including the central plan assistance for States and Union Territories. The break-up of the proposed outlays between General Services, Social and Community Services and Economic Services was shown together with various physical targets wherever possible.

Plan and Non-Plan Budget: Currently, in pursuance of the recommendations of the Auditor and Comptroller General of India, the

previous practice of dividing budget into revenue account, capital account and plan budget stands modified. Now the budget is first split up into plan and non-plan parts and within each part, there is a further division between Revenue and capital accounts.

In the new classification, the expenditures are categorized as plan expenditure and non-plan expenditures.

Plan expenditure covers only that portion of the total expenditure, which is directed to finance the schemes specifically initiated under the given plan or which are the spillover of the previous plan (s). The non-plan expenditure includes such expenditures, which are done on the maintenance of completed projects and other running expenditure of government.

Zero Based Budgeting (ZBB)

Zero based budgeting is an extension of corporate principles to the arena of public budgeting. The main objective behind zero based budgeting is to achieve efficiency in the budgetary process by minimising wasteful expenditure and maximising the outcomes. In a wider sense, the ZBB is a means to convert a programme budget into an essentially performance budget.

In the sphere of public budgeting, ZBB was first tried by Mr. Jimmy Carter, Governor of Georgia in 1973. Gradually zero based budgeting was given a trial in other states of the USA.

In zero based budgeting each item of expenditure going to various segments of an industrial/manufacturing activity would have to be justified against its actual performance (vis-à-vis target) and achievement. If a segment/section is not able to justify its own existence, it would be closed down. And if its existence is justified, the optimum levels of its operations and the corresponding budgetary provisions have also to be defended. ZBB refers to budgeting process where every section (item of expenditure) has to justify its worth against the expenditure it claims. In other words justification as to why money should be spent on a particular head has to be proved by the spender. Every time, this exercise has to start ab initio. An effective adoption of ZBB needs a lot of understanding and detailed working out of different levels. The main hurdles, apart from lack of data are firstly that ZBB may prove more expensive for it needs elaborate study and

secondly no department would like to recommend its own closure.

PUBLIC EXPENDITURE

Public expenditure refers to government expenditure. Public expenditure has been increasing all over the world due to increased involvement of governments in development and welfare activities. It is classified as follows:

Plan Expenditure

This is essentially the Budget support to the central plan and the central assistance to state plans like all Budget heads, this is also split into revenue and capital components.

Non-plan Expenditure

This is largely the revenue expenditure of the government. The biggest items of expenditure are interest payments, subsidies, salaries, defence and pension. The capital component of the non-plan expenditure is relatively small with the largest allocation going to defence. It is important to note that the entire defence expenditure is non-plan expenditure.

Deficit Financing

Deficit financing means an excess of public expenditure over public revenue. This excess may be met by sale of public assets, borrowings from the domestic market, borrowings from abroad, or drawing down of cash balances of GOI or the issue (print) of fresh money by the Central Bank.

Fiscal Deficit

When the government's non-borrowed receipts (revenue receipts plus loan repayments received by the government plus miscellaneous capital receipts, primarily disinvestment proceeds) fall short of its entire expenditure, it has to borrow money from the public to meet the shortfall. The excess of total expenditure over total nonborrowed receipts is called the fiscal deficit.

Primary Deficit

The revenue expenditure includes interest payments on government's earlier borrowings. The primary deficit is the fiscal deficit less interest payments. A shrinking primary deficit

would indicate progress towards fiscal health. We had already discussed revenue deficit earlier. The Budget document also mentions the deficit as a percentage of the GDP. This is to facilitate comparison and also get a proper perspective. In absolute terms, the fiscal deficit may be large, but if it is small compared to the size of the economy then it is not such a bad thing. Prudent fiscal management requires that government does not borrow to consume, in the normal course. That brings us to the FRBM Act.

Various Kinds of Deficits

1. **Budget Deficit** = Deficit on Revenue Account plus Deficit on Capital Account.
2. **Revenue Deficit** = Deficit on Revenue Account

That is Revenue Expenditure - Revenue Receipt. (Rev. Exp. > Rev. Rec.)

This deficit is an indicator of government's imprudent consumption.

3. **Fiscal Deficit** = Budget Deficit + Other liabilities = Budget Deficit plus borrowings from internal market other than 91-day ad-hoc treasury bills + External borrowing = Budget Deficit + Borrowing through treasury bills (other than 91-day) + Borrowing from Small Savings + Borrowing from provident fund + other borrowings including external.
4. **Monetised Deficit** = Net increase in borrowing from RBI in a fiscal year.
5. **Primary Deficit** = Fiscal Deficit - Interest payment.

Since 91 day ad-hoc treasury bills are not issued since 1997, the concept of budget deficit has been stopped to be used to gauge the fiscal health of the country. Monetised deficit is also not calculated now because the FRBM Act has prohibited government borrowings from the RBI for budgetary purposes. Instead there is a provision for ways and means advance through which governments at state or central levels may borrow for their temporary revenue shortfalls for duration of 15-90 days.

Fiscal Policy

Fiscal policy refers to the policy related to revenue and expenditure of the government with a view to correcting the situations of excess demand or deficient demand in the economy. The instruments of fiscal policy are:

(a) **Fiscal Instruments Related to Government Expenditure:** The government of a country incurs various types of expenditure such as expenditure on public works (construction of roads, dams, bridges etc), education and public welfare, defence, maintenance of law and order, various types of subsidies, and transfer payments to the public. Government corrects the situations of excess demand or deficient demand in the economy by varying any or all types of expenditure.

(b) **Fiscal Instruments Related to Financing of Government Expenditure:** Taxation, public debt and deficit financing are the three fiscal instruments related to financing of government expenditure. Government can correct the situations of excess demand or deficient demand in the economy by using above mentioned instruments.

(c) **Fiscal Policy and Deficient Demand**

Following fiscal measures to correct the situation of deficient demand:

(1) **Decrease in Taxes:** Government decreases taxes, which leaves the households with more purchasing power and the firms with more cash reserves. Direct taxes like income tax, corporation tax etc are reduced. As a result both households as well as investors will be encouraged to spend more. Consequently, demand will increase.

(2) **Increase in Public Expenditure:** To stimulate the demand the government increases expenditure over public health, education, subsidies and transfer payments, and public works. Public expenditure causes the level of income to increase in economy. Higher level of income causes high level of demand.

(3) **Increase Deficit financing:** Deficit financing (by way of printing more notes for additional expenditure) is increased during times of deficient demand so that the overall level of purchasing power is enhanced in the economy.

(4) **Public Borrowing:** Public borrowing is reduced so that people are left with greater disposable income.

(d) **Fiscal Policy and Excess Demand**

Excess demand generates inflationary pressures in the system. Following fiscal measures are taken to correct the inflationary situation.

(i) **Increase in taxes:** Tax rates are increased progressively to mop up additional purchasing power within the economy.

(ii) **Decrease in Government Expenditure:** Government expenditure is reduced so as to cause the demand to decline.

(iii) **Reduce Deficit Financing:** Deficit financing is greatly restricted. The printing of more notes would only increase the rate of inflation.

(iv) **Public Borrowing:** The situation demands less purchasing power with the people. So, the government takes resort to increased public borrowing.

Main Objectives of Fiscal Policy in India

The fiscal policy is designed to achieve certain objectives as follows:-

1. Development by effective Mobilization of Resources

The principal objective of fiscal policy is to ensure rapid economic growth and development. This objective of economic growth and development can be achieved by Mobilization of Financial Resources.

The central and the state governments in India have used fiscal policy to mobilize resources.

The financial resources can be mobilized by:

a) **Taxation:** Through effective fiscal policies, the government aims to mobilize resources by way of direct taxes as well as indirect taxes because most important source of resource mobilization in India is taxation.

b) **Public Savings:** The resources can be mobilized through public savings by reducing government expenditure and increasing surpluses of public sector enterprises.

c) **Private Savings:** Through effective fiscal measures such as tax benefits, the government can raise resources from private sector and households. Resources can be mobilized through government borrowings by ways of treasury bills, issue of government bonds, etc., loans from domestic and foreign parties and by deficit financing.

2. Efficient allocation of Financial Resources

The central and state governments have tried to make efficient allocation of financial resources. These resources are allocated for Development Activities which includes expenditure on railways, infrastructure, etc, whereas Non-development Activities includes expenditure on defence, interest payments, subsidies, etc.

But generally the fiscal policy should ensure that the resources are allocated for generation of goods and services which are socially desirable. Therefore, India's fiscal policy is designed in such a manner so as to encourage production of desirable goods and discourage those goods which are socially undesirable.

3. Reduction in inequalities of Income and Wealth

Fiscal policy aims at achieving equity or social justice by reducing income inequalities among different sections of the society. The direct taxes such as income tax are charged more on the rich people as compared to lower income groups. Indirect taxes are also more in the case of semi-luxury and luxury items, which are mostly consumed by the upper middle class and the upper class. The government invests a significant proportion of its tax revenue in the implementation of Poverty Alleviation Programmes to improve the conditions of poor people in society.

4. Price Stability and Control of Inflation

One of the main objectives of fiscal policy is to control inflation and stabilize price. Therefore, the government always aims to control the inflation by reducing fiscal deficits, introducing tax savings schemes, Productive use of financial resources, etc.

5. Employment Generation

The government is making every possible effort to increase employment in the country through effective fiscal measure.

6. Balanced Regional Development

Another main objective of the fiscal policy is to bring about a balanced regional development. There are various incentives from the government for setting up projects in backward areas such as Cash subsidy, Concession in taxes and duties in the form of tax holidays, Finance at concessional interest rates, etc.

7. Reducing the Deficit in the Balance of Payment

Fiscal policy attempts to encourage more exports by way of fiscal measures like Exemption of income tax on export earnings, Exemption of central excise duties and customs, Exemption of sales tax and octroi, etc.

The foreign exchange earned by way of exports and saved by way of import substitutes helps to solve balance of payments problem. In this way adverse balance of payment can be corrected either by imposing duties on imports or by giving subsidies to export.

8. Development of Infrastructure

Government has placed emphasis on the infrastructure development for the purpose of achieving economic growth. The fiscal policy measures such as taxation generates revenue to the government. A part of the government's revenue is invested in the infrastructure development. Due to this, all sectors of the economy get a boost.

Fiscal Responsibility and Budget Management (FRBM) Act

Enacted in 2003, the Fiscal Responsibility and Budget Management Act requires the elimination of revenue deficit by 2008-09. This means that from 2008-09, the government will have to meet all its revenue expenditure from its revenue receipts. Any borrowing would then only be to meet capital expenditure - repayment of loans, lending and fresh investment. The Act also mandates a 3% limit on the fiscal deficit after 2008-09. This is a reasonable limit that allows significant leverage to the government to build capacities in the economy without compromising fiscal stability. It is important to note that since the entire Budget is at current market prices the deficits are also calculated with reference to GDP at current market prices. The main features of the bill are as follows:

The Fiscal Responsibility and Budget Management (FRBM) Bill was introduced in December 2000 and enacted in August 2003. The rules are effective from July 5, 2004 and the government has implemented the FRBM Act. Following are the main features of the FRBM Act:

- The Act stipulates the elimination of revenue deficit by March 31, 2008.
- According to the Act, the revenue deficit is to be reduced by a minimum of 0.5% of GDP per annum and the fiscal deficit by

0.3%. The rolling targets of FRBM provide for a reduction in the revenue deficit to 1.5% in 2005-06 and to 1.1% in 2006-07 and eventually to zero in 2008.

- The FRBM Act also caps the level of guarantees and prohibits government to borrow from the RBI after April 1, 2006.
- The Act requires that on a quarterly basis, the Government would have to place before both the Houses of Parliament an assessment of trends of receipts and expenditure. The Government also has to annually present the macro-economic framework statement, medium term fiscal policy statement and fiscal policy strategy statement. The three statements would provide the macro economic background and assessment relating to the achievement of FRBM goals.
- The medium term fiscal policy statement will contain a three-year rolling target for key fiscal parameters that underpin the Government's fiscal correction trajectory.
- Through the FRBM discipline, the Government is also committed to undertake an intra-year assessment of the achievement of its budgetary targets.

TAX REFORMS

Recommendation of the Chelliah Committee

The tax reform committee under the chairmanship of Raja J. Chelliah (1991) has recommended far reaching changes in the tax system. The main objectives of tax reform were (i) to remove loopholes from the system that lead to evasion (ii) to simplify and rationalize the tax structure, (iii) to make the tax structure efficient and transparent from the point of view of revenue collection. In brief the proposals of the tax reform committee are related with simplification, rationalization and efficiency in the tax structure.

In respect of particular taxes the Chelliah Committee has, inter-alia, recommended the following:

Direct Taxes

Income Tax: (i) Lower rates of taxation with a narrower spread between the entry rate and maximum marginal rate, and a minimum of tax incentives, (ii) The system of subjecting the income of both partnership firms as well as the

partners to taxation amounted to double taxation and this should be avoided.

Corporation Tax: Corporation tax rate for domestic companies being high should be lowered to 40 per cent and the surcharge should be abolished. Tax rates for foreign companies should also be lowered and the differential between the tax rates on domestic and foreign companies should be around 7.5 percentage points and in no case to exceed 10 percentage points.

Capital Gains Tax: The present tax treatment of long-term capital gains is not correct because the deductions allowed in computing taxable gain is not related to the period of time for which the assets have been held. It does not take into account the inflation that may have occurred over-time. So the committee has recommended a system of indexation to ward-off the inflationary effect on capital gains.

The Committee also suggested that for levying wealth tax a distinction is to be made between productive and non-productive assets. Thus by exempting productive assets such as shares, securities, bonds, bank deposits, etc. from wealth tax, the government can encourage investment in them.

Indirect Taxes:

Customs Duties : Reduction in the general level of tariffs, a reduction in the dispersion of the tariff rates and a rationalization of the system with abolition of numerous end-use exemptions and concessions.

Excise Duties: The committee has recommended the switching over to ad-valorem rates from specific rates. In case a specific rate has to be retained; the same should be revised every year taking into account the price inflation.

For the sake of efficiency, the committee recommended a general reduction in exemptions, tax rates and tax slabs. It also emphasized broad basing of the tax system. (Such as introduction of presumptive tax, taxes on services, etc.)

The government has accepted almost all the recommendations of Chelliah Committee. All the budgets after 1991 have tried to accommodate these recommendations. The tax reforms have led to simplification, rationalization and

broad basing of the tax system. All this has resulted into increase in tax revenue and decrease in tax evasion and avoidance. The tax system has become more growth oriented after implementing Chelliah Committee recommendations.

Kelkar Committee on Tax Reforms

In its report presented to the Finance Minister, Mr P. Chidambaram, the Taskforce on Implementation of the Fiscal Responsibility and Budget Management (FRBM) Act, headed by Mr Vijay Kelkar, has contended that slashing Government spending "would be contractionary for the macro-economy," whereas "raising tax revenues is likely to be less contractionary." It has recommended that fiscal consolidation should be "revenue-led" rather than based on reduction in expenditures. The report has also argued that the Government should enhance capital expenditures "in order to counter-balance the contractionary effects of fiscal consolidation." Following are the main recommendations of the Kelkar Committee:

- A new Income Tax package comprising two rate-structure and removal of exemptions except for housing loans, women, and senior citizens.
- Only three rate custom duty structure reaching ASEAN levels.
- New proposal with states on goods and service tax.
- Reduction in corporate tax to 30 per cent for domestic cos.
- Reduction in general depreciation rate from 25 to 15 per cent
- Existing tax incentives for corporate units to be "grand fathered" for existing units, but removed for new units. The report favoured revenue mobilisation through low and few tax rates, alongside widening of the tax base and shifting the incidence of taxation upon consumption.

There will be only two marginal rates: 20 per cent for income levels of Rs 1 lakh to Rs 4 lakh

and 30 per cent for incomes above Rs 4 lakh. The marginal rate would be nil on income levels up to Rs 1 lakh. At the same time, the standard deduction available to salaried tax payers will be done away with and all tax exemptions are to go, barring those relating to housing loans and schemes for senior citizens and women.

For corporates, the Taskforce has similarly mooted a reduction in the tax rate from 35.875 per cent to 30 per cent for domestic companies, along with a lowering of the general depreciation rate from 25 per cent to 15 per cent. All existing tax incentives will be 'grandfathered,' i.e., new units will not be entitled for such benefits.

A radical suggestion made by the Taskforce is to have Goods and Services Tax, which will be a single country-wide value added tax (VAT) covering virtually all goods and services. Further, there will be no demarcation between goods and services on which the powers of taxation rest only with the Centre or the States.

Instead, the Taskforce has envisaged a 'grand bargain,' whereby States will have the power to tax all services concurrently with the Centre, and "both Central and State Government would exercise concurrent but independent jurisdiction over common or almost common tax bases extending over all goods and services, and in both cases, going up to the final consumer."

Within this framework, the report has proposed a three-slab ad valorem tax rate structure - a floor rate of 10 per cent (6 per cent levied by the Centre and 4 per cent levied by States), a standard rate of 20 per cent (12 per cent plus 8 per cent) and a peak rate of 34 per cent (20 per cent plus 14 per cent).

As per this, the total tax burden on most goods would work out to 20 per cent, which "compared favourably with the standard VAT rates seen in OECD countries." Further, the Centre's standard rate would work out to 12 per cent, which is below the existing Cenvat rate of 16 per cent. The Taskforce has favoured a 'front-loaded' approach towards meeting the goal of zero revenue deficit by 2008-09, as per the FRBM Act.



BANKING SYSTEM IN INDIA

CHRONICLE
IAS ACADEMY
A CIVIL SERVICES CHRONICLE INITIATIVE

Banking is defined as the accepting, for the purpose of lending or investment of deposits, money from the public, repayable on demand or otherwise and withdrawable by cheque, draft, and order or otherwise. Thus the two essential functions of banks are to accept chequable deposits from the public and lending.

Acceptance of chequable deposits is a necessary, but not sufficient condition for Financial Institution (FI) to be a bank. For example, post office savings banks are not banks in this sense of the term even though they accept deposits from the public. This is because they do not perform the other essential function of lending.

Similarly, lending alone does not make FI a bank. For example, many FIs like LIC, UTI, and IFC, etc, lend to others but they are not banks in this sense of the term, as they do not accept chequable deposits.

The main functions that commercial banks perform are:

1. Acceptance of Deposits

The bank accepts three types of deposits from the public:

- **Current Account Deposits:** Deposits in current accounts are payable on demand. They can be drawn upon by cheque without any restriction. These accounts are usually maintained by businesses and are used for making business payments. No interest is paid on these deposits. However, the banks offer various services to the account holders for a nominal charge, the most important being the cheque facility. Banks keep regular accounts of all transactions made in a particular account and submit statements of the same to the account-holder at regular intervals.

- **Fixed/Term Deposits:** These are deposits for a fixed term (period of time) varying from a few days to a few years. They are not payable on demand and do not enjoy chequing facilities. The moneys deposited in such accounts become payable only on the maturity of the fixed period for which the deposit was initially made. A variant of fixed deposits are recurring deposits. In these accounts, a depositor makes a regular deposit of an agreed sum over an agreed period e.g. Rs. 100 per month for 5 years. Interest is paid on the deposits in these accounts.

- **Savings Accounts Deposits:** These deposits combine the features of both current account deposits and fixed deposits. They are payable on demand and also withdrawable by cheque, but with certain restrictions on the number of cheques issued in a period of time. Interest is paid on the deposits in these accounts but the interest paid on savings account deposits is less than that of the fixed deposits.

2. Giving Loans

The deposits received by the bank are not allowed to lie idle by the bank. After keeping a certain portion of the deposits as reserves, the bank gives the balance to borrowers in the form of loans and advances. The different types of loans and advances made by banks are as follows:

- **Cash Credit:** In this arrangement an eligible borrower is first sanctioned a credit limit upto which he may borrow from the bank. This credit limit is determined by the bank's estimation of the borrower's creditworthiness. However, actual utilisation of credit by the customer depends upon his withdrawing power. The withdrawing power depends on the value of the borrower's current assets,

which comprise mainly of stocks of goods-raw materials, semimanufactured or finished goods, and bills receivable (dues) from others. The borrower has to submit a stock statement of his assets to the bank showing evidence of on-going trade and production activity and acting as a legal document in possession of the bank, to be used in case of default. The borrower has to pay interest on the 'drawn' or utilized portion of the credit only.

- **Demand Loans:** A demand loan is one that can be recalled on demand. It has no stated maturity. The entire loan amount is paid in lump sum by crediting it to the loan account of the borrower. Thus, the entire loan amount becomes chargeable to interest. Security brokers and others whose credit needs fluctuate day to day usually take these loans. The security against these loans may be personal, financial assets or goods.
- **Short-term Loans:** - Short-term loans may be given as personal loans, loans to finance working capital or as priority sector advances. These loans are secured loans, i.e. they are loans made against some security. The whole amount of the term loan sanctioned is paid in lump sum by crediting it to the loan account of the borrower. Thus, the entire loan amount becomes chargeable to interest. The repayment is made as scheduled, either in one instalment at the end of the loan period, or in a number of instalments over the period of the loan. In addition, commercial banks extend the following facilities when they are demanded by their customers.

3. Overdrafts

An overdraft is an advance given by allowing a customer to overdraw his current account upto an agreed limit. The security for overdrafts is usually financial assets of the account holder such as shares, debentures, life insurance policies etc. Overdraft is a temporary facility and the rate of interest charged on the amount of credit used is lower than that on cash credit because the risk involved and service cost of such credit is less - it is easier to liquify financial assets than physical assets.

4. Discounting Bills of Exchange

A bill of exchange is a document acknowledging an amount of money owed in consideration for goods received. For example, if A buys goods from B, he may not pay B immediately. He may give B a bill of exchange, stating the amount of money owed and the time when the debt has to be settled. If B wants money immediately, he will present the bill of exchange to the bank for discounting. The bank will deduct a commission and pay the present value of the bill to B. Upon maturity of the bill; the bank will secure payment from A.

5. Investment of funds

The banks invest their surplus funds in three types of securities - Government securities, other approved securities, and other securities. Government securities are securities of both the central and state governments such as treasury bills, national savings certificates etc.

Other approved securities are securities approved under the provisions of the Banking Regulation Act, 1949. These include securities of state associated bodies like electricity boards, housing boards, debentures of Land Development Banks, units of UTI, shares of Regional Rural Banks etc.

Part of the banks investment in government securities and other approved securities are mandatory under the provisions of the Statutory Liquidity Ratio requirement of the RBI. However, banks hold excess investments in these securities because banks can borrow against these securities from RBI and others, or sell these securities in the open market to meet their need for cash. Banks hold them even though the return from them is lower than that on loans and advances because they are more liquid.

TYPES OF BANKS IN INDIA

1) Reserve Bank of India

The Reserve Bank of India Act of 1934 established the Reserve Bank as the central banking institution of India which controls the monetary policy of the rupee as well as the currency reserves. The shares were entirely

owned by private shareholders. Finally Reserve Bank of India was nationalized in the year 1949.

The Bank was constituted for the following basic functions:

- To regulate the issue of Bank Notes
- To maintain reserves with a view to securing monetary stability and
- To operate the credit and currency system of the country to its advantage.

2) Commercial Banks

Commercial Banks are banking institutions that accept deposits and grant short-term loans and advances to their customers. In addition to giving short-term loans, commercial banks also give medium-term and long-term loan to business enterprises. Now-a-days some of the commercial banks are also providing housing loan on a long-term basis to individuals. There are also many other functions of commercial banks, which are discussed later in this lesson.

Types of Commercial banks:

- (i) Public Sector Banks:** These are banks where majority stake is held by the Government of India or Reserve Bank of India. Examples of public sector banks are: State Bank of India, Corporation Bank, Bank of Baroda and Dena Bank, etc.
- (ii) Private Sectors Banks:** In case of private sector banks majority of share capital of the bank is held by private individuals. These banks are registered as companies with limited liability. For example: The Jammu and Kashmir Bank Ltd., Bank of Rajasthan Ltd., Development Credit Bank Ltd, Lord Krishna Bank Ltd., Bharat Overseas Bank Ltd., Global Trust Bank, Vysya Bank, etc.
- (iii) Foreign Banks:** These banks are registered and have their headquarters in a foreign country but operate their branches in our country. Some of the foreign banks operating in our country are Hong Kong and Shanghai Banking Corporation (HSBC), Citibank, American Express Bank, Standard & Chartered Bank, Grindlay's Bank, etc. The number of foreign banks operating in our country has increased since the financial sector reforms of 1991.

3) Regional Rural Banks

Regional Rural Banks were established under the provisions of an Ordinance promulgated on the 26th September 1975 and the RRB Act, 1976 with an objective to ensure sufficient institutional credit for agriculture and other rural sectors. The RRBs mobilize financial resources from rural / semi-urban areas and grant loans and advances mostly to small and marginal farmers, agricultural labourers and rural artisans. The area of operation of RRBs is limited to the area as notified by Government of India covering one or more districts in the State.

RRBs are jointly owned by Government of India, the concerned State Government and Sponsor Banks (27 scheduled commercial banks and one State Cooperative Bank); the issued capital of a RRB is shared by the owners in the proportion of 50%, 15% and 35% respectively.

4) Co-operative Banks

Co-operative banks are small-sized units organized in the co-operative sector which operate both in urban and non-urban centers. Co-operative Banks in India are registered under the Co-operative Societies Act. The cooperative bank is also regulated by the RBI. They are governed by the Banking Regulations Act 1949 and Banking Laws (Co-operative Societies) Act, 1965.

Types of Co-operative Banks

- (i) Primary Credit Societies:** These are formed at the village or town level with borrower and non-borrower members residing in one locality. The operations of each society are restricted to a small area so that the members know each other and are able to watch over the activities of all members to prevent frauds.
- (ii) Central Co-operative Banks:** These banks operate at the district level having some of the primary credit societies belonging to the same district as their members. These banks provide loans to their members (i.e., primary credit societies) and function as a link between the primary credit societies and state co-operative banks.
- (iii) State Co-operative Banks:** These are the apex (highest level) co-operative banks in all the states of the country. They mobilise funds and help in its proper channelisation

among various sectors. The money reaches the individual borrowers from the state co-operative banks through the central co-operative banks and the primary credit societies.

Cooperative banks in India finance rural areas under:

- a) Farming b) Cattle
- c) Milk d) Hatchery
- e) Personal finance

Cooperative banks in India finance urban areas under:

- a) Self-employment b) Industries
- c) Small scale units d) Home finance
- e) Consumer finance f) Personal finance

WHAT IS KYC NORM?

KYC is an acronym for “Know your Customer”, a term used for customer identification process. It involves making reasonable efforts to determine true identity and beneficial ownership of accounts, source of funds, the nature of customer’s business, reasonableness of operations in the account in relation to the customer’s business, etc which in turn helps the banks to manage their risks

Targets and Sub-targets for banks under priority sector are as follows:

Categories	Domestic commercial banks / Foreign banks with 20 and above branches “	Foreign banks with less than 20 branches “
Total Priority 20 branches “	40	32
Total agriculture	18	No specific target.
Advances to Weaker Sections	10	No specific target.

mainstream financial products such as bank accounts and low cost loans. This financial exclusion forces them to borrow from the money lenders at high cost. Thus to overcome this problem, serious attention was given to the access to banking, access to affordable credit, and access to free face-to-face money advice.

Financial Inclusion is the process of ensuring access to appropriate financial products and services needed by all sections of the society in general and vulnerable groups

prudently. The objective of the KYC guidelines is to prevent banks being used, intentionally or unintentionally by criminal elements for money laundering.

KYC has two components - Identity and Address. While identity remains the same, the address may change and hence the banks are required to periodically update their records.

**WHAT IS PRIORITY
SECTOR LENDING?**

Priority sector refers to those sectors of the economy which may not get timely and adequate credit in the absence of this special dispensation. Typically, these are small value loans to farmers for agriculture and allied activities, micro and small enterprises, poor people for housing, students for education and other low income groups and weaker sections.

Priority Sector includes the following categories: Agriculture; Micro and Small Enterprises; Education; Housing; Export Credit and Others.

WHAT IS FINANCIAL INCLUSION?

A vast section of Indians, particularly those living on low incomes, can not access

as follows:

such as weaker sections and low income groups in particular at an affordable cost in a fair and transparent manner by mainstream institutional players.

In advanced economies, Financial Inclusion is more about the knowledge of fair and transparent financial products and a focus on financial literacy. In emerging economies, it is a question of both access to financial products and knowledge about their fairness and transparency.

The financial services include the entire gamut - savings, loans, insurance, credit, payments etc.

RBI has taken following steps for financial inclusion in India:

- **No-Frill accounts:** In November 2005, RBI asked banks to offer no-frills savings account which enables excluded people to open a savings account. Normally, the savings account requires people to maintain a minimum balance and most banks now even offer various facilities with the same. No-frills account requires no (or negligible) balance and is without any other facilities leading to lower costs both for the bank and the individual. The number of no-frills account has increased mainly in public sector banks from about 0.4 million to 6 million between March 2006 and March 2007. The number of No-frill accounts in private sector banks also increased from 0.2 million to 1 million in the same period. Recently RBI has directed all the commercial banks to offer zero balance account with minimum facilities like cheque book and ATM to all customers.
- **Usage of Regional language:** The Banks were required to provide all the material related to opening accounts, disclosures etc in the regional languages.
- **Simple KYC Norms:** In order to ensure that persons belonging to low income group both in urban and rural areas do not face difficulty in opening the bank accounts due to the procedural hassles, the KYC procedure for opening accounts has been simplified for those persons who intend to keep balances not exceeding rupees fifty thousand (Rs. 50,000/-) in all their accounts taken together and the total credit in all the accounts taken together is not expected to exceed rupees one lakh (Rs.1,00,000/-) in a year.
- KYC norms include proof of identity and proof of address. Passport, voter's ID card, PAN card or driving license are accepted as proof of identity, and proof of residence as on ration card, an electricity or telephone bill or a letter from the employer or any recognised public authority

certifying the address in order to prevent identity theft, identity fraud.

- **Easier Credit facilities:** Banks have been asked to consider introducing General purpose Credit Card (GCC) facility up to Rs. 25,000/- at their rural and semi urban branches. GCC is in the nature of revolving credit entitling the holder to withdraw upto the limit sanctioned. The limit for the purpose can be set Based on assessment of household cash flows, the limits are sanctioned without insistence on security or purpose. The Interest rate on the facility is completely deregulated. A simplified mechanism for one-time settlement of overdue loans up to Rs.25,000/- has been suggested for adoption. Banks have been specifically advised that borrowers with loans settled under the one time settlement scheme will be eligible to re-access the formal financial system for fresh credit.
- **Using Information Technology:** A few Pilot projects have been initiated to test how technology can be used to increase financial inclusion such as
 - a) Smart cards for opening bank accounts with biometric identification.
 - b) Link to mobile or hand held connectivity devices ensure that the transactions are recorded in the bank's books on real time basis.
 - c) Issuance of AADHAR numbers.
 - d) Some State Governments are routing payments under the National Rural Employment Guarantee Scheme through smart cards. The same delivery channel can be used to provide other financial services like low cost remittances and insurance.
- **Financial Education:** RBI has taken number of measures to increase financial literacy in the country. It has set up a multilingual website in 13 languages explaining about banking, money etc. It has started putting up comic strips to explain various difficult subjects like importance of saving, RBI's functions etc. These comics explain myriad and complex concepts in an entertaining manner. The website states: The Reserve Bank of India has undertaken a project titled "Project Financial Literacy". The Objective of the project is to disseminate information

regarding the central bank and general banking concepts to various target groups, including, school and college going children, women, rural and urban poor, defence personnel and senior citizens.

The ultimate objective of financial inclusion is to ensure that banking services reaches to the poor to ensure inclusive growth.

WHAT IS NEFT AND RTGS?

• NEFT : National Electronic Funds Transfer System

This system is a nationwide funds transfer system to facilitate transfer of funds from any bank branch to any other bank branch. Under this Scheme, individuals, firms and corporates can electronically transfer funds from any bank branch to any individual, firm or corporate having an account with any other bank branch in the country participating in the Scheme.

Even such individuals who do not have a bank account (walk-in customers) can also deposit cash at the NEFT-enabled branches with instructions to transfer funds using NEFT. However, such cash remittances will be restricted to a maximum of Rs.50,000/- per transaction. Such customers have to furnish full details including complete address, telephone number, etc. NEFT, thus, facilitates originators or remitters to initiate funds transfer transactions even without having a bank account.

The NEFT system also facilitates one-way cross-border transfer of funds from India to Nepal. This is known as the Indo-Nepal Remittance Facility Scheme. The beneficiary would receive funds in Nepalese Currency.

Advantages:

- a) The remitter need not send the physical cheque or Demand Draft to the beneficiary.
- b) The beneficiary need not visit his / her bank for depositing the paper instruments.
- c) The beneficiary need not be apprehensive of loss / theft of physical instruments or the likelihood of fraudulent encashment thereof.
- d) Cost effective.

- e) Credit confirmation of the remittances sent by SMS or email.
- f) Remitter can initiate the remittances from his home / place of work using the internet banking also.
- g) Near real time transfer of the funds to the beneficiary account in a secure manner.

RTGS: Real Time Gross Settlement System

RTGS stands for 'Real Time Gross Settlement'. It can be defined as the continuous (real-time) settlement of funds transfers individually on an order by order basis (without netting).

'Real Time' means the processing of instructions at the time they are received rather than at some later time. 'Gross Settlement' means the settlement of funds transfer instructions occurs individually (on an instruction by instruction basis i.e. on one to one basis). Considering that the funds settlement takes place in the books of the Reserve Bank of India, the payments are final and irrevocable. This is the fastest mode of funds transfer available in India through banking channel.

The RTGS system is primarily meant for large value transactions. The minimum amount to be remitted through RTGS is ` 2 lakh. There is no upper ceiling for RTGS transactions.

Advantages:

- a) Since the funds transfer instructions are processed and settled in real time, the credit and liquidity risks are eliminated.
- b) Leads to a seamless movement of funds from one end to another using the IT platform and reduces the systematic risks in the settlement system.
- c) As the funds are received instantly online, in the RTGS system, the collecting banks and their customers can use the funds immediately without exposing themselves to settlement risk.

MONETARY POLICY

The use by the Central Bank of interest rate and other instruments to influence money supply to achieve certain macro economic goals is known as monetary policy. Credit policy is a part of monetary policy as it deals only with how much and at what rate credit is advanced by the banks. Objectives of monetary policy are: accelerating

growth of economy, maintaining price stability, stabilization of exchange rate, balancing savings and investment and generating employment.

Monetary policy is generally referred to as either being an expansionary policy, or a contractionary policy, where an expansionary policy increases the total supply of money in the economy, and a contractionary policy decreases the total money supply. Expansionary policy is traditionally used to combat unemployment in a recession by lowering interest rates, while contractionary policy has the goal of raising interest rates to combat inflation.

Tools of Monetary Policy

The tools available for the central bank to achieve the above ends are: Bank rate, Reserve ratios, Open market operations, Intervention in the forex market and Moral suasion

Bank rate

Bank Rate is the rate at which RBI lends to commercial banks. Bank Rate is a tool which RBI uses for managing money supply and credit. Any revision in Bank Rate by RBI is a signal to banks to revise deposit rates as well as Prime Lending Rate. It stands at 6% presently (2008 July)

Reserve Requirements

In economics, fractional-reserve banking is the near-universal practice of banks in which banks keep a fraction of the total deposits managed by a bank as reserves and are not lent. The reserve ratios are periodically changed by the RBI. The reserve requirement (or required reserve ratio) is a bank regulation that sets the minimum reserves each bank must hold as a part of the deposits. These reserves are designed to satisfy various needs like providing loans to the Government (SLR) and inflation management (CRR). They are in the form of RBI approved securities (SLR) kept with themselves or cash that is kept with the RBI (CRR).

Statutory liquidity Ratio (SLR)

It is the portion of time and demand liabilities of banks that they should keep in the form of designated liquid assets like government and other RBI-approved securities like public sector bonds; current account balances with other banks and gold. SLR is aimed at ensuring that the need for government funds is partly but surely

met by the banks. The commitment of the Government to reduce fiscal deficit means that it will borrow less and so the SLR was progressively brought down from 38.5% in 1991 to 25% today.

The Reserves Bank of India Act, 1934 and the Banking Regulation Act, 1949 fixed the floor and cap on SLR at 25% and 40% respectively. But the amendment made in these statutes removed the limits-lower and upper: RBI has, as a result, the freedom to fix the SLR at any rate depending on the macro economic conditions. The amendment was an enabling one.

Cash Reserve Ratio (CRR)

CRR is 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 Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949 fixed the floor and cap on CRR at 3% and 20% respectively. But the amendment made in these statutes removed the limits-lower and upper. RBI has, as a result, the freedom to fix the CRR at any rate depending on the macro economic conditions. The amendment was an enabling one.

CRR is adjusted to manage liquidity and inflation the more the CRR, the less the money available for lending by the banks to players in the economy. CRR was 15% in 1991 and today it is 8.75%. If inflation is high, money supply needs to be taken out and so CRR is generally increased. But in a regime of moderate inflation, low CRR is in place.

RBI increases CRR to tighten credit for example, CRR today (July 2008) stands at 8.75%-high because inflation is also at 13-year high at 1.89% on WPI (July 2008). It needed to be controlled by a variety of means one of which was hike in CRR.

CRR as a tool of monetary policy is used when there is a tremendous need to reduce inflation and tighten credit as in 2008. Otherwise, normally, RBI relies on open market operations for liquidity management.

Open Market Operations (OMOs) of RBI

OMOs of the RBI can be described as: Purchases and sales of government and certain other securities in the open market (banks and

financial institutions) by the RBI in order to influence the volume of money and credit in the economy: Purchases of government securities injects money into the market and thus expands money and credit; sales have the opposite effect – absorb excess

Liquidity and shrink 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.

Ready Forward Contracts (Repos)

It is a transaction in which two parties agree to sell and repurchase the same security. Under such an agreement the seller sells specified securities with an agreement to repurchase the same at a mutually decided future date and a price. Similarly, the buyer purchases the securities with an agreement to resell the same to the seller on an agreed date in future at a predetermined price.

In India, RBI lends on a short term basis to banks on the security of the government paper (repo). Banks undertake to repurchase the security at a later date-over night or few days. RBI charges a repo rate for the money it lends. It is 8.5% presently (2008 July).

Reverse repo is when RBI borrows from the market (absorbs excess liquidity) with the sale of securities and repurchases them the next day or after a few days. The rate at which it borrows is called reverse repo rate as it is the reverse of the repo operation. Reverse repo rate presently is 6% (July 2008)

The repo rate and reverse repo rate are 6% and 8.5% respectively today (July 2008)

The Repo/Reverse Repo transaction can only be done at Mumbai and 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.

Selective Credit Controls

Certain businesses can be given more and certain others may get less credit from banks on the orders of the RBI. Thus, selective credit controls can be imposed for meeting various goals like discouraging hoarding and black-marketing of

certain essential commodities by traders etc. Either credit can be rationed or interest rate can be hiked by RBI as a part of SCCs. In SCCs, the total quantum of credit does not change, but the amount lent and the cost of credit may be changed for specific sector or sectors.

Moral suasion

A persuasion measure used by central bank to influence and pressure, but not force, banks into adhering to policy. Measures used are closed-door meetings with bank directors, increased severity of inspections discussion, appeals to community spirit etc.

Recently the RBI Governor appealed to banks not to raise rates even though the central bank was following a tight money policy.

When is the Monetary Policy announced?

Historically, the Monetary Policy is announced twice a year - a slack season policy (April-September) and a busy season policy (October-March) in accordance with agricultural cycles. These cycles also coincide with the halves of the financial year.

Initially, the Reserve Bank of India announced all its monetary measures twice a year in the Monetary and Credit Policy. The Monetary Policy has become dynamic in nature as RBI reserves its right to alter it from time to time, depending on the state of the economy.

However, with the share of credit to agriculture coming down and credit towards the industry being granted whole year around, the RBI since 1998-99 has moved in for just one policy in April-end. However a review of the policy does take place later in the year.

How is the Monetary Policy different from the Fiscal Policy?

Two important tools of macroeconomic policy are Monetary Policy and Fiscal Policy.

The Monetary Policy regulates the supply of money and the cost and availability of credit in the economy. It deals with both the lending and borrowing rates of interest for commercial banks.

The Monetary Policy aims to maintain price stability, full employment and economic growth.

The Reserve Bank of India is responsible for

formulating and implementing Monetary Policy. It can increase or decrease the supply of currency as well as interest rate, carry out open market operations, control credit and vary the reserve requirements.

The Monetary Policy is different from Fiscal Policy as the former brings about a change in the economy by changing money supply and interest rate, whereas fiscal policy is a broader tool with the government.

The Fiscal Policy can be used to overcome recession and control inflation. It may be defined as a deliberate change in government revenue and expenditure to influence the level of national output and prices.

For instance, at the time of recession the government can increase expenditures or cut taxes in order to generate demand.

On the other hand, the government can reduce its expenditures or raise taxes during inflationary times. Fiscal policy aims at changing aggregate demand by suitable changes in government spending and taxes.

The annual Union Budget showcases the government's Fiscal Policy.

What are the objectives of the Monetary Policy?

The objectives are to maintain price stability and ensure adequate flow of credit to the productive sectors of the economy.

Stability for the national currency (after looking at prevailing economic conditions), growth in employment and income are also looked into. The monetary policy affects the real sector through long and variable periods while the financial markets are also impacted through short-term implications.

There are four main 'channels' which the RBI looks at:

- Quantum channel: money supply and credit (affects real output and price level through changes in reserves money, money supply and credit aggregates).
- Interest rate channel.
- Exchange rate channel (linked to the currency).
- Asset price.

There are other secondary goals which monetary policy is supposed to take care, growth in income output and employment. But in develop-

ing countries like India the problem of trade cycle is not the only concern. In such countries monetary policy is framed in such a manner that it promotes capital formation on the one hand and addresses the problems of interpersonal, inter-regional and intersectoral inequality on the other. Monetary policy has many instruments such as bank rate, reserve ratio and open market operation policies. These instruments affect the quantity of money supply in the economy directly; hence they are called quantitative instruments.

There are other instruments, which affect the direction and amount of credit available to various sectors and regions through (a) change in marginal requirements, (b) putting ceiling to the amount of maximum credit and (c) charging different interest rates for various economic activities. These instruments are known as instruments of selective credit control or qualitative method of credit control. They are very relevant in case of developing countries like India. Monetary policy is framed and implemented by the Central Bank (RBI in case of India).

With the introduction of the Five Year Plans, the need for appropriate adjustment in monetary and fiscal policies to suit the pace and pattern of planned development became imperative.

The monetary policy since 1952 emphasised the twin aims of the economic policies of the government.

1. Speed up the economic development in the country to raise national income and the standard of living.
2. To control and reduce the inflationary pressure on the economy.

This policy of the Reserve Bank of India since the First Plan period was termed broadly as one of 'controlled expansion' i.e. a policy of "adequate financing of economic growth and at the same time ensuring reasonable price stability." Expansion of currency and credit was essential to meet the increased demand for investment funds in an economy like India, which had embarked on rapid economic development.

RBI recognized and appreciated the need for expansion of credit and money supply commensurate with the rapid development and diversification of the economy. At the same time it was equally aware that an excessive expansion of money and credit would be clearly inflationary and would ultimately endanger the

financial stability of the economy. Accordingly, the RBI helped the economy to expand through the expansion of money and credit and attempted to check rise in prices through selective controls.

Monetary policy is formulated with the consideration of macroeconomic objectives generally determined by the government within the frame of a fiscal budget or annual plan. The major macroeconomic concerns in India have been the usual ones - aggregate growth, inflation and the balance of payments.

Until 1974, the preoccupation with inflation was the concern of monetary policy. After the abrupt reduction of inflation in the second half of 1974-75, the emphasis shifted toward achieving higher rates of aggregate growth. After 1979-80, policy efforts shifted, first gradually and then sharply towards financial restraint as efforts were mounted to limit the price effects of a severe drought and sharply reduced growth.

Thus in the pre-reform period monetary policy played a largely accommodative role to fiscal policy. The central government had free access to borrowing from the RBI through ad hoc treasury bills. It helped to adopt an expansionary fiscal policy and had a multiplier effect on expansion of money supply.

CREDIT CONTROLS

General Credit Controls: These weapons of control are broadly two: quantitative and qualitative controls. Quantitative controls are used to control the volume of credit and indirectly to control inflationary and deflationary pressures caused by expansion and contraction of credit. Quantitative controls consist of bank rate policy, open market operations and cash reserve ratio. All these methods have been used with discretion since the beginning of Planning in India. Since 1955-56 and particularly after 1973-74 the inflationary rise in price has been steadily increasing. Increased government expenditure financed through deficit spending has the direct effect of increasing prices, wages and incomes. Shortfalls in production, and hoarding and speculation in essential commodities have contributed to this inflationary pressure. RBI has various weapons of control and, through using them; it hopes to achieve its monetary policy.

Bank Rate

The bank rate is an important monetary instrument in modern economies. Its most useful role is to signal and/or clarify the central bank's monetary and interest rate stance to all participants in the financial sector and particularly to banks. If monetary policy is effective and credible, a change in the bank rate will result in a change in the prime lending rates of banks and thus act as an independent instrument of monetary control. However, the role of bank rate as an instrument of monetary policy has been very limited in India because of the following basic factors:

- The structure of interest rates is administered by the RBI - they are not automatically linked to the bank rate.
- The commercial banks enjoy specific refinance facilities, and do not necessarily rediscount eligible securities at the bank rate.
- The bill market is under developed and the different sub markets of the money market are not influenced by the bank rate.

In other words, the bank rate in India is not the pace setter to other market interest rates of interest and the money market rates do not automatically adjust themselves to changes in the bank rate. At the same time, the deposit and lending rates of banks (and of development financial institutions) are not related to the bank rate.

Cash Reserve Requirements (CRR)

Another weapon available to the RBI for credit control is use of variable cash reserve requirements. Under the RBI Act 1934, every commercial bank has to keep certain minimum cash reserves with the RBI. Initially it was 5% against demand deposits and 2% against time deposits. These are known as the statutory cash reserves. Since 1962, the RBI was empowered to vary the cash reserve requirements between 3% and 15% of total demand and time deposits. The RBI has varied the CRR a number of times to reduce or increase bank credit.

In accordance with the Narasimham Committee recommendations the CRR has been kept low since 1992.

Statutory Liquidity Requirements (SLR)

Apart from the cash reserve requirements which the commercial banks have to keep with the RBI, all banks have to maintain with the RBI or with themselves liquid assets in the form of cash, gold and unencumbered approved securities equal to not less than 25% of their total time and demand deposits. This is known as the statutory liquidity requirement as has to be maintained in addition to the CRR. A higher SLR ratio works in two ways:

- It reduces the money supply in the economy and thus is deflationary
- It can also be used to divert funds to finance government expenditure

Open Market Operations

In economies with well developed money markets central banks use open market operations - i.e. buying and selling of eligible securities by the central bank in the money market - to influence volume of cash reserves with the commercial banks and thus influence the volume of loans and advances that they can make to the commercial sector. The RBI had not used this instrument for many years. Since 1991, the enormous inflow of foreign funds into the Indian economy created the problem of excess liquidity with the banking sector and the RBI undertook large scale open market operations. When RBI sells government securities in the open market, it withdraws a part of the cash reserves of the commercial banks, and thereby reduces their ability to lend to industrial and commercial sectors. Thus money supply contracts.

The opposite will happen if the RBI buys securities from the open market and pays for them. The commercial banks will find that they have more surplus cash. Thus money supply increases.

Selective and Directed Credit Controls

Under the Banking Regulation Act 1949, Section 21 empowers RBI to issue directive to the banking companies regarding their advances. These directives may relate to:

- The purpose for which advances may or may not be made.
- The margins to be maintained with regard to secured advances.
- The maximum advance to any borrower.

- The maximum amount upto, which guarantees may be given by the banking company on behalf of any firm, company, etc.
- The rate of interest and other terms and conditions for granting advances.

Since 1956-57 the RBI has made full use of Section 21 of the Banking Regulation Act, 1949 to check speculation and rising prices, the controls are selective as they are used to check the rising tendency of prices of certain individual commodities of common use.

Generally the RBI uses three kinds of Selective Credit Controls:

- Minimum margin for lending against certain specific securities.
- Ceiling on amounts of credits for certain purposes.
- Discriminatory rates of interest charged on certain types of advances.

While imposing selective controls, RBI takes great care that bank credit for production and transportation of commodities exports is not affected. Selective credit controls are mainly focussed on credit to traders for financing inventories (for purpose of hoarding and speculation).

Non-Performing Assets

In common parlance, the loans which have become "bad loans" or such loans whose recovery is not possible are called Non-performing assets (NPAs). The issue of Non-performing assets (NPAs) in the financial institutions in India has assumed a disturbing dimension. The problem of NPAs, however, is not peculiar to India alone. Countries such as Japan and China are notoriously known for their huge NPAs.

Meaning of NPAs

An asset is classified as non-performing asset (NPAs) if dues in the form of principal and interest are not paid by the borrower for a period of 180 days. However with effect from March 2004, default status has been given to a borrower if dues are not paid for 90 days. If any advance or credit facilities granted by bank to a borrower become non-performing, then the bank will have to treat all the advances/credit

facilities granted to that borrower as non-performing without having any regard to the fact that there may still exist certain advances / credit facilities having performing status.

Difference between Gross NPAs and Net NPAs

In view of the time lag in recovery process and the detailed procedures and safeguards involved in regard to write-off, even after making provisions for advances considered as irrecoverable banks continue to hold such advances in their books. These are termed as gross NPAs while provisioning adjusted NPAs are termed as net NPAs.

CLASSIFICATION OF BANK ASSETS

RBI Guidelines on Classification of Bank Advances

Reserve Bank of India (RBI) has issued guidelines on provisioning requirement with respect to bank advances. In terms of these guidelines, bank advances are mainly classified into:

Standard Assets: Such an asset is not a non-performing asset. In other words, it carries not more than normal risk attached to the business.

Sub-standard Assets: It is classified as non-performing asset for a period not exceeding 18 months.

Doubtful Assets: Asset that has remained NPA for a period exceeding 18 months is a doubtful asset.

Loss Assets: Here loss is identified by the banks concerned or by internal auditors or by external auditors or by Reserve Bank India (RBI) inspection.

In terms of RBI guidelines, as and when an asset becomes a NPA, such advances would be first classified as a sub-standard one for a period that should not exceed 18 months and subsequently as doubtful assets.

RBI guidelines on Provisioning Requirement of Bank Advances

As and when an asset is classified as an NPA, the bank has to further sub-classify it into sub-standard, loss and doubtful assets. Based on this classification, bank makes the necessary provision against these assets.

Capital Adequacy Ratio

Capital Adequacy Ratio or Capital to Risk Weighted Assets Ratio (CRAR) refers to the ratio between total capital and risk weighted assets of a bank. Risk weighting became necessary in view of the adoption of Basel-I by the Indian banks.

Basel Committee on Banking Supervision

The Basel Committee on Banking Supervision is an institution created by the central bank Governors of the Group of Ten nations. It was created in 1974 and meets regularly four times a year. The Committee's members come from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The Committee usually meets at the Bank for International Settlements (BIS) in Basel, Switzerland, where its 12 member permanent Secretariat is located. The Committee is often referred to as the BIS Committee after its meeting location. However, the BIS and the Basel Committee remain two distinct entities.

The Basel Committee formulates broad supervisory standards and guidelines and recommends statements of best practice in banking supervision.

Basel I

Basel I is the round of deliberations by central bankers from around the world, and in 1988, the Basel Committee (BCBS) in Basel, Switzerland, published a set of minimal capital requirements for banks. This is also known as the 1988 Basel Accord, and was enforced by law in the Group of Ten (G-10) countries in 1992. Basel I is now widely viewed as outmoded. Indeed, the world has changed as financial conglomerates, financial innovation and risk management have developed. Therefore, a more comprehensive set of guidelines, known as Basel II are in the process of implementation by several countries and new updates in response to the financial crisis commonly described as Basel III. Basel I, that is, the 1988 Basel Accord, primarily focused on credit risk. Assets of banks were classified and grouped in five categories according to credit risk, carrying risk weights of zero (for example home country sovereign debt), ten,

twenty, fifty, and up to one hundred per cent (this category has, as an example, most corporate debt). Banks with international presence are required to hold capital equal to 8 % of the risk-weighted assets. However, large banks like JPMorgan Chase found Basel I's 8% requirement to be unreasonable, and implemented credit default swaps so that in reality they would have to hold capital equivalent to only 1.6% of assets. Since 1988, this framework has been progressively introduced in member countries of G-10, currently comprising 13 countries, namely, Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Spain, Sweden, Switzerland, United Kingdom and the United States of America.

Basel II

Basel II is the second of the Basel Accords, which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision. The purpose of Basel II, which was initially published in June 2004, is to create an international standard that banking regulators can use when creating regulations about how much capital banks need to put aside to guard against the types of financial and operational risks banks face. Advocates of Basel II believe that such an international standard can help protect the international financial system from the types of problems that might arise should a major bank or a series of banks collapse. In theory, Basel II attempted to accomplish this by setting up risk and capital management requirements designed to ensure that a bank holds capital reserves appropriate to the risk the bank exposes itself to through its lending and investment practices. Generally speaking, these rules mean that the greater risk to which the bank is exposed, the greater the amount of capital the bank needs to hold to safe-guard its solvency and overall economic stability.

Basel III

Basel III is a new global regulatory standard on bank capital adequacy and liquidity agreed by the members of the Basel Committee on Banking Supervision. The third of the Basel Accords was developed in a response to the deficiencies in financial regulation revealed by the global financial crisis. Basel III strengthens bank capital requirements and introduces new regulatory requirements on bank liquidity and bank leverage. The OECD estimates that the implementation of Basel III will decrease annual GDP growth by 0.05 to 0.15 percentage point.

Securitisation Bill (2002)

It's a known fact that the banks and financial institutions in India face the problem of swelling non-performing assets (NPAs) and the issue is becoming more and more unmanageable. In order to bring the situation under control, some steps have been taken recently. The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 was passed by Parliament, which is an important step towards elimination or reduction of NPAs.

An economy with foreign trade with the rest of the world is known as 'open economy'. An economy with no foreign trade is known as a 'closed economy'. Erstwhile Soviet Union was a closed economy. At present all the economies are 'open economies'. "Autarky" is a term used for self-sufficient closed economy. "Globalisation" means opening up of the economy and integrating it with world economies. International trade involves exchange of goods and services as well as foreign currencies. Trade in goods is known as merchandise trade, while trade in services is known as 'invisible trade'. Real Investment or investment in productive/industrial activities by foreigners is known as Foreign Direct Investment (FDI). Investment in financial instruments such as banks and stock market is known as portfolio investment.



Inflation is a rise in the general level of prices of goods and services in an economy over a period of time. When the general price level rises, each unit of currency buys fewer goods and services. Consequently, inflation also reflects erosion in the purchasing power of money.

As for example

If we were able to buy 1kg of rice at say Rs.50 but due to price rise same amount is costing Rs.70. The price rise of the commodities over a period of time is inflation that is affecting the purchasing power of the people. This in turn reduces the value of money as for each commodity we have to spend more than the previous one.

Types Of Inflation

1. **Demand pull inflation:** This type of inflation occurs when total demand for goods and services in an economy exceeds the supply of the same. When the supply is less, the prices of these goods and services would rise, leading to a situation called as demand-pull inflation. This type of inflation affects the market economy adversely during the wartime.

As for example

High prices of onions: Due to the crop failure the supply of onions decreased but the demand among the masses remained the same. Thus as a result prices increased drastically reached around Rs.80. The government had imported the onions from Pakistan. As the supply increases in the market the prices automatically decrease. Thus this is demand pull inflation. The vicious circle of demand and supply controls the prices."

2. **Cost-push Inflation:** If there is increase in the cost of production of goods and services, due to increase of wages and raw materials cost, there is likely to be a consequent increase in the prices of finished goods and services.

As for example

High petrol prices: ongoing increase in the prices of petrol is resulting in high inflation rate. Since petroleum is so important to developing economies, a large increase in its price can lead to the increase in the price of most products, raising the inflation rate.

3. **Pricing Power Inflation:** Pricing power inflation is more often called as administered price inflation. This type of inflation occurs when the business houses and industries decide to increase the price of their respective goods and services to increase their profit margins. A point noteworthy is pricing power inflation does not occur at the time of financial crisis and economic depression, or when there is a downturn in the economy. This type of inflation is also called as oligopolistic inflation because oligopolies have the power of pricing their goods and services.

As for example

Increment in prices of cars: due to increase in cost of steel, plastic etc and to maintain profit margins the price of cars have to be increased.

4. **Sectoral Inflation:** The sectoral inflation takes place when there is an increase in the price of the goods and services produced by a certain sector of industries. For instance, an increase in the cost of crude oil would directly affect all the other sectors, which are directly related to the oil industry. Thus, the ever-increasing price of fuel has become an important issue related to the economy all over the world.

As for example

Increment in airfare: In Aviation industry when the price of oil increases, the ticket fares also go up.

Concepts related to Inflation

- **Stagflation:** It is a situation in which the inflation rate is high and the economic growth rate is low. It raises a dilemma for economic policy since actions designed to lower inflation may worsen economic growth and vice versa.

There can be two reasons for stagflation:

Firstly, stagflation can result when the productive capacity of an economy is reduced by an unfavorable supply shock, such as an increase in the price of oil for an oil importing country. Such an unfavorable supply shock tends to raise prices and slows the economy by making production more costly and less profitable.

Secondly, stagflation can result due to inappropriate macroeconomic policies. For example, central banks can cause inflation by permitting excessive growth of the money supply and the government can cause stagnation by excessive regulation of goods markets and labour market.

- **Reflation:** It is the act of stimulating the economy by increasing the money supply or by reducing taxes. It is an act of pumping money in the market to increase the circulation so that economy can be stipulated again.

As in U.S to increase the growth rate government has announced special bailout packages for the companies thus trying to pump economy out of recession.

- **Disinflation:** It is a decrease in the rate of inflation – a slowdown in the rate of increase of the general price level of goods and services in a nation's gross domestic product over time.
- **Deflation:** It is a decrease in the general price level of goods and services. Deflation occurs when the inflation rate falls below 0% (a negative inflation rate). This should not be confused with disinflation which is a slowdown in the inflation rate (i.e. when inflation declines to lower levels).
- **Hyper inflation:** It is the extremely rapid escalation of prices (typically more than 50% per month) for goods and services. The most famous hyperinflation of the modern era occurred in Germany in 1920-1923 when the government began printing

money to make up for revenue lost. The German hyperinflation resulted in a percentage increase in prices in the millions per month. Other cases of hyperinflation (Greece, Hungary) following World War II were even more extreme. The root cause of hyperinflation tends to be the excessive printing of currency by the monetary authority. Hyperinflation is extremely disruptive by making savings worthless very quickly, thus encouraging workers to spend money as fast as it is earned.

- **Recession:** A significant decline in activity across the economy, lasting longer than a few months is recession. It is visible in industrial production, employment, real income and wholesale-retail trade. The technical indicator of a recession is two consecutive quarters of negative economic growth as measured by a country's gross domestic product (GDP).
- **Depression:** It is a sustained, long-term downturn in economic activity in one or more economies. A depression is characterized by its length, by abnormally large increases in unemployment, falls in the availability of credit— often due to some kind of banking or financial crisis, shrinking output—as buyers dry up and suppliers cut back on production, and investment, large number of bankruptcies—including sovereign debt defaults, significantly reduced amounts of trade and commerce—especially international, as well as highly volatile relative currency value fluctuations—most often due to devaluations.

How Inflation Is Measured

Inflation is measured using two price indexes CONSUMER PRICE INDEX and WHOLESALE PRICE INDEX.

A price index is a normalized weighted average of prices for a given class of goods or services in a given region, during a given interval of time. It is a statistic designed to help to compare how these prices, taken as a whole, differ between time periods

Price indices have several potential uses. For particularly broad indices, the index can be said to measure the economy's price level or a cost of living.

A price index is selected and its index is assumed as 100 and on this basis price index for the current year is calculated. If index is below 100 it indicates deflation whereas if high then inflation.

CONSUMER PRICE INDEX

A consumer price index (CPI) measures changes in the price level of consumer goods and services purchased by households. It is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

In India CPI is calculated in different fields as:

- *CPI-IW i.e. Consumer Price Index for Industrial Workers (BASE YEAR IS 2001)*
- *CPI-AL i.e. Consumer Price Index for Agricultural Labour (BASE YEAR IS 1986-87)*
- *CPI-RL i.e. Consumer Price Index for Rural Labours (BASE YEAR IS 1986-87)*

WHOLESALE PRICE INDEX

The Wholesale Price Index or WPI is the price of a representative basket of wholesale goods. The Indian WPI figure is released monthly and influences stock and fixed price markets. The Wholesale Price Index focuses on the price of goods traded between corporations, rather than goods bought by consumers, which is measured by the Consumer Price Index. The purpose of the WPI is to monitor price movements that reflect supply and demand in industry, manufacturing and construction. This helps in analyzing both macroeconomic and microeconomic conditions. Base year for WPI is 2004-05.

The limitations of WPI are related to

- (a) Non-inclusion of services;
- (b) following a fixed weighting scheme while the economy is undergoing major structural changes, and
- (c) use of gross transactions data rather than data on final purchases.

MONETARY MEASURES TO CONTROL INFLATION (GIVEN BY RBI)

• Cash reserve ratio:

Cash reserve Ratio (CRR) is the amount of funds that the banks have to keep with RBI. If RBI decides to increase the per cent of this, the available amount with the banks comes down. RBI is using this method (increase of CRR rate), to drain out the excessive money from the banks.

Effect on inflation

The foremost reason of inflation is increment in money supply in the market. Cash reserve ratio is the amount kept by banks in RBI. If for example the bank has 100000 rupees and CRR is 10% then 10% of 100000 has to be kept with RBI i.e. 10000 rupees. Now if the CRR increased to 12% then banks has to kept 12% of 100000 i.e. 12000 with RBI. Hence the money with the banks decreases as CRR increases and thus money supply in the market decreases too and hence the inflation decreases.

• Statutory liquidity ratio:

Statutory Liquidity Ratio is the amount of liquid assets, such as cash, precious metals or other approved securities, that a financial institution must maintain as reserves other than the Cash with the Central Bank

Effect on inflation

As we have understood that the foremost reason of inflation is increment in money supply in the market. SLR is the amount of assets maintained by a bank. If for example the bank has 1000000 rupees and SLR is 20% then 20% of 1000000 have to be maintained by banks i.e. 200000 rupees in form of gold, securities etc. Now if the SLR increased to 30% then banks has to kept 30% of 1000000 i.e. 300000. Hence the money with the banks decreases as SLR increases and thus money supply in the market decreases too and hence the inflation decreases.

• Bank rate:

This is the rate at which central bank (RBI) lends money to other banks or financial institutions. If the bank rate goes up, long-term interest rates also tend to move up, and vice-versa. Thus, it can said that in case bank rate is hiked, in all likelihood banks will hikes

their own lending rates to ensure and they continue to make a profit.

Effect on inflation

When the private or public banks are in need of money, they borrow from RBI. RBI lends them at a rate known as bank rate (simply the interest at which money is given).

As for example if the bank rate increases interest given by banks to RBI increases thus banks money circulation decreases. Decrement in money circulation decreases inflation.

- **Repo rate and reverse repo rate:**

A repurchase agreement is the sale of securities together with an agreement for the seller to buy back the securities at a later date. The repurchase price should be greater than the original sale price, the difference effectively representing interest, called the repo rate. The party that originally buys the securities effectively acts as a lender. The original seller is effectively acting as a borrower, using their security as collateral for a secured cash loan at a fixed rate of interest.

A reverse repo is simply the same repurchase agreement from the buyer's viewpoint, not the seller's. Hence, the seller executing the transaction would describe it as a "repo", while the buyer in the same transaction would describe it as a "reverse repo". So "repo" and "reverse repo" are exactly the same kind of transaction, just described from opposite viewpoints. The term "reverse repo and sale" is commonly used to describe the creation of a short position in a debt instrument where the buyer in the repo transaction immediately sells the security provided by the seller on the open market.

Effect on inflation

A reduction in the repo rate will help banks to get Money at a cheaper rate. When the repo rate increases borrowing from the central bank becomes more expensive. In order to increase the liquidity in the market, the central bank increases or decreases the rate. Thus inflation get automatically controlled.

...

Fiscal federalism concerns the division of public sector functions and finances among different tiers of government. In undertaking this division, economics emphasizes the need to focus on the necessity for improving the performance of the public sector and the provision of their services by ensuring a proper alignment of responsibilities and fiscal instruments. While economic analysis, as encapsulated in the theory of fiscal federalism, seeks to guide this division by focusing on efficiency and welfare maximization in determining optimal jurisdictional authority, it needs to be recognized that the construction of optimal jurisdictional authority in practice goes beyond purely economic considerations. Political considerations, as well as historical events and exigencies, have in practice, played major roles in shaping the inter-governmental fiscal relations in most federations.

Even in non-federal states, there has been a growing movement towards greater fiscal decentralisation in recent years. Some analysts have attributed this to globalisation and deepening democratisation the world over on the one hand and increasing incomes on the other.

Other specific reasons for increasing demand for decentralisation are:

- It is becoming increasingly impossible for the Central Governments to meet all of the competing needs of their various constituencies, and are attempting to build local capacity by delegating responsibilities downward to their regional governments.
- Central governments are looking to local and regional governments to assist them on national economic development strategies.
- Regional and local political leaders are demanding more autonomy and want the taxation powers that go along with their expenditure responsibility.

Moreover, in recent years, decentralisation has become a feature of reform agenda promoted and supported by the World Bank and other multilateral institutions. The rationale for this has been in part that decentralisation promotes accountability. It is not therefore surprising that by 1997, 62 of 75 developing nations had embarked on one form of decentralisation or another.

An important feature of a successful system of fiscal federalism is the assignment of adequate revenue powers to sub-national governments to forge a strong link between revenue and expenditures at the margin. This is necessary for both efficiency and accountability reasons. Assignment of revenue powers is also necessary to ensure a hard budget constraint.

The transfer system should address the problem of imbalance between revenue and expenditure powers and should enable every governmental unit to provide comparable levels of public services at comparable tax rates. At the same time, it is important to ensure that the transfer system does not provide the incentive to “raid the fiscal commons”. Ensuring proper incentive structure in the transfer system is critical to preventing the soft budget constraints. It is necessary to ensure that the transfer system does not enable the states to pass on the burden of their public services to non-residents. In addition to equalisation transfers, specific purpose matching (open-ended) transfer should be designed to compensate the public services provided by the sub national governments, the benefit of which spill over the jurisdictions. A major advantage of a multilevel fiscal system is the large common market, but the benefit can accrue only when not only all impediments to trade in factors of production as well as commodities are removed, but also mobility of commodities, capital and goods is facilitated. Ensuring a common market is at the heart of creating dynamism in fiscal federalism. Such impediments can be posed by policies restricting the movement of labour, capital, and

commodities. It was also recognised that, given the multiplicity of local public goods with varying geographical patterns of consumption, there was hardly any level of government that could produce a perfect mapping for all public goods. Thus, it was recognised that there would be local public goods with inter-jurisdictional spill-overs. For example, a road may confer public goods characteristics, the benefits of which are enjoyed beyond the local jurisdiction. The local authority may then under-provide for such a good. To avoid this, the theory then resorts to traditional Pigouvian subsidies, requiring the central government to provide matching grants to the lower level government so that it can internalise the full benefits.

Based on the following, the role of government in maximising social welfare through public goods provision came to be assigned to the lower tiers of government. The other two roles of income distribution and stabilisation were, however, regarded as suitable for the central government.

PRINCIPLES OF FISCAL FEDERALISM

Independence and Responsibility

The central facet of federations is the division of powers and functions between the federal government and the state governments. The division of financial resources and obligations as between the two levels of governments should correspond to the division of powers and functions. Earnest efforts have to be made to ensure that each level of government is financially self-sufficient and independent of each other to the maximum extent possible. Political autonomy will be meaningless unless it is supported by financial autonomy. No doubt, concerns which are of national character, or which transcend the interests of one unit, should be entrusted to the central government. Functions of a purely local character, confined to a unit in each and objectives for instance, should generally be left to the Central Government. Normally, there should be occasion for the central government to encroach upon jurisdiction of the unit governments and vice-versa. In times of national emergencies, however, the Constituent units shed some of their political and financial jurisdiction in favour of the central government for achieving national objectives. Federal Constitutions usually contain specific provisions to cope with such contingencies.

Adequacy and Elasticity

Financial independence also implies that central and unit governments should have adequate financial powers to perform their exclusive functions. The correspondence between revenues and functions should be understood in a dynamic sense. The sources of revenue should be elastic enough to keep pace with the growth of responsibilities in the specified spheres of activity. In order to implement a process of national development, the central governments were made financially strong both in terms of powers and resources. Customs revenue is, therefore, left in all federations to the central government. Same is the case with direct taxation. The sources of revenue for each level of government should be such that the revenues generated should not remain static but should be quite elastic. The revenues should increase as the needs of the governments grow. None of the governments would want to be burdened with static sources which will soon fall behind the demand that a government will have to face and meet.

Efficiency

The system of distribution of functions should conform to the requirements of efficiency and economy. "No matter how well intentioned a scheme may be or how completely it may harmonise with the abstract principles of justice, if the tax does not work administratively, it is doomed to failure". Two factors determine the effectiveness of different taxes, namely, nature of the tax and the character of administration. A land tax for instance, may be expected to be administered best by local authorities because "it is, after all, the local assessors who may be presumed to possess the most exact knowledge of the local conditions upon which the value of the land depends". One of the reasons for the formation of a federation is that a government at a the federal level will be efficient for the nation as a whole: the division of sources is, therefore, based on the principle of relative interest and efficiency. Taxes which have an inter-state base, like customs, income and wealth tax are assigned to the federal government and those which have a local base, like sales tax and entertainment tax, are assigned to the states. Costs of collection of taxes, the feasibility of levying taxes at the nationwide level rather than at the local level are important considerations in the allocation of powers and functions.

Equity

Fiscal federation is viewed within the framework of welfare economics. Equitable distribution of wealth and income of the community are the proper concerns of a welfare state. Experts argue that the entire system of federal and state taxation and expenditure should be so framed as to impose equal burdens and confer equal benefits upon similarly placed persons irrespective of their residence. From the point of view of the nation, there is a distinct advantage in taxing the richer states more and spending that revenue in poorer states since the sacrifice in extra taxation in richer states is less than the benefit that will be derived if that money were spent in poorer states. The ideal is to maximise national benefit from the state and federal expenditure. This would necessitate a reduction of welfare generating expenditure in richer states and an increase in such expenditure in poorer states. Federal fiscal operations have an equalizing role in respect of tax burdens and benefits from public expenditure as between the affluent and less fortunate states. Distributive aspects of income and wealth are best performed by the central government. If redistribution policy is left to the state governments regional disparities may be perpetuated. Rich may leave the region where redistribution measures are more egalitarian, while the poor will move to such regions. Progressive income tax which is an important redistribution measure must be uniform throughout the country. This is possible only when the tax is entrusted to the national government.

Salient Features of Indian Fiscal Federalism:

- Most populous and diverse democratic federal polity
- Transition from plan to market: Need for reforms in policies and institutions (implicit transfers, common market principles, regional equity)
- Globalization and fiscal federalism: Need to reorient the system to create a competitive environment.
- Changing political environment: emergence of coalition government at Centre, regional parties in States, latter becoming pivotal members in Central coalition government, changing priorities and time horizons of political parties.

- **Notable Feature:** Holding the country together for 60 years; Constitution with fundamental rights guaranteed; Independent judiciary; free press and steel frame bureaucracy.
- **Dissatisfaction:** Has not reaped gains from “magnitude and littleness”; highly centralised system; impediments to common market; Regional aspirations and demand for statehood; absence of satisfactory institutional mechanism to resolve with Centre-State and inter-State disputes.

INDIA'S CONSTITUTIONAL STRUCTURE RELATED TO FINANCE

Indian Constitution has made elaborate provisions, relating to the distribution of the taxes as well as non-tax revenues and the power of borrowing, supplemented by provisions for grants-in-aid by the Union to the States.

Article 268 to 293 deals with the provisions of financial relations between Centre and States.

- **The Constitution divides the taxing powers between the Centre and the states as follows:**
 - The Parliament has exclusive power to levy taxes on subjects enumerated in the Union List, the state legislature has exclusive power to levy taxes on subjects enumerated in the State List, both can levy taxes on the subjects enumerated in Concurrent List whereas residuary power of taxation lies with Parliament only.
- **The distribution of the tax-revenue between the Union and the States stands as follows:**
 - a) **Duties Levied by the Union but Collected and Appropriated by the States:** Stamp duties on bills of Exchange, etc., and Excise duties on medical and toilet preparations containing alcohol. These taxes don't form the part of the Consolidated Fund of India, but are assigned to that state only.
 - b) **Service Tax are Levied by the Centre but Collected and Appropriated by the Centre and the States.**
 - c) **Taxes Levied as Well as Collected by the Union, but Assigned to the States:** These include taxes on the sale and

purchase of goods in the course of inter-state trade or commerce or the taxes on the consignment of goods in the course of inter-state trade or commerce.

- d) **Taxes Levied and Collected by the Union and Distributed between Union and the States:** Certain taxes shall be levied as well as collected by the Union, but their proceeds shall be divided between the Union and the States in a certain proportion, in order to effect an equitable division of the financial resources. This category includes all taxes referred in Union List except the duties and taxes referred to in Article 268, 268-A and 269; surcharge on taxes and duties mentioned in Article 271 or any Cess levied for specific purposes.
- e) **Surcharge on certain duties and taxes for purposes of the Union:** Parliament may at any time increase any of the duties or taxes referred in those articles by a surcharge for purposes of the Union and the whole proceeds of any such surcharge shall form part of the Consolidated Fund of India.

Grants-in-Aid

Besides sharing of taxes between the Center and the States, the Constitution provides for Grants-in-aid to the States from the Central resources. There are two types of grants:-

1. Statutory Grants
2. Discretionary Grants
 1. **Statutory Grants:** These grants are given by the Parliament out of the Consolidated Fund of India to such States which are in need of assistance. Different States may be granted different sums. Specific grants are also given to promote the welfare of scheduled tribes in a state or to raise the level of administration of the Scheduled areas therein (Art.275).
 2. **Discretionary Grants:** Center provides certain grants to the states on the recommendations of the Planning Commission which are at the discretion of the Union Government. These are given to help the state financially to fulfill plan targets (Art.282).

Effects of Emergency on Center-State Financial Relations:-

1. **During National Emergency:** The President by order can direct that all provisions regarding division of taxes between Union and States and grants-in-aids remain suspended. However, such suspension shall not go beyond the expiration of the financial year in which the Proclamation ceases to operate.
2. **During Financial Emergency: Union can give directions to the States:-**
 - a) To observe such canons of financial propriety as specified in the direction.
 - b) To reduce the salaries and allowances of all people serving in connection with the affairs of the State, including High Courts judges.
 - c) To reserve for the consideration of the President all money and financial Bills, after they are passed by the Legislature of the State.

TYPES OF TAXES IN INDIAN FINANCIAL SYSTEM

Taxes represent the amount of money we pay to the Government at predefined rates and periodicity. Taxes are the basic source of revenue to the Government using which it provides various kinds of services to the tax payers. There are mainly two types of Taxes, direct tax and indirect tax which are governed by two different boards, Central Board of Direct Taxes (CBDT) and Central Board of Excise and Customs (CBEC).

1) Direct Taxes

Direct taxes are the personal liability of tax payer. These are collected directly from the tax payers and they have to be paid by the persons on whom it is imposed. Important direct taxes are listed below:

- a) **Income Tax** - This is most important type of direct tax and almost everyone is familiar with it. TDS is its famous synonym and whosoever is earning above a minimum amount (tax exemption limit) has to pay income tax.
- b) **Wealth Tax** - This is in addition to the income tax and is levied if your net

wealth exceeds Rs. 30 Lakh at the rate of 1% on the amount exceeding Rs 30 Lakh. "In Budget 2013-2014 Finance Minister Mr P. Chidambaram introduced a surcharge of 10 percent on taxpayers with an annual taxable income of more than 1 crore (10 million) rupees

- c) **Property Tax/Capital Gains Tax** - This is levied on the capital gains arrived by selling property and stocks. Tax rates are different for long term and short term capital gains.
- d) **Gift Tax/ Inheritance or Estate Tax** - Amount exceeding Rs. 50000 received without consideration by an individual/HUF from any person is subjected to gift tax as income under "other sources". There are exemptions like money received from relatives is not taxable. Marriage gifts and money received through inheritance are also exempt from gift tax. Inheritance tax was earlier in practice but has been repealed by the government.
- e) **Corporate Tax** - Companies operating in India are taxed as per the corporate tax rate on their income. This tax is one of the major sources of revenue for government."

2) Indirect Tax

Impact and incidence of indirect Taxes fall on different persons as opposed to direct taxes where impact and incidence is on the same person. These taxes are recovered from different groups of people but the liability remains with the person who collects it. Tax payer recovers the indirect taxes paid from their consumers and clients and finally pays it to government. For example, when we purchase any product we pay VAT, when we eat in restaurants we pay service tax which are ultimately deposited in government's kitty by the service providers. Brief about various types of indirect taxes is given below:

a) Service Tax

Service providers in India are subject to service tax, which is charged on the aggregate amount received by the service provider. Services like leasing, internet/voice, transport, etc are subject to service tax.

b) Custom Duty

Custom duties are indirect taxes which are levied on goods imported to/exported from India. There are different rules for different types of goods and sectors. Government keeps on changing these rates so as to promote import/export of specific goods.

c) Excise Duty

Excise duties are indirect taxes which are levied on goods manufactured in India for domestic consumption. Like custom duty, there are a number of rules which keep on changing as per government discretion.

d) Sales Tax and VAT

Sales tax is levied by the government on sale and purchase of products in Indian market. As customers, whatever you buy from the market, you pay sales tax on it. Now, sales tax is supplemented with new Value Added Tax so as to make it uniform across country.

e) Security Transaction Tax (STT)

STT is levied on transactions (sale/purchase) done through the stock exchanges. STT is applicable on purchase or sale of various financial products like stocks, derivatives, mutual funds etc.

FINANCE COMMISSION OF INDIA

The Finance Commission of India came into existence in 1951. The Finance Commission is established under Article 280 of the Indian Constitution of India by the President of India. The Indian Finance Commission Act was passed to give a structured format to the Finance Commission of India as per the world standard. The need for the Finance Commission was felt by the British for guiding the finance of India. The structure of the modern Act was laid in the early 1920's. The Finance Commission is formed to define the financial relations between the Centre and the State. The Finance Commission Act of 1951 tells about the qualification, appointment, term, eligibility, disqualification, powers, etc. of the Finance Commission.

Functions of the Finance Commission

The Finance Commission's duty is to recommend to the President as to-

- The distribution of net proceeds of taxes between the Union and the States.

- To evaluate the increase in the Consolidated Fund of a state to affix the resources of the Panchayats in the state.
- To evaluate the increase in the Consolidated Fund of a state to affix the resources of the Municipalities in the state.

Powers of the Commission

The Finance Commission has the following powers:

- The Commission shall have all the powers of the Civil Court as per the Code of Civil Procedure, 1908.
- It can call any witness, or can ask for the production of any public record or document from any court or office.
- It can ask any person to give information or document on matters as it may feel to be useful or relevant.
- It can function as a civil court in discharging its duties.

Qualifications for appointment and the manner of selection:

The Chairman of the Finance Commission is selected among persons who have had the experience of public affairs, and four other members are selected among persons who

- Are, or have been, or are qualified as judges of High Court, or
- Have knowledge of finance, or
- Have vast experience in financial matters and are in administration, or
- Have knowledge of economics.

Term of Office of the Members

Every member of the Commission shall be in the office as specified by the President. He can also be reappointed, provided that he has already addressed a letter to the President for his resignation.

Conditions of service and salaries and allowance of members:

- Each member should provide whole time or part time service to the Commission as the President with respect to each case might specify.
- Each member shall receive salaries according to the provisions made by the Central Government.

Disqualification:

A member may be disqualified if:

- He is of unsound mind.
- He is involved in a vile act.
- If his interests are likely to affect the smooth functioning of the Commission.

THIRTEENTH FINANCE COMMISSION

Terms of Reference of the Thirteenth Finance Commission:

1. The Commission shall make recommendations as to the following matters, namely :-
 - (i) The distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them under Chapter I, Part XII of the Constitution and the allocation between the States of the respective shares of such proceeds;
 - (ii) The principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India and the sums to be paid to the States which are in need of assistance by way of grants-in-aid of their revenues under Article 275 of the Constitution for purposes other than those specified in the provisos to Clause (1) of that Article; and
 - (iii) The measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State.
2. The Commission shall review the state of the finances of the Union and the States, keeping in view, in particular, the operation of the States' Debt Consolidation and Relief Facility 2005-2010 introduced by the Central Government on the basis of the recommendations of the Twelfth Finance Commission, and suggest measures for maintaining a stable and sustainable fiscal environment consistent with equitable growth.

3. In making its recommendations, the Commission shall have regard, among other considerations, to -

- (i) The resources of the Central Government, for five years commencing on 1st April 2010, on the basis of levels of taxation and non-tax revenues likely to be reached at the end of 2008-09;
- (ii) The demands on the resources of the Central Government, in particular, on account of the projected Gross Budgetary Support to the Central and State Plan, expenditure on civil administration, defence, internal and border security, debt-servicing and other committed expenditure and liabilities;
- (iii) The resources of the State Governments, for the five years commencing on 1st April 2010, on the basis of levels of taxation and non-tax revenues likely to be reached at the end of 2008-09;
- (iv) The objective of not only balancing the receipts and expenditure on revenue account of all the States and the Union, but also generating surpluses for capital investment;
- (v) The taxation efforts of the Central Government and each State Government and the potential for additional resource mobilisation to improve the Tax-Gross Domestic Product ratio in the case of the Union and Tax-Gross State Domestic Product ratio in the case of the States;
- (vi) The impact of the proposed implementation of Goods and Services Tax with effect from 1st April, 2010, including its impact on the country's foreign trade;
- (vii) The need to improve the quality of public expenditure to obtain better outputs and outcomes;
- (viii) The need to manage ecology, environment and climate change consistent with sustainable development;
- (ix) The expenditure on the non-salary component of maintenance and upkeep

of capital assets and the non-wage related maintenance expenditure on plan schemes to be completed by 31st March, 2010 and the norms on the basis of which specific amounts are recommended for the maintenance of the capital assets and the manner of monitoring such expenditure;

- (x) The need for ensuring the commercial viability of irrigation projects, power projects, departmental undertakings and public sector enterprises through various means, including levy of user charges and adoption of measures to promote efficiency.
4. In making its recommendations on various matters, the Commission shall take the base of population figures as of 1971, in all such cases where population is a factor for determination of devolution of taxes and duties and grants-in-aid.
5. The Commission may review the present arrangements as regards financing of Disaster Management with reference to the National Calamity Contingency Fund and the Calamity Relief Fund and the funds envisaged in the Disaster Management Act, 2005(53 of 2005), and make appropriate recommendations thereon.
6. The Commission shall indicate the basis on which it has arrived at its findings and make available the estimates of receipts and expenditure of the Union and each of the States.
7. The Commission shall make its report available by the 31st day of October, 2009, covering the period of five years commencing on the 1st day of April, 2010.

Summary of Key Recommendations made by the ThFC (Thirteenth Finance Commission):

- Share of the States in the net proceeds of Central tax collections fixed at 32% over the ThFC's award period (the share was set at 30.5% by the TwFC).
- Indicative ceiling for revenue transfers (taxes and grants) from the Centre to the States set at 39.5% of the gross revenue receipts of the Centre (was set at 38% by the TwFC).

- Total grant to be provided by the Centre to the State Governments over ThFC award period set at Rs. 3,185.81 billion (more than twice the amount recommended by the TwFC).
- Loans worth Rs. 45.06 billion from GoI to the State Governments for Centrally sponsored schemes and Central plan schemes (administered by ministries/ departments other than the MoF) to be written off.
- Interest rate on loans to the States from the NSSF contracted until 2006-07 and outstanding at the end of 2009-10 to be reset at 9% (from either 9.5% or 10.5% at present based on the date on which the loans were contracted), with an estimated benefit of Rs. 135.17 billion for the State Governments. NSSF to be reformed into a market-aligned scheme.
- Target for reducing the consolidated debt stock of the Centre and the States set at 68% of GDP by 2014-15; 45% of GDP for the Centre and 25% of GDP for the States.
- Timelines specified for elimination of revenue deficits and reduction in the financing gap to 3% of GDP for the Centre and 3% of GSDP for the States. Thereafter, the States are to maintain their financing gap at 3% of GSDP. In the event of macroeconomic shocks, additional resources to be raised by the Centre and passed on to the States in accordance with the horizontal devolution formula. A long-term and permanent target of eliminating revenue deficit of the Centre and the States has also been prescribed.
- Structural shocks such as payout of Pay Commission related arrears to be avoided by making the award take effect from the date of acceptance of the same.
- Borrowing limits for the States to be calculated by GoI on the basis of the recommended fiscal reform path for the years between 2011-12 and 2014-15.

The ThFC has recommended higher transfers of Central taxes and Finance Commission grants to be provided by the Centre to the States as

compared with what the Twelfth Finance Commission (TwFC) had advised. The ThFC has recommended that the share of the States in the net proceeds of Central tax collections be fixed at 32% over the ThFC's award period, higher than the share of 30.5% that had been set by the TwFC for the award period 2005-06 to 2009-10. Additionally, the total grant of Rs. 3,185.81 billion to be provided by the Centre to the State Governments over the ThFC award period is more than twice the amount recommended by the TwFC. The ThFC's recommendations on Central tax devolution and grants would serve to reduce the vertical imbalance between the Centre and the States and are a positive from the point of view of fiscal federalism. The ThFC, by modifying the criteria and the associated weights governing horizontal devolution, has changed the inter se shares of the Indian States within the overall pool of shareable taxes. Regardless of the lowering of the inter se shares for some States, the taxes to be devolved to all the States over the ThFC period are likely to be substantially higher than they were during the TwFC period, considering the anticipated buoyancy in Central tax collections following resumption of higher economic growth from 2010-11 onwards, reversal of certain tax cuts and the possibility of successful implementation of the Goods and Services Tax (GST). Thus, all States are expected to witness a significant increase in the magnitude of transfers (Central taxes + Finance Commission grants) during the ThFC period over the TwFC period.

Higher transfers would boost the State's revenue receipts, thereby creating fiscal space for the State Governments to incur additional expenditure while at the same time providing assistance for the attainment of the fiscal targets laid down by the ThFC. However, maintaining a check on the pace of expenditure growth and enhancing the quality of expenditure would be critical to achieving structural improvement in the States' finances over the medium term. Prioritizing of expenditure would be crucial to improve socio-economic indicators and attain developmental goals.

While higher devolution of taxes to the States implies lower net tax revenues for the Central Government, the anticipated increase in tax

buoyancy over the medium term suggests that the Centre's net tax collections would also enjoy healthy growth. Nonetheless, expenditure adjustments at the Centre, rather than over-reliance on revenue growth, remain critical in the pursuit of sustainable fiscal consolidation at the national level. The total grant of Rs. 3,185.81 billion to be provided by the Centre to the State Governments over the ThFC award period includes an amount of Rs. 875.19 billion for further transfer from the States to their Local Bodies. The latter amount is more than thrice the sum recommended by the TwFC (Rs. 250 billion), and being so would augment the revenues and improve the financial position of the Local Bodies significantly. However, an increase in the magnitude and improvement in the regularity of devolution by the State Governments to their Local Bodies would also be required to reduce the resource gap of the latter and enable improved delivery of services.

During the first three years of the TwFC period, high revenue growth helped the Centre and the States achieve considerable success in their endeavor towards fiscal adjustment. With incentives aimed at encouraging fiscal consolidation provided by the Debt Consolidation and Relief Facility (DCRF) of the TwFC, a number of States were able to achieve considerable improvement in their fiscal balances in the first three years of the TwFC period. However, this was followed by slippages in the subsequent two years marked by a slowdown in economic and revenue growth and an increase in expenses because of Pay Commission related payouts in a number of States.

The ThFC has suggested a revised fiscal roadmap for the Centre and the States to provide the basis for sustainable adjustment of public finances going forward. The ThFC has set a target of reducing the consolidated debt stock of the Centre and the States to 68% of gross domestic product (GDP) by 2014-15 from an estimated 82% of GDP in 2009-10. In accordance with the projected debt to GDP ratios over the ThFC period, the ThFC has drawn up roadmaps for the Centre and the States, which specify timelines for the elimination of revenue deficits and reduction in the financing gap 1 to 3% of GDP for the Centre and 3% of gross state

domestic product (GSDP) for the States. The annual borrowing limits of the latter are to be determined by GoI on the basis of the level of the financing gap envisaged as per the fiscal reform path indicated by the ThFC for the period 2011-12 to 2014-15. This mechanism is expected to induce the States to adhere to the financing gap targets. ICRA believes this mechanism would help maintain the focus on fiscal consolidation at the State level. However, in the absence of a mechanism (like the TwFC's DCRF facility) to incentivize compliance with the fiscal targets set by the ThFC, the efficacy of the ThFC's recommendations for fiscal consolidation remains to be seen; the extent of success in this regard is likely to hinge on the commitment demonstrated by individual States to the goal of fiscal consolidation.

The ThFC has recommended that the States maintain their financing gap at 3% of GSDP beyond 2014-15, and that the Centre raise additional resources and pass these on to the States in accordance with the horizontal devolution formula in the event of macroeconomic shocks. This would help maintain the focus on fiscal consolidation at the State level over the course of business cycles and prevent such slippages as seen during the last two years of the TwFC period, which coincided with the macroeconomic slowdown in India.

If implemented, the ThFC's recommendation that structural shocks, such as payout of Pay Commission related arrears, be avoided and would help smoothen the revenue expenditures of the State Governments and prevent income-expenditure mismatches. As has historically been seen in India, settlement of large Pay Commission related arrears imposes considerable stress on the fiscal balances of the State Governments, which then take recourse to higher debt, in the process suffering deterioration in their debt service indicators. While avoidance of such structural shocks would prevent the periodic weakening of the States' credit profiles, it remains to be seen whether this recommendation is politically acceptable. The ThFC has suggested resetting of the interest rate on loans to the States from the National Small Savings Fund (NSSF) to reduce the interest asymmetry between the Centre and

the States. The interest rate on loans contracted by the States from the NSSF until 2006–07 and outstanding at the end of 2009–10 is to be reset at 9%, from either 9.5% or 10.5% at present based on the date on which the loans were contracted. This is estimated to provide a benefit of Rs. 135.17 billion to the States over the ThFC period.

The ThFC has also recommended write-off of Rs. 45.06 billion worth of loans from GoI to the State Governments administered by ministries / departments other than the Ministry of Finance (MoF). The magnitude of these benefits is however small relative to the benefits that the States derived from the DCRF facility.

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MONEY MARKET INSTRUMENTS IN INDIA

CHRONICLE
IAS ACADEMY
A CIVIL SERVICES CHRONICLE INITIATIVE

The money market is a monetary system of lending and borrowing of short-term funds.

Money markets exist to facilitate efficient transfer of short-term funds between holders and borrowers of cash assets. For the lender/investor, it provides a good return on their funds. For the borrower, it enables rapid and relatively inexpensive acquisition of cash to cover short-term liabilities. RBI being the main constituent in the money market aims at ensuring that liquidity and short term interest rates are consistent with the monetary policy objectives.

Features of Indian Money Market

Money market in India has the following features.

(I) Existence of Unorganized Money Market

The existence of the indigenous bankers has always been the major defect of the Indian money market, as these indigenous bankers do not distinguish between the purposes of finance. RBI's control over the money market is limited, to the extent that these bankers/companies are outside the organized money market.

(II) Absence of Integration

At one time, Indian money market was divided into several segments or sections, loosely connected to each other. Each section of the money market limited itself broadly to a particular class of business and remained independent in its own sphere. Furthermore, relations were not very cordial between the various sections of money market. This prevails even now between Indian banks and foreign banks.

(III) Diversity in Money Rates of Interest

The existence of too many rates of interest is yet another defect of the Indian money market—the borrowing rate of the government, the deposit and lending rates of commercial banks, deposit and lending rates of cooperative banks, the lending rates of Development Financial

Institutions, etc are different. Immobility of fund from one section of the money market to another provides the basic reason for the existence of so many rates of interest simultaneously. However, different money rates of interest have been promptly adjusting to changes in the bank rate.

(IV) Seasonal stringency of Money

There prevails seasonal monetary stringency and high rates of interest during the busy season from November to June when funds are required to move the crops from the village and countryside to the cities and ports. Banks carry large surplus funds and the rates of interest reach low levels during the off-season (July to October) or slack season. There are even now wide fluctuations in the money rates of interest from one period of the year to another.

(V) Highly Volatile Call Money Market

The call money rate refers to the rate at which funds are borrowed in this market. Call money rates are market-determined—by demand for and the supply of short term funds.

The demand for the short term funds comes from public sector banks (about 80 per cent of the borrowing) and foreign banks and private sector banks which together account for the balance of 20 per cent. While some banks fulfill their banking activities as of both lenders and borrowers, others act either as borrowers or lenders. Non-bank financial institutions such as IDBI, LIC, GIC & others account for 80 per cent of the total funds supply. While balance 20 per cent of the funds are supplied by the banks in the call money market. The call money market rates used to rise to 7 to 8 per cent during the busy season, even before 1935 while in the slack season they fell to ½ per cent per annum. The call money rates have continued to be highly volatile, notwithstanding RBI made all the efforts

to moderate the fluctuations on the call money rates. The high rates reflected the huge demand for short term funds by the banking system specially to meet the condition of minimum CRR.

(VI) Availability of Credit Instruments

The Indian money market did not have adequate short term paper instruments till 1985-86. There was only the Treasury Bill market apart from the call money market. At the same time there were no specialist dealers and brokers dealing in different segments of the Indian money market and in different kinds of paper instruments. The Reserve Bank of India started introducing new paper instruments only after 1985-86, such as 182 days treasury bills, later converted to 364 days treasury bills, certificate of deposit and commercial paper.

Different instruments of the Money Market are:

- **Call Money:**

Call money is a method of borrowing and lending for one day. This is also called overnight money. The rate of interest used to be decided by RBI earlier. After 1989, the interest rate was deregulated and now the liquidity position (availability of funds) determines the rate of interest. Only permitted organizations like scheduled commercial banks, large co-operative banks, DHFI, Primary dealers, NABARD are permitted to borrow funds through call money market. However, funds can be provided or lent even by other entities like LIC, GIC, large corporate, big mutual funds, etc.

- **Treasury Bills (T-Bills):**

Treasury Bills, one of the safest money market instruments, are short term borrowing instruments of the Central Government of the Country issued through the Central Bank (RBI in India). Treasury bills began being issued by the Indian government in 1917. They are short-term instruments issued by the Reserve Bank of India. They are one of the safest money market instruments because they are risk free, but the returns from this instrument are not very high. They have 3-month, 6-month and 1-year maturity periods. The price with which treasury bills are issued comes separate

from that of the face value, and the face value is achieved upon maturity.

Repurchase Agreements

Repurchase transactions, called Repo or Reverse Repo are transactions or short term loans in which two parties agree to sell and repurchase the same security. Repo/Reverse Repo transactions can be done only between the parties approved by RBI and in RBI approved securities viz. GOI and State Govt Securities, T-Bills, PSU Bonds, FI Bonds, Corporate Bonds etc.

Under repurchase agreement the seller sells specified securities with an agreement to repurchase the same at a mutually decided future date and price. Similarly, the buyer purchases the securities with an agreement to resell the same to the seller on an agreed date at a predetermined price.

Such a transaction is called a Repo when viewed from the perspective of the seller of the securities and Reverse Repo when viewed from the perspective of the buyer of the securities. Thus, whether a given agreement is termed as a Repo or Reverse Repo depends on which party initiated the transaction. The lender or buyer in a Repo is entitled to receive compensation for use of funds provided to the counterparty. Effectively the seller of the security borrows money for a period of time (Repo period) at a particular rate of interest mutually agreed with the buyer of the security who has lent the funds to the seller. The rate of interest agreed upon is called the Repo rate. The Repo rate is negotiated by the counterparties independently of the coupon rate or rates of the underlying securities and is influenced by overall money market conditions.

Commercial Papers:

Commercial papers are usually known as promissory notes which are unsecured and are generally issued by companies and financial institutions, at a discounted rate from their face value. The fixed maturity for commercial papers is 1 to 270 days. The purposes with which they are issued are - for financing of inventories, accounts receivables, and settling short-term liabilities or loans. The return on

commercial papers is always higher than that of T-bills. Say, for example, a company has receivables of Rs 1 lacs with credit period 6 months. It will not be able to liquidate its receivables before 6 months. The company is in need of funds. It can issue commercial papers in form of unsecured promissory notes at discount of 10% on face value of Rs 1 lacs to be matured after 6 months. The company has strong credit rating and finds buyers easily. The company is able to liquidate its receivables immediately and the buyer is able to earn interest of Rs 10K over a period of 6 months. They yield higher returns as compared to T-Bills as they are less secure in comparison to these bills; however chances of default are almost negligible but are not zero risk instruments. Commercial paper being an instrument not backed by any collateral, only firms with high quality credit ratings will find buyers easily without offering any substantial discounts. It was in 1990 that Commercial papers were first issued in the Indian money market.

Certificate of Deposit:

It is a short term borrowing more like a bank term deposit account. It is a promissory note issued by a bank in form of a certificate entitling the bearer to receive interest. The certificate bears the maturity date, the fixed rate of interest and the value. It can be issued in any denomination. They are stamped and transferred by endorsement. However, on payment of certain penalty the money can be withdrawn on demand also. The returns on certificate of deposits are higher than T-Bills because it assumes higher level of risk. It was in 1989 that the certificate of deposit was first brought into the Indian money market.

MONETARY AND LIQUIDITY AGGREGATES

The entire quantity of bills, coins, loans, credit and other liquid instruments in a country's economy is known as money supply.

Money supply is divided into multiple categories - M_0 , M_1 , M_2 and M_3 - according to the type and size of account in which the instrument is kept. The money supply is important to economists trying to understand how policies will affect interest rates and growth

M_0 = Currency in circulation + bankers deposits with the RBI + other deposits with RBI

M_1 = Currency with the Public + Demand Deposits with the banking system + Demand Liabilities portion of Savings Deposits with the banking system + other deposits with the bank

M_2 = M_1 + Savings deposits with Post office savings banks.

M_3 = M_2 + Time deposits with the contractual maturity of over one year with the banking system + Call Borrowings from 'Non-Depository' Financial Corporations by the banking system

M_3 is termed as broad money and M_1 is known as narrow money.

Liquidity aggregates in India

Liquidity is the degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid assets.

"There are three measures of liquidity in India

L_1 = M_3 + all deposits with post office savings bank except NSC

L_2 = L_1 + term deposits with Term Lending Institutions and Refinancing Institutions (FIs) + term borrowing by FIs and Certificates of Deposits issued by FIs

Quarterly compilation

L_3 = L_2 + public deposits of non banking financial companies



INDIAN CAPITAL MARKET

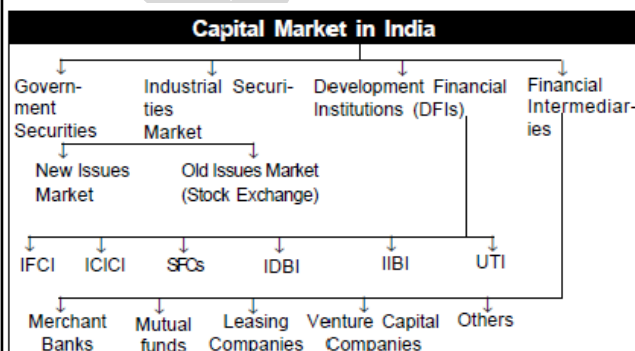
The capital market provides an alternative mechanism for allocating resources; channelises household savings to the corporate sector and allocates funds among firms. In this process it allows both firms and households to share risk. The capital market enables the valuation of firms on an almost continuous basis and it plays an important role in the governance of the corporate sector. The reforms in the capital market are aimed at enhancing the efficiency, safety, integrity and transparency of the market.

Capital market is the market for long term funds, just as the money market is the market for short term funds. Capital market refers to all the facilities and the institutional arrangement for borrowing and lending medium and long term funds. It is concerned with the raising of money/capital for investment purpose. Private sector manufacturing industries, agriculture and the government predominantly make demand of long term capital for purpose of investment. The central and state governments require substantial sums from the capital market and they invest not only on economic overheads as transport, irrigation and power development but also on basic industries and sometimes even consumer goods industries. Individual savers, corporate savings, banks, insurance companies, specialized financing agencies and government are important supplier of funds for the capital market. Among institutions, commercial banks are important investors, but are largely interested in government securities and to a small extent on investment in debentures of companies; LIC and GIC are of growing importance in the Indian capital market though their major interest is still in government securities; Private funds constitute a major medium of savings but their investments too are mostly in government securities; and special institutions, set up since independence—IFCI, ICICI, IDBI, UTI etc.—all these aim at providing long term capital to the private sector.

Gilt-edged market and the industrial securities market are two prominent constituents of the Indian capital market. The gilt-edged market refers to the market for government and semi-government securities backed by the Reserve Bank of India.

Structure of the Capital Market

The capital market can be divided into two constituents, the financial institutions and the securities market. The financial institutions provide long term and medium term loans. The securities market is divided into (a) the gilt edged market (or the market for government securities), and (b) the corporate or industrial securities market.



• Gilt-Edged market

The gilt-edged market is also known as the securities guaranteed (both principal and interest) by the government apart from government securities. The government securities are risk free because the government can't default on its payment obligations and are hence known as gilt-edged (which means 'of the best quality'). The important characteristics of the government securities are:

- (1) It is without risk and returns are guaranteed. There is no place for speculation and manipulation of the market as also no uncertainties regarding yield, payment on time, etc.
- (2) Government securities market consists of the new issues market and the secondary

market. R.B.I. is responsible for all the new issues of government loans, as it manages entirely the public debt operations of both the central and state governments. The secondary market deals in old issues.

- (3) The investors in the gilt-edged market are predominantly institutions—commercial banks, Life Insurance Corporation, General Insurance Corporation and the provident funds—which are required statutorily to invest a certain portion of their funds in government securities. These institutions mobilise the savings of the people through their various scheme and invest a certain proportion in government securities.
- (4) Government securities are the most liquid debt instruments.
- (5) The transactions in the government securities market are large.

Many private sector mutual funds have entered this market in a considerable way in recent times and have floated various gilt-edge funds for this purpose on account of the risk-free returns guaranteed by the government securities market and its high liquidity. Many risk-averse individual investors (particularly those belonging to fixed-income groups) have welcomed this opportunity as investment in gilt-edged funds is better than investment in bank fixed deposits due to better liquidity and exemption from tax on dividends.

• Corporate Securities Market

Securities issued by firms (i.e. shares, bonds and debentures) can be bought and sold freely in corporate securities market. It comprises the new issues market (the primary market) and the secondary market (stock exchanges).

• The New Issues Market/Primary Market

The new issues market is concerned with the issue of new securities—bonds debentures, shares and so on. Funds are often raised by the public limited companies from the primary market for setting up or expanding their business. However, the company has to fulfill various requirements and decide upon the appropriate timing and method of issue for selling its securities. The various methods through which capital can be raised are:

- (1) **By Prospectus:** Capital can be raised from the general public by the issue of

prospectus which is an invitation to the general public for subscribing to the capital. The prospectus contains various details regarding particulars of the company, its financial position etc.

- (2) **By Offer for Sale:** A method similar to the prospectus where initially shares are taken up by a third party in bulk. The peculiar feature of this arrangement is that while company already receives the money, any premium received from the public goes to this third party rather than to the company.
- (3) **By Private Placing:** The shares are sold to individuals or institutions directly by making a private appeal to them. The cost of raising capital in this method becomes far lesser than the cost of raising capital via other methods.
- (4) **By offering Rights Issue:** By this, companies raise capital from the existing shareholders. Under this method of issuance, the shareholders have the right to a certain number of shares in proportion to the shares held by them.

• The Secondary Market/ Stock Exchange

The stock exchange or the secondary market is a highly organized market for the purchase and sale of second-hand quoted or listed securities (quoting or listing of a particular security implies incorporating that security in the register of the stock exchange so that it can be bought and sold there). A stock exchange is an association, organization or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business in buying, selling and dealing in securities, as has been defined by the securities Contracts (Regulation) Act, 1956.

STOCK EXCHANGES IN INDIA

With over 25m shareholders, India has the third largest investor base in the world after the USA and Japan. Over 9,000 companies are listed on the stock exchanges, which are serviced by approximately 7,500 stockbrokers. The India capital market is significant in terms of the degree of development, volume of trading and its tremendous growth potential.

Stock exchanges provide an organised market for transactions in securities and other

securities. There are 23 stock exchanges in the country, 21 of them being regional ones with allocated areas. Three others set up in the reforms era, viz., National Stock Exchange (NSE), the Over the Counter Exchange of India Limited (OTCEI) and Inter-connected Stock Exchange of India Limited (ISE). Important Stock Exchanges in India are Bombay Stock Exchange, popularly known as BSE and National Stock Exchange located in Mumbai. The stock exchanges in India are located at Ludhiana, New Delhi, Jaipur, Merrut, Ahmedabad, Rajkot, Indore, Vadodara, Bombay, Pune, Hyderabad, Mangalore, Bangalore, Ernakulam, Coimbatore, Madras, Patna, Kanpur, Bhubaneshwar, Calcutta and Guwahati.

Bombay Stock Exchange (BSE)

The Bombay Stock Exchange or BSE is the oldest stock exchange in Asia. The Bombay Stock Exchange was established in 1875. There are around 4,800 Indian companies listed with the stock exchange. As of 2008, it is among the five biggest stock exchanges in the world in terms of transactions volume. In 2005, the status of the exchange changed from an Association of Persons (AoP) to a full fledged corporation under the BSE (Corporatization and Demutualization) Scheme, 2005 and its name was changed to the Bombay Stock Exchange Limited. The BSE Sensex (Sensitive Index), also called the BSE 30, is a widely used market index in India and Asia.

1. The **Bombay Stock Exchange (BSE)** is the oldest stock exchange in Asia established in 1875. It is the 4th largest stock exchange in Asia and the 8th largest in the world (as per 2010 data).
2. The Bombay Stock Exchange developed the **BSE SENSEX** in 1986, giving the BSE a means to measure overall performance of the exchange.
3. In 1989 **BSE National Index** (Base: 1983-84) was introduced. It comprised of 100 stocks, listed at five major stock exchanges in India - Mumbai, Calcutta, Delhi, Ahmadabad and Madras. It was renamed as BSE-100 in 1996.
4. The **Bombay Stock Exchange** switched to an electronic trading system in 1995 and introduced automated, screen-based trading platform called BSE On-line Trading (BOLT). It currently has a capacity of 8 million orders per day.
5. The BSE has also introduced the world's first centralized exchange-based internet trading system, **BSEWEBX.co.in** to enable investors anywhere in the world to trade on the BSE platform.

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

• **National Stock Exchange of India**

The National Stock Exchange of India (NSE) is one of the largest and most advanced stock markets in India. The National Stock Exchange of India was promoted by leading financial institutions at the behest of the Government of India, and was incorporated in 1992. In 1993, it was recognized as a stock exchange. NSE commenced operations in 1994. The NSE is the world's third largest stock exchange in terms of transaction. It is located in Mumbai, the financial capital of India.

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

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

• **Over the Counter Exchange of India (OTCEI)**

The Over the Counter Exchange of India (OTCEI), incorporated under the provisions of the Companies Act 1956, is a public limited company. It allows listing of small and medium sized companies. OTCEI is promoted by the Unit Trust of India, Industrial Development Bank of India, the Industrial Finance Corporation of India and others and is a recognised stock exchange.

• **MCX-SX**

The MCX Stock Exchange (MCX-SX) has received approval from the Securities and Exchange Board of India and the Reserve Bank of India to launch currency options on its platform.

The approvals will allow the exchange to expand its currency derivatives business by introducing options in the dollar-rupee currency pair. MCX-SX will soon announce the launch date for live trading.

MCX-SX, which began trading in 2008 with currency futures, had won approval from regulators to start trading equities, equity futures, interest rate futures and wholesale debt products.

MCX-SX is controlled by the Multi-Commodity Exchange of India (MCEI.BO), India's biggest commodity bourse, which raised \$135 million in an initial public offering in the local market earlier in 2012.

• GREENEX

The BSE has launched the Green Index called Greenex. This is India's first carbon-efficient live index. The index has been developed by the BSE in collaboration with IIM Ahmedabad. It is the second thematic index launched by BSE. BSE Greenex will measure the performances of companies in terms of carbon emissions. The index will target socially-aware investors. There are many investors willing to pay a premium for green investments in companies to get better returns.

The new index will comprise 20 stocks based on a minimum carbon footprint, market capitalisation and turnover. The BSE Greenex will assess the energy efficiency of firms, based on energy and financial data.

The selection of companies was on the basis of greenhouse emissions in the last four financial years from 2007-08 till 2010-11. The companies were tested in different combinations of carbon emission intensity, market capitalisation, and turnover. The index comprises 20 companies from the BSE 100. It gives equal weightage to both energy efficiency and profitability - together indicating a long-term sustainable strategy.

This is the first index based on actual performance on the energy efficiency front, rather than stated future plans. The index follows a sector-specific algorithm. Each company is measured only against the best in the same industry, based on disclosed energy and financial data. The index will have fair representation of firms from all sectors. It will include topranking companies from each sector.

The index can be used to develop green financial products including mutual funds, exchange-traded funds and structured products. Further, the index is expected to enable investors to take more informed investment decisions on companies in the energy-intensive sectors. It will help screen companies doing well on the carbon side, as the concerns of climate change is growing among stakeholders.

The index can be used by individual and institutional investors such as asset management companies, pension funds, and insurance companies looking for investments in companies with strong long-term prospects and develop green financial products.

• CARBONEX

The Bombay Stock Exchange (BSE) has launched BSE Carbonex, the first carbon-based thematic index in the country, which takes a strategic view of organizational commitment to climate change mitigation.

This index has been launched with the aim of creating a benchmark, and increasing awareness about the risks posed by climate change.

It will enable investors to track performance of the constituent companies of BSE-100 index regarding their commitment to greenhouse gases emission reduction.

Constituents of BSE Carbonex are over or underweighted compared to the benchmark based on their performance in the assessment process. In every industry, companies that achieve the strongest assessment scores are favoured at the expense of those achieving poor results.

The British High Commission in India through the British Foreign & Commonwealth Office's Prosperity Fund supported the development phase of the index. ENDS Carbon, a specialist in environment, social and governance (ESG) ratings and benchmark services provider, has provided its expertise in assessing the companies with data sourced from the carbon disclosure project (CDP), a not-for-profit organisation which holds the largest and most continuous set of climate change data in the world.

The top 10 constituents in BSE Carbonex are ITC Ltd having 7.11 per cent market

capitalisation followed by Reliance Industries (6.48 per cent market capitalisation), ICICI Bank (5.54 per cent), HDFC Bank (5.48 per cent), HDFC Ltd (5.30 per cent), Infosys (5.27 per cent), L&T (4.21 per cent), TCS (3.49 per cent), Hindustan Unilever (2.73 per cent) and ONGC (2.68 per cent).

Meanwhile, the carbon credit market worldwide is now reported to be worth about USD 188 billion, one of the only markets that continued to increase during the recent years of worldwide recession.

- **Islamic Index**

BSE and S&P Dow Jones Indices has announced the launch of the S&P BSE 500 Shariah index, the first new index resulting from the strategic partnership formed between the two companies in February 2013.

The S&P BSE 500 Shariah index was designed to represent all Shariah compliant stocks of the broad based S&P BSE 500 index. The S&P BSE 500 consists of 500 of the largest, most liquid Indian stocks trading at the BSE. The S&P BSE 500 represents nearly 93 percent of the total market capitalization on the BSE and covers all 20 major industries of the economy.

The S&P BSE 500 Shariah index meets the need for an investable benchmark in India to gauge the performance of some of the most widely followed Shariah compliant stocks trading at the BSE.

Shariah is Islamic canonical law, which observant Muslims adhere to in their daily lives. Shariah has certain strictures regarding finance and commercial activities permitted for Muslims.

S&P Dow Jones Indices has contracted with Ratings Intelligence Partners (RI) to provide the Shariah screens and to filter the stocks. Ratings Intelligence Partners is a London/Kuwait-based consulting company specializing in solutions for the global Islamic investment market.

The partnership brings together BSE's closely watched India index suite, which includes the SENSEX, with S&P Dow Jones Indices' 115 years of experience in publishing uncompromised global benchmarks.

CONCEPTS IN CAPITAL MARKET

Derivatives

It derives from an underlying asset-securities, shares, debt instruments, commodities etc. Derivative is a financial instrument. 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.

Options

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

Buyback of Shares

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

Rolling Settlement

Rolling Settlements is a mechanism of settling trades. In Rolling Settlements, trades done on a single day are settled separately from the trades of other day on the basis of Trade day + 2 days (T+2). Such netting of trades is done only for the day. As such, in Rolling Settlement, is carried out on a daily basis.

FMC

Forward Markets Commission (FMC) headquartered at Mumbai is a regulatory authority, which monitors and disciplines the working of the exchanges. It recognizes an exchange or can withdraw such recognition. It

collects and whenever the Commission thinks it necessary publishes information regarding the trading conditions in respect of goods. It makes inspection of the accounts and other documents of any recognized association or registered association or any member of such association whenever it considers it necessary.

Mutual Fund

Mutual fund is a financial intermediary that mops up money from a group of investors to invest in capital market so as to generate returns for the investors.

Global Depository Receipts (GDR)

Indian companies are allowed to raise equity capital in the international market through the issue of Global Depository Receipt (GDRs). GDRs are designated in dollars/euros. They are also called euroissues. The proceeds of the GDRs can be used for financing capital goods imports, capital expenditure including domestic purchase/installation of plant, equipment and building and investment in software development, prepayment or scheduled repayment of earlier external borrowings, and equity investment in JVs in India.

American Depository Receipts (ADR)

American depository receipts are issued to US retail and institutional investors. They are entitled to bonus, stock split and dividend. They are listed either on Nasdaq or NYSE. They help raise equity capital in forex for various benefits like expansion, acquisition etc.

Participatory Notes (PN)

Participatory Notes are instruments used for making investments in the stock markets. In India, Foreign Institutional Investors use these instruments for facilitating the participation of overseas funds like hedge funds and others who are either not interested or not eligible for participating directly in the Indian stock market.

Clearing House

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

Share

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

Bond

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

Debenture

Debt not secured by a specific asset of the corporation, but issued against the issuer's general credit, that is, it is unsecured debt.

Bear Market

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

Bull Market

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

Market capitalization

It is the market's total valuation of a public company. Price per share multiplied by the total number of shares outstanding gives market capitalization of a company.

Insider Trading

Insider trading occurs when any one with information related to strategic and price-influencing information purchases or sells stocks so as to make speculative profits.

National Securities Depository Limited (NSDL)

The enactment of Depositories Act in 1996 led to the establishment of NSDL, the first depository in India. It holds more than 85% of the securities held in dematerialized mode in India. Promoted by IDBI, UTI and NSE, NSDL has established a national infrastructure that handles most of the securities held and settled in dematerialized form in the Indian capital markets.

Background

India continued to follow import substitution strategy (ISS) of growth during the period 1951-1980. "The ISS with heavy 'industry' first strategy with central planning created a plethora of controls, procedures, permits and bureaucratic restrictions". The ISS, along with other factors landed us into economic crisis of 1990-91. The New Economic Policy of July, 1991 heralded a new era for India by introducing comprehensive reforms in industrial sectors as well as in services sector. It was expected that these policy measures would restore the health of the economy and put it on higher growth trajectory.

As a consequence of the adoption of the New Economic Policy (NEP) of 1991, the growth rate of the Indian economy which stood at 3.5 per cent per annum during 1951-79, 5.0 per cent per annum during 1980-91, in fact accelerated to 6.1 per cent per annum during 1992-2000 (IDR, 2002). The economy has moved on from the 'Hindu Rate of Growth' of 3.5% per annum of yesteryears to 'unstoppable India' at 9 % per annum at present. India emerged as one of the fastest growing economies of the world during the 1990s. The remarkable performance of India's economy is attributable in significant part to the spectacular dynamism shown by the services sector.

Against this background, it would be every appropriate to answer some questions:

- i. Firstly, what are the constituents of service sector in India?
- ii. Secondly, how this sector performed on growth and employment fronts?
- iii. Thirdly, what happened to service sector productivity in post 1980 period?
- iv. Fourthly, what are the policies adopted by the government of India to promote the services sector?

- v. Fifthly, what are the problems or challenges ahead in this sector?
- vi. Lastly, what are the prospects /potential for growth in this sector.

Composition of Service Sector in India

In India, the national income classification given by Central Statistical Organization is followed. In the National Income Accounting in India, service sector includes the following:

1. Trade, hotels and restaurants (THR)

- Trade
- Hotels and restaurants

2. Transport, storage and communication

- Railways
- Transport by other means
- Storage
- Communication

3. Financing, Insurance, Real Estate and Business Services

- Banking and Insurance
- Real Estate, Ownership of Dwellings and Business Services

4. Community, Social and Personal services

- Public Administration and Defense (PA & D)
- Other services

Performance of Services Sector in India

(a) Sectoral Composition of GDP Growth

The analysis of the sectoral composition of GDP and employment for the period 1950-2000 brings out the fact that there has taken place 'tertiarization' of the structure of production and employment in India. During the process of growth over the years 1950-51 to 1999-2000, the Indian economy has experienced a change in production structure with a shift away from

agriculture towards industry and tertiary sector. The share of agricultural sector in real GDP at 1993-94 prices declined from 55.53% in the 1950's to 28.66 % in 1990's. The share of industry and services increased from 16% to 27.12% and 28.09% to 44.22% respectively during the same period. During the 1950's it was the primary sector which was the dominant sector of the economy and accounted for the largest share in GDP. But the whole scenario changed subsequently, and especially in the 1980's. The service sector output increased at a rate of 6.63% per annum in the period 1980-81 to 1989-90 (i.e. pre-reform period) compared with 7.71% per annum in the period 1990-91 to 1999-2000 (i.e. post-reform period). The tertiary sector emerged as the major sector of the economy both in terms of growth rates as well as its share in GDP in 1990s. It is to be noted here that while agriculture and manufacturing sectors have experienced phases of deceleration, stagnation and growth, the tertiary sector has shown a uniform growth trend during the period 1950-51 to 1999-2000. The share of this sector in GDP further increased to 55.1% in 2006-07. This sector accounted for 68.6% of the overall average growth in GDP in the last five years between 2002-03 and 2006-07.

(b) Employment Scenario

The sectoral distribution of workforce in India during the period 1983 to 2004-05 reveals that the structural changes in terms of employment have been slow in India as the primary sector continued to absorb 56.67% of the total workforce even in 2004-05, followed by tertiary and industrial sectors (24.62% and 18.70%) respectively. There has been disproportionate growth of tertiary sector, as its share in employment has been far less when compared to its contribution to GDP.

It is important to point out that, within the services sector employment growth rate is highest in finance, insurance, and business services, followed by trade, hotels and restaurants and transport, etc. The community, social and personal services occupy the last rank in growth rates of employment.

Further, there was a sharp drop in labour absorptive capacity of growth in the economy (employment elasticity of growth) from 0.40 to 0.15 during post -reform period (1993-94 to 1999-2000) initially, reflecting the phenomenon of jobless growth. However, during 1999-2000 to 2004-05 period the employment elasticity of growth registered an increase from 0.15 to 0.51. With the exception of one sub-sector of tertiary sector i.e., transport, storage, communication and all other sub-sectors of services sector exhibited an increasing trend in employment elasticities and thereby overall elasticity of employment increased from 0.15 to 0.5.

(c) Productivity Growth in Service Sector -- Post-1980 Scenario

The process of acceleration in growth started in 1980s rather than in 1990s. "Of the 2.4 percentage point increase in the rate of economic growth that took place in the post-1980 period, about 40 per cent is accounted for by a faster growth in TFP in services." The three sectors viz. agriculture, industry and services have witnessed acceleration in the growth rates of output, output per worker and total factor productivity (TFP) in the post -1980 period. However, the increase is more marked in case of services. Partially the spurt in growth rate is attributable to productivity growth in certain sub-sectors of services sector. It has been noticed that growth rate in output per man is highest in case of PA & D and other community social and personal services (4.2% p.a), followed by transport, storage, communication (3.3 % pa), trade, hotels, restaurants (2.9%pa) and banking, insurance, real estate and business services. The acceleration in growth rate of output per worker in PA & D and other community, social and personal services might have resulted from the downsizing of the public sector because of privatisation and hikes in the salaries of the central and state government employees from time to time (i.e., due to accounting reasons). Whereas productivity growth in THR has derived stimuli from surge in demand for such services with a subsequent expansion in these activities. Part of the productivity growth in the services sector might be an outcome of application of IT services. Despite increase in growth rate of labour productivity in service sector, measurement of

service sector output and productivity are still debatable issues.

Policy Measures for the Development of the Services Sector

In post-1991 period, there were several measures undertaken by the government to develop services sector, especially through deregulation of some sub-sectors of services sector. Foreign direct investment (FDI) varying between 26 per cent (in print media) to 100% in information technology (IT) sector, business process outsourcing (BPOs), e-commerce activities, infrastructure, etc.) has been permitted. There are several other promotional measures taken by the government to sustain the growth of the services sector. For example, having realized that in knowledge- intensive world driven by IT, integration with global economy cannot take place without making quality telecom services accessible at affordable prices, a large number of steps like launching of National Telecom Policy 1994, New Telecom Policy 1999, Broad Band Policy 2004, etc were undertaken. In addition to this, a number of promotional measures have been taken up in IT and ITES (Information Technology Enabled Services) segment, trade, tourism, banking and insurance and real estate sectors.

India has emerged as a top destination for offshoring as per Global Services Location Index 2007. There is a lot of scope for future expansion as only 10 % of the potentially addressable global IT/ ITES market has been realized. The remaining 90% (worth \$300 billion) remains to be tapped.

Problems/Challenges Ahead

The sustainability of impressive growth of Indian economy has been questioned in the wake of some challenges in the form of lack of social infrastructure, physical infrastructure, IT infrastructure, agricultural and industrial sector reforms, rupee appreciation and US sub-prime crisis, etc. Besides, challenges in the field of IT and ITES like rising labour costs, rapid growth in demand for talented manpower/quality staff, high attrition rate, outsourcing backlash, etc., are some other limiting factors. The growth of IT and ITES is having social, economic, health, ethical and environmental implications also. Further, delay in the promotion of

conducive business environment and good governance will enable us to catch up with the global giants in terms of world-wide presence and scale. It is also important to point out here that the measurement of output, productivity, non-availability of data or availability of data after a time lag are other problems confronted with in case of services . The problem gets further compounded because of the entry of new species of services (like IT, ITES, etc) and lack of development of concepts on the one hand and non-inclusion of unpaid households on the other. Further, quality of each unit of the same service varies from the other. Therefore, it is too difficult to achieve the same level of output in terms of quality. Further, quality improvements stemming from the application of new technologies are extremely hard to measure.

Prospects for Growth in the Services Sector

One of the major drivers of service sector growth in the post globalization era in India is the IT and ITES sector. That is why NASSCOM (2005) says that, "The IT and BPO industries can become major growth engines for India, as oil is for Saudi Arabia and electronics and engineering are for Taiwan. Saudi Arabia's oil exports accounted for 46% of GDP in 2004; Taiwan's electronics and engineering exports accounted for 17% of GDP in the same year. India's IT and BPO industries could account for 10-12% of India's GDP by 2015" (NASSCOM). There is a huge potential for growth in the services sector because of increase in disposable income, increasing urbanization, growing middle class, a population "bulge" in the working age groups providing 'demographic window of opportunity,' and emergence of a wide array of unconventional /new services like IT, ITES, new financial services (ATMs, credit cards) and tourism services (eco-tourism, health tourism), etc.

Conclusion

To sum up, the present paper provides a brief overview of performance, prospects and problems encountered by the services sector in India's economy. It is heartening to note that India is called the 'services hub' of the world. The traditional perception of India stands changed today from a 'land of beggars', 'snake

charmers' and 'cyber-coolies' of yesteryears to a 'land of knowledge workers' ---Thanks to IT and ITES. Telecom and ITES-BPO revolution have already marked their presence in India. A number of sector specific measures have been taken up by the government of India to promote IT and ITES and other sun-rise sectors like telecom, organised retail, hospitality, entertainment and financial services sectors. That is why the futurists are very optimistic regarding the bright future and performance

ahead of the sector. That optimism is well reflected in the following words of Mr Kamal Nath, the then Minister of Commerce and Industry which were a part of his speech at World Economic Forum, ".... The question for CEOs the world over is no longer "should my company go to India?", but rather "can my company afford not to be in India?". On the tourism front, it is "Incredible India", but on the economic front, it is clearly, "Opportunity India."

BALANCE OF PAYMENTS

The balance of payments of a country is a systematic record of all economic transactions between the residents of the reporting country and residents of foreign countries during a given period of time.

The balance of payment record is maintained in a standard double-entry book-keeping method. International transactions are entered into the record as credit or debit. The payments received from foreign countries are entered as credit and payments made to other countries as debit.

A complete BoP account comprises the following two broad accounts: (a) Current Account; and (b) Capital and Financial Account.

Current Account Transactions

The current account deals with the trade of goods and services between two countries. An export is a good (or service) that is sent from the domestic country and purchased abroad. An import is a foreign produced good that is imported for domestic consumption. The monetary value of exports from a country and imports into a country are measured in the current account. If the value of a country's exports exceeds the value of the goods and services it imports, then that country has a trade surplus otherwise a trade deficit.

In brief current account includes:

- Payments related to foreign trade, current business and services.
- Short term banking and Credit facilities.
- Payments due as interest on loans and dividends.
- Foreign travel, education, medical expenses.
- Remittances i.e. money sent by individuals working abroad back at home.

Capital account Transactions

It includes those transactions which are undertaken by a resident of India such that his/her assets or liabilities outside India are altered (either increased or decreased). For example: - (i) a resident of India acquire an immovable property outside India or acquire shares of a foreign company. This way his/her overseas assets are increased; or (ii) a resident of India borrows from a non-resident through External commercial Borrowings (ECBs). This way he/she has created a liability outside India.

It includes:

Foreign direct investment (FDI) refers to long term capital investment such as the purchase or construction of machinery, buildings or even whole manufacturing plants. If foreigners are investing in a country, that is an inbound flow and counts as a surplus item on the capital account. If a nation's citizens are investing in foreign countries, that's an outbound flow that will count as a deficit.

Portfolio investment refers to the purchase of shares and bonds in Indian share market by the foreigners.

Other investment includes capital flows into bank accounts or provided as loans. Large short term flows between accounts in different nations are commonly seen when the market is able to take advantage of fluctuations in interest rates and/or the exchange rate between currencies.

Reserve account, the reserve account is operated by a nation's central bank i.e. RBI to buy and sell foreign currencies; it can be a source of large capital flows to counteract those originating from the market.

WHAT ARE EXTERNAL COMMERCIAL BORROWINGS?

External Commercial Borrowings (ECB) refer to commercial loans [in the form of bank loans, buyers' credit, suppliers' credit, securitised instruments (e.g. floating rate notes and fixed rate bonds)] availed from non-resident lenders with minimum average maturity of 3 years. Even loans from Foreign Equity Holders are considered as ECBs.

Thus ECBs mean foreign currency loan raised by residents from recognised lenders.

ECB can be accessed under two routes, viz., **(i) Automatic Route and (ii) Approval Route**

•AUTOMATIC ROUTE

Eligible borrowers

- Corporates (registered under the Companies Act, except financial intermediaries (such as banks, financial institutions (FIs), housing finance companies and NBFCs) are eligible to raise ECB.
- Individuals, Trusts and Non-Profit making Organisations are not eligible to raise ECB.
- Units in Special Economic Zones (SEZ) are allowed to raise ECB for their own requirement. However, they cannot transfer or lend ECB funds to sister concerns or any unit in the Domestic Tariff Area.

ECB for investment in real sector – industrial sector, especially infrastructure sector in India, are under Automatic Route, i.e. do not require RBI/Government approval.

Recognised lenders

Borrowers can raise ECB from internationally recognised sources such as (i) international banks, (ii) international capital markets, (iii) multilateral financial institutions (such as IFC, ADB, CDC, etc.), (iv) export credit agencies, (v) suppliers of equipment, (vi) foreign collaborators and (vii) foreign equity holders.

• APPROVAL ROUTE

Eligible Borrowers

The following types of proposals for ECB are covered under the Approval Route:

- 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.
- Banks and Financial Institutions which had participated in the textile or steel sector restructuring package as approved by the Government are also permitted to the extent of their investment in the package and assessment by Reserve Bank based on prudential norms.
- ECB with minimum average maturity of 5 years by Non-Banking Financial Companies (NBFCs) from multilateral financial institutions, reputable regional financial institutions, official export credit agencies and international banks to finance import of infrastructure equipment for leasing to infrastructure projects.
- Special Purpose Vehicles, or any other entity notified by the Reserve Bank, set to finance infrastructure companies / projects exclusively, will be treated as Financial Institutions and ECB by such entities and will be considered under the Approval Route.
- Non-Government Organisations (NGOs) engaged in micro finance activities are eligible to avail ECB for Rupee expenditure for permissible end-uses.
- Corporates in service sector viz. hotels, hospitals and software companies can avail ECB for import of capital goods.

Recognised Lenders

Borrowers can raise ECB from internationally recognised sources such as (i) international banks, (ii) international capital markets, (iii) multilateral financial institutions (such as IFC, ADB, CDC, etc.), (iv) export credit agencies, (v) suppliers of equipment, (vi) foreign collaborators and (vii) foreign equity holders (other than erstwhile OCBs).

WHAT ARE ADR, GDR AND IDR?

A depositary receipt (DR) is a type of negotiable (transferable) financial security that is traded on a local stock exchange but

represents a security, usually in the form of equity that is issued by a foreign publicly listed company. The DR, which is a physical certificate, allows investors to hold shares in equity of other countries.

The increasing demand for Depositary Receipts is driven by the desire of individual and institutional investors to diversify their portfolios, reduce risk and invest internationally in the most efficient manner possible. While most investors recognize the benefits of global diversification, they also understand the challenges presented when investing directly in local trading markets. These obstacles can include inefficient trade settlements, uncertain custody services and costly currency conversions. But Depositary Receipts offer cost benefits and conveniences.

How Does the DR Work?

The DR is created when a foreign company wishes to list its already publicly traded shares or debt securities on a foreign stock exchange. Initial public offerings, however, can also issue a Depositary Receipt.

To allow creation of DRs, the shares of the foreign company, which the DRs represent, are first of all delivered and deposited with the custodian bank of the depository through which they intend to create the DR. On receipt of the delivery of shares, the custodial bank creates DRs and issues the same to investors in the country where the DRs are intended to be listed. These DRs are then listed and traded in the local stock exchanges of that country.

American Depositary Receipt

ADRs allow U.S. investors to invest in non-U.S. companies and give non-U.S. companies easier access to the U.S. capital markets.

The first ADR was created in 1927 by a U.S. bank to allow U.S. investors to invest in shares of a British department store. Today, there are more than 2,000 ADRs available representing shares of companies located in more than 70 countries.

ADRs may be “sponsored” or “unsponsored.” Sponsored ADRs are those in which the non-U.S. company enters into an

agreement directly with the U.S. depository bank to arrange for recordkeeping, forwarding of shareholder communications, payment of dividends, and other services. An unsponsored ADR is set up without the cooperation of the non U.S. Company and may be initiated by a broker dealer wishing to establish a U.S. trading market.

Global Depositary Receipt

A global depository receipt is a certificate issued by a depository bank, which purchases shares of foreign companies and deposits it on the account. GDRs represent ownership of an underlying number of shares. Global depository receipts facilitate trade of shares, and are commonly used to invest in companies from developing or emerging markets.

The typical GDR structure offers DRs in Europe or other non-US markets pursuant to Regulation S (Reg S) promulgated under the US Securities Act of 1933. GDRs are listed on a European stock exchange such as London or Luxembourg and clear through the Euromarkets clearing systems, Euroclear and Clearstream. GDRs may also be listed on other exchanges, such as Dubai and Singapore. The ability of retail investors to purchase GDRs will depend on the type and location of the listing. In general, however, GDR offerings are aimed at institutional investors and depending on the exchange, they can then be purchased by retail investors in the secondary market.

Indian Depositary Receipt

An Indian Depositary Receipt (IDR) is an instrument denominated in Indian Rupees in the form of a depository receipt created by a Domestic Depository (custodian of securities registered with the SEBI) against the underlying equity of issuing company to enable foreign companies to raise funds from the Indian Securities Markets.

The foreign company IDRs will deposit shares to an Indian Depository. The depository would issue receipts to investors in India against these shares. The benefit of underlying shares (like bonus, dividends etc.) would accrue to the depository receipt holders in India

Standard Chartered PLC became the first global company to file for an issue of Indian depository receipts in India.

BENEFITS OF DEPOSITORY RECEIPTS

To the Issuers

- Broaden and diversify a company's investor base.
- Enhance a company's visibility, status and profile internationally among institutional investors.
- Establish/increase total global issuer liquidity by attracting new investors.
- Develop and/or increase research coverage outside the home market.
- Get an international valuation as the Company is valued alongside its peer group.
- Offer a new avenue for raising equity capital.
- Meet internationally accepted corporate governance standards.

To the Investors

- Trading of GDRs alongside their peer group in the international markets.
- Easier to purchase and to hold than the issuer's underlying ordinary shares.
- Trade easily and conveniently in US dollars and settle through established clearinghouses.
- Facilitate diversification into securities of foreign issuers.
- Create accessibility of price, trading information and research.
- Represent a way to provide international exposure for institutional investors (mutual funds, pension funds) despite restrictions against investing in certain countries or in foreign investment instruments.
- Eliminate unfamiliar custody safekeeping arrangements.



EXCHANGE RATE: CONCEPT

The exchange rate expresses the national currency's quotation in respect to foreign ones. For example, if one US dollar is worth 50 rupees, then the exchange rate of dollar is 50. If something costs Rs. 150, it automatically costs 3 US dollars as a matter of accountancy. Thus, the exchange rate is a conversion factor, a multiplier or a ratio, depending on the direction of conversion.

Each country, through varying mechanisms, manages the value of its currency. As part of this function, it determines the exchange rate regime that will apply to its currency. For example, the currency may be free-floating, pegged or fixed, or a hybrid.

When the exchange rate can freely move, assuming any value that private demand and supply jointly establish, it is called "flexible" exchange rate.

If the central bank timely and significantly intervenes on the currency market, then a "managed floating exchange rate regime" takes place.

In "freely" and "managed" floating regimes, a loss in currency value is conventionally called "depreciation", whereas an increase of currency's international value will be called "appreciation". If the dollar rises from 50 rupees to 60, then it has shown depreciation i.e. value of Indian currency is decreasing with respect to Dollar.

But central banks can also declare a fixed exchange rate, offering to supply or buy any quantity of domestic or foreign currencies at that rate. Under this regime, a loss of value, usually forced by market or a purposeful policy action, is called "devaluation", whereas an increase of international value is a "revaluation".

Merits and demerits of fixed and flexible foreign exchange rates:

Merits of fixed exchange rate:

- It ensures stability in exchange rate. The exporters and importers have not to operate under uncertainty about the exchange rate. Thus it promotes foreign trade.
- It promotes capital movements. Fixed exchange rate system attracts foreign capital because a stable currency does not involve any uncertainties about exchange rate that may cause capital loss.
- Stable exchange rate prevents capital outflow.
- It prevents speculation in foreign exchange market.
- It forces the government to keep inflation in check. In case of fixed exchange rate system, inflation causes balance of payments deficit resulting in depletion of foreign exchange reserves.

Demerits of fixed exchange rate:

- It contradicts the objective of having free markets
- Under this system, countries with deficits in balance of payment run down this stock of gold and foreign currencies. This can create serious problem for them. They may be forced to devalue their currency. On the other hand countries with surplus in balance of payments will face the problem of inflation.
- There may be undervaluation or overvaluation of currency. If the fixed exchange rate is at a level which is lower than the market level i.e. at which demand for foreign currency far exceeds its supply, it will result in deficit in balance of payment. If it is higher than the market level i.e. at which the supply exceeds demand then it may create inflationary

pressure because of balance of payments surplus. It is difficult to fix a rate that may prove to be equilibrium rate

Merits of flexible exchange rate system

- It eliminates the problem of overvaluation or undervaluation of currencies, Deficit or surplus in balance of payments is automatically corrected under this system.
- It frees the government from problem of balance of payments.
- There is no need for the government to hold any reserves.
- It enhances the efficiency in the economy by achieving optimum resource allocation.

Demerits of flexible exchange rate system

- It creates situations of instability and uncertainty. Wide fluctuations in exchange rate are possible. This hampers foreign trade and capital movements between countries.
- It encourages speculation which may lead to larger uncertainties and fluctuations.
- The uncertainty caused by currency fluctuations can discourage international trade and investment.

RUPEE DEPRECIATION CONCEPT

Exchange rate is defined as rate or price at which one country's currency is exchanged for another country's currencies. It depends on the comparative trade advantages and economic strengths of the countries. Higher the demand the stronger it becomes. However for currencies like Rupee which are not traded on exchanges, the value depends on capital inflows in the country.

Rupee depreciation means that rupee has become less valuable with respect to dollar. If the rupee moves upward from 30 per dollar to 40 per dollar then rupee is said to depreciate. It means that rupee is now cheaper than what it used to be earlier.

Causes for depreciation

• Stock market performance

It is a known fact that Indian stock market is dominated by overseas investors. When the economy is performing well and stock market is performing better than other countries, overseas investors will become

heavy investors here. To invest here, they require rupee. This will increase the demand for rupee and will result in higher value for rupee. On the other hand, when these investors are pulling money out of Indian stock market, rupee will be depreciated. Indian markets are in a bad shape for the last 1 year. The sentiments after the US downgrade and the European crisis etc. resulted in overseas investors selling in India and buying dollars.

In a bad performing market, when there is depreciation in rupee, it will bring down the overseas investors real returns. So they will start selling, which will again deepen the situation. Very high prices for gold have created panic among investors and fearing a bubble there, investors started moving towards dollar. This demand in dollar is also causing depreciation of rupee.

• Inflation

Another factor affecting the currency value is inflation. India is experiencing very high inflation rate. This will decrease the purchasing power against other currencies. Thus leads to depreciation of the currency.

• Current account deficit

Current account deficit occurs when a country's total import exceeds the total exports. This makes the country, a net debtor to the rest of the world. This is not good for the country because, the country needs to buy more foreign currency. More demand for the foreign currency will reduce the value of that country's currency. India's current account deficit is more than the expected level now and this also contributes to the depreciation of Indian rupee.

• Corruption and Political paralysis

In the last 1 year, lot of corruption issues came to limelight thus affecting investor sentiments globally.

Rupee depreciation: who are affected?

- a) **Foreign investment:** Any investment abroad, whether in stocks or real estate, would become dearer. For instance, to buy stocks worth a dollar, now a person would be required to pay around Rs. 50 compared with Rs.45 few months ago. However, since different countries have

different currencies, the actual impact would depend upon the fluctuations of currency of a country in which a person is investing. Normally, the rupee is first converted into dollars, which in turn is converted into the currency of the third country. Hence, the actual impact would vary according to the level of depreciation in rupee vis-a-vis the third currency.

b) Foreign education (for aspiring students): Students who plan for next year admissions will end up paying more for the forms of exams such as Test of English as a Foreign Language (TOEFL), Graduate Record Exam (GRE) and Graduate Management Admission Test (GMAT). These are entrance exams that students take to prove their eligibility for studying abroad in terms of basic language, skills and IQ. Moreover, the application forms of foreign universities, which cost \$50-1,000, will be more expensive for Indian students.

c) Foreign education (for existing students): The overall budget will be affected as every item in the budget list will witness a change, as apart from the application fee, examination fee and the tuition fee, even the cost of living will be higher for the students. This will have an impact on students who have delayed paying their fees to the universities for the July-September 2011 batch. Students may now have to pay Rs. 50,000-1 lakh over the fee which they were to pay earlier this year.

d) Foreign travel: The depreciating rupee will increase the cost of foreign travelling.

Rupee depreciation: who are benefited?

a) Remittance to India: those who are dependent on remittances, Rupee depreciation would benefit them as upon conversion to Indian currency the amount would be higher.

Effect on Export and Import

For equity investors, the rupee depreciation would have a twin impact. Some sectors that are primarily export oriented stand to gain from rupee depreciation while sectors dependent on import may be affected adversely. These include petroleum products, metals, capital goods and power.

A number of steps have been taken recently to stimulate capital inflows and curb speculation in foreign exchange market to stabilize the value of the rupee.

MEASURES TO INCREASE SUPPLY OF FOREIGN EXCHANGE

Trade Credit

a) All-in-cost ceiling for trade credit has been increased from 6 months Libor + 200 basis points (bps) to 6 months Libor + 350 bps.

ECBs

a) The existing ECB limit under automatic approval route has been enhanced from US\$ 500 million to US\$ 750 million for eligible corporates. For borrowers in the services sector, the limit was enhanced from US\$ 100 million to US\$ 200 million.

b) The proceeds of ECBs raised abroad for rupee expenditure in India should be brought immediately. In other words, ECB proceeds meant only for foreign currency expenditure can be retained abroad pending utilization. The rupee funds however will not be permitted to be used for investment in capital markets or real estate or for inter-corporate lending.

FII Investment

a) The FII limit for investment in government securities and corporate bonds has been increased by US\$ 5 billion each to US\$ 15 billion and US \$ 20 billion respectively, from earlier limits of US\$ 10 billion and US\$ 15 billion. The investment limit in long-term infrastructure corporate bonds, however, has been kept unchanged at US\$ 25 billion. With this, overall limit for FII investment in corporate bonds and government securities now stands at US\$ 60 billion.

Major administrative measures

a) Forward contracts involving the rupee as one of the currencies, booked by residents irrespective of the type and tenor of the underlying exposure, once cancelled, cannot be rebooked.

b) All cash/tom/spot transactions by authorized dealers on behalf of clients will be undertaken for actual remittances/

delivery only and cannot be cancelled / cash settled.

- c) The Board of Directors of Authorized Dealers was allowed to fix suitable limits for various treasury functions with net overnight open exchange position and aggregate gap limits required to be approved by the RBI.

FOREIGN EXCHANGE MANAGEMENT ACT (FEMA)

When a business enterprise imports goods from other countries, exports its products to them or makes investments abroad, it deals in foreign exchange. Foreign exchange means 'foreign currency' and includes: - (I) deposits, credits and balances payable in any foreign currency; (II) drafts, travellers' cheques, letters of credit or bills of exchange, expressed or drawn in Indian currency but payable in any foreign currency; and (III) drafts, travellers' cheques, letters of credit or bills of exchange drawn by banks, institutions or persons outside India, but payable in Indian currency.

In India, all transactions that include foreign exchange were regulated by Foreign Exchange Regulation Act (FERA), 1973.

The main objective of FERA was conservation and proper utilization of the foreign exchange resources of the country. It also sought to control certain aspects of the conduct of business outside the country by Indian companies and in India by foreign companies. It was a criminal legislation (punishable with imprisonment as per code of criminal procedure) which meant that its violation would lead to imprisonment and payment of heavy fine. It had many restrictive clauses which deterred foreign investments.

In the light of economic reforms and the liberalized scenario, FERA was replaced by a new Act called the Foreign Exchange Management Act (FEMA), 1999. The Act applies to all branches, offices and agencies outside India, owned or controlled by a person resident in India.

FEMA emerged as an investor friendly legislation which is purely a civil legislation in the sense that its violation implies only payment of monetary penalties and fines. However,

under it, a person will be liable to civil imprisonment only if he does not pay the prescribed fine within 90 days from the date of notice but that too happens after formalities of show cause notice and personal hearing. FEMA also provides for a two year sunset clause for offences committed under FERA which may be taken as the transition period granted for moving from one 'harsh' law to the other 'industry friendly' legislation.

Broadly, the objectives of FEMA are:

- (i) To facilitate external trade and payments; and
- (ii) To promote the orderly development and maintenance of foreign exchange market.

The Act has assigned an important role to the Reserve Bank of India (RBI) in the administration of FEMA. The rules, regulations and norms pertaining to several sections of the Act are laid down by the Reserve Bank of India, in consultation with the Central Government. The Act requires the Central Government to appoint as many officers of the Central Government as Adjudicating Authorities for holding inquiries pertaining to contravention of the Act.

There is also a provision for appointing one or more Special Directors (Appeals) to hear appeals against the order of the Adjudicating authorities. The Central Government also establishes an Appellate Tribunal for Foreign Exchange to hear appeals against the orders of the Adjudicating Authorities and the Special Director (Appeals).

The FEMA provides for the establishment, by the Central Government, of a Director of Enforcement with a Director and such other officers or class of officers as it thinks fit for taking up for investigation of the contraventions under this Act.

The Act deals with two types of foreign exchange transactions – Capital Account Transactions and Current Account Transactions.

FEMA permits only authorized persons to deal in foreign exchange or foreign security. Such an authorized person, under the Act, means authorized dealer, money changer, off-shore banking unit or any other person for the time being authorized by Reserve Bank.