INDIAN ECONOMY

Key concepts

Sixth edition

Sankarganesh Karuppiah

McGraw Hill

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To my
Ammachi (Grandma)

Contents

Foreword

Indian economic development involves a wide range of changes in a variety of economic and social indicators. In this context, the author of the book has provided an introduction to the key concepts of Indian economy covering ten important chapters reflecting Indian perspectives ranging from human development, poverty, unemployment, public finance, money and capital market, trade and capital. Keeping in view of the requirements of the students who appear for various professional and competitive examinations both at the central and state levels, this book has been written in a lucid style, providing informative and interesting contributions on Indian economy. Besides providing multiple choice questions, the author also has given subject index for better clarity, comprehensive and easy reference. Therefore, the book can also be used even by students with no prior knowledge of economic subject. I congratulate K. Sankarganesh for bringing out this timely and useful book at a young age, which shows his commitment and dedication.

Dr. D. Rudrappan M.A., M.Phil., Ph.D.,
Professor of Economics & Development Studies,
Covenant University,Ota,
Ogun state, Nigeria.

Preface to Sixth Edition

At the time of conceptualising this book, a decade back, my aim was to write a book for self study. As I graduated in economics through distance education and learnt economics on my own without attending classrooms, I was confidnet that I could write such a book. The response of the readers of the previous editions shows that my confidence was at the optimum level and not overconfidence.

The second aim was to help the readers read economic news and higher level books rather than giving something in economics on a platter as I believe in the proverb 'give a man a fish and you feed him for a day; teach a man to fish and you feed him for a lifetime'. This aim was also fulfilled as many readers who had the chance to give feedback expressed that they were now able to understand basic concepts related to Indian economy and could read newspapers and higher level books without much difficulty.

The third aim was to write a book which is eternal and would not need update and revision. This aim was on a wrong belief that the basic concepts won't change and are eternal. The concepts related to Indian economy undergo change to be in line with international standards. The changes are followed and updated and additional features are added in this book.

From the first edition, this edition has come a long way. Interaction with the readers helped to make some corrections in the book.

Additional features of the 6th edition

- A new chapter Constitution and Indian Economy is added
- The chapter on Human Development Index is updated based on Human Development Report 2018
- The Chapter on Poverty and Unemployment is revamped based on NSSO reports and other relevant literature
- The tax sharing mechanism in the post GST era is updated and the features of GST Council is added
- Additional concepts like Effective Revenue Deficit, Fiscal Destination vs Origin Principle are added

I thank my personal designer S. Kathiravan and the designer at Insight Publishing Solutions. I thank the Publisher McGraw Hill. My special thanks to M. Karthikeyan of Aram IAS academy and Ridhi Gupta, Assistant Manger, MHE. I thank Ms. Shukti Mukherjee and the content development team consisting Malvika Shah, Gagan Gusai and Sachin Kumar for their continuous support. Above all, thanks to those 75,000 plus readers who read and supported this book.

SANKARGANESH KARUPPIAH

Preface to First Edition

The doubts my friends and I had in economics prodded me to write this book. Though many books in economics and dictionary of economics are available in the market, this book is brought to you to provide the concepts which are essential, relevant to the Indian economy and scattered in many books under one umbrella and to give more clarity to you in economic concepts with some practical examples. This book is also aimed to avoid blind reading. So some of the chapters are a bit technical and go into details of the concept. This book is brought not to ensure high marks in competitive exams but to make your reading of economics in newspapers and books without any aversion to economics and to make the subject a more loved one for you. I hope the purpose of this book will be served to the maximum possible extent.

I extend my sincere thanks to my friends and those who helped me in one or another way to bring out my first book. Muni Raja patiently typed the preliminary draft of the book. He typed it not in a blind manner but improved the style of this book with his suggestions. P. Surendaran had drawn various diagrams and also taught me how to do that. P. Amarnath read the first three chapters of this book meticulously and corrected spelling mistakes. Likewise my friend, Arun Shanker Gorky, helped in proofreading and pointed out contradictions and missing concepts in this book, which were corrected and included subsequently. The following IRS colleagues also helped in proofreading and gave valuable suggestions - R. Menaka, M Rani Kanchana, Neeju Gupta, K. Rohan Raj, Nithya Durai Raju, Madhusmita Sahoo, Vikram Pagaria, and M. Karthik Manickam. R. Menaka and M. Rani Kanchana gave critical comments which helped in improving the quality of the book. Neeju Gupta and K. Rohan Raj read all the chapters of this book and gave valuable coments. I thank Thiru. R. Ravichandran, Additional Director General, National Academy of Direct Taxes, Nagpur who read the chapter on Capital Market and gave his valuable comments.

I extend my sincere thanks to Prof. Dr. D. Rudrappan who not only wrote an encouraging foreword but also gave valuable inputs in improving the standard of the book. I extend my sincere thanks to Ganesa Subramanian, who encouraged me in writing this book from the start to this day. I also extend my sincere thanks to Kavin Mukhil publications and the production head of Kavin Mukhil Publications, Ganapathy Subramanian, designer S. Kathirava. Last but not the least, my thanks goes to printer D. Krishnakumar as well.

K. SANKARGANESH

How to use this book

The reader need not read this book again and again and by heart it. Simply read the book once or twice and use it as a reference book like a dictionary with the help of the index provided at the back. On account of the dynamic nature of the Indian economy this book has deliberately avoided data as much as possible. Therefore, all the data given is only for the sake of understanding.

Any suggestions can be mailed to indianeconomykey@gmail.com

Keep yourself updated by reading the newspaper.

AUTHOR DISCLAIMER

The views expressed in this book are of the author and in no way reflect the views of the Ministry of Finance, Government of India, where author works.

Abbreviations

ADR	American Depository Receipts
AFC	Asset Finance Company
AMS	Aggregate Measurement of Support
ANBC	Adjusted Net Bank Credit
AoA	Agreement on Agriculture
ARC	Asset Reconstruction Company
ARDC	Agriculture Refinance Development Corporation
BCCT	Banking Cash Transaction Tax
BOLT	BSE Online Trading
BoP	Balance of Payment
BSE	Bombay Stock Exchange
C	Consumption
CAC	Capital Account Convertibility
CAR	Capital Adequacy Ratio
CARDB	Cooperative Agriculture and Rural Development Bank
CD	Certificates of Deposit
CDS	Current Daily Status
CDSL	Central Depository Services Limited
CENVAT	Centralised Value Added Tax
CP	Commercial Paper
CPI	Consumer Price Index

CPI (AL)	Consumer Price Index (Agriculture Labour)
CPI (IW)	Consumer Price Index (Industrial Worker)
CPI (RL)	Consumer Price Index (Rural Labour)
CPI (UNME)	Consumer Price Index (Urban Non-Manual Employees)
CRAR	Capital to Risk Weighted Asset Ratio
CRR	Cash Reserve Ratio
CSO	Central Statistical Organisation
CWS	Current Weekly Status
DCA	Department of Company Affairs
DSB	Dispute Settlement Body
ECB	External Commercial Borrowings
EPF	Employees Provident Fund
ESOP	Employee Stock Option
ESOS	Employee Stock Purchase
FCNR (B)	Foreign Currency Non Resident (Bank)
FDI	Foreign Direct Investment
FI	Financial Institution
FII	Foreign Institutional Investment
FPO	Follow on Public Offering
FRBM	Fiscal Responsibility and Budget Management
FTP	Financial Transaction Plan
G	Government consumption
GATS	General Agreement on Trade in Services
GATT	General Agreement on Trade and Tariff
GDP	Gross Domestic Product
GDR	Global Depository Receipts
GII	Gender Inequality Index
GNI	Gross National Income
GNIE	Government Not Included Elsewhere
GNP	Gross National Product
GPF	General Provident Fund
HDI	Human Development Index
HDR	Human Development Report

HNI	High Net worth Individual
HSBC	Hong Kong Shanghai Banking Corporation
HTM	Held To Maturity
HUF	Hindu Undivided Family
I	Investment
IC	Investment Company
ICOR	Incremental Capital Output Ratio
IDBI	Industrial Development Bank of India
IDR	Indian Depository Receipts
IFCI	Industrial Finance Corporation of India
IHDI	Inequality Adjusted Human Development Index
IIP	Index of Industrial Production
IMF	International Monetary fund
IPO	Initial Public Offering
ITES	Information Technology Enabled Services
LAB	Local Area Bank
LAF	Liquidity Adjustment Facility
LC	Loan Company
LPG	Liberalisation, Privatisation, Globalisation
LIBOR	London Inter Bank Offer Rate
M	Import
ManVAT	Manufacturing Value Added Tax
MAT	Minimum Alternate Tax
MDPI	Multi Dimensional Poverty Index
MFN	Most Favoured Nation
MoA	Memorandum of Association
Mod VAT	Modified Value Added Tax
MRP	Mixed Recall Period Method
MSS	Market Stabilisation Scheme
NABARD	National Bank for Agriculture and Rural Development
NAV	Net Asset Value
NBFC	Non-Banking Financial Company
NDTL	Net Demand and Time Liabilities
NEAT	National Exchange Automated Trading

NHB	National Housing Bank
NNP	Net National Product
NNPFC	Net National Product at Factor Cost
NNPMP	Net National Product at Market Price
NPA	Non Performing Asset
NPISHs	Non-profit Institutions Serving Households
NR (E) RA	Non Resident (External) Rupee Account
NRO	Non Resident Ordinary Rupee account
NSC	National Saving Certificate
NSCCL	National Securities Clearing Corporation of India Limited
NSDL	National Securities Depository Limited
NSE	National Stock Exchange
NSSF	National Saving Scheme Fund
NSSO	National Sample Survey Organisation
NT	National Treatment
NTB	Non Tariff Barrier
OBE	Off- Balance Sheet Exposure
OME	Oil Marketing Enterprise
P	Price
PACS	Primary Agriculture Credit Societies
PD	Primary Dealer
PLB	Poverty Line Basket
PMI	Purchasing Manager's Index
PPP	Purchasing Power Parity
PPP US $	Purchasing Power Parity at US dollar
PSU	Public Sector Undertaking
Q	Quantity
QIB	Qualified Institutional Buyer
RBI	Reserve Bank of India
RRB	Regional Rural Bank
SBI	State Bank of India
SC	Scheduled Caste
SCB	State Cooperative Bank

SDR	Special Drawing Right
SEBI	ecurities and Exchange Board of India
SLR	Statutory Liquidity Ratio
SNA	System of National Accounts
STT	Securities Transaction Tax
ST	Scheduled Tribe
TRIMS	Trade Related Intellectual Measures
TRIPS	Trade Related Intellectual Property Rights
UNDP	United Nations Development Programme
URP	Uniform Recall Period Method
UPS	Usual Principal Status
USD	United States Dollar
VAT	Value Added Tax
WIPO	World Intellectual Property Organisation
WPI	Whole Sale Price Index
WTO	World Trade Organization
X	Export

CHAPTER 1

Introduction to Economics

There are many definitions for Economics. As the subject keeps on evolving, the definition also keeps on evolving. The father of Economics Adam Smith characterised economics as an inquiry into the nature and causes of the wealth of nations.

Thereafter, a lot many economists defined Economics in different ways based on their own research and perception. But none of them are universally accepted. So, it is better to have an idea about economics rather than having a definition.

An Idea About Economics

This is a study that centres on resources. Resources may be abundant or scarce; natural or man-made; monetary or non-monetary.

It is said so for the reason that the horizon of Economics has widened. Economics deals with scarce resources like diamonds and as well as resources like air, which available in plenty. It speaks about the prices of both. It points out the scarce nature of diamond as a reason for its high price and as air is available in plenty it is not priced. Adam Smith in his *Wealth of Nations* observes, "The things which have the greatest value in use have frequently little or no value in exchange; and, on the contrary, those which have the greatest value in exchange have frequently little or no value in use. Nothing is more useful than water: but it will purchase scarce anything; scarce anything can be had in exchange for it. A diamond, on the contrary, has scarce any value in use; but a very great quantity of other goods may frequently be had in exchange for it."[1] He discusses about the exchange value of both water and diamond. The first one is available in plenty, the second one is scarce. So, it is clear that it studies both abundance and scarcity. The causes and effects of inflation that are related to abundance of money as well as scarcity or shortage of goods and services are also studied. From these premises it is clear that Economics studies both scarcity and abundance. But most part of the economic study is devoted to the study of scarcity, as human tendency is to care for scarce resources.

It is stated as a study that centres on resources for the reason that it not only studies resources but also the factors, stake holders involved in creation, extraction and consumption. It deals with the allocation of resources, allocation of factors of production, consumption pattern of factors of production, the motive and aim of factors of production, behaviour of factors of production and consumers and the psychology behind these motives and aims and behaviour and so many other things.

Factors of production refer to the participants in a production process. They are land, labour, capital and entrepreneur. The land is a base to establish the production unit, transportation and sometimes the source of raw material. Labour contributes her might physically and mentally. Capital is used to purchase men and material. An entrepreneur brings in all other factors of production and puts them in to use, to produce what best can be produced using these. The entrepreneur may be either governmental or private.

A Study Under Controlled Atmosphere

In the technical specifications of a car the mileage of the car is mentioned as, say for example, 22 Kilometres per Litre (KMPL). It means the car runs for 22 kilometres per litre of fuel. But when it is bought and used it may not run 22 km per litre. Have you ever thought why this difference arises? The difference is due to the fact that the 22 KMPL is mentioned after a thorough check under certain laboratory conditions like well-laid road, perfect air pressure in tyre, traffic free atmosphere etc. but in actuality, all the roads are not well laid, the city traffic may be heavy and the air pressure may not be maintained properly all the time. These factors reduce the mileage of the car.

Likewise, certain varieties of seeds yield a high amount of produce in laboratory or in field trial but when it comes to mass scale production by farmers, the yield may not be the same. The reason is difference in atmospheric and other varying conditions of laboratory and field.

The same logic is applicable for Economics. The laboratory conditions are laid in the form of assumptions when it comes to the study of Economics. The economic theories and models are created under specific conditions and assumptions. For example, the demand theory considers that demand for goods and services are based on the level of price for specific goods and services under consideration. It says, if the price is high, the demand for the product is low and vice versa. It is said so because, the theory of demand assumes that other factors that have an impact on demand remain unchanged. But in actuality it is not the case. There are many other factors other than the price that have influence on the demand. The reason for making these assumptions are that the factors considered in theory play a major role in deciding the outcome of the interplay of these factors. The other things do not have a significant influence but at the same time they cannot be ignored. The second reason for assumption is to simplify the study and build a base theory, based on which a further complicated study can be done by considering all other factors that have impact or influence on the issue under consideration. The assumption of other variables being unchanged is called *Ceteris paribus. The Economic Times* defines *Ceteris paribus* as "This commonly-used phrase stands for 'all other things being unchanged or constant'. It is used in conomics to rule out the possibility of 'other' factors changing, i.e. the specific causal relation between two variables is focused."[2]

In the way in which the laboratory-checked cars and seeds yield less on the field, the economic theories also deliver less in practice as the world is more complicated than what was considered while building economic theories and models. But these economic theories and models do not fail the world as due care is taken while building them and framing them to make them as close as possible to the realities of the world.

Two Main Streams

There are two main streams of Economics. They are Microeconomics and Macroeconomics.

The term 'Micro' is used to indicate something relating to a specific area, rather a general one. The term 'Macro' is used to denote something relating to a general area rather than being detailed or specific. Likewise, Microeconomics studies the specific area of Economics such as individuals, a smaller group like labourers, economics of a firm etc. Macroeconomics studies the economy of a nation as a whole.

The study of demand of individuals, the production function of a production unit, also known as a 'firm', are covered under Microeconomics. At the same time the study of the demands of the nation, the production or supply level of a nation, the general level of employment etc. are covered under Macroeconomics.

A careful reading of the following table will give clarity on the question as to what is Microeconomics and what is Macroeconomics.

Issue considered	**Is it Micro?**	**Is it Macro?**
Quantity of orange demanded by Asstha Mathur	Yes	No
Quantity of orange demanded by North- east India	Yes	No
Quantity of orange demanded by India	Yes	No
Quantity of all products demanded by India	No	Yes
Price of orange in Nagpur	Yes	No
Price level of all products in India	No	Yes
Level of employment in Iron and steel industry	Yes	No
Level of employment in India	No	Yes

This book looks at Indian economy from the macroeconomic perspective, but does not dwell into theoretical aspects. It concentrates on the concepts and its practical implications.

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1 Adam Smith *Wealth of Nations*, Bantam Classic Edition / March 2003, p. 41.
2 http://economictimes.indiatimes.com/definition/ceteris-paribus - the web page accessed on 25.1.2014.

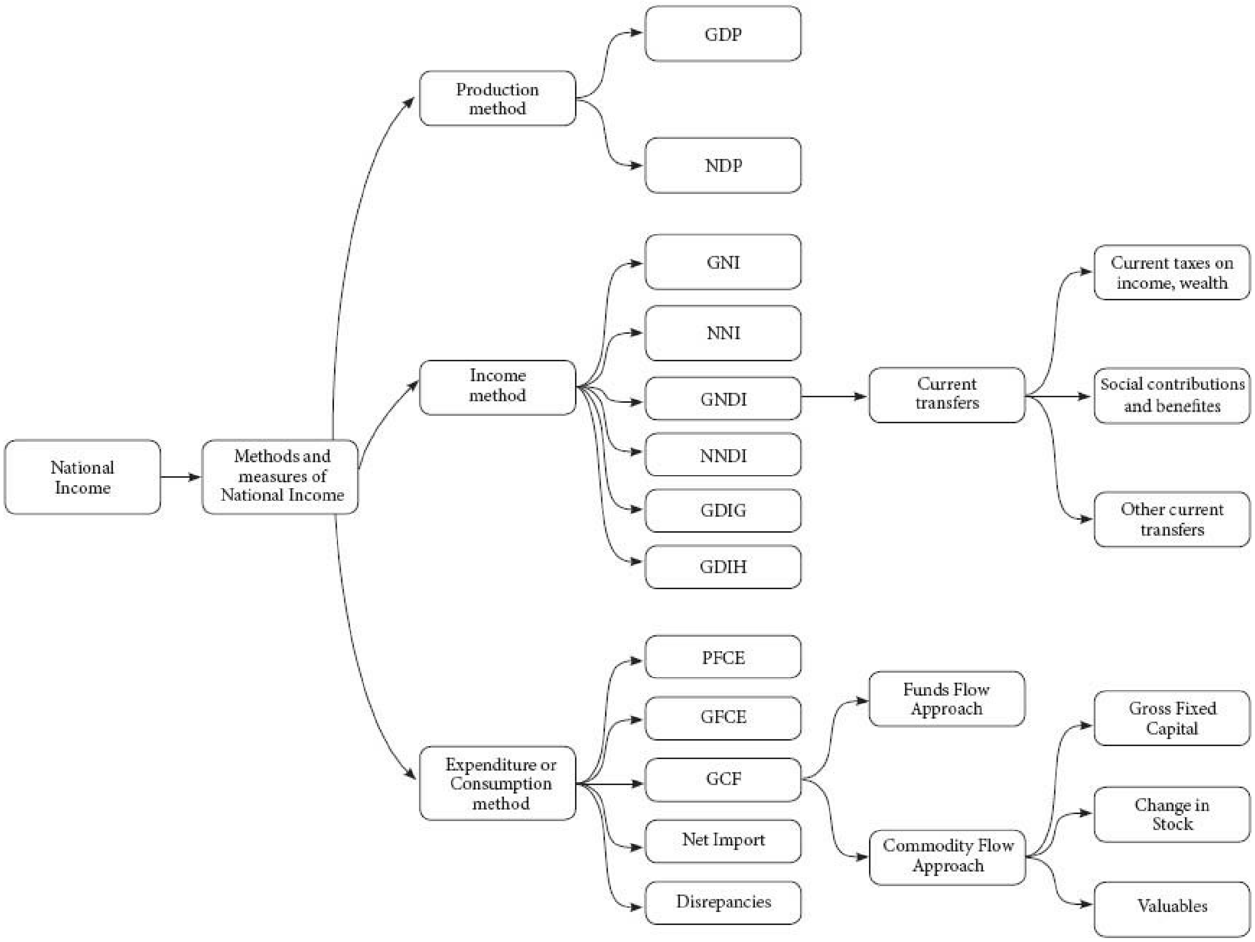
CHAPTER

2

National Income[1]

- Methods and Measures
- Estimates of National Income in India
- Related Terms

Mind Map 2.1



National Income of a country is the total income generated by the residents of a country in its economic territory in a particular period of time usually, one year. This definition of National Income is very generic and not in a strict sense of economics. The growth of National Income helps to know the progress of the country.

This chapter covers the methods of measuring National Income, measures of National Income, and its estimates in India.

National Income - Methods and Measures

There are various estimates of National Income, and each estimate helps in measuring the income from a different perspective. Before learning these methods, it is important to understand the flow of income among various players who take part and contribute to the

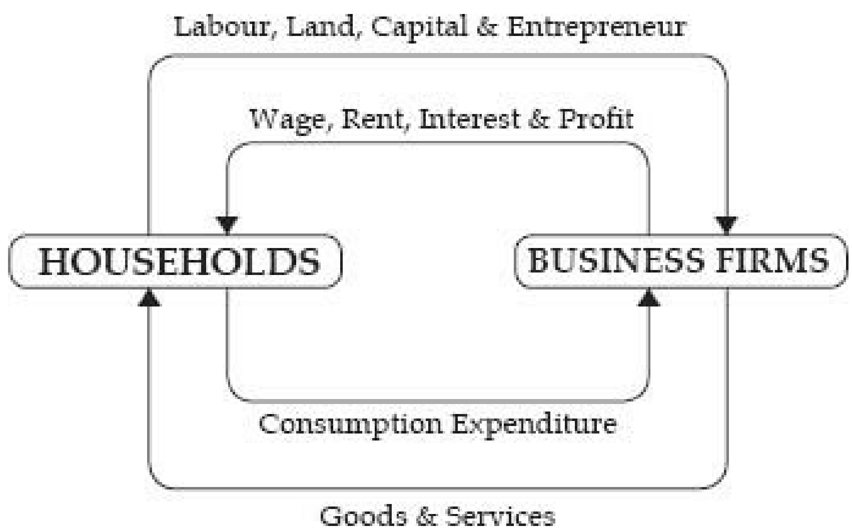
National Income.

There are four players namely, individuals or households, business firms or investors, government and foreign nationals. For the sake of simplicity, we shall consider only the first and second.

The figure 2.1 shows circular flow of income between households and business firms. The upper part shows the supply side of economy and the lower part shows the demand side of the economy.

In the upper part, the households supply factors of production viz., labour, land, capital and entrepreneur to business firms to produce goods and services. In return, the business firms give wage, rent, interest and profit to labour, land, capital and entrepreneur respectively.

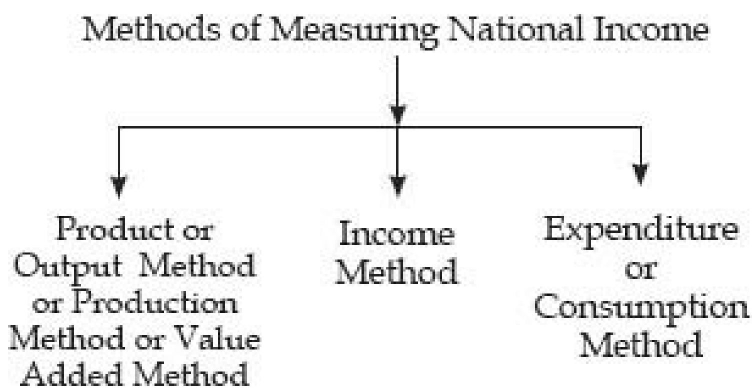
Figure 2.1 A graphical representation of flow of income



The wage, rent, interest and profit are expenditure to business firms but income to households. So, one's income is another's expenditure. Hence, it is evident that the expenditure of one player and the income of another player are equal. So, National Income can be calculated by compiling income of all or expenditure of all. The calculation of National Income by compiling income of household is called **Income Method.**

The bottom of the figure shows the flow of goods and services that are produced by business firms and demanded by the people. For the flow of goods and services produced and supplied by business firms, households pay money. Here, the value of goods and services produced (price × quantity) is equal to the expenditure incurred by households on purchase of those goods and services. Both are equal. So, the National Income can be calculated by calculating the total value of all goods and services or by compiling total expenditure incurred by the people. The former is called **Product Method (or) Output Method (or) Production Method (or) Value added method. The latter is called the Consumption Method (or) Expenditure Method.** This is shown in the following figure 2.2.

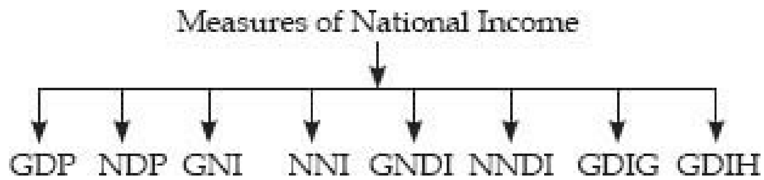
Figure 2.2



The Ministry of Statistics and Programme Implementation, Government of India, introduced a new series of national income estimation in January 2015 guided by the recommendations of the international guidelines on the subject, System of National Accounts (SNA), 2008. Let us call it, shortly, New Series.

As mentioned earlier, there are various measures of National Income. They are similar to one another and shown in the following figure 2.3.

figure 2.3.



Before knowing about GDP and other measures of National Income it is essential to know about two other measures. They are GVA at basic prices and GVA at factor cost.

GVA at basic prices

GVA stands for Gross Value Added. GVA at basic prices is also called GVA at Producer's prices. The term Basic prices is the alternate term to describe Producer's prices. It is different from market prices or buyer's prices. The producer's price is equal to production cost. The buyer's prices over and above producer's prices include product taxes less product subsidies.

Buyer's prices = producer's price + (Product taxes – product subsidies)

The GVA is arrived from output of 11 industries (The 11 industries are listed in box 1.1). The output consists of input material and services which is called intermediate consumption and the value addition made to input material and services to bring it as final goods and services.

Output = *Input materials and services* + *Value added*

So to arrive at gross value added the intermediate consumption is deducted from output value. It is in formulaic as below:

GVA at basic prices = *Output – Intermediate consumption*

Take an example of wheat flour. It is manufactured in industries and is a final product of these industries. Let us take value of 1 kg wheat flour at basic price as `80. So the output is `80. To manufacture wheat flour, wheat and electricity are needed to be used as inputs. Wheat and electricity are outputs of other industries. Wheat is output of agriculture sector (Sl. No 1 of box 2.1). Electricity is output of electricity, gas, water supply and other utility services sector (Sl. No 4 of box 1.1). They were already accounted as output of those sectors. Hence, they are deducted from output of manufacturing sector to arrive at value addition of manufacturing sector.

Let us assign value to the inputs.

Input value of wheat = ₹20

Input value of electricity = ₹10

Let us calculate gross value added by wheat flour manufacturing industry.

GVA at basic prices = Output – Intermediate consumption

Gross value added by wheat flour manufacturing industry = Output of wheat manufacturing – Inputs of wheat flour manufacturing

50 = 80 – 30

The gross value added by wheat flour manufacturing industry is ₹50.

The value addition is done by entrepreneur or enterprise engaging employees and plant and machinery. The entrepreneur or enterprise, employees and plant and machinery are called **factors of production**. The enterprise or entrepreneur, employees need to be rewarded.

In addition to these factors of production the services of government are being used for which the enterprise needs to pay land revenue, licence fee, etc. These payments to the government are to be made irrespective of the fact whether the production is done or not. These expenditures are called production taxes. At the same time the enterprises receive production subsidy from the government.

Box 2.1

1. Agriculture, forestry and fishing
2. Mining and quarry
3. Manufacturing
4. Electricity, gas, water supply and other utility services
5. Construction
6. Trade, repair, hotels and restaurants
7. Transport, storage, communication and service related to broadcasting
8. Real estate, ownership of dwelling and professional services
9. Public administration and defence
10. Financial services
11. Other services

Please don't memorise this list; just have a look at it

There is a difference between tax on products and tax on production. Tax on product includes taxes like sales tax and excise duty. It is the tax imposed as it was produced and sold. Tax on production refers to tax imposed irrespective of production like licence fees and land tax.

Production taxes or subsidies are paid or received with relation to production and are independent of the volume of actual production. Some examples are:

Production Taxes - Land Revenues, Stamps and Registration fees and Tax on profession.

Production Subsidies - Subsidies to Railways, Input subsidies to farmers, Subsidies to village and small industries, Administrative subsidies to corporations or cooperatives, etc.

The plant and machinery fall under the category of capital asset. It undergoes wear and tear in the manufacturing process and it is a sort of consumption and is called **consumption of fixed capital**.

The reward to employee, entrepreneur or enterprise and consumption of fixed capital is called **factor cost**. All these are expenditures to manufacture wheat flour. All these added together is the value addition done to wheat and electricity. It is the **Gross Value Added** by the wheat flour manufacturing industry.

Gross value added at basic prices = Compensation of Employees (CE) + Operating Surplus / Mixed income (OS/MI) + Consumption of Fixed Capital (CFC) + Production taxes less Production subsidies

The payments made to employees are called **compensation to employees (CE)** and the payments made to enterprises are called **operating surplus or mixed income (OS/MI)**. The machinery and buildings undergo wear and tear which leads to loss in their value. It is called **consumption of fixed capital (CFC)**. The production taxes are taken as net of production subsidies.

Compensation of Employees

Compensation of employees is defined as the total remuneration, in cash or in kind, payable by an enterprise to an employee in return for work done by the latter. It is simply known as the wage and salary paid to workers and employees either in cash or in kind. An example for payment made in kind is agriculture produce given to agriculture labourers.

Operating Surplus or Mixed Income

Operating surplus or mixed income is a measure of the surplus accruing from processes of production before deducting any explicit or implicit interest charges, rent or other property incomes payable on the financial assets, land or other natural resources required to carry on the production.

The surplus is arrived by deducting compensation to employees and production taxes less production subsidies and consumption of fixed capital from gross value added.

The surplus so arrived in the case of incorporated enterprises are called **Operating surplus**. The surplus arrived in the case of unincorporated enterprises are called **mixed income**.

Incorporated enterprises refer to enterprises that are established as a separate legal entity. A separate legal entity is an entity which can be treated like a human being. It is capable of entering into contracts and on failure of its contract it can be sued in a court. It can borrow from anybody and it has to repay. The examples of incorporated enterprises are Companies and Limited Liability Partnerships (LLPs) registered under the Companies Act.

If the legal entity is not able to repay the borrowed loan, the investors or promoters of the legal entity are not responsible to repay the loan availed by the company. For example for the default of Kingfisher Airlines Ltd., Vijay Mallya cannot be held responsible unless it is proven that he misused his position and misappropriated the borrowed funds.

Even the promoters' or investors' investment itself is a liability of the company it owes to investors or promoters. The company is altogether a separate person from the investors and promoters. The fixed assets and other assets created out of the investments are of the legal entity and not of the investor or promoters.

Unincorporated enterprises are enterprises that are not incorporated as separate legal entity. There is no distinction between the owners/investors and the entities. Examples of unincorporated entities are proprietorship concerns, partnership firms. The proprietorship concerns cannot enter into any contract. They cannot borrow. Everything should be done in the name and by the owner/investor.

The unincorporated enterprises are owned by households in which the owner(s) or members of the same household may contribute unpaid labour inputs of a similar kind to those that could be provided by paid employees. The households do not charge separately for the labour contributed by them for their own enterprises. They take the entire surplus. The surplus is described as mixed income because it implicitly contains an element of remuneration for work done by the owner, or other members of the household, that cannot be separately identified from the return to the owner as entrepreneur. In many cases the element of remuneration may dominate the value of mixed income.

In practice, all unincorporated enterprises owned by households that are not quasi-corporations are deemed to have mixed income, except owner-occupiers in their capacity as producers of housing services for own final consumption, households leasing dwellings and households employing paid domestic staff. For owner-occupiers and those leasing dwellings, all value added is operating surplus. For domestic staff all value added is compensation of employees (unless any taxes or subsidies on production are payable or receivable on the output).

Consumption of Fixed Capital

It is the decline in the current value of the stock of fixed assets owned and used by a producer as a result of physical deterioration, normal obsolescence or normal accidental damage.

The term depreciation is often used in place of consumption of fixed capital but it is avoided in the SNA because in commercial accounting the term depreciation is often used in the context of writing off of historic costs whereas in the SNA, consumption of fixed capital is dependent on the current value of the asset.

Writing off of historic cost denotes that irrespective of the amount of physical deterioration, normal obsolescence or normal accidental damage, reduction is made on a certain percentage of the value of the fixed assets from the original purchase cost. For example if a machine was purchased for ₹1 lakh writing off at historic cost would refer to reducing ten thousands from the value of the machinery every year to arrive at the year-end value of the machinery.

In SNA consumption of fixed capital is arrived after deducting the current value of assets from the initial value of assets. The current value is estimated using various techniques available.

Consumption of fixed capital = Initial value of asset - Current value of asset

Initial value of asset is the actual value of asset at the beginning of the year and the current value of asset is the actual value of asset at the end of the year.

Production Taxes

The production taxes are taken as net of production subsidies i.e. production taxes minus production subsidies, as expenditure on account of production taxes come down to the extent of production subsidies. It is taken as **production taxes less production subsidies**. To put in formula the gross value added is as follows:

Let us assign value to the factors used for value addition to wheat and electricity to produce wheat flour.

Compensation of employees (CE) = ₹15

Operating surplus/ Mixed income (OS/MI) = ₹20

Consumption of fixed capital (CFC) = ₹10

Production taxes = ₹10

Production subsidies = ₹5

Gross value addition = 15 + 20 + 10 + (10 – 5) = 50

GVA at factor cost

The value of gross value addition made excluding the production taxes less production subsidies is called GVA at factor cost.

GVA at Factor Cost = Output – (Intermediate consumption) – (Production Taxes – Production subsidies)

GVA at Factor Cost = GVA at basic prices – (Production Taxes – Production subsidies)

GVA at Factor Cost = CE+OS or MI +CFC

Here the value addition is comprised only of reward to factors of production which is called factor cost.

From the above discussion it is clear that Gross Value Added is strictly a production measure defined only in terms of output and intermediate consumption.

With the clear understanding of the concepts of GVA at factor cost and GVA at basic prices we can move to the concepts of GDP and other measures of national income.

Production Method

1. Gross Domestic Product (GDP)

Gross domestic product (GDP) at market prices is equal to the sum of the gross value added of all **resident units** plus those taxes, less subsidies, on products. It denotes Gross Value Added plus tax on product less subsidies on products. GDP at market prices is called shortly GDP.

GDP = GVA at basic prices + (Product Taxes including import duties – Product Subsidies)

GDP = GVA at basic prices + Net Indirect Taxes

Product taxes are paid and product subsidies are received per unit of product. Some examples are:

Product Taxes: Excise duty, Sales tax, Service tax and Import and Export duties

Product Subsidies: Food, petroleum and fertiliser subsidies, interest subsidies given to farmers, households etc. through banks, subsidies for providing insurance to households at lower rates

It is necessary to have a clear idea about 'resident units'. The concept of residence in the SNA is not based on nationality or legal criteria. If an institutional unit has a centre of predominant economic interest in the economic territory of a country it is said to be a **resident unit** of that country; that is, when it engages for an extended period of one year or more in economic activities on its territory.

Box 2.2. Institutional sectors

Institutional units having similar principal functions, behaviour and objectives are grouped together and called **institutional sectors**. As per SNA there are five institutional sectors. They are explained below:

a. *Non-financial corporations* are institutional units that are principally engaged in the production of market goods and non-financial services.

b. *Financial corporations* are institutional units that are principally engaged in financial services including financial intermediation.

c. *General government* consists of institutional units that, in addition to fulfilling their political responsibilities and their role of economic regulation, produce services (and possibly goods) for individual or collective consumption mainly on a non-market basis and redistribute income and wealth.

d. *Households* are institutional units consisting of one individual or a group of individuals. All physical persons in the economy must belong to one and only one household. The principal functions of households are to supply labour, to undertake final consumption and, as entrepreneurs, to produce market goods and non-financial (and possibly financial) services. The entrepreneurial activities of a household consist of unincorporated enterprises that remain within the household except under certain specific conditions.

e. *Non-profit institutions serving households (NPISHs)* are legal entities that are principally engaged in the production of non-market services for households or the community at large and whose main resources are voluntary contributions. Examples for NPISHs are Trusts, NGOs, etc.

Institutional units are the economic units that can engage in the full range of transactions and are capable of owning assets and incurring liabilities on their own behalf. Examples for institutional units are manufacturing units, banks.

It is necessary to have a clear idea about 'economic territory'. The most commonly used concept of **economic territory** is the area under the effective economic control of a single government.

An economic territory includes islands, airspace, territorial waters and territorial enclaves in the rest of the world (such as embassies, consulates, military bases, scientific stations, information or immigration offices, that have immunity from the laws of the host territory) physically located in other territories. Economic territory has the dimensions of physical location as well as legal jurisdiction, so that corporations created under the law of that jurisdiction are part of that economy. The economic territory also includes special zones, such as free trade zones and offshore financial centres. These are under the control of the government and so are part of the economy, even though different regulatory and tax regimes may apply depending on the country where it is located. The territory excludes international organisations and enclaves of other governments that are physically located in the territory.

GDP is a production measure as it is obtained by summing the gross value added of all resident institutional units, in their capacities as producers, and adding the values of any taxes, less subsidies, on production or imports to the gross value added.

2. Net Domestic Product (NDP)

Net Domestic Product (NDP) is arrived after deducting Consumption of Fixed Capital from gross domestic product.

NDP = GDP – Consumption of Fixed Capital

In principle, the concept of value added should not include the consumption of fixed capital. Consumption of fixed capital is not a current expenditure. It is a reduction in the value of previously created fixed assets when they are used up in the production process. It is just a reduction in the value of fixed assets. Wear and tear is like evaporation of petrol and diesel. It means it is spent but did not benefit anybody. It is a part of expenditure in the production process but not of income of anybody who is involved in the production process. Thus, theoretically, value added should be a net concept and GDP should be a net concept. Hence consumption of fixed capital is deducted from GDP and thereby NDP is arrived at.

However, gross measures of product and income are commonly used for various reasons. It is due to difficulty in measuring and obtaining data of consumption of fixed capital and to enable international comparison. The calculation of consumption of fixed capital requires that statisticians estimate the present value of the stock of fixed assets, the lifetime of various types of assets, patterns of depreciation, etc. Estimation requires well qualified statisticians, data and tools which generally not available in all countries. Hence, not all countries make such calculations. The estimations done by different countries are not comparable due to the difference in the methodology followed and estimation with inadequate data .

The gross measure is devoid of these difficulties to some extent and comparable as all countries measure value addition on gross basis and they are generally considered more comparable between countries. So, GDP is broadly used even if it is economically inferior to NDP, on a conceptual basis. However, NDP should also be calculated, with improved estimates of consumption of fixed capital when necessary, in order to provide a significant tool for various types of analysis.

Income Method

3. Gross National Income (GNI)

Gross national income (GNI) is the aggregate value of the gross balances of primary incomes of all resident institutional units. **It is an income measure.**

Primary incomes are incomes that accrue to institutional units as a consequence of their involvement in processes of production or ownership of assets that may be needed for purposes of production.

A major item of primary income is compensation of employees that represents the income accruing to individuals in return for their labour input into production processes. Primary incomes that accrue by lending or renting financial or natural resources, including land, to other units for use in production is called **property income**. As these two components are earned by factors of production namely labour and entrepreneur they are also called **factor income**. Receipts from taxes on production and imports (less subsidies on production and imports) are treated as primary incomes of governments.

Primary incomes do not include the payments of social contributions to social insurance schemes and the receipt of benefits from them, current taxes on income, wealth, etc. and other current transfers. In short it does not include the current transfers. Current transfers are explained later.

As explained earlier the value added is equal to the income accrued to institutional units involved in the production process that is value addition process. Hence GDP should be equal to GNI.

But all the income does not accrue to resident institutional units. Primary incomes generated in the production activity of resident producer units within the economic territory are distributed mostly to other resident institutional units. However, part of them may go to non-resident units. In the same way part of primary incomes generated in the production activity in the Rest of the World by their resident units are distributed to their non-resident units. Some of their non-resident units may be our resident units and some income is distributed to our resident units. Hence GNI can be arrived by adding net primary income to GDP.

The difference between primary income accrued to non-resident institutional units in the economic territory of a country and income accrued to resident institutional units in the ROW is called **net primary income from Rest of the World (ROW)**.

As per SNA 2008, GNI is equal to GDP less primary incomes payable to non-resident units plus primary incomes receivable from non-resident units. In other words, GNI is equal to GDP less taxes net of subsidies on production and imports, compensation of employees and property income payable to the rest of the world plus the corresponding items receivable from the rest of the world. Thus GNI is the sum of gross primary incomes receivable by resident institutional units or sectors form domestic economic territory and foreign economic territory. GNI is expressed in formulaic form as follows:

GNI = GDP + [(taxes less subsidies on production and imports + compensation of employees and property income payable to the rest of the world)– (taxes less subsidies on production and imports + compensation of employees and property income receivable from the rest of the world)]

The shortened version of the above formula is as below:

GNI = GDP + Net Primary Income from Rest of the World (ROW)

The word net indicates receipt of resident institutional units less payment to non-resident institutional units. The word Rest of World indicates area lying outside the economic territory.

The press note on New Series Estimates of National Income, Consumption Expenditure, Saving and Capital Formation released by Ministry of Statistics and Programme Implementation, Government of India, dated January 30, 2015, has the formulae for various measures of national income. As per this note the formula for GNI is,

GNI = GDP + Net Primary income from Rest of the World (ROW)

It has formula for net primary income from Rest of the World also. As per this note the Net Primary Income from Rest of the World (ROW) has two components. They are Net Compensation of Employees and Net Property and Entrepreneurial Income. In formulaic form it is written as follows:

Net Primary Income from Rest of the World (ROW) = Net Compensation of Employees + Net Property and Entrepreneurial Income

Hence,

GNI = GDP + Net Compensation of Employees from Rest of the World (ROW) + Net Property and Entrepreneurial Income from Rest of the World (ROW)

The Net Primary Income of the government is not accounted as per the above formula. The press note didn't elaborate the reason for the same.

If Net Primary Income from ROW is positive GNI is higher than GDP and vice versa.

GNI > GDP if Net Primary Income from ROW is positive.

GNI < GDP if Net Primary Income from ROW is negative.

Difference between GDP and GNI

Both GDP and GNI are obtained by summing over the same set of resident institutional units; there is no justification for labelling one as "domestic" and the other as "national". Both aggregates refer to the total economy defined as the complete set of resident institutional units or sectors. The difference between them is not one of coverage but the fact that GDP measures production while GNI measures income. Both have an equal claim to be described as domestic or national. However, as the terms "gross *domestic* product" and "gross *national* income" are deeply embedded in economic usage, the SNA did not propose to change them. Emphasis should be given, however, to the third rather than second letter of the acronym to emphasise the fact that GDP refers to production (output) and GNI to income.

The catch word for GDP is "product" and the catch word for GNI is "income". GDP is strictly a production measure and GNI is strictly an income measure.

4. Net National Income (NNI)

Net National Income (NNI) is arrived after deducting Consumption of Fixed Capital from gross national income.

NNI = GNI – Consumption of Fixed Capital

It is known as national income. By dividing this by estimated population **Per Capita Income** is arrived at.

5. Gross National Disposable Income (GNDI)

Disposable income refers to the income that is available which can be disposed (spent) or saved.

Disposable Income = Income available for spending + Income available for saving

All the income received cannot be spent. Direct tax payments like income tax are to be paid out of income. These have to be deducted to arrive at disposable income.

Gross national disposable income measures the income available to the total economy for final consumption and gross saving. National disposable income is the sum of disposable income of all resident institutional units or sectors.

The whole primary income received by the factors of production involved in the production process is not retained by them. A part is transferred to non-residents. At the same time resident units may receive transfers originating out of primary incomes in the Rest of the World.

Gross national disposable income is equal to GNI less current transfers (other than taxes, less subsidies, on production and imports) payable to non-resident units, plus the corresponding current transfers receivable by resident units from the rest of the world.

GNDI = GNI + (Current transfers receivable by resident units from the Rest of the World – Current transfers payable to non-resident units to the Rest of the World)

GNDI = GNI + Net current transfers from ROW

As said earlier GNI does not include current transfers, the GNDI is arrived at by adding it to GNI.

Current transfer is a transaction in which one institutional unit provides a good or service to another unit. It is provided without receiving from the latter any good or service directly in return as counterpart. It does not oblige one or both parties to acquire, or dispose of, an asset.

Current transfer payments are made as a part of social responsibility. The receiver need not pay anything in return directly. These payments are made not against any productive activity on the part of the receiver. The examples are, old age pension, unemployment compensation, disaster relief payment, interest paid on public debt, taxes paid to government, etc.

Tax paid to government is an example of current transfer. Tax is a compulsory levy payable by an institutional unit to the government without any corresponding entitlement to receive a definite and direct quid pro quo from the government. Quid pro quo refers to something given or taken equivalent to another.

Three main kinds of current transfers are:
a. Current taxes on income, wealth, etc.;
b. Social contributions and benefits;
c. Other current transfers.

a. Current taxes on income, wealth, etc,

It consists mainly of taxes on the incomes of households or profits of corporations and of taxes on wealth that are payable to the government. To put it in short, it consists of income tax and wealth tax payable by the households and corporations to the government.

b. Social contributions and benefits

Social contributions are payments to social insurance schemes and other social security payments like provident fund, payment to new pension scheme, etc. These payments are made either by employers or employees or by both. Households themselves make these kinds of payments in their capacity as employed, self-employed or unemployed persons.

Social benefits are current transfers received by households. It is intended to provide for the needs that arise from certain events or circumstances, for example, sickness, unemployment, retirement, housing, education or family circumstances. Social benefits may be provided under social insurance schemes or by social assistance.

Example for social insurance schemes are Pradhan Mantri Suraksha Bima Yojana /Pradhan Mantri Jeevan Jyoti Bima Yojana and example for social assistance is Indira Gandhi National Old Age Pension Scheme.

c. Other current transfers

The current transfers other than current taxes on income, wealth and social contributions and social benefits are called other current transfers. Other current transfers include the following:

i) Net premiums and claims under non-life insurance policies

ii) Current transfers between different kinds of government units, usually at different levels of government, and also between general government and foreign governments, such as transfers under aid programmes intended to sustain the consumption levels of populations affected by war or natural disasters such as droughts, floods or earthquakes

iii) Current transfers to and from NPISHs and

iv) Current transfers between resident and non-resident households i.e, foreign remittances between resident and non-resident households.

These current transfer payments and receipts are between resident institutional units, or between resident and non-resident units. Transfer from one resident unit to other resident unit does not make any impact on the disposable income of an economy as it is within the economy. If it reduces disposable income of one resident unit who pays, it increases the disposable income of receiving resident unit. But the current transfers between resident and non-resident units affect the disposable income of the economy. The net of current transfer paid to and received from non-resident units is called net current transfer from ROW.

If net current transfer from ROW is positive GNDI is higher than GNI and vice versa.

GNDI > GNI if net current transfer from ROW is positive.

GNDI < GNI if net current transfer from ROW is negative.

The press note on New Series Estimates of National Income, Consumption Expenditure, Saving and Capital Formation released by Ministry of Statistics and Programme Implementation, Government of India, dated January 30, 2015, has the formulae for various measures of national income. As per this note the formula for GNDI is as follows:

GNDI = GNI + Net other current transfers from ROW

The same press note has remarks on the formula. It reads "*Other Current Transfers refers to current transfers other than the primary incomes".* From this remark it can be inferred that **other net current transfers** include all the three components of current transfers viz., Current taxes on income, wealth, etc., Social contributions and benefits; and other current transfers.

6. Net National Disposable Income (NNDI)

By adding net other current transfers from ROW to NNI the NNDI can be arrived at.

NNDI = NNI + net other current transfers from ROW

By deducting the consumption of fixed capital from gross national disposal income also net national disposable income is obtained.

NNDI = GNDI – Consumption of fixed capital

7. Gross Disposable Income of Government (GDIG)

As said earlier, the disposable income is the total of income available for spending and income available for saving.

Gross Disposable income of Government = GFCE + Gross Savings of

General Government

Where

GFCE stands for Government Final Consumption Expenditure.

8. Gross Disposable Income of Households (GDIH)

The Gross Disposable Income of Households can be arrived at from Gross National Disposable Income by deducting Gross Disposable Income of Government and Gross Savings of All Corporations.

GDIH = GNDI – GDIG – Gross Savings of All Corporations

The above calculation of national income is based on output method. The national income can be calculated based on expenditure method too.

Expenditure Method

The calculation of GDP above was by gross value added method or output method and GNI was by income method. The GDP can be calculated by expenditure method. As seen in the flow of income, output is equal to expenditure. Hence, GDP can be calculated by expenditure method as well.

The income earned is used for consumption and savings. The total of these should be equal to income.

Income = Consumption expenditure + Savings

The consumption expenditure is done by both private and government. Savings are ultimately used for investments in fixed assets and financial assets. Investments in fixed assets and financial assets put together are called capital formation.

So the above formula can be rewritten as follows:

Income = Consumption expenditure + Capital formation

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

GDP = PFCE + GFCE + GCF + Export of Goods and Services – Import of Goods and Services) + Discrepancies

Where,

PFCE – Private Final Consumption Expenditure

GFCE – Government Final Consumption Expenditure

GCF – Gross Capital Formation

In the above formula PFCE, GFCE and Export of Goods and Services – Import of Goods and Services are expenditure items. GCF is a savings item.

In the SNA, final consumption expenditure is incurred only by general government, NPISHs and households. Corporations do not have final consumption expenditure. They may purchase the same kinds of goods or services as households use for final consumption (for example electricity or food) but such goods or services are either used for intermediate consumption or provided to employees as remuneration in kind.

I. Private Final Consumption Expenditure

Final consumption expenditure is the amount of expenditure on consumption goods and services. The final consumption expenditure borne by private is called private final consumption expenditure. Here by the word private we mean households. All consumption expenditure by households is incurred by them for their own benefit. The final consumption expenditures are incurred both within the economic territory and in ROW. The PFCE is expressed in formulaic form as below:

PFCE = Private Final Consumption Expenditure in Domestic Market + (Final Consumption Expenditure of Resident households in the rest of the world – Final Consumption Expenditure of Non-resident households in the economic territory)

II. Government Final Consumption Expenditure

Final consumption expenditure is the amount of expenditure on consumption goods and services. The final consumption expenditure borne by the government and NPISH is called General Government Final Consumption Expenditure. Consumption expenditure by General Government is either for the benefit of the community at large or for the benefit of individual households. The examples for the consumption expenditure by the government for the benefit of community at large are control of law and order, disease control measure, etc. The examples for the consumption expenditure by the government for the benefit of individual households are subsidised public distribution, disaster relief payments, etc.

The expenditures that government units or NPISHs make on individual goods and services that they provide to households as social transfers in kind are recorded as final consumption expenditure incurred by government units or NPISHs.

III. Gross Capital Formation

Gross capital formation refers to addition of new capital assets. From addition of new assets the disposed assets are deducted and the net addition of capital assets is called gross capital formation. The capital assets are fixed assets like building, machinery plus inventories and valuables. The estimation of Gross capital formation is dealt below.

IV. Export less import

The difference between export of goods and services and import of goods and services is called **net import**. Excess import over export is the amount of consumption expenditure that goes to GDP of the other countries. Hence it is deducted from our GDP.

V. Discrepancies

The GDP calculated by gross value added method and expenditure method differ as the difference in value recorded for a product between when it is produced and the moment it is consumed are considerable. There may be loss or gain in the value or quantity during storage and transport of products. It leads to the difference in estimate by these two methods. This difference is treated as discrepancies.

Gross Capital Formation - Estimation

Gross Capital Formation (GCF) is estimated by two approaches. They are:

A. Funds flow approach
B. Commodity flow approach

In commodity flow approach, the investments made in different types of assets forming part of GCF are measured either industry-wise or institutional sector-wise. The investment in these assets comes from financial savings. So adding the gross savings of domestic institutional sectors and fund flow from ROW will be equal to the investments made in different types of assets. So GCF is calculated by adding gross savings of domestic institutional sectors and fund flow from ROW. This later method is called funds flow approach.

A. Funds Flow Approach

As said earlier the investment has to come from financial savings. Hence in the fund flow method the GCF is derived as gross savings plus net capital inflow from abroad.

GCF = Gross Savings + Net capital inflow from ROW

Gross Savings = Savings of non-financial corporations + Savings of financial corporations + Savings of General Government + Savings of households

Net capital inflow from abroad is capital inflow from ROW to economic territory less capital outflow from economic territory to ROW.

Box 2.3. Institutional sector wise GCF

The investment made by the following institutional sectors

1. Public non-financial corporations
2. Private non-financial corporations
3. Public financial corporations
4. Private financial corporations
5. General government
6. Household sector, in the following assets are added together to arrive at institutional sector wise GCF:

i) Dwellings, other buildings & structures

ii) Machinery & equipment

iii) Cultivated biological resources

iv) Intellectual property products

In the way the CGF calculated by institutional sector wise it can be calculated industry (agriculture industry, mining, etc) wise. It is called **industry of use method**. However, GCF by industry of use and by institutional sectors does not include "valuables", and therefore, these estimates are lower than the estimates available from commodity flow.

The estimates of GCF through the flow of funds approach are treated as the firmer estimates as the data availability for fund flow approach is easier and less error prone. This is not the case with commodity flow approach so it leads to difference in the GCF calculated by these two methods. The difference between the two approaches is taken as “errors and omissions”.

Net capital inflow from ROW = Capital inflow from ROW to economic territory – Capital outflow from economic territory to ROW

B. Commodity Flow Approach

In commodity flow approach the GCF is estimated by the type of assets. There are three types of assets. They are:

a) Gross fixed capital
b) Inventories or change in stock
c) Valuables

B. a) Gross Fixed Capital

Gross fixed capital refers to fixed assets like buildings, plant and machinery used in production. Fixed assets are produced assets that are used repeatedly or continuously in production processes for more than one year. They are durable and put into productive use to produce goods and services. Fixed assets include not only structures, machinery and equipment but also cultivated assets such as trees or animals that are used repeatedly or continuously to produce other products such as fruit or dairy products. They also include intellectual property products such as software or artistic originals used in production.

b) Change in stock

Input materials to be used in production, semi-finished goods and unsold finished goods are called inventories.

The input materials are called goods of intermediate consumption. They are used to produce either consumer goods or fixed assets and valuables. Semi-finished goods are goods in the process of production of consumer goods or fixed assets and valuables.

Take an example of shoe manufacturing industry. The raw leather is input materials. The processed leather are semi-finished goods and the shoes are finished goods. Assume that the same shoe factory is expanding its capacity and the construction is going on. The building in progress is a semi-finished fixed asset.

The input materials and semi-finished materials neither can be consumed nor used as fixed assets or stored as valuables. Likewise the unsold finished goods also neither can be consumed nor used as fixed assets or stored as valuables. To put it simply the products till they reach market as final goods and services are called inventories. But the expenditure on such products is incurred by producers of goods and services. Hence they are accounted in the expenditure method.

The inventories once they become final products on sale to consumer as consumable products or valuables or to producer as fixed assets are accounted as either as PFCE or as GCF in the subsequent years. Likewise in the subsequent years new inventories are added.

The inventories are measured on net basis. The inventories on the first day of the accounting period are deducted from the inventories on the last day of the accounting period. It is called **change in stock.** The inventory existing on the first day is deducted from the inventory on the last day of accounting period because inventory on the first day was already accounted in the previous year. It ensures only the current period inventory alone is accounted for the current period. In India the accounting period is April to March. The following example makes it clear.

Inventories on 1.04.2015 ₹100 Crore
Inventories on 31.03.2016₹150 Crore
Change in inventory is ₹ 50 Crore

Inventories capture the expenditure to the extent the products are completed. They do not capture final expenditure.

c) Valuables

Valuables are expensive and durable goods. Valuables include works of art, precious metals and stones and articles of jewellery. They are one form of investment. During needy hours they can be sold and used for the needed purpose if necessary. Earlier the valuables were treated as consumption but in the new series it is treated as assets.

Both fixed assets and valuables are durable goods but the distinction lies in the fact that fixed assets are those durable goods used in production of goods and services and valuables are just investment as store of value to be used for future needs.

National Income at Constant Price and Current Price

To calculate and compare the national income of various years, the national income is calculated with reference to a particular year. It is called the **base year**. The price in this year is called **price of base year or constant price**.

The national income at constant price means the total quantity of all final goods and services produced in a particular year multiplied by the price of base year (constant price). The national income calculated by this method is called the real income.

National income $_{\text{at constant price}}$ = *Total quantity of all final goods and services produced in a particular year × the price of base year (constant price)*

National Income at current price means the total quantity of all final goods and services produced in a particular year multiplied by the price of that particular year (current price). The national income calculated by this method is called the nominal income.

National income $_{\text{at current price}}$ = *Total quantity of all final goods and services* *produced in a particular year × the price of the goods and services in that particular year (current price)*

For example, take 2004–05 as base year.

National income for 2008–09 $_{\text{at constant price}}$ = Total quantity of all final goods and services produced in 2008–09 × the price of 2004–05

National Income for 2008–09 $_{\text{at current price}}$ = Total quantity of all final goods and services produced in 2008–09 × the price of 2008–09

The reason behind calculating National Income at constant price is to check whether the National Income has grown or not. Take the following example,

The base year = 2004–05

The base year price = 100

1. National income for 2007–08

Total quantity = 120; Price = ₹110
National income $_{\text{at current price}}$ = 120 × 110
= ₹13,200
National income $_{\text{at constant price}}$ = 120 × 100
= ₹12,000

2. National income for 2008–09

Total Quantity =110; Price = ₹130
National income $_{\text{at current price}}$ = 110 × 130
= ₹14,300
National income $_{\text{at constant price}}$ = 110 × 100
= ₹11,000

The National Income for 2008–09 at current price is ₹14300 which is higher than the National Income for 2007–08 at current price of ₹ 13200. But National Income for 2008–09 at constant price is ₹11000 which is less than the National Income for 2007–08 at constant price of ₹12000. This is because the actual quantity produced in 2008–09 is less than that of 2007–08. It means no real growth has taken place in 2008–09. The high income at current price is due to the increase of price in the year 2008–09.

GDP Deflator

The GDP deflator (implicit price deflator for GDP) is a measure of the level of prices of all domestically produced final goods and services in an economy in a particular period of time. This is calculated to find the overall rise in the level of price.

GDP Deflator = Nominal GDP/Real GDP × 100

In our above example, the nominal GDP is₹14300 and real GDP is ₹ 11000 for 2008–09

GDP Deflator = 14300/11000 × 100 = ₹130

Therefore the price is 130%. It means price rise of 30% i.e. (130 – 100 = 30)

If the increase in price is already known, the real GDP can be calculated from nominal GDP.

Real GDP =Nominal GDP / GDP deflator.

National Income Growth

National income growth $_{\text{at current price}}$ = (National Income of this year $_{\text{at current price}}$ – National Income of previous year at current price) / National Income of previous year $_{\text{at current price}}$ × 100.

In our example, National Income growth $_{\text{at current price}}$ for 2008–09 =

(14300 – 13200)/13200 × 100 = 8.33%

National income growth $_{\text{at constant price}}$ = (National Income of this year $_{\text{at constant price}}$ – National Income of previous year $_{\text{at constant price}}$) / National Income of previous year $_{\text{at constant price}}$ × 100.

In the example, National Income growth at constant price for 2008 – 09 = (11000 – 12000)/12000 × 100 = – 8.33 %

The National Income $_{\text{at current price}}$ shows positive growth whereas at the same time the National Income $_{\text{at constant price}}$ shows negative growth.

Incremental Capital Output Ratio (ICOR)

Capital output ratio (ICOR) is the ratio between capital and output.

In formulaic form,

Capital output ratio = *Capital / Output*

It shows the amount of capital required to produce a product.

Incremental capital output ratio means the additional amount of capital required to produce one additional product.

ICOR = *Incremental Capital / Incremental Output*

It helps to calculate the amount of capital investment required to achieve a target growth rate.

Growth rate = *Capital investment/ ICOR*

Or

Capital investment = *Growth rate* × *ICOR*

For example, if the ICOR is 4 and targeted growth rate is 8%, the required investment is 32%.

$32 = 8 \times 4$

This formula has been used by Harrod – Domar in their growth models.

Estimates of National Income in India

The calculation of National Income dates back to pre-independence period. This is updated, modified and fine-tuned to changing times.

Before Independence

In 1868, Dadabhai Naoroji wrote a book named *Poverty and Un British Rule in India* in that book, he estimated the per capita income of Indians as ₹20. Thereafter, the following persons had also calculated the per capita income.

Findlay Shirras (1911) – ₹49.00

Wadia and Joshi (1913–14) – ₹44.30

For the period of 1925–29, Dr. V.K.R.V. Rao calculated per capita income of Indians as ₹76. He was the first person to estimate National Income scientifically with a proper method.

After Independence

National Income Committee was formed in 1949 under the chairmanship of Prof. P.C. Mahalanobis. It submitted its first report in 1951 and final report in 1954. It reported that the per capita income was ₹246.90 for the period of 1950–54.

Later, the Central Statistical Organisation (CSO) was formed. The first official estimate by CSO was in 1956 with base year 1948–49. Base year has been shifted seven times so far i.e. 1960–61, 1970–71, 1980 – 81, 1993–94 and 1999–2000, 2004–05 and the year 2011–12 is the new base year from January 2015.

New Series

The new series of national income was started in January 2015 with new base year 2011–12. It is based on the international guidelines. The international guidelines are taken from SNA 2008 of the United Nations.

In the old series, GDP at factor cost was called GDP but in the new series GDP at market price is called GDP.

Earlier the sector-wise manufacturing data on value addition was sourced from the RBI Industrial Outlook Survey conducted on quarterly basis and Annual Survey of Industries (ASI). The Industrial Outlook Survey is based on sampling method. The ASI, being an annual exercise, was extrapolated using Index of Industrial Production (IIP) to calculate value addition in the intervening period to publish quarterly estimation.

But now, for incorporated sector, along with IIP data the MCA21 data is also being used. With the Ministry of Corporate Affairs making it obligatory on the part of the companies registered under the Companies Act for online reporting, the MCA 21 database has been used for the manufacturing sector value addition data. The MCA database as on date covers 5 lakh companies. It captures the data on value addition completely rather than capturing sample data. MCA 21 is an e-governance initiative of Ministry of Corporate Affairs.

One more advantage of the MCA data is that it captures the entire value addition done by an enterprise including on advertisement, brand building. This is called enterprise based method. In the old method the value addition data was obtained industrywise. It captured only value addition of manufacturing. It is called establishment method.

An enterprise is a unit of producer of goods and services. It may be a company or partnership firm or proprietary concern. It may engage in production of different kinds of goods and services. An establishment is a unit located in a single location and involved in single productive activity or in which the principal productive activity accounts for most of the value added. An enterprise may have different establishment within it. For example a company may produce talcum powder and advertise it and market it. It has three establishments; one is manufacturing, the second one is advertising agency and the third one is marketing agency. In enterprise method, all the data is captured at single place; in establishment method establishment-wise data needs to be collected from different enterprises.

Effective Labour Input Method is adopted for Unincorporated Manufacturing and Services Enterprises for compiling the estimates for unorganised non-agriculture sector. Through survey value addition per labour is calculated and amount of labour used in unincorporated enterprises is multiplied by per labour value addition to calculate the total value addition of it.

Earlier labour input method was used but now effective labour input method is being used. This method assigns due weights to different types of workers based on productivity and skills, unlike the earlier method which assumed equal value addition of each worker, irrespective of their skills and productivity. For this the details of new NSS Surveys viz. Unincorporated Enterprises Surveys (2010–11) and Employment & Unemployed Survey, 2011– 12 are used. Gross Value Added per worker was obtained from the enterprise surveys of NSS and Labour Input was obtained from employment and unemployment surveys.

The time lines of data availability in the old series and the new are given in the following table:

Series	Year 1 (Advance & Provisional)	Year 2 (1st Revised Estimate)	Year 3 (2nd Revised Estimate)
2004–05 series	IIP	IIP	ASI
2011–12 series	IIP + Advance filing of Corporate Accounts	IIP + MCA 21	MCA 21 + Non-corporate ASI

It may be noted that IIP is a pure volume index. Value added data is available from accounts and the ASI. The 2011–12 series captures value addition information based on corporate filing right from the first year and comprehensively from second year as against 2004–05 series where this informationwas getting captured only in the third year.

In the trade sector the gross value added was earlier calculated using the Gross Trading Income Index (GTI) this has been replaced by the index derived from sales tax collection and GST collection. Gross Trading Income (GTI) Index is an index of trading income of all commodity producing sectors. The trading income is derived from the marketable surplus of these commodities by applying trade margins.

The Gross Trading Income Index tracked the growth in volume of tradable goods, in the economy, derived from current estimates of production in agriculture and manufacturing. The underlying assumption was that value added is strongly correlated with the physical volume of goods available for trade. This is a reasonable assumption in short intervals of time;however, when projections are extended over long periods of time, errors build up. This is because in addition to physical volume, value added also depends on levels of intermediation between the producer and consumers, changes in underlying quality of goods, and changes in marketing practices, for instance, bundling higher quality value added services with goods like warranties, etc. and so on. In the current new series, in addition to the updated surveys, this has also been partly corrected by changing the underlying indicator from a volume indicator to one based on value, namely Sales tax and GST collections. Since Sales tax and GST is value based, growth in this indicator captures the underlying growth better in value added.

In the new series data collected from local bodies is also used and the coverage is 60 percent.

Related Terms

Index of Industrial Production (IIP)

It measures the growth of industrial production in India. This index classifies industries into Mining, Manufacturing and Electricity sectors and measures growth in production in each industry. In addition, use based classification of basic goods, intermediate goods and capital goods is also available. This helps in predicting GDP growth as industry is one of the major contributor to growth. IIP is released by CSO on a monthly basis. The base year is 2011–12.

Nikkei India Manufacturing Purchasing Manager's Index (PMI)

Nikkei India Manufacturing PMI is published every month by Nikkei, a media house. It is compiled by IHS Markit. Purchasing Manager's Index predicts the level of industrial production in advance. It predicts the industrial production by tracking the following parameters: new order flows, output, employment, stocks of items purchased and supplier's delivery time. This is done by surveying purchasing executives over 400 manufacturing companies in India. The index above 50 reflects expansion and below 50 reflects contraction in the industrial production.

IHS Markit India Services PMI

It is compiled by IHS Markit. Service PMI predicts the level of service sector output in advance. This is done by surveying purchasing executives over 400 services companies in India. The index above 50 reflects expansion and below 50 reflects contraction in the service sector output.

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1 This chapter is based on System of National Accounts 2008, published by Inter-Secretariat Working Group on National Accounts (ISWGNA), which consists of five organisations: the Statistical Office of the European Communities (Eurostat), the International Monetary Fund (IMF), the Organisation for Economic Cooperation and Development (OECD), the United Nations Statistics Division and regional commissions of the United Nations, Secretariat and the World Bank. For practical purposes, the 2008 SNA was presented to the United Nations Statistical Commission.

CHAPTER

3

Human Development[1]

The concept of human development is evolving and undergoes change from time to time. Currently it is measured as composite index of achievement in long and healthy life, knowledge and a decent standard of living. The measure of Human Development Index is published by United Nations Human Development Programme (UNDP) since 1990 through its Human Development Report. It is released at the global, regional, national and sub national level.

The United Nations Development Programme (UNDP) defines HDI as follows: "The Human Development Index (HDI) is a summary measure of human development. It measures the average achievements in a country in three basic dimensions of human development: a long and healthy life, access to knowledge and a decent standard of living."[2]

The UNDP says “Human development is about human freedoms. It is about building human capabilities – not just for a few, not even for most, but for everyone.” To reflect it better the UNDP is bringing new indices.

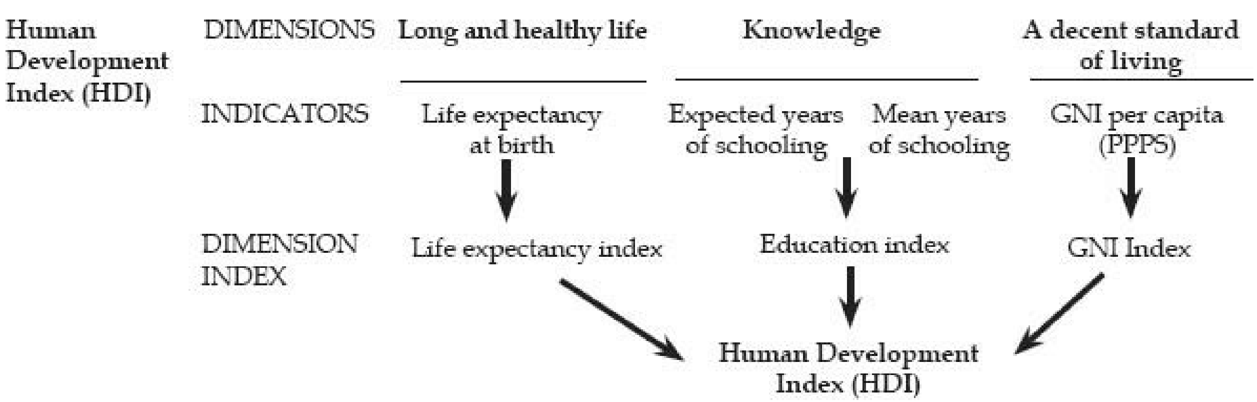
They are Inequality-adjusted Human Development Index (IHDI), Gender Development Index (GDI), Gender Inequality Index (GII) and Multi-Dimensional Poverty Index (MPI).

This chapter highlights the different dimensions, indicators, goal posts and calculation of HDI and new indices.

HDI: Dimensions, Indicators, Dimension Index and Goal Posts

Three dimensions used to measure HDI are long and healthy life, knowledge and a decent standard of living. Long and healthy life is measured by the indicators life expectancy at birth; knowledge by mean years of schooling and expected years of schooling and the decent standard of living by GNI Per capita (PPP$). It is computed as Life expectancy index, Education index and GNI index respectively. These are called dimension index. The geometric mean of these three indices gives HDI.

A graphical presentation of HDI:



Source: UNDP

The indicator for health is life expectancy at birth. Life expectancy is the average number of years people are expected to live. It is a probability calculation. It is calculated using the birth and death data of past.

The indicators for education are expected years of schooling for a school-age child and mean years of prior schooling for adults aged 25 and older. Mean years of schooling is estimated based on duration of schooling at each level (primary, secondary and higher) of education. Expected years of schooling estimates are based on enrolment by age at all levels of education and population of official school age for each level of education. The education index measures the educational achievements qualitatively. It measures the sustainability of enrolment by measuring the expected and average years of schooling.

The indicator for standard of living is Gross National Income (GNI) per capita. GNI per capita gives a correct picture national produce that accrues to the people of the country as it excludes the out flow of remittances and includes inflow of remittances, foreign aid, etc. Therefore, GNI per capita is a better measure of per capita income than any other measure like GDP per capita.

The goal posts are necessary to convert the indicators in different units to indices from 0 to 1. The value change from 0 towards 1 shows progress. The minimum and maximum values used to convert the indicators of different units into uniform indices are called goal posts. The minimum and maximum values are fixed based on scientific studies. The minimum values act as the "natural zeros" and the maximum values as "aspirational targets".

The table 3.1 shows the dimensions, indicators and goal posts.

Table 3.1

Dimensions	Indicators	Min. Value	Basis	Max. Value	Basis
Long and Healthy Life	Life expectancy at birth (years)	20	No country in the 20th century had a life expectancy of less than 20 years as per research studies of A. Maddison, J.Oeppan and J.W. Vaupel and J.C. Riley	85	A realistic aspirational target for many countries over the last 30 years
Knowledge	a) Expected years of schooling for a school-age child	0	Societies can subsist without formal education	18	It is equivalent to achieving a master's degree in most countries
	b) Mean years of prior schooling for adults aged 25 and older.	0	Societies can subsist without formal education	15	The projected maximum for 2025
A decent Standard of Living	GNI per capita(2011 PPP US $)	100	Considerable amount of unmeasured subsistence and nonmarket production in economies is close to this minimum value. It is not captured in the official data.	75000	There is virtually no gain in human development and well-being from annual per capita income of this amount as per the study of D. Kahneman and A. Deaton.

Source: HDR 2009, 2010 and 2018

Calculation of Sub Indices and Master Index

Performance for health, education and standard of living is expressed as a value between 0 and 1 by applying the following formula:

Dimension Index = (Actual value – Minimum Value)/(Maximum value – Minimum Value)

The method of converting the absolute value into indices by using the above formula is called **normalisation.** It is also called **standardisation**.

To calculate education index, the indices viz., expected years of schooling and average years of schooling are given same weight and their arithmetic mean is calculated.

The capability of higher level of income is not that of lower level of income in expanding the human capability. It diminishes with increase in income. Sudhir Anand and Amartya Sen in their study

"The Income component of the Human Development Index" in 2000 stated that each additional dollar of income has a smaller effect on expanding human capabilities. To ensure this effect, in calculation of GNI index natural log value is used to normalise. The log value assigns less importance to higher value compared to lower value and ensure the diminishing capability of income. For example, the natural log value of 5 is 1.60 and natural log value of 25 is 3.21. Here, the number 25 is five times higher than the number 5 but the natural log value is only two times higher. This means, the importance of higher value is getting diminished. So, the **law of diminishing capability of income** is ensured. The natural logarithm is denoted by ln or loge. The value of e is 2.718.

The sub-indices of life expectancy at birth, Education and GNI are calculated using above normalisation and the geometric mean of these three indices is worked to arrive at HDI.

Table 3.2: Sample calculation

Dimensions	Indicators	Achievement
1. Long and Healthy Life	Life expectancy at birth (years)	68.8
2. Knowledge	(i) Mean years of schooling	6.4
	(ii) Expected years of schooling	12.3
3. A decent Standard of Living	Per capita GNI (2011PPP US $)	6,353

1. Life Expectancy Index/ Health Index

$$= 68.8 - 20/85 - 20 = 0.7507$$

2. Education Index

Mean years of schooling

$$= 6.4 - 0 /15 - 0 = 0.4266$$

Expected years of schooling

$$= 12.3 – 0 / 18 – 0 = 0.6833$$

Education index

$$= 0.4266 + 0.6833/ 2 = 0.5549$$

3. Income Index/Standard of Living Index = ln (6353) – ln (100) / ln (75000) – ln (100)

$$= 0.6271$$

HDI = $(0.7507 \times 0.5549 \times 0.6271)^{1/3} = 0.6392$

Country Groupings:

The HDR 2014 introduced fixed cut off points for grouping the countries based on the achievements. It is tabulated below category wise.

Table 3.3

Category of Human Development	Level of HDI achieved
Very High	0.800 and above
High	0.700 – 0.799
Medium	0.550 – 0.699
Low	Below 0.550

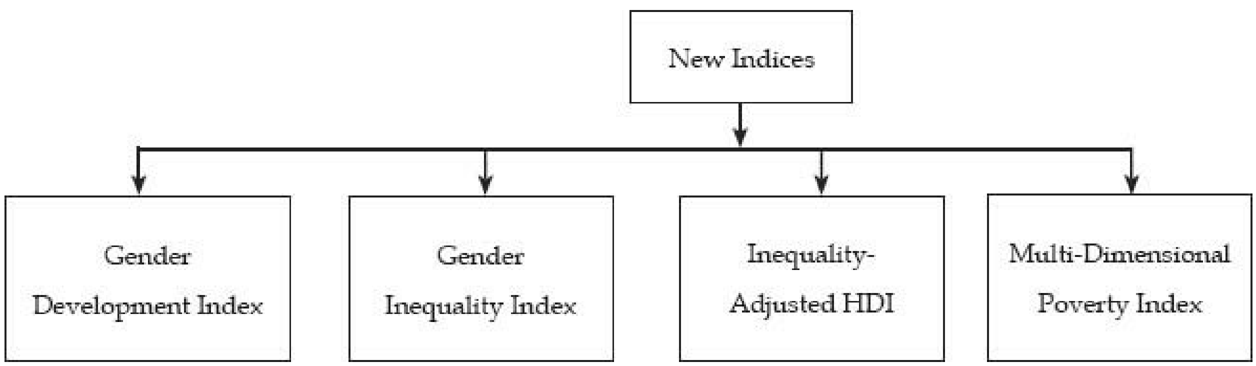
Gender Development Index

GDI measures inequality in achievement of three basic dimensions namely health, education and command over economic resources. The indicators for health and education are same as that of HDI. The India's achievement in 2017 is 0.640 and ranks 130 among 189 countries. She falls in the category of medium development.

New Indices

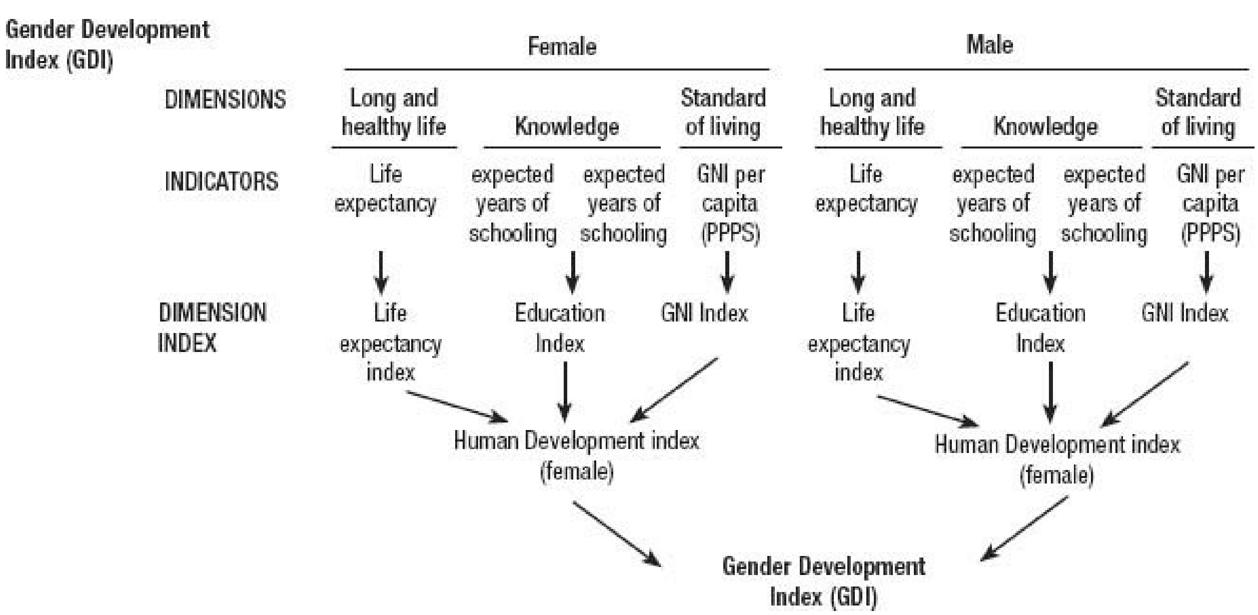
In 1995 in addition to HDI the UNDP introduced Gender Development Index (GDI). Moreover, the 20th anniversary edition introduced three new indices namely Multidimensional Poverty Index, Inequality-adjusted HDI, and Gender Inequality Index. These are shown in the following figure 3.1. indicator for command over economic resources is estimated earned income. It is calculated for male and female separately the way HDI is calculated. The ratio between the two is GDI.

Figure 3.1



$$GDI = HDI_{female}/HDI_{male}$$

A graphical representation of GDI:

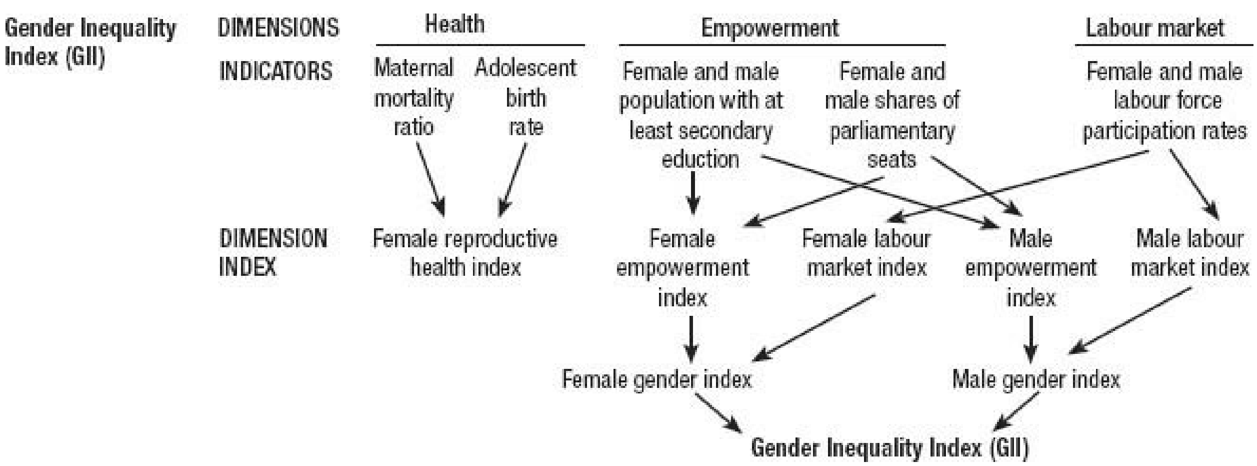


Source: UNDP

Gender Inequality Index (GII)

Gender Inequality Index measures inequality that exists between men and women across three dimensions viz, reproductive health, empowerment and the labour market. To say more precisely, it reflects women's disadvantage in these dimensions. The indicators for reproductive health are Maternal Mortality Rate and Adolescent Fertility Rate (it is not applicable for men). The indicators for empowerment are parliamentary representation and attainment at secondary and higher education. Labour market indicator is labour market participation.

A graphical representation of GII:



Source: UNDP

GII ranges from 0 to 1. Zero represents fair equality and one represents very poor equality. The calculation of this index is a bit complicated. Hence it is not explained here.

Multi-Dimensional Poverty Index (MDPI)

Multi-Dimensional Poverty Index measures the deprivation of people in health, education and standard of living at household level.

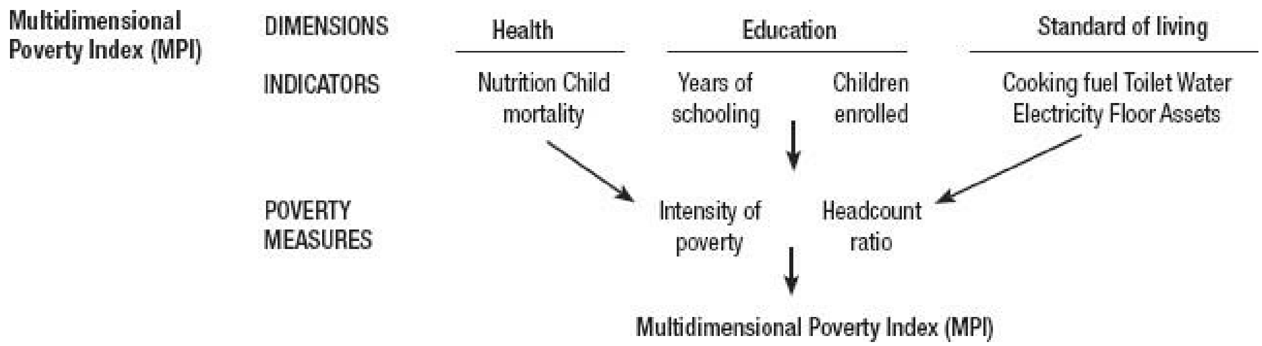
HDI measures the level of achievements of individuals in the dimensions of health, education and standard of living, the MDPI index measures the under achievements in these dimensions. For example, HDI measures average years of schooling but MDPI counts households in which no one has completed five years of schooling. The dimensions and indicators are shown in table 3.4.

Table 3.4: Dimensions and Indicators of Multi-Dimensional Poverty Index

Dimensions	Indicators	(Household wise) Deprivation if	Weights
Health	Nutrition	At least one member is malnourished	1/6
	Child Mortality	One or more children have died	1/6
Education	Years of schooling	No one has completed five years of schooling	1/6
	School Attendance	At least one school-age child not enrolled in school	1/6
Standard of Living	Electricity	No electricity	1/18
	Drinking water	No access to clean drinking water	1/18
	Sanitation	No access to adequate sanitation	1/18
	Housing	House has dirt floor	1/18
	Cooking fuel	Household uses "dirty" cooking fuel (dung, firewood or charcoal)	1/18
	Assets	Household has no car and owns at most one of: bicycle, motorcycle, radio, refrigerator, telephone or television	1/18

Source: HDR 2010

A graphical representation of MPI:



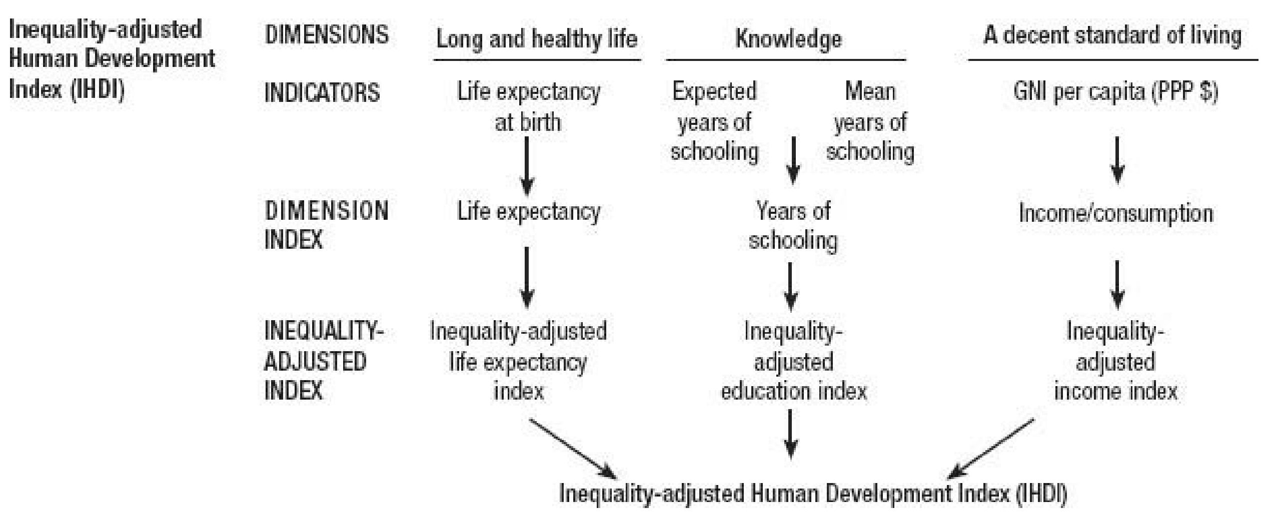
Source: UNDP

Inequality-Adjusted HDI (IHDI)

Inequality adjusted HDI adjusts the HDI for inequality in distribution of the dimensions - life expectancy, years of schooling and household income or consumption - that exists across the age (life expectancy) and individual (schooling and income/ consumption). Adjusted means the inequality in each dimension is discounted from the average level of achievement in each dimension.

If HDI and IHDI are equal, it means there is no inequality. If IHDI is less than HDI, it means there is inequality.

A graphical representation of IHDI:



Source: UNDP

1 This chapter is based on HDR 2010
2 http://hdr.undp.org/en/media/HDR_2010_EN_TechNotes_reprint.pdf

CHAPTER 4

Poverty and Unemployment

Poverty can be defined as a social phenomenon in which a section of the society is unable to fulfill its basic necessities of life. Unemployment is a situation in which individuals are ready and willing to work at the prevailing rate of wages but do not get work. In India poverty and unemployment are estimated using consumer expenditure surveys and Employment and Unemployment surveys of NSSO (now National Statistical Office - NSO) respectively.

Consumption Expenditure

The consumption expenditure data was collected by (NSSO) through various rounds of Household Consumer Expenditure Surveys (HCES). It has been conducting these surveys based on large samples quinquennially from 1972–73. These surveys are the primary source of data on various indicators of living standards of different strata of the population at the national and state levels. They are used for planning, policy formulation, decision making and as inputs for further statistical exercises by various government organisations academicians, researchers and scholars.

Based on these surveys various reports are being published by NSSO. These reports are assigned with a particular serial no. For example one of the reports based on the 68th round is Level and Pattern of Consumer Expenditure 2011–12 (LAPOCE 2011–12). Its serial no is NSS Report N0.555 (68/1.0/1). In short Report No 555.

A detailed description of household consumer expenditure is given in the chapter Two of Report No 555. The initial paragraph of the same is reproduced below:

> *"2.1.2* **Household consumer expenditure:** *The expenditure incurred by a household on domestic consumption during the reference period is the household's consumer expenditure. Expenditure incurred towards productive enterprises of households is excluded from household consumer expenditure. Also excluded are expenditure on purchase and construction of residential land and building, interest payments, insurance premium payments, payments of fines and penalties, and expenditure on gambling including lottery tickets. Money given as remittance, charity, gift, etc. is not consumer expenditure. However, self-consumed produce of own farm or other household enterprise is valued and included in household consumer expenditure. So are goods and services received as payment in kind or free from employer, such as accommodation and medical care, and travelling allowance excluding allowance for business trips."*

To find out the head count of people falling in various level of consumption the Monthly Per Capita Expenditure (MPCE) is calculated from Household consumption expenditure. It is arrived at by dividing the household monthly consumer expenditure by household size.

MPCE = Household monthly consumer expenditure / Household size

To collect the consumption expenditure data, the respondents are requested to recall and report the volume of consumption during a particular period say a week or month. This period is called **Reference period** or **Recall period**.

The respondents were requested to recall their consumption of the following three groups of items:

1. food, *pan* (betel leaves), tobacco, intoxicants and fuel &light
2. clothing and footwear and
3. Miscellaneous goods and services and durable articles.

The Report No 555 summarised MPCEs based on different recall periods in page 9 is as follows:

> *"2.3.4* **Uniform Reference Period MPCE** *(or* **$MPCE_{URP}$***): Household consumer expenditure on each item is recorded for a reference period of "***last 30 days***" (preceding the date of survey).*
>
> *2.3.5* **Mixed Reference Period MPCE** *(or* **$MPCE_{MRP}$***): Household consumer expenditure on items of clothing and bedding, footwear, education, institutional medical care, and durable goods is recorded for a reference period of "***last 365 days***", and expenditure on all other items is recorded with a reference period of "***last 30 days***".*
>
> *2.3.6* **Modified Mixed Reference Period MPCE** *(or* **$MPCE_{MMRP}$***): household consumer expenditure on edible oil, egg, fish and meat, vegetables, fruits, spices, beverages, refreshments, processed food, pan, tobacco and intoxicants is recorded for a reference period of "***last seven**

days", *and for all other items, the reference periods used are the same as in case of* **Mixed Reference Period** *MPCE (*$MPCE_{MRP}$*)."*

The consumption expenditure collected by the above methods is reported for rural and urban areas separately. The rural and urban prices for the consumption items for which data was collected is also collected by NSSO and are used to arrive at the value of the consumption. They are reported fractile classes wise. A **fractile** is that point below which a stated fraction (or decimal equivalence) of the values lie. The MPCE fractile classes of population may be referred to simply as "0–5%", "5–10%", "10–20%", etc.

The range of MPCE is divided into 12 fractile classes based on the population falling within that range. For example in the 61st round it was found that the bottom most 5 per cent of population was having MPCE in the range of ₹ 0–235. It is obvious that with ₹ 0 nobody can survive. But it is the bottom most non-negative integer. Hence the range was fixed as ₹ 0–235. The average $MPCE_{URP}$ of this fractile class at constant 1993–94 price for rural is ₹ 114 for urban it is ₹ 141. To illustrate it better the 12 fractile classes and the respective range of MPCE for rural and urban is tabulated below for 61st round.

Table 4.1: Fractile classes and range of MPCEs of 61st round

S. No.	Fractile classes	MPCE class (₹)	
		Rural	Urban
1	0 – 5%	0 – 235	0 – 335
2	5 – 10%	235 – 270	335 – 395
3	10 – 20%	270 – 320	395 – 485
4	20 – 30%	320 – 365	485 – 580
5	30 – 40%	365 – 410	580 – 675
6	40 – 50%	410 – 455	675 – 790
7	50 – 60%	455 – 510	790 – 930
8	60 – 70%	510 – 580	930 – 1100
9	70 – 80%	580 – 690	1100 – 1380
10	80 – 90%	690 – 890	1380 – 1880
11	90 – 95%	890 – 1155	1880 – 2540
12	95 – 100%	1155 & more	2540 & more

Poverty estimation and Consumption expenditure Surveys

The data collected through these HCES are used to estimate poverty and inequality. The 61st Round survey (2004–05) of NSSO has fixed ₹ 356.30 and ₹ 538.60 as per capita monthly consumption expenditure as

poverty line for rural and urban areas respectively. The estimation of poverty using this monetary measure is called **income/consumption poverty** or **money-metric poverty**. Counting the people below this or any other level of income or expenditure by fixing it as poverty line is called **head-count ratio**.

Using different methodology poverty is calculated based on these data. NSSO and Planning Commission used different methodology to estimate the incidence of poverty. NSSO used mixed recall period method. The Planning Commission used uniform recall period method. Due to different methodology and difference in the period of estimation they cannot be compared. Hence their respective estimate is presented below in tables:

Table 4.2: NSSO's Poverty estimation (Head-count Ratio) based on Mixed Reference Period

Particulars	1999 – 2000 55th Round	2004 – 05 61st Round
1. In percentage (National)	26.1%	21.8%
i) Rural	27.1%	21.8%
ii) Urban	23.6%	21.7%
2. In absolute term (National)	260 million	238.5 million
i) Rural	195 million	170.3 million
ii) Urban	65 million	68.2 million

Source: Planning Commission

Table 4.3: Planning Commission's Poverty estimation (Head-count Ratio) based on Uniform Recall Period (URP):

Particulars	Year	
	1993–94 50th Round	2004–05 61st Round
1. In percentage (National)	36.0%	27.5%
i) Rural	37.3%	28.3%
ii) Urban	32.4%	25.7%

2. In absolute term (National)	–	301.7 million
i) Rural	–	220.9 million
ii) Urban	–	80.8 million

Different Approaches to Poverty Estimation

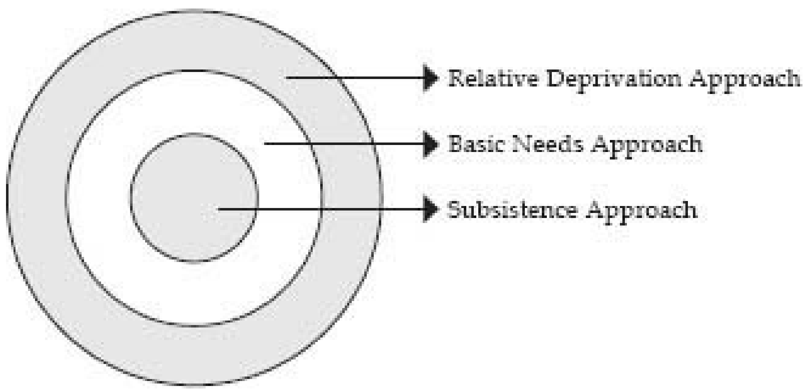
The above approach is called **subsistence approach**. It focuses on the individual level and measures whether the individuals are able to meet their physiological needs namely food, *pan* (betel leaves), tobacco, intoxicants and fuel & light, clothing and footwear and miscellaneous goods and services and durable articles. The subsistence is the state or fact of existing. The *Oxford Dictionary* defines subsistence level as 'A standard of living (or wage) that provides only the bare necessities of life'[1]. The people who could not afford even the bare necessities of life are called poor. The subsistence approach is uni-dimensional.

A higher level approach is **basic needs approach**. It is relatively wider than the subsistence approach. It focuses not only on individual level but also on community level. It necessitates provision of amenities and services like sanitation, education, healthcare etc. at community level and those who lack these facilities are considered poor. This approach is multi-dimensional.

The **relative deprivation approach** look at poverty at a broader level compared to the two previous approaches. It is wider than the above two concepts and measures deprivation an individual or a group face compared to others. It goes beyond physical and basic needs and specially focuses on social inequality. Social exclusion also considered in this approach. It is one of the measures of relative poverty. This approach is also multi-dimensional.

These three approaches to poverty are represented graphically reflecting their scope.

Figure 4.1



Absolute vs Relative Poverty

The poverty line based on subsistence approach measures absolute poverty. It measures in absolute term as to how many people are below a reference point. The poverty line fixed in India is one such reference point. As seen earlier NSSO fixed rural poverty line at ₹ 356.30 (2004–05 price) and estimated rural poor people as 170.3 million and it is 21.8 per cent of all India population.

In the relative poverty measure the poverty is measured in a relative sense. It is measured against any one of measures of central tendency like mean, median, quartiles and percentiles etc. In this measure persons falling within the 40–50 percentile of income may be above poverty line but are poor compared to persons falling within the percentile of 60–70. This measure helps to find out inequality that exists in the society. The usual tendency is to compare the top most group with the bottom most group.

Measures of Inequality

Quintile income ratio

The quintile income ratio is one of the measures of inequality. It is a ratio of the average income of richest 20 per cent of the population to that of the poorest 20 per cent.

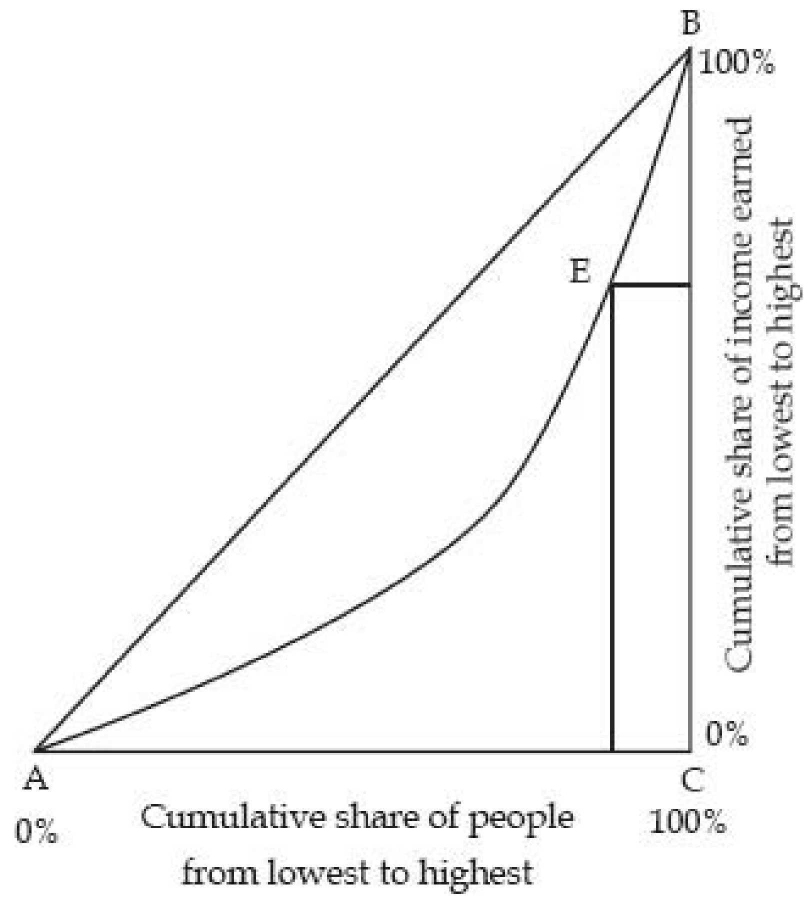
Quintile Income Ratio = average income of richest 20 per cent / average income of poorest 20 per cent.

Note: Percentile divides the whole population into 100 equal sub groups say 1 per cent, 2 per cent, 3 per cent etc. **Decile** divides the whole population into 10 equal sub groups say 0-10 per cent, 11-20 per cent. **Quintile** divides the whole population into five equal sub groups say 0-20 per cent, 21-40 per cent. **Quartile** divides the whole population into four equal sub groups say 0-25 per cent, 26-50 per cent etc. These are called positioned averages and measures of central tendency.

Lorenz curve

Lorenz curve maps the relationship between the percentage of income or wealth earned or appropriated and percentage of people earned that particular percentage of income or wealth. The cumulative percentage of income is measured on the Y axis and the cumulative percentage of people is measure on X axis.

Figure 4.2



In the figure AB is the line of equality. The line AEB is Lorenz curve. It is the line of inequality. The point E, shows that 90 per cent of people earn 60 per cent of income and the remaining 10 per cent of people earns the remaining 40 per cent of income. It shows that there is inequality.

Gini coefficient

Gini coefficient measures the inequality using Lorenz curve. It is the ratio between area between the Lorenz curve and line of equality and area below the line of equality.

Gini coefficient = Area between Lorenz curve and line of equality / Area below the line of equality

The area above Lorenz curve is the area between Lorenz curve and line of equality. The area below Lorenz curve is the area between the line of equality and axis of the graph.

In the above graph, Gini coefficient = AEB/ ACB

Poverty Estimation in India

Poverty alleviation is one of the key objectives to improve the standard of living of the people in India after independence. The Planning Commission kickstarted official poverty estimation in India. Later various committees were formed to estimate poverty in India.

Subsistence approach is used to measure absolute poverty. There are two methods under this approach. One is Cost of Basic Needs (CBN) and the other one is Food Energy Intake (FEI) method.

In CBN food and non-food related needs are considered. First the expenditure to be incurred on a food basket needed to meet prefixed calorie is calculated. It is called **'food poverty line'**. In the second stage along with food, non-food related basket of goods is identified and the total amount of expenditure needed to meet them is calculated it is called **'aggregate poverty line'**.

In FEI the expenditure needed to have a prefixed level of calorie consumption is found out and the poverty line is fixed. The commonality to both approaches is both consider food energy intake and actual pattern of consumption data is needed to arrive at the poverty line.

Perspective Planning Division - Working Group

- A Working Group was constituted in 1962 and it submitted report in the same year.
- At national level it fixed per capita monthly bare minimum consumption expenditure of ₹ 20 at 1960-61 prices. For rural area it is ₹ 18.90 and for urban area it is ₹ 25. It placed 60 per cent of Indian people Below Poverty Line

- It appears that a balanced diet prescribed by the Nutrition Advisory Committee of Indian Council of Medical Research formed the basis for fixing the above amount. It is the Food Energy Intake (FEI) approach.
- It estimated that along with expenditure needed to meet the dietary needs reasonable expenditure needed for consumption of other items is ₹ 35. If this amount has been adopted 80 per cent of Indian people would have been placed under poverty.

Task Force on Projections of Minimum Needs and Effective Consumption Demand

- It was constituted by Planning Commission in 1977 under the Chairmanship of Dr. Y.K Alagh. It submitted its report in 1979.
- It fixed nutritional requirement for rural area at 2400 kilocalories per-capita per day and at 2100 for urban area. It was based on recommendation of Nutritional expert group in 1968.
- The task force used NSSO's first quinquennial consumption expenditure survey of 1973-74. The consumption expenditure survey presents data of quantity and value of each food and non-food items fractile class wise along with proportion of the population falling in that fractile. The calorific value and the corresponding amount of expenditure can be calculated.
- The task force calculated that ₹ 49.09 is needed for rural areas and ₹ 56.56 for urban areas to meet the above prescribed calorie intake at 1973-74 prices.
- It is also a case of Food Energy Intake Method.
- The Planning Commission updated the poverty line for 1977-78 and 1983-84.
- First the consumption expenditure distribution given by NSSO farctile class wise was scaled up by Planning Commission using the ratio between mean private final consumption expenditure (PFCE) of CSO and NSSO. It is an adjusted consumption

expenditure distribution.

- It was updated to current price using CSO's PFCE deflator. It is nothing but what we seen in the chapter CSO - SNA.

PFCE deflator = PFCE of current year/ PFCE of base year

The previous poverty line is multiplied by this ratio to arrive at the current year's poverty line. This mere updating of the existing poverty line for price led to a problem of mismatch between the quantum of expenditure and nutritional value of that expenditure. The updated poverty line fell short to meet the required nutrition. This is called **'nutritional drift'.**

Expert group on estimation of Proportion and Number of Poor

- This expert group was constituted under the chairmanship of Prof. D.T.Lakdawala in 1989. It submitted its report in 1993.
- It recommended to discontinue the Planning Commission's adjusted consumption distribution based poverty line.
- It endorsed the methodology adopted by 1977 Task force under the Chairmanship of Dr. Y.K Alagh.
- It recommended that the year 1973-74 needs to be treated as base year.
- It also recommended to update rural poverty line using Consumer Price Index for Agricultural Labourers (CPI-AL) and urban poverty line by using Consumer Price Index for Industrial Worker (CPI-IW) and Consumer Price Index for Urban Non-Manual Employee (CPI-UNME)
- It also recommended sate specific poverty line using state specific prices.
- It also cautioned not to continue with 1977 task force methodology forever.

Expert Group to Review the methodology for Estimation of Poverty

- It was constituted under the chairmanship of Professor Suresh D. Tendulkar in 2005 and the report was submitted in 2009.
- This committee adopted a new method, moved from calorie based poverty estimation to a basket of commodity based approach. It called it Poverty Line Basket (PLB).
- It identified the PLB based on 61st NSSO survey of 2004-05.
- It also relied on the NSSO data of Mixed Recall Period Method. It called to adopt urban poverty line for rural area also, after adjusting for price differential. It means the quantity of consumption fixed for both urban and rural is same and only the price differs. By this the urban India PLB which is fixed at ₹ 578.80 was re-valued at ₹ 446.68 for rural India at 2004-05 prices.
- This committee fixed poverty ratio for All India total at 37.2 per cent, rural India at 41.8 per cent and urban India at 25.7 per cent during the year 2004-05.
- For 2009-10 it is estimated at 21.9 per cent and for 2011-12 at 29.8 per cent at all India level.
- It also recommended state specific PLB based on state specific prices.
- The expert group stated that it moved away from traditional method of anchoring poverty line estimate based on nutrition. However it cross validated its estimate with the nutrition based approach saying that the actual expenditures incurred on nutrition, education and health is equal to/adequate to cover the PLB suggested by it.

Expert Group to Review the Methodology for Measurement of Poverty

- There was lot of criticism about Tendulkar Committee methodology.
- So the Government formed an **Expert Group to Review the Methodology for Measurement of Poverty** under the

chairmanship of Dr. C. Rangarajan in 2012. It submitted its report in 2014.

- It adopted the method of calorie based methodology as in the past. In addition it accounted for nutrition, fat and other essential non-food items to arrive at poverty line.
- It fixed ₹ 972 per capita per month as poverty line for rural area and ₹ 1407 for urban area at 2011-12 prices.
- The poverty ratio at all India level for 2011-12 comes to 29.5 per cent and 38.2 per cent in 2009-10.

Ability to Pay Based Poverty Line

The author of this book in his article '*Poverty Redefined*'[2] published in *Business Line* on July 2, 2014 argues to fix poverty line at the level of Basic Exemption Limit (BEL) fixed for income tax purpose. This limit is fixed on the principle of ability to pay. The basic exemption limit is fixed at a level where the people are considered rich enough to part with their income for general cause in the form of tax. It means, at that level a person is considered rich. So the author calls to name people as poor whose income is below this limit.

The basic exemption limit is for individual. Even if a family has only one earning member he is charged to tax if his income is above this limit. So, the author calls to divide the BEL by five as the average family size in India is for a family. For example if the BEL is five which is the least tax exemption available ₹ 2,00,000 the exemption available per person of a family of five is ₹ 40,000 per year. This amount needs to be fixed as poverty line. It means poverty line needs to be fixed at 20 per cent of BEL.

Employment and Unemployment

NSSO conducts Employment and Unemployment Surveys along with Consumption Expenditure Survey. The employment and unemployment survey is to assess and collect data on various aspects of labour and employment at national and state level. It collects data sector (formal and informal) wise, industry wise, occupation wise and region wise about age, education, gender, earnings, conditions of employment in different economic activities. This survey helps to generate indicators on labour force participation, worker population ratio, employment and unemployment etc. These data and indicators are useful for policy making, research on labour market and employment condition.

As per the NSSO, here are the concepts and definitions of employment and unemployment estimates.[3]

Employment Indicators

The key employment indicators are Labour Force Participation Rate, Worker Population Ratio, Proportion Unemployed and Unemployment rate. The definitions of these key indicators are given below:

Labour force participation rate (LFPR): LFPR is defined as

$$\frac{\text{Number of persons in the labour force}}{\text{1000 persons}}$$

Or

$$\frac{\text{Number of person days in the labour force}}{\text{1000 person days}}$$

Or

$$\frac{\text{No. of employed persons + No. of unemployed persons}}{\text{Total population}}$$

Worker Population Ratio (WPR): WPR defined as

$$\frac{\text{Number of persons employed}}{\text{1000 persons}}$$

Or

$$\frac{\text{Number of person days employed}}{\text{1000 person days}}$$

Or

$$\frac{\text{Number of employed persons}}{\text{Total population}}$$

Proportion Unemployed (PU): It is defined as

$$\frac{\text{Number of persons unemployed}}{\text{1000 persons}}$$

Or

$$\frac{\text{Number of persons day unemployed}}{\text{1000 person days}}$$

Or

$$\frac{\text{No. of unemployed persons}}{\text{Total population}}$$

Unemployment Rate (UR): UR is defined as

$$\frac{\text{Number of persons unemployed}}{\text{1000 persons in the labour force}}$$

Or

$$\frac{\text{Number of persons days unemployed}}{\text{1000 persons days in the labour force}}$$

Or

$$\frac{\text{No. of unemployed persons}}{\text{No. of employed persons + No. of unemployed persons}}$$

These indicators are worked out based on the activity status of persons. The activity status is based on the question whether a person is engaged in economic activity or not.

Economic Activity

If an activity results in production of goods and services that adds value to national product (National Income) it is considered an economic activity, if not it is not considered as an economic activity. The economic activities further divided into two parts - **market activities and non-market activities**.

Market activities: Activities that involve remuneration in the form of wage or profit to those who perform it are market activities. Production of goods and services for market both by private and government are examples for market activities. The government services done without price and purely for the welfare of the people also constitute market activity.

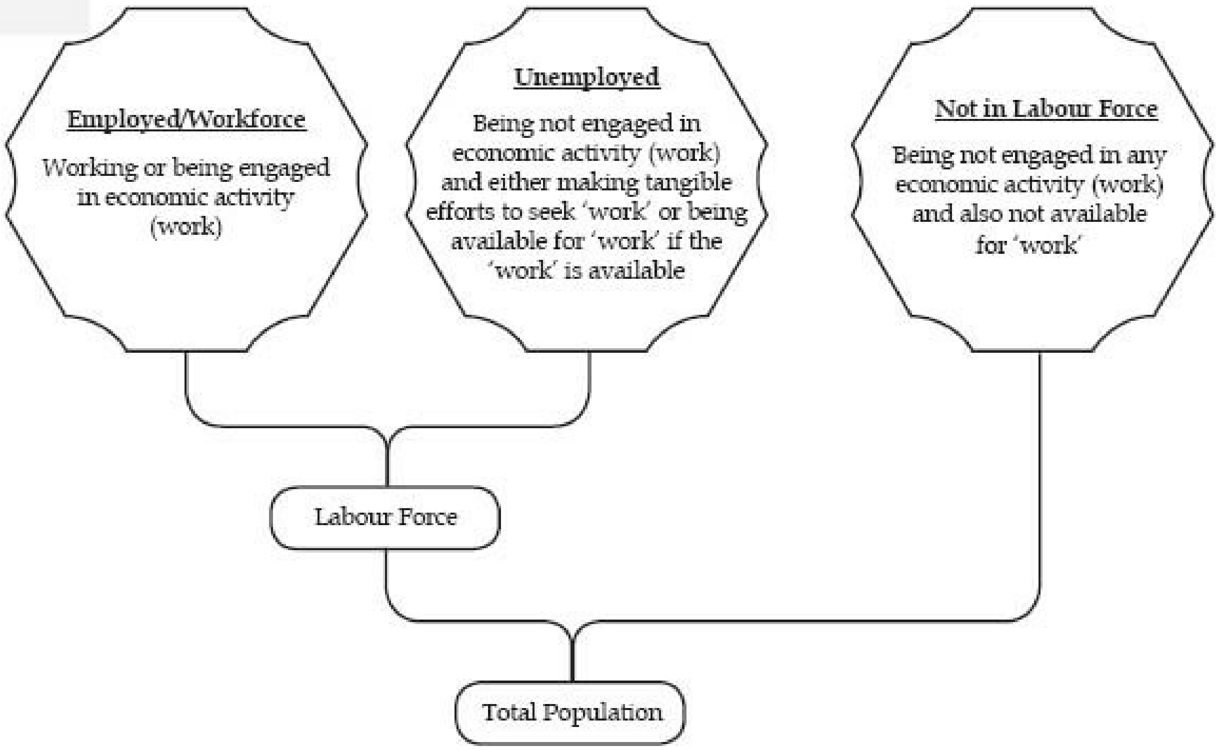
Non-market activities: Activies not compensated and carried out for own consumption are non-market activities. The examples are

a. Production of primary commodities for own consumption like cereals and grains

b. Own account production of fixed assets like housing construction with own labour or construction of common facilities like road, wells for community free of charge.

Illegal activities like smuggling are considered as economic activity. But as a convention activities like prostitution and begging are not considered as economic activities. Any person working without compensation voluntarily is considered as unemployed. At the same time if a labourer is forced to work without compensation he is considered employed.

Flow Chart 4.1



Broad Activity status

It is the activity situation in which a person is found during a reference period, which concerns the person's participation in economic and non-economic activities.

According to this, a person will be in one or a combination of the following three statuses during a reference period.

- Working or being engaged in economic activity (work) (1)
- Being not engaged in economic activity (work) and either making tangible efforts to seek 'work' or being available for 'work' if the 'work' is available and (2)

- Being not engaged in any economic activity (work) and also not available for 'work'. (3)

Persons in the categories (1) and (2) above are called **labour force**.

Persons in the category (1) are called employed. They also termed as **work force**.

Persons in the category (2) are called **unemployed**.

Persons in the category (3) are termed as **not in the labour force**.

The different broad activity statuses have been presented graphically in flow chart 4.1.

It can be expressed as:

(i) Labour force = Employed + Unemployed

(ii) Population = Labour force + Not in the labour force.

Different approaches for determining Activity Status

The activity status is determined with reference to three types of reference periods. They are (i) One year (ii) One week and (iii) each day of the reference week. Based on these three periods, three different measures of activity status are arrived at.

The activity status,

- determined on the basis of the reference period of **one year** is known as the **usual activity status/usual principal activity status** of a person;
- determined on the basis of a reference period of **one week** is known as the **current weekly status (CWS)** of the person and

Table 4.4: Various Activity Status and Their Measures

Reference period	Activity Status	Unit of measurement	Measure
One year	Usual activity status	No of persons	Categorisation
One week	Current weekly status (CWS)	No of persons	Categorisation
Each day of the reference week	Current daily status (CDS)	No of person days	Intensity

- determined on the basis of **each day of the reference week** is known as the **current daily status (CDS)** of the person.

These activity statuses help to classify the persons into categories of employed, unemployed and not in the labour force. It is categorisation. It also helps to measure the extent of employment and unemployment of persons. It is a measure of intensity.

In the categorisation we measure number of persons employed or unemployed or not in the labour force, say 30 million persons/year are employed. In the intensity measurement the extent of employment and unemployment is measured. It is measured in person days or person years, say 20 million person days of employment. Here it does not mean that 20 million persons are employed. This 20 million person days of employment may be of 1 lakh workers for 200 days (1 lakh × 200 = 20 million). The above table 4.4. throws a clear picture.

Current daily status (CDS) is considered to be a comprehensive measure of unemployment, as it captures chronic unemployment as well as under employment on a daily basis.

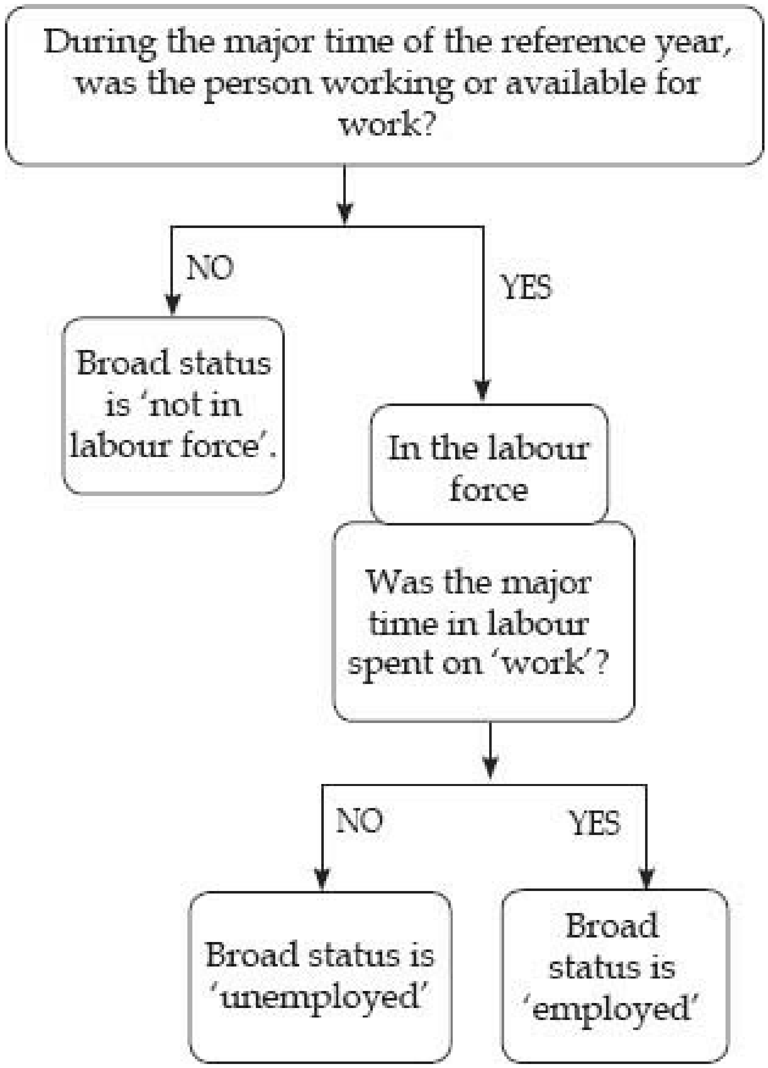
At times a person may fall into more than one category of broad activity i.e. employed, unemployed and not in the labour force. For example in a day a person might have worked only half a day. He falls into the category of employed for half a day and unemployed for the remaining half day. To avoid overlap major time criterion and priority criterion are used.

Usual Activity Status

The usual activity status relates to the activity status of a person during the reference period of 365 days preceding the date of survey. The activity status on which a person spent relatively long time (**major time criterion**) during the 365 days preceding the date of survey is considered the *usual principal activity status* of the person.

To decide the usual principal activity of a person, he/ she is first categorised as belonging to the labour force or not, during the reference period on the basis of major time criterion. Persons, thus adjudged as not belonging to the labour force, are assigned the broad activity status 'neither working nor available for work'. For the persons belonging to the labour force, the broad activity status of either 'working' or 'not working but seeking and/ or available for work' is then ascertained again on the basis of the relatively long time spent in the labour force during the 365 days preceding the date of survey. This process is given in the flow chart 4.2.

Flow Chart 4.2



Subsidiary Status

A person is considered employed in subsidiary status if he worked minimum of 30 days in the last 365 days.

The 30 days of working need not be continuous. A person may be engaged in both principal activity status as well as subsidiary status. For example a person self employed for a major part of the year may be worked as an employee in a company for 30 days.

Table 4.5 throws light on the usual principal status and subsidiary status.

Current Weekly Status

The current weekly status relates to the activity status of a person during the reference period of seven days preceding the date of survey. It is decided **on the basis of a certain priority cum major time criterion**. According to the priority criterion, the status of 'working' gets priority over the status of 'not working but seeking or available for work', which in turn gets priority over the status of 'neither working nor available for work'.

Flow chart 4.3

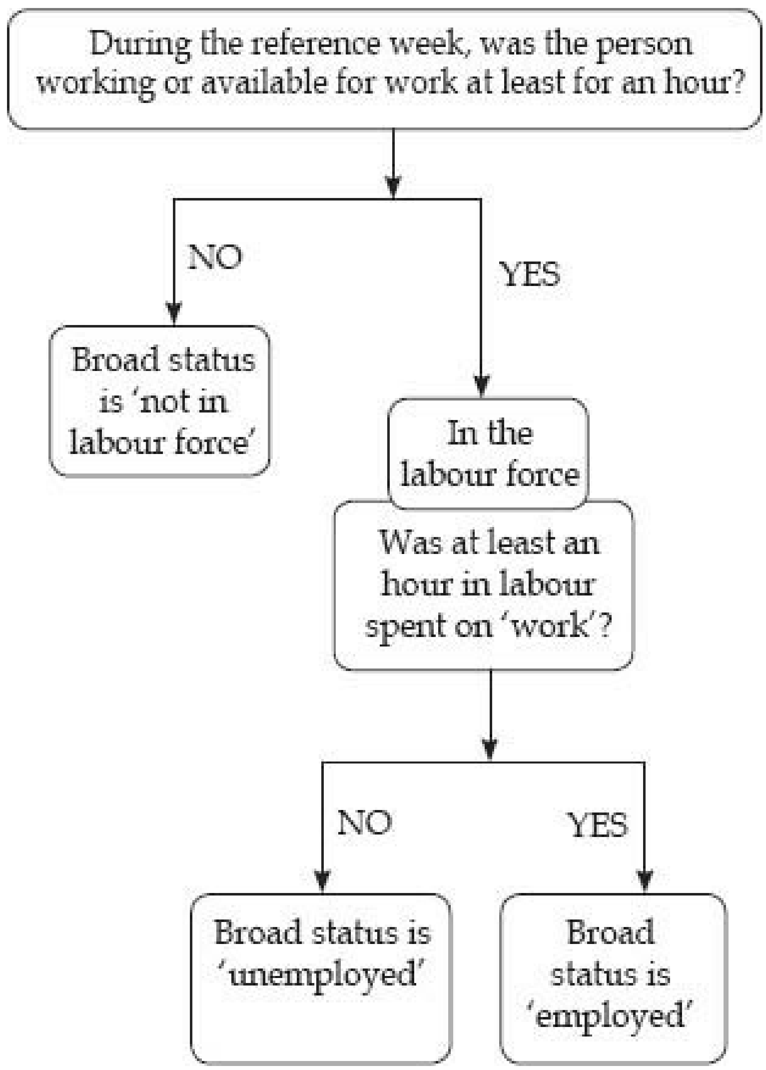


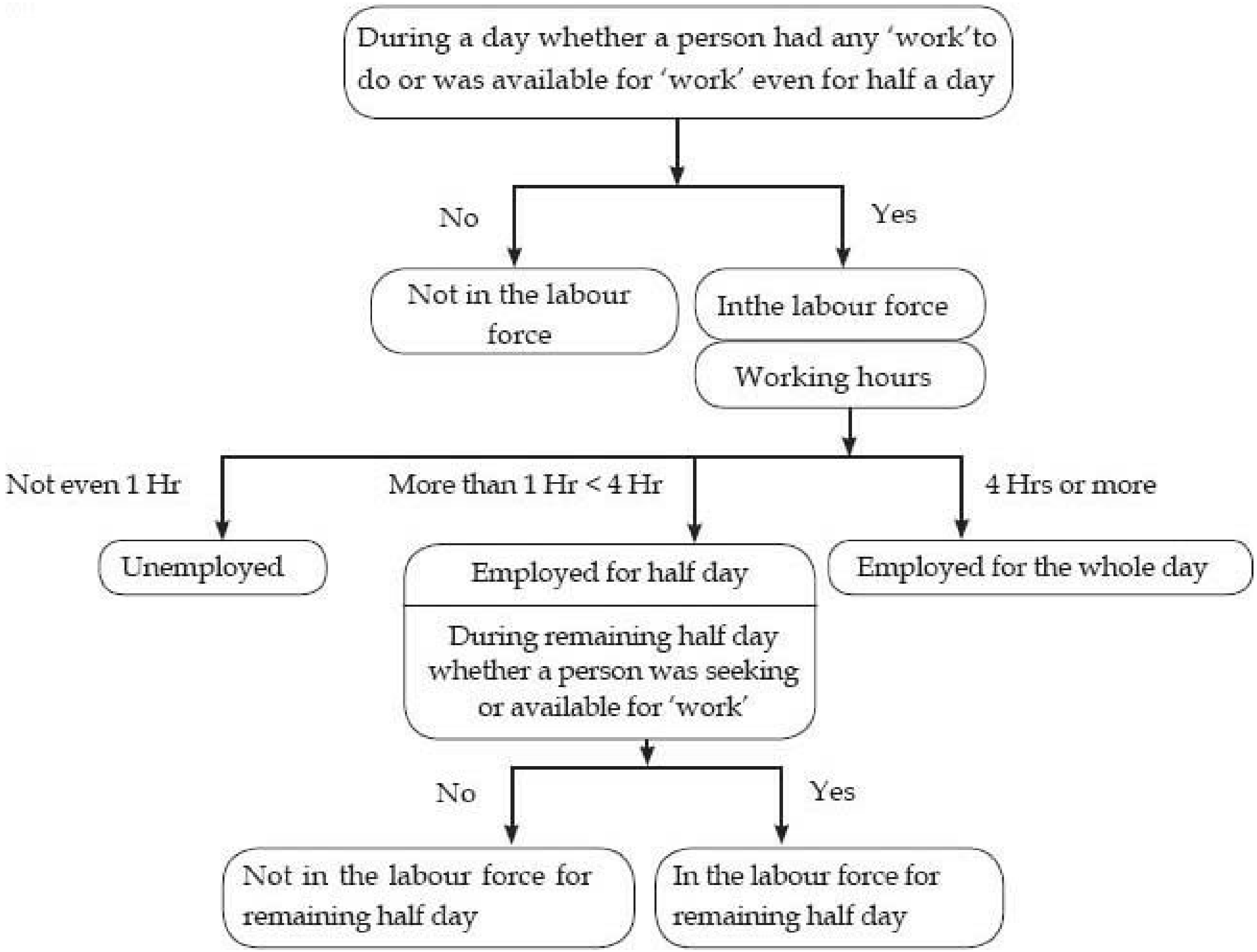
Table: 4.5: Classification of Principal and Subsidiary Status

Number of months or equivalent days					
in labour force			Not in labour force	Usual principal activity status	Subsidiary status
Person	Employed	Unemployed			
A	5	4	3	employed	
B	4	5	3	unemployed	employed in subsidiary status (SS)
C	1	0	11	not in labour force	employed in subsidiary status (SS)

A person is considered working (or employed)) if he/ she, while pursuing any economic activity, had worked for **at least one hour on at least one day** during the seven days preceding the date of survey.

A person is considered 'seeking or available for work (or unemployed)' if during the reference week no economic activity was pursued by the person but he/ she made efforts to get work or had been available for work any time during the reference week though not actively seeking work in the belief that no work was available. A person, who had neither worked nor was available for work any time during the reference week, is considered to be engaged in non-economic activities (or not in labour force). Having decided the broad current weekly activity status of a person on the basis of 'priority' criterion, the detailed current weekly activity status is again decided **on the basis of 'major time' criterion if a person is pursuing multiple economic activities**. This process is given in the flow chart 4.3.

Flow Chart 4.4



Current Daily Activity Status

The current daily status relates to the activity status of a person during each day of the reference period of seven days preceding the date of survey. It sees each day into two halves or in full and record activity status for each half separately. It is more suitable for unorganised sector where the availability of work/employment vary each day. Even in a day the work may be available only for half a day. Consider agricultural sector, the work of irrigating the field depends on the availability of electricity. It may be for half a day.

- Each day of the reference week is looked upon as consisting of either two 'half days' or a 'full day' for assigning the activity status.
- A person is considered 'working' (employed) for the entire day if

she/he had worked for 4 hours or more during the day.

- If the person had worked for 1 hour or more but less than 4 hours, she/he is considered 'working' (employed) for half-day.
- In the balance half-day, if seeking or available for work', she/he is considered as unemployed for half-day. If 'neither seeking nor available for work' then considered as not in labour force for half-day.
- If a person was not engaged in work even for 1 hour in a day but was seeking/ available for work even for 4 hours or more, she/he is considered 'unemployed' for the entire day.
- If a person was 'seeking/available for work' for more than 1 hour and less than 4 hours only, she/he is considered 'unemployed' for half day and 'not in labour force' for the other half of the day.
- A person who neither had any 'work' to do nor was available for 'work' even for half a day was considered 'not in labour force' for the entire day.

This process is given in the flow chart 4.4.

Types of Unemployment

1. Structural Unemployment

Rapidly growing population, fall in the rate of capital formation, technological change etc., in the economy are called structural changes. The unemployment caused by structural changes is called structural unemployment. It is of long-run nature. It takes a longer time to correct unless some precautionary measures were taken. The high proportion of young working age population currently in India and associated unemployment is one such example.

2. Frictional Unemployment

It is human tendency to shift from one job to another in search of better salary and employment condition. Shifting from one job to another is called attrition. It was high in software industry. It is now coming down as the scope for shifting is coming down. In the interregnum period of shifting from one job to another persons may remain unemployed. This is called frictional unemployment. The individual job seekers have to take care of this problem with adequate precaution.

3. Cyclical Unemployment

The economy undergoes the cycles of boom, depression and crisis. These are called business cycles. At the time of crisis and depression the level of employment falls. It leads to unemployment. The root cause for this type of unemployment is lack of aggregate demand. The loss of jobs in the aftermath of the financial crisis in 2008 the world over comes under this category.

4. Disguised Unemployment

In this unemployment the persons are employed on face but their contribution to production/national product is zero. It means the marginal product/productivity is zero. Marginal product here refers to the produce added to the existing production due to addition of a new employee/worker.

For example, if six persons are employed in a factory and they produce 24 units and the fifth person is added and the produce increased to 26 units, the additional 2 units (26 - 247=2) is marginal product. Here, we can consider the fifth person as employed. If there is no increase in production, the marginal product is zero and he is disguisedly unemployed. Even if she/he is removed from the activity, there will be no decline in production.

This type of unemployment is widely noticed in Indian agriculture. At times addition of one more person may lead to decline in the marginal product. It means the contribution of additional employee is negative.

5. Educated Unemployment/ Open Unemployment

A persons educated/ trained and skilled either seek employment or available for work but fails to obtain a job suited to his qualification is said to be educated/openly unemployed. It is also called open unemployment. The migrant population from rural to urban area faces this problem usually.

6. Underemployment

Underutilisation of available manpower both in terms of time and skill is called underemployment. If a doctoral degree holder works as a clerk or an office assistant in an office, he is underutilised in terms of skill. We often come across news saying that for government clerical job PhD holders applied! This is common in a developing economy. If a person with the right qualification in a right job but is not engaged in that work whole day for which he is available then that person is underutilised in terms of time.

In current daily activity status it is recorded. A person is employed for half day, seek and available for work for the remaining half day but couldn't find employment. He is considered unemployed for half a day. It is a case of underemployment.

7. Voluntary Unemployment

Persons neither seek employment nor available for work even though adequate work/employment is available come under this category. These people are not in the labour force.

Related Terms

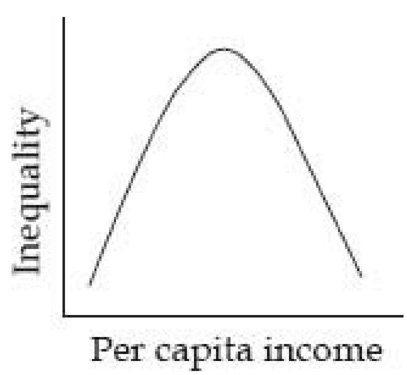
Engel's law

Ernst Engel said that with the increase in income the proportion of expenditure spent on food falls down. But there may be an increase in the absolute amount spent on food. For example when the income is ₹ 3,000 per month the family may spend ₹1500 on food. It is 50 per cent of income. But when the income rises to ₹10,000 the family may spend ₹3,500 on food. In absolute term there is an increase of ₹2000 but in percentage term it is only 35 per cent of total income. So the proportion spent on food came down from 50 per cent to 35 per cent.

Kuznets Curve

The Kuznet curve says that in a developing economy initially the inequality will increase and with increase in growth the inequality will come down. This was said by economist Simon Kuznets. It is a bell shaped curve. It is shown in the Figure 4.3.

Figure 4.3



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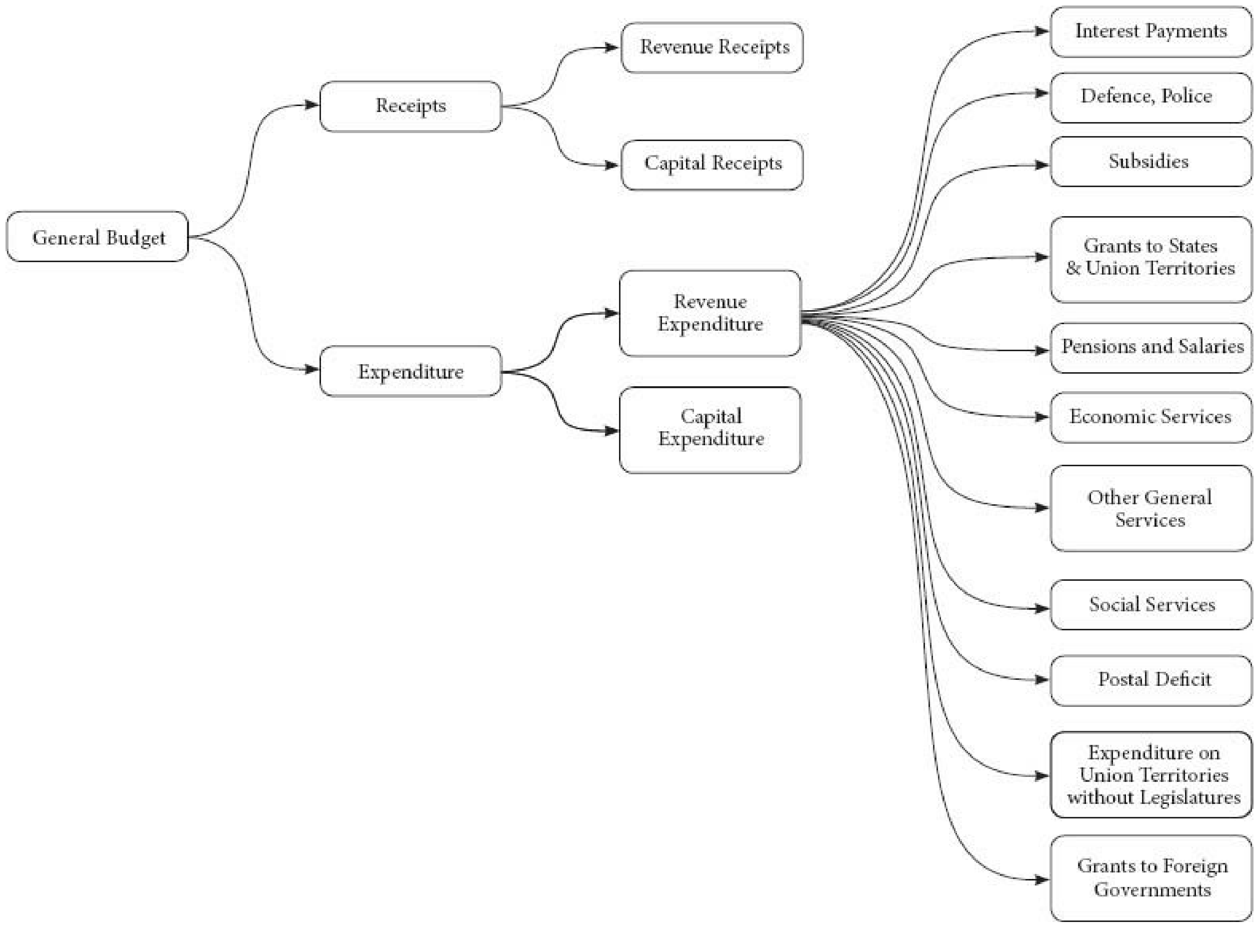
1 https://en.oxforddictionaries.com/ definition/ subsistence_level
2 http://www.thehindubusinessline.com/ opinion/poverty-redefined/article6167218.ece
3 Instructions guide to field staff-Volume I, Designs, Concepts, Definitions and Procedures. NSSO 64th Round, July 2007-June 2008

CHAPTER

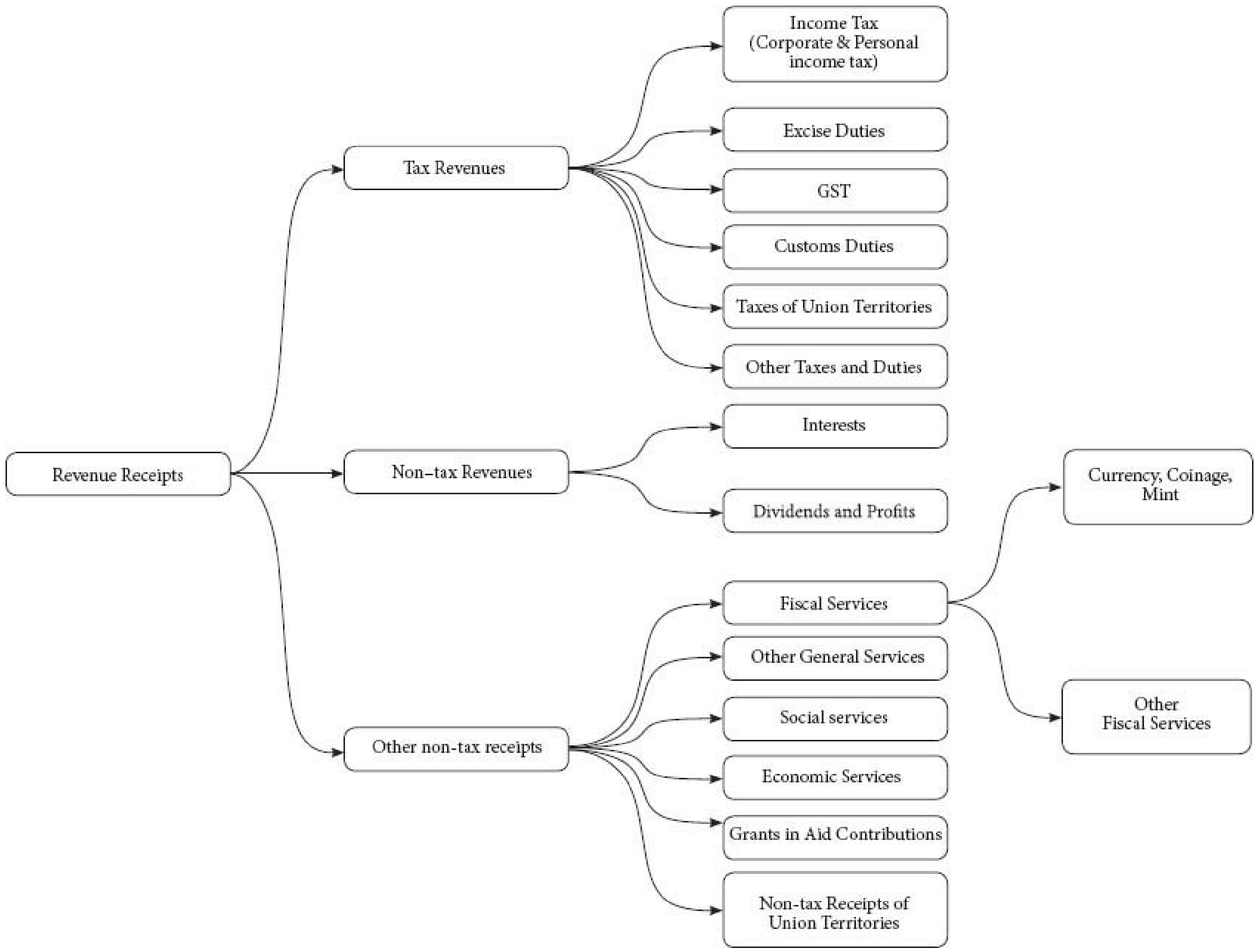
5

Public Finance

Mind Map 5.1


General Budget
Receipts
Revenue Receipts
Capital Receipts
Expenditure
Revenue Expenditure
Capital Expenditure
Interest Payments
Defence, Police
Subsidies
Grants to States & Union Territories
Pensions and Salaries
Economic Services
Other General Services
Social Services
Postal Deficit
Expenditure on Union Territories without Legislatures
Grants to Foreign Governments

Mind Map 5.2



Mind Map 5.3

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Public finance is one of the disciplines in economics that deals with resource mobilisation and utilisation of the same to accomplish state activities at all levels viz., central, state and local governments.

This chapter covers general budget, types of deficit, types of budget, tax, additional terms related to tax, Fiscal Responsibility and Budget Management (FRBM) Act and tax regime of the Centre and State.

General Budget

Budget is an annual financial statement. In case of central government Article 112 and in case of state government Article 202 of the Indian Constitution requires the annual financial statement to be laid before the respective legislatures. The budget is a statement of accounts of the Government.

Pranab Mukherjee observes: “The Union Budget cannot be a mere statement of Government accounts. It has to reflect the Government’s vision and signal the policies to come in future.”[1] So it is more than just a financial statement.

Railway Budget was separated from General Budget since 1921 on the recommendation of “Acworth Committee”. this practice was continued till 2016–17 Budget. From 2017–18 budget it is merged with General Budget on the recommendation of the committee headed by Bibek Debroy.
General Budget contains estimated receipts and expenditure for one year usually. It has three sets of figures as under;

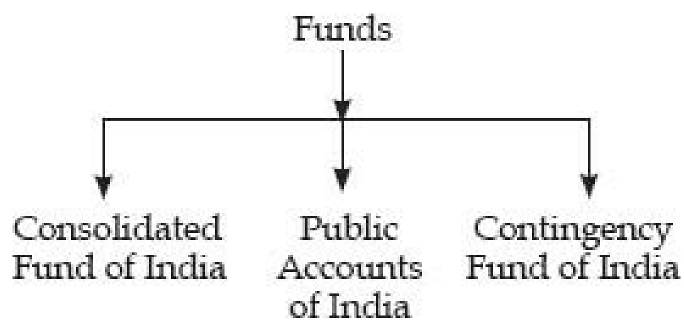
1. Actual figure of the previous year
2. Budget and Revised figure for the current year
3. Budget estimate for the upcoming year

Budget estimates are based on the previous two year estimates.

If it is the budget of 2009–10, the previous year is 2007–08, the current year is 2008–09 and the coming year is 2009–10. Here a confusion may arise regarding the years mentioned. You may raise the question as to how 2008–09 will become current year for 2009–10 budget. Please remember that the budget for 2009–10 is submitted at the end of the fiscal year 2008–09. So it becomes the current year. Accordingly other years also come to be mentioned.

The estimated receipts and expenditures are essentially made into and out of following funds. They are shown in the figure 5.1.

Figure 5.1



A. Consolidated Fund of India

The Consolidated Fund has been defined in Article 266 (1) of the Constitution. According to this, all revenues received by the Government of India, all loans raised by that Government by the issue of treasury bills, loans or ways and means advances and all moneys received by that Government in repayment of loans shall form one consolidated fund which is entitled as "The Consolidated Fund of India".[2]

All expenses incurred by the Government including repayment of debts and loans given to State Governments/UTs is spent from this Fund.

B. Public Accounts of India

It is established under Article 266 (2) of the Constitution. All public money received other than those included in Consolidated Fund of India are held in Public Accounts of India. This account mainly consists of money raised through small saving schemes, provident fund schemes, etc. The government is just custodian of these. It has to repay either on maturity date or whenever claimed by people. This kind of debt or obligation raised by the government is called **other liabilities**. But it is to be noted that Public Accounts of India doesn't contain other liabilities alone. There are some other receipts also.

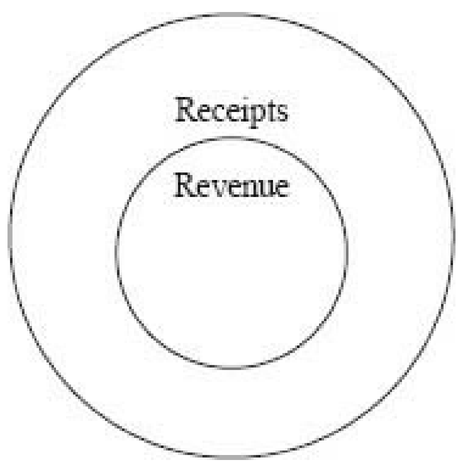
C. Contingency Fund of India

It is created by Article 267 of the Constitution to meet unforeseen expenditure. It is held at the disposal of the President of India. He/she can meet the expenditure and get the approval of the Parliament later.

Receipts

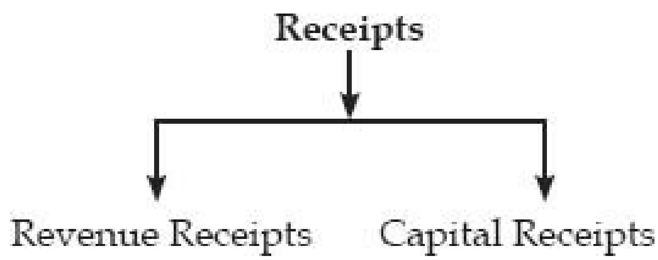
Before getting into the details of receipts it is necessary to see the difference between receipts and revenue. Revenue belongs to the receiver. It need not be repaid by the receiver. If we take an individual, the salary received by him is his revenue. Receipts include revenue apart from others. For example loan received is also included in receipts. The loan received needs to be repaid. The figure 5.2 explains this relationship.

Figure 5.2



As per Articles 112 and 202 of the Indian Constitution it is necessary to distinguish revenue expenditure from other expenditure. In addition to this classification Indian Budget classifies receipts also alike.

Figure 5.3



R.1. Revenue Receipts

Revenue receipts are those receipts which need not to be paid again to the payee by the government and income from government assets. These are necessarily one way transaction i.e. there is no need to return the receipts and it is a onetime settlement. Revenue receipts are three types:

through their business activitiesR.1.1. Tax Revenues

R.1. 2. Non–tax Revenues

R.1.3. Other non-tax receipts

R.1.1. Tax Revenues

The revenue generated by levy and collection of taxes by the Central Government is called tax revenue.

R.1.1. 1. Union Excise Duties

Duties of excise on the following goods manufactured or produced in India :

(a) petroleum crude; (b) high speed diesel; (c) motor spirit (commonly known as petrol); (d) natural gas; (e) aviation turbine fuel; and (f) tobacco and tobacco products.

R.1.1. 2. Goods and Service Tax

It is the tax on the supply of goods and services except on the supply of the alcoholic liquor for human consumption.

R.1.1. 3. Customs Duties

It is the tax on export and import of commodities from and to the country.

R.1.1. 4. Corporate Tax

It is levied on the company's profit income. There is no separate tax called corporate tax. It is also income tax. But the contribution of tax from corporate to the income tax is large. So it is shown under separate head.

R.1.1. 5. Income Tax (Personal income tax)

It is a tax on the personal income of the individuals, Hindu Undivided Families (HUFs), partnership firms, limited liability partnership firms etc.

R.1.1. 6. Taxes of Union Territories

In India, Union Territories [except Delhi and Puducherry] are under the direct administration of the Centre. So their tax income is lumped and taken into account in the Central budget.

R.1.1. 7. Other Taxes and Duties

Tax income from other taxes like wealth taxes, securities transaction tax are lumped together under this category.

R.1.2. Non Tax Revenues

R.1.2.1. Interest Receipts

It is the interest income from the loans given by the Central Government to state governments and other government bodies.

R.1.2.2. Dividends and Profits

Dividends from public sector enterprises and other investments, dividend/surplus of Reserve Bank of India, nationalised Banks and financial institutions are accounted as dividend and profits.

RBI prints the currency notes keeps a part with it and circulate the rest. In addition the commercial banks keeps their currency reserve with the RBI. The printed currency notes and the reserves maintained by the Commercial banks are fixed liabilities for which the RBI does not pay any interest.However, the central bank invests that money in domestic and foreign government bonds and earns interest. The total cost of printing the currency is approximately 1/7th of the total interest income. Approximately the balance 6/7th of interest income is profit for RBI.

The nationalised banks, financial institutions and Public sector enterprises generate profit through their business activities.

R.1.3. Other Non-Tax Receipts

R.1.3.1. Fiscal Services

R.1.3.1. a. Currency, Coinage, Mint

Revenue from currency, coinage and mint, which is profit from circulation of coins, is accounted under this head. The Government of India has the sole right to mint coins. The responsibility for coinage vests with the Government of India in terms of the Coinage Act, 2011 as amended from time to time. The designing and minting of coins in various denominations is also the responsibility of the Government of India. Coins are minted at the four Government of India Mints at Mumbai, Alipore (Kolkata), Saifabad (Hyderabad), Cherlapally (Hyderabad) and NOIDA (UP).

Coins in India are presently being issued in denominations of ₹1 and above and are called Rupee Coins. Coins can be minted and issued up to the denomination of ₹ 1000 as per the Coinage Act, 2011. The coins are circulated through Reserve Bank of India (RBI). The commemorative coins are also issued by the Government of India.

The difference between the intrinsic value and face value is the profit for the Government. **Intrinsic value** means the cost of production of the coins. It is the metal and other costs. **Face value** is the value mentioned on the coin. For example the cost of production of a ₹5 coin may be ₹1 but its face value is ₹5. The profit from a ₹5 coin is ₹4. It is called **Seigniorage**.

R.1.3.1.b. Other Fiscal Services

These receipts are mainly relate to contributions by Reserve Bank of India towards Extended Fund Facility (EFF) charges payable to the International Monetary Fund, remunerations, etc. received from IMF and penalties, etc. realised against Economic Offences.

R.1.3.2. Other General Services

Receipts from Public Service Commissions, central police etc., are included in this category.

R.1.3.3. Social services

Receipts from departments like education, sports, culture, health, information and publicity, etc., constitute this category.

R.1.3.4. Economic Services

Receipts from departments like agriculture and allied activities, irrigation and flood control, energy, transport and communication come under this category.

R.1.3.5. Grants in Aid Contributions

These are receipts from foreign governments and multilateral bodies as gift to the government which need not be repaid. It also includes contribution in the form of material and equipment.

External monetary assistance from multilateral bodies like Asian Development Bank, International Fund for Agriculture, International Bank for reconstruction and European Union and bilateral assistance from countries like Germany and Japan and international bodies like Global Environment Fund, UNDP are accounted as External Grant Assistance.

Apart from monetary assistance aid and material contributions also form part of grants in aid and contributions.

R.1.3.6. Non-tax Receipts of Union Territories

The receipts of the Union Territories (without legislature) mainly relate to administrative services; sale of timber and forest produce mainly in Andaman and Nicobar Islands; receipts from Chandigarh Transport Undertaking and receipts from shipping; tourism and power .

R.2. Capital Receipts

These receipts are essentially two way transactions. Once disbursed, the money will come in the form of regular income or at the time of disposal if any asset was created out of the disbursed money. These receipts can be raised either from already invested amount in the form of loan given /asset created by disposing it or on the assurance that it will be paid back in future if the government has not invested already and has no claim over the source of this receipt. In short, they are:

a. Receipts due to disposal of permanent assets
b. Recovery of loans given to others
c. Fresh loans raised by the government

Capital receipts can be classified into two categories as shown below:

1. Debt capital receipts
2. Non-debt capital receipts

R.2.1. Debt capital receipts

Among the above listed capital receipts, fresh loans raised (borrowings) by the government along with other liabilities fall under this category. In short, they are:

R.2.1. I. Borrowings

R.2.1. II. Other liabilities

R.2.1. I. Borrowings

Borrowings or public debts are money raised on the security of Consolidated Fund of India and repayable out of it. The borrowings are of two types as under:

R.2.1.I. A. Internal borrowings

R.2.1.I. B. External borrowings

R.2.1.I. A. Internal Borrowings

Money borrowed within the country from various sources and various instruments is called internal borrowing.

R.2.1.I. A. a. Market Loans (net)

Net market loans = Gross market loans – Repayment of old loans

Market Loans: Government of India's borrowing through dated government securities is called Market Loan. Dated government securities are long term (more than one year) debt instruments. Generally, the tenor of dated securities ranges from 5 years to 40 years.

These are sold through auctions. Since 2002–03, the Central Government has been announcing half-yearly Indicative Market Borrowing Calendar based on its core borrowing requirements. These auctions are conducted by the Reserve Bank of India's Public Debt Office (PDO), as debt manager to the Central Government. The dated securities are mostly Fixed Coupon Securities. The Government has also issued Floating Rate Bonds (FRBs) on which the coupon rate are reset semi-annually by adding a 'spread' to the base rate, determined through auction. Coupon means rate of interest. Interest is payable semi-annually on both fixed as well as floating rate bonds.

R.2.1.I. A. b. Treasury Bills Issued to RBI and Banks

Treasury bills are securities issued by the Government treasury. They are of short term nature and in this regard they differ from market loans. They are non-interest bearing (zero interest / zero coupons). These kinds of bonds are called Zero coupon bonds. They are issued at a discount rate. It means, security worth of ₹1,000 is issued against receipt of an amount lower than ₹1000. The purchaser of security can redeem the full ₹1,000 at a particular date. This is called redeem at par (original value).

There are a number of Treasury bills of differing maturity. Till 1991–

92, there were only 91 daysTreasury bills. It was also called as ad-hoc Treasury bill. It was discontinued from 1997–98. To replace it, ways and means was introduced. In 1998–99, 182 days Treasury bills were introduced. But it was soon replaced by 364 days Treasury bills. Again, 182 days Treasury bills were reintroduced and later 14 days Treasury bills were introduced in 1999–2000.

R.2.1.I. A. c. Other Internal Debt

Debt raised to meet budget needs apart from the previous two methods is called other internal debt.

1. Funded Securities

Sometimes short term treasury bills are converted as market loans (long term loans) to defer the repayment. These are called as funded securities. These were made as non-marketable. Sometimes, portion of these securities was made marketable. Non-marketable means it cannot be sold to any third party.

2. Other Special Securities Issued to RBI

Bonds issued by the government, to raise funds which were outside its annual borrowing programme such as the oil bonds, fertiliser bonds were classified as special securities. If these bonds were subscribed by RBI, they are accounted in this head.

3. Cash Management Bills (CMBs)

Cash Management Bills (CMBs) are short term debt instruments issued to meet the temporary mismatches in the cash flow of the Government of India. The CMBs have the generic character of T-bills but are issued for maturities less than 91 days. Like Treasury bills these are zero coupon bonds issued at a discount. In 2010, Government of India, in consultation with RBI introduced it.

4. Ways and Means Advance

As a banker to the government the RBI gives temporary loan facilities to the centre and state governments. This temporary loan facility is called Ways and Means Advances (WMA).

The WMA will generally be restricted up toa maximum of three months from the date of making the advance. The interest rate on WMA is Repo rate. In case WMA outstanding continues for more than three months from the date of such advance, a higher interest of Repo rate plus one per cent is charged. A limit is set by the RBI in consultation with the Government of India under this facility.

If the Government exceeds the set limit it is overdraft. The overdraft is charged at a rate higher than the Repo rate.

The difference between the cash management bills and Ways and means advances are the first one is subscribed by others through auction like Treasury bills and the latter is a loan given by the RBI. Both are to meet temporary mismatch in the cash flow of the Government.

5. Market stabilisation Scheme: It is not a pure budgetary/fiscal instrument. It is a fiscal cum monetary instrument. It is a facility to control liquidity due to excess foreign exchange flow into the country. The foreign exchange flow leads to inflation as there will be a matching rupee circulation in the country. To avoid this, Government issues securities through RBI and mob up the excess liquidity/ money supply. The amounts subscribed are used by the Government for its needs till repayment. The interest is paid by the Government of India. The amount of issue and date of issue is decided by RBI in consultation with Ministry of Finance, Government of India.

6. Special Floating and Other Loans

Special loan schemes are launched to raise money and their interest is subject torevision periodically, in accordance with some pre-defined variables. These are called special floating. One such scheme was launched in 2001–02.

7. Securities against Small Savings

In 1999–2000, the Government of India created a fund called National Small Savings Fund in the Public Accounts of India. Barring State provident funds, insurance and pension funds, trusts and endowments, and some small saving funds, collections of various small savings schemes like Post Office Savings Account, National Savings Time Deposits, National Savings Recurring Deposits, National Savings Monthly Income Scheme Account, Senior Citizens Savings Scheme, National Savings Certificate, KisanVikas Patra and Sukanya Samriddhi Account and Public Provident Fund are deposited in National Small Savings Fund (NSSF). **Note:** NSSF forms part of Public Accounts of India.

Net collections are invested in Central and State Government Special Securities and invested in various public agencies like Food Corporation of India, National Highways Authority of India, Air India etc. These are called **Securities against Small Savings**. Net collections means deposits minus withdrawal during the financial year. The interest amounts generated from these investments are used to pay interest for the subscribers of small saving schemes.

All the states except Arunachal Pradesh, Delhi, Madhya Pradesh and Kerala have opted out from the operation of NSSF. Arunachal Pradesh is availing 100 per cent and remaining three states are borrowing 50 per cent of net collections mobilised within their respective territories.

Only the amounts invested in Central Government Securities are accounted under this head. The respective states and the public sector enterprises account their borrowings.

8. Compensation Bonds and Others

Compensation bonds are bonds issued by the government to affected persons by its policy decision. For example, government abolished Zamindari system and to compensate their loss, the government issued bonds. These bonds were made to be converted into money in the future and are of long term nature.

9. Non-negotiable, Non-interest Bearing Securities Issued to International Financial Institutions

These securities are issued to international financial institutions like World Bank, Asian Development Bank. They are non-negotiable which means they cannot be sold to others by security holders and can be redeemed only from the issuing authority.

R.2.1.I. B. External Borrowings

Money borrowed from outside the country from various sources and instruments is called external borrowing. They are classified as multilateral and bilateral loans.

R.2.1.I. B.a. Multilateral Loans

These are loans received from multilateral agencies like IMF, World Bank. Unlike non-negotiable, non-interest bearing securities issued to international financial institutions, these are not borrowed against securities.

R.2.1.I. B. b. Bilateral Loans

These are loans raised from foreign governments and foreign government bodies directly.

R.2.1.II. Other Liabilities

Liability literally means the responsibility to pay money or responsible for something. Other liabilities in Indian official context are money not borrowed directly from people but available for government's expenditure purpose. They are money deposited in the custody of the government by the public. The government uses this money for socio-economic development. So the government is liable to repay. This money is kept in the Public Accounts of India and paid out of it whenever claimed. They are:

R.2.1.II. A. Small Saving Scheme

R.2.1.II. B. Provident Funds

R.2.1.II. C. Other Accounts

R.2.1.II. D. Reserve Funds

R.2.1.II. A. Small Saving Scheme

It includes all small savings prior to the creation of NSSF (National Saving Scheme Fund) and those small savings not credited into NSSF.

R.2.1.II. B. Provident Funds

It includes General (public) Provident Funds (GPF) and state provident funds prior to the creation of NSSF and only general public provident fund thereafter.

R.2.1.II. C. Other Accounts

a. Deposits of non-government provident funds, etc.

Deposits of Employees Provident Fund (EPF) of non-government sector are included in this category.

b. Other items

This includes securities issued to nationalised banks, oil companies, etc.

R.2.1.II. D. Reserve Funds of the Railways, Posts and Telegraphs

These are funds created by these departments to iron out excessive variations, undue fluctuations in revenues by using it as a buffer stock. Other funds like depreciation funds, railway safety funds are also included in this category.

These budget liabilities are taken into account while calculating deficits of the government budget if they are drawn from Public Accounts of India for the purpose of government expenditure.

R.2.2. Non-debt capital receipts

Amounts received by the government from disposal of its assets (except public sector assets which will be credited to the National Investment Fund) and recovery of loan given to others are included in this. They can be listed as:

1. Recoveries of loans and advances
2. Disinvestment of government shares other than PSUs (Public Sector Units)

National investment fund is a fund created by government to deposit the proceeds from disinvestment of PSUs.

After restructuring of the National Investment Fund (NIF) on January 17, 2013 the disinvestment proceeds with effect from the fiscal year 2013–14 is credited to the existing 'Public Account' under the head NIF and they would remain there until withdrawn/invested for the approved purpose. It was decided that the NIF would be utilised for the following purposes:

a. Subscribing to the shares being issued by the Central Public Sector Enterprises (CPSE) including Public Sector Banks (PSBs) and Public Sector Insurance Companies, on rights basis so as to ensure 51 per cent ownership of the Government in those CPSEs/PSBs/Insurance Companies, is not diluted.

b. Preferential allotment of shares of the CPSE to promoters as per SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 so that government share holding does not go down below 51per cent in all cases where the CPSE is going to raise fresh equity to meet its Capex programme.

c. Recapitalisation of public sector banks and public sector insurance companies.

d. Investment by Government in RRBs/IIFCL/NABARD/Exim Bank.

e. Equity infusion in various Metro projects.

f. Investment in Bhartiya Nabhikiya Vidyut Nigam Limited and Uranium Corporation of India Ltd.

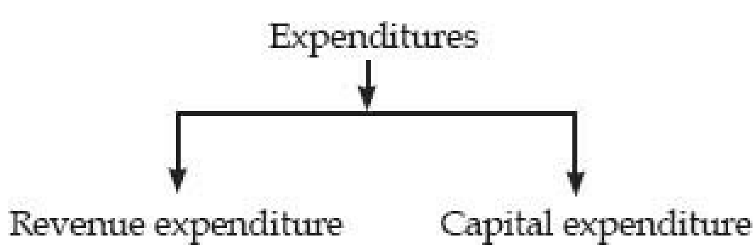
g. Investment in Indian Railways towards capital expenditure.

The allocations out of the NIF will be decided in the Government budget. [3]

Expenditures

The public expenditure can be classified as shown in the figure 5.4.

Figure 5.4



E.1. Revenue Expenditure

Expenditure incurred to meet day to day and regular needs of government and that will not yield any revenue in future are termed as revenue expenditure. It is a one-way payment. It means, if government spends money, it cannot recover it. These are:

E.1. 1. Interest Payments

Interest paid on borrowing and other liabilities and discounts on treasury bills constitute this category.

E.1. 2. Defence, Police

Expenditure of revenue nature towards law and order and defefnce come under this category.

E.1. 3. Subsidies

Subsidies on public distribution, fertilisers, etc, are included in this category.

E.1. 4. Grants to States & Union Territories

Grants given by the Centre to states and Union Territories come under this head. Though these grants are spent under capital expenditure by the receiving governments they come under this head as stipulated by Article 34(c) of the Audit Code.

E.1. 5. Pensions and Salaries

Pensions and salaries of central government departments and those paid out of consolidated fund as charged expenditure come under this category. Charged expenditure means the expenditures that can be spent without vote (approval) of legislature.

E.1. 6. Economic Services

Non-Capital expenditure towards agriculture, industry, power, transport, communication etc are included under this category.

E.1. 7. Other General Services

Non-Capital expenditure towards organs of states, tax collection, external affairs, etc, are included in this category.

E.1. 8. Social Services

Non-Capital expenditure towards education, health, broadcasting, etc, is included in this category.

E.1. 9. Postal Deficit

Postal department is unable to meets its expenditure out of its own revenue. This shortfall crosses ₹1,000 crore, which is met by the Central Government.

E.1. 10. Expenditure on Union Territories without Legislatures

Expenditure towards administration and other expenditure on Union Territories without legislatures come under this.

E.1. 11. Grants to Foreign Governments

Grants given to foreign governments like Bhutan, Nepal, and some other developing countries towards their developmental expenditure and aid given during disaster, natural calamities to all foreign countries constitute this category.

E.2. Capital Expenditure

In general, expenditures that create permanent assets and yield periodical income and loans given to state governments and local bodies are called capital expenditure. It is a two way payment. It means money spent can be recovered through periodical income and/or by disposal of the asset created.

In addition, as per Article 34 of the Audit Code, the following considerations are relevant in arriving at a decision whether or not expenditure is of capital nature.[4]

Article 34 (a): It is not essential that the concrete assets should be productive in character or that they should even be revenue producing. A productive asset may be considered as one which produces sufficient revenue to afford a surplus over all charges relevant to its functioning. It may on rare occasions be necessary and justifiable to treat as a capital scheme not commercially remunerative but involving large expenditure, say for construction of a new city.

(b) The purpose of commutation of recurring liabilities is their extinction or reduction. Although expenditure on this purpose may be genuinely capital expenditure, it is always necessary to examine from the point of view of economic financial administration whether such capital expenditure does not in fact merely replace one set of recurring payment by another, for example, where commutation by debit to capital of pension payment does not result in the substitution of equivalent payments of interest.

(c) It is inherent in the definition of capital expenditure that the assets produced should belong to the authority incurring the expenditure. Expenditure by the Government on grants-in-aid to local bodies or institutions for the purpose of constructing assets which will belong to these local bodies cannot legitimately be considered as capital expenditure.

(d) Expenditure on a temporary asset cannot ordinarily be considered as expenditure of a capital nature.

Deficit

Deficit means shortage. Here deficit refers to the shortage of money for expenditure. The gap between the receipts and expenditure is called deficit. There are various types of deficits which are explained below. (In the case of equations, you just keep in mind the words in italics. The words in normal letters are to make its components in detail.)

Budget Deficit

It is the difference between Total Expenditure and Total Receipts. Budget deficit is always zero. It doesn't have any meaning in the Central Government budget. So

Budget Deficit = *Total Expenditure – Total Receipts*

= (Capital expenditure + Revenue expenditure)
– (Capital Receipts + Revenue Receipts)

= (Capital expenditure + Revenue expenditure)
– {(Borrowings and other liabilities + Receipts
other than Borrowing) + (Revenue Receipts)}

Revenue Deficit

Revenue deficit is the difference between revenue expenditure and revenue receipts.

Revenue Deficit = *(Revenue Expenditure – Revenue Receipts)*

Or

= *[Current Revenue Expenditure – Current Revenue Receipts]*

Effective Revenue Deficit

The calculation of effective revenue deficit was introduced from 2010–11 budget. Though a part of the grants in aid given to States and UTs with legislatures or other bodies were used to create capital assets they are not considered as capital expenditure of the Central Government as the assets belong to the recipient of the grants and not the Central Government. As far as the Central Government is concerned there will be no return either in the form of recurring revenue or by way of disposal of the assets. Hence they are not considered as capital expenditure of the Central Government. However as the grants in aid used for creation of capital assets contribute to development of the national economy they are considered as productive expenditures. To capture it this new measure of deficit was introduced.

Effective Revenue Deficit = Revenue Deficit – Grants in aid for creation of capital assets

Fiscal Deficit

Fiscal Deficit is the difference between Total Expenditure and Total Receipts except Borrowing and Other liabilities.

Fiscal Deficit = Total Expenditure – Total Receipts except Borrowing and Other liabilities

= *Total Expenditure –[Capital Receipts other than Borrowings and other Liabilities + Revenue Receipts]*

= Budget Deficit + [Borrowing from RBI + Public borrowing and other liabilities]

To be precise about fiscal deficit, it is the amount of *Borrowing and other Liabilities.*

Primary Deficit

Primary Deficit is measured by subtracting the interest payments from fiscal deficit. It is a measure of current year's fiscal operation after excluding the liability of interest payment created due to borrowings of the past.

Primary Deficit = Fiscal Deficit – Interest Payment

Monetised Deficit

Monetised deficit goes beyond the Government's budgetary operations. This represents the increase in the net RBI credit to the Union Government which is the sum of increases in the RBI's holding of Government debt and any draw down by the Government of its cash balance with RBI. To say simply, the monetised deficit represents the expansion in money by the RBI.

Monetised Deficit = Borrowing from RBI + Draw down balance of government from RBI

Types of Budget

There are different kinds of budget. These budgets have different principles to achieve best results. They are explained in the following passage.

Performance and Programme Budgeting

In this budget, the chosen programmes/projects are subjected to the tests of actual performance against their expected standards. So, it involves stage wise planning and standard fixation to assess performance of programmes. It establishes a correlation between physical (output) and financial (input) aspects of each programme and activity.

It was introduced in India in 1968 for four ministries and in 1975 – 76 for all developmental departments.

Outcome Budget

It is the compilation of anticipated and intended outcomes of various ministries. Outcome is not just the physical output of financial input. Outcome refers to the benefits that arise out of physical output from the respective financial inputs. For example if 'n 'number of dams are constructed out of allocated money, it is the physical output. The rise in the productivity of fields getting irrigation facility from these dams and the resultant increase in the income of farmers etc., is the outcome. The first Outcome Budget was introduced on August 25, 2005.

Zero based Budget

In this budgeting, all the schemes and programmes are not included in every year's budget just because they already exist. Under it, every scheme should be reviewed critically and re-justified as to why they have to be included in the coming budget. It involves a consideration that there are no existing schemes/programmes and the budget has to be started from scratch/ zero base. So it is called Zero based Budget. The Finance Ministry has the plan to introduce it in future.

Tax

Tax is a compulsory levy payable by an economic unit to the government without any corresponding entitlement to receive a definite and direct quid pro quo from the government. Quid pro quo means something is given or taken equivalent to another.

Broad Areas of Tax

a. Tax on income and expenditure

Taxes imposed on Personal income, Corporate income, GST and Sales tax come under this area.

b. Tax on commodities

Taxes like Excise duty, Custom duty fall under this category.

c. Tax on Property & Property Transaction

Taxes like Wealth tax, Estate & Succession duties are classified under this category.

Tax Base

Tax base is the legal description of the object with reference to which the tax is payable. It may have a time dimension like a year or month.

E.g. Base of excise duty is production of commodities.

Base of income tax is the income of individual.

Tax Buoyancy

It measures actual or observed change in tax revenue relative to GDP.

Buoyancy = Proportionate change in the tax revenue/Proportionate change in GDP

Tax Buoyancy= $\%\Delta T / \%\Delta GDP$

Where, ΔT = Change in Tax revenue

ΔGDP = Change in Gross Domestic Product

Here, the change in the tax can be for two reasons. One is due to automatic increase and another one is due to discretionary changes in tax rate or coverage or both.

Change in tax rate will lead to change in tax revenue. Change in coverage means bringing new groups of economic units (tax base) into or leaving existing groups out of taxation. The introduction of negative list in service tax is an example for this. The negative list system brought all the services into service tax net except services listed in the negative list.

Tax Elasticity

Proportionate change in tax revenue, without any discretionary change, relative to GDP is called tax elasticity. Tax revenue that is calculated after setting aside the change in tax revenue due to discretionary changes is called adjusted tax revenue.

Tax Elasticity = Proportionate change in Adjusted tax revenue/Proportionate change in GDP

Tax Elasticity$=\%\Delta AT/\%\Delta GDP$

Where,

ΔAT = Change in Adjusted Tax Revenue

ΔGDP = Change in Gross Domestic Product

Example:

Total change in tax revenue is 20 per cent. Out of this, change in tax revenue automatically is 10 per cent and due to discretionary changes like change in tax, the rate is 10 per cent.

Change in GDP is 10%. Then

Tax Buoyancy = 20/10 = 2

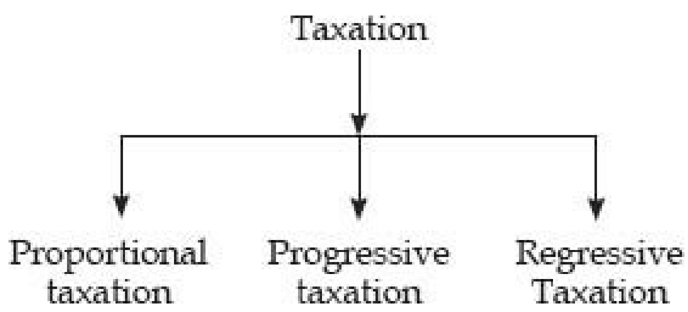
Tax Elasticity = 10/10 = 1

These measures help in forecasting the tax revenue and in deciding the policy regarding tax rate and coverage to achieve targeted tax revenue.

Classification of Taxation

The taxation can be classified mainly into three types as shown in the figure 5.5.

Figure 5.5



Proportional Taxation

Tax levied as a percentage of tax base irrespective of size of tax base, at a uniform rate is called as proportional tax. For example both who receive income/spend/purchase worth of ₹10,000 and ₹100,000 pay equal per cent of tax.

Table 5.1

Size of tax base	Tax rate	Tax amount
₹10,000	10%	₹1,000
₹100,000	10%	₹10,000

Here the tax rate remains the same but the absolute amount of tax increases with increase in size of tax base.

Progressive Taxation

If tax rate increases with the increase in size of tax base, it is called progressive tax. For example, those who receive income/spend/purchase worth of ₹100,000 pay higher tax rate than those of ₹10,000.

Progressive taxation helps to ensure economic equality in the society.

Table 5.2

Size of tax base	Tax rate	Tax amount
₹10,000	10%	₹1,000
₹100,000	20%	₹20,000

Here, the tax rate as well as the absolute amount of tax increases with increase in size of tax base.

Regressive taxation

If tax rate decreases with the increase in the tax base it is called regressive tax. Here those who receive income/spend/purchase worth of ₹100,000 pay lesser tax rate than that of ₹10,000.

Table 5.3

Size of tax base	Tax rate	Tax amount
₹10,000	10%	₹1,000
₹100,000	5%	₹5,000

Here the tax rate decreases but the absolute amount of tax increases with increase in size of tax base but less than that of proportional and progressive taxation.

Impact of Tax

Impact of a tax is on its first point of contact with the tax payers. It is upon those who bear the first responsibility of paying it to the authorities. In case of Income Tax, it is income recipient. In case of Sales Tax, it is seller.

Incidence of Tax

Incidence of a tax is on its final resting place, i.e. those economic units which finally bear the money burden of tax, and which are not able to pass it to others. In case of income tax, it is the income recipient who has to bear the money burden of paying tax. In case of sales tax, tax is paid by seller but ultimately paid by consumer along with price. Here the seller acts as an intermediate between the government and consumer by collecting tax along with price. While the seller can pass the tax burden to the consumer, the consumer cannot. So the seller is the point of impact and consumer is point of incidence.

Effects of Tax

When a tax is imposed and collected, it elicits certain responses from tax payer which have influence on working hours, saving, investment, etc. Such responses and their results are called effects. For example, if heavy tax is imposed on spending, people will save more to avoid tax burden.

Methods of Taxation on Goods

1. Ad valorem

If tax is levied as a percentage of the value of the goods regardless of number of units produced/sold/imported, then it is called ad valorem e.g. 10% on the value of a car. Revenue increases with rise in price. Let us take an example. If price of the car is ₹2 lakh, the tax amount is ₹20000 and if the car price increase to ₹4 lakh, the tax amount is ₹40000.

2. Specific duty

If tax is levied at a flat rate per unit of goods produced/sold/imported regardless of the value then it is called specific duty. E.g. ₹2 per 1 kg of iron, ₹3 per 1 mtr of cloth. Revenue increases only with number of units not with value. Let us take the above example: the tax amount will not increase if car price increase from ₹2 lakh to ₹4 lakh if tax of ₹10000 per car is imposed. Tax revenue will increase only if car sales increase from one to two. The tax revenue will increase from ₹10000 to ₹20000.

In some cases, both types of tax is levied on the same good, e.g. ₹ 10,000 per car plus 10 per cent on the value of car.

Types of Taxes

There are two types of taxes namely,

1. Direct Tax
2. Indirect tax

1. Direct Taxes

If the impact and incidence lies on the same point it is called as direct tax. e.g. income tax levied on 'X' person paid by the same 'X' person.

Direct taxes are progressive in nature in India and all over the world and are highly elastic in nature.

Income Tax (Personal income tax)

It is a tax on the personal income of the individuals, Hindu Undivided Families (HUFs), partnership firm, etc.

Corporate Tax

It is levied on the company's profit income. There is no separate tax called corporate tax. It is also income tax. But the contribution of tax from corporate to the income tax is large. So it is shown in separate head.

Securities Transaction Tax (STT)

It was introduced in 2004–5. It is a tax imposed on transactions of Securities in Stock Exchanges.

Commodities Transaction Tax

It is a tax on the sale of commodities in Commodity Exchanges. It was introduced in 2013–14.

Minimum Alternate Tax (MAT)

It is a tax imposed on companies, which escaped corporate tax net or pay very low tax by using the provisions of exemptions, deductions, Incentives, etc., which are called Zero tax companies. It was introduced in 1996 – 97. In case, total income of the company after availing all eligible deductions is less than 30 per cent of the book profits, the company shall be charged to a minimum tax as a percentage of total income. This is to ensure that companies pay at least a minimum amount of tax.

The same kind of tax imposed on commercial establishment, other than companies, like partnership firms, limited liability partnership firms, etc. is called **Alternate Minimum Tax (AMT).**

There are no separate taxes called MAT and AMT. These are special provisions in Income Tax Act to levy tax at special rates.

2. Indirect Tax

If impact is on one point and incidence on some other point, it is called indirect tax. e.g. excise duty – levied on producer, but ultimately paid by consumer along with price.

Irrespective of spending capacity and purchasing power of people usually all were charged an equal percentage of tax. It is well known that ₹10 is a big amount for a person who earns ₹100 per day but it is not the case for a person who earns ₹1000 per day. In this case, if both were required to pay equal amount of tax of ₹10, it puts higher burden on the first person than second. So these taxes are considered as regressive in nature.

But by imposing higher rate of taxes on luxury goods and lower rate of taxes on essential goods the progressiveness of indirect taxes is ensured to some extent.

Union Excise Duties

Duties of excise on the following goods manufactured or produced in India :

(a) petroleum crude; (b) high speed diesel; (c) motor spirit (commonly known as petrol); (d) natural gas; (e) aviation turbine fuel; and (f) tobacco and tobacco products.

In addition to the excise duty and customs duty levied, **National Calamity Contingent Duty (NCCD)** is levied on some of the specified tobacco products and on crude petroleum. It is credited to National Calamity Contingent Fund (NCCD) and National Disaster Response Fund (NDRF).

Customs Duties

It is the tax on import and export of commodities. It is levied on exports very rarely especially to protect the domestic interest like price control and to make the product supply enough.

Sales Tax /VAT (Value Added Tax)

It is a tax on sale of commodities. It is a state level sales tax. The tax rate is imposed as a percentage of value added. Hence, it is called VAT. After the introduction of GST only few products like petrol and diesel are under VAT.

GST (Goods and Services Tax)

It is a uniform tax on goods and services throughout the country. It has been implemented from July 1, 2017 with the motto of One Nation, One tax and One market.

In clause 12A of Article 366 of Constitution the GST is defined as follows:

"Goods and service tax" means any tax on supply of goods or services or both except taxes on the supply of the alcoholic liquor for human consumption.

The clause 26A of Article 366 of the Constitution says "Services" means anything other than goods.

This tax is introduced with the intention of simplifying indirect tax landscape of the country. There were multiple indirect taxes levied by the centre and state. Most of them are subsumed into GST.

The list of indirect taxes of the centre subsumed into GST are Central Excise Duty (except few fossil fuels and tobacco), Additional Excise Duties, Excise Duty levied under the Medicinal and Toilet Preparations (Excise Duties) Act, 1955, Service Tax, Additional Customs Duty commonly known as Countervailing Duty, Special Additional Duty of Customs, and Surcharges and Cess on these taxes and duties.

The list of indirect taxes of the states subsumed into GST are Value Added Tax/Sales Tax (except few fossil fuels and tobacco), Entertainment Tax (other than the tax levied by the local bodies), Central Sales Tax (levied by the Centre and collected by the States), Octroi and Entry tax, Purchase Tax, Luxury tax, Taxes on lottery, betting and gambling and State cess and surcharges on these taxes and duties.

Note: Please refer the heading 'The Tax Regime of the Centre and States' to know what are the taxes still kept out of the ambit of GST.

It has most of the features of VAT. In VAT, only goods were taxed but in GST both goods and services are taxed on the basis of tax on value addition method.

The tax is imposed as a percentage of value added. Here consider a cotton shirt production prior to introduction of the concept of tax on value added.

First the cotton sold was taxed. It was bought by a spinning mill owner. He had to pay the price of cotton including sales tax on it. He would process it into yarn and sell it to a weaver. Again Sales tax was imposed. Here, the price included cost of the cotton + Sales tax on cotton + value added by spinner. So the tax amount already paid also got taxed. It continued till the end product. It inflated the price of the end product. This is called the cascading effect. To avoid this and to bring about uniformity in indirect tax throughout the country all indirect taxes were subsumed into GST.

It is a multi-stage tax. Here the tax paid on the input is adjusted with the tax payable on the output. It is called input tax credit or tax credit. In the above example the tax paid on the cotton is adjusted with tax payable on the yarn. So the producer pays tax only on the value added by him. Tax on tax is avoided. Cascading effect is undermined. So price rise is avoided.

Salient Features of GST

- It is consumption or destination based tax levied on the basis of the "Destination principle"
- GST is applicable on supply of all goods and services except Alcohol for human consumption and few other goods.
- It is payable by supplier of Goods and or Services. At times it is payable by the recipient of supply of goods or services or both instead of the supplier of such goods or services. It is called "reverse charge".

- The actual incidence usually falls on the recipients of goods.
- The law and rule is more or less same across India.
- It gives a feeling of India as single market.
- There will be no competition between states to reduce tax and attract investment.
- As multiple taxes go away, the compliance cost to tax payer will come down.
- The price of goods and services may come down.
- The tax rate throughout India is same. It is fixed at 0 (exempted items), 0.25 per cent (rough diamond) 3 per cent (gold, silver and diamond jewellery), 5 per cent, 12 per cent, 18 per cent and 28 per cent for rest of the products. The last four are common slabs.
- The Centre and the States simultaneously levy GST on a common base.
- The GST levied by the Centre is called Central GST (CGST) and that is levied by the States is called State GST (SGST). The former is shortly called Central tax and the latter is shortly called State tax.
- For Union territories without a legislature UTGST is levied by centre. Over and above this CGST is applicable.
- GST levied on interstate trade and commerce is called Integrated GST (IGST). It is shortly called Integrated tax.
- The following combination of taxes are applicable for any transaction:
    a. For Supply of goods and/or services within a state (Intra-State): CGST + SGST;
    b. For Supply of goods and/or services within Union Territories (Intra-UT):
CGST + UTGST;
    c. For Supply of goods and/or services across States and/or Union Territories (Inter State / Inter-UT): IGST

- Tobacco and tobacco products would be subject to GST. In addition, the Centre could continue to levy Central Excise duty.
- The threshold turnover limit for exemption from levy of GST is ₹ 20 lakh. For the Special Category States, it is ₹ 10 lakh.

Integrated GST (IGST)

It is levied on supplies in the course of inter-State trade or commerce. Such tax shall be levied and collected by the Government of India and thereafter shall be apportioned between the Union and the states in the manner as may be provided by Parliament by law on the recommendations of the Goods and Services Tax Council. Import of goods or services would be treated as interstate supplies and thus it would be subject to IGST in addition to applicable custom duties. The customs duty shall continue. The IGST replaces duties levied over and above customs duties like additional customs duty.

Compensation Cess on **IGST**

An additional tax on supply of specified goods such as luxury cars, aerated drinks, pan masala and tobacco products, is applicable, in the course of interstate trade or commerce. It shall be levied and collected by the Government of India for a period of five years or such other period as the Goods and Services Tax Council may recommend. The net proceeds of additional tax on supply of goods shall be assigned to the states from where the supply originates. This cess is called compensation cess.

FRBM Act 2003

[Fiscal Responsibility and Budget Management Act]

FRBM Act was enacted in 2003 with the purpose of correcting the fiscal imbalances like high revenue and fiscal deficit. Apart from provisions of the Act, FRBM rules were also framed to fix targets of deficits among other things. Special features of the act and rules are as under:

Act

- Central Government to take appropriate measures to reduce the fiscal deficit and revenue deficit so as to eliminate revenue deficit by March 31, 2008 and thereafter build up adequate revenue surplus
- Rule to be made under this Act to specify the annual targets for reduction of fiscal deficit and revenue deficit, contingent liabilities and total liabilities
- The revenue deficit and fiscal deficit may exceed targets specified in the rules only on grounds of national security or national calamity or such other exceptional grounds as the Central Government may specify
- The Central Government shall not borrow from the RBI except by way of advances to meet temporary excess of cash disbursements over cash receipts
- RBI not to subscribe to the primary issues of the Central Government securities from the year 2006–07
- Central Government has to take suitable measures to ensure greater transparency in its fiscal operations. As a part of it, Central Government has to lay in each financial year, before both houses of Parliament, three statements with budget. They are as follow:
  i. Macroeconomic Framework
  ii. Fiscal Policy Strategy Statement and
  iii. Mid-term Fiscal Policy Statement.

These are explained under the heading 'Budget Documents'

Rules

- Finance Minister to make a quarterly review of trends in receipts and expenditure in relation to the budget and place the review before both Houses of Parliament

- Reduction of revenue deficit by an amount equivalent of 0.5 per cent or more of the GDP at the end of each financial year, beginning with 2004–05 and to be brought to zero by 2008–09
- Reduction of fiscal deficit by an amount equivalent of 0.3 per cent or more of the GDP at the end of each financial year, beginning with 2004–5, so that deficit is less than 3 per cent by 2008–9. The budget of 2015–16 shifted the target year to 2017–18. [5]
- No assumption of additional liabilities (including debt at current exchange rate) in excess of 9 per cent of GDP for the financial year 2004–5 and progressive reduction of this limit by at least one percentage point of GDP in each subsequent year to 6 per cent by 2007–8.
- No guarantees in excess of 0.5 per cent of GDP in any financial year, beginning with 2004–05.
- Four fiscal indicators namely (i) Revenue deficit as a percentage of GDP, (ii) Fiscal deficit as a percentage of GDP, (iii) Tax revenue as percentage of GDP and (iv) Total outstanding liabilities as percentage of GDP are to be projected in the medium term fiscal policy statement.
- For greater transparency in the budgetary process, rules mandate the Central Government to disclose changes, if any, in accounting standards, policies and practices that have a bearing on the fiscal indicators.
- The Government is also mandated to submit statements of receivables and guarantees and a statement of assets, at the time of presenting the annual financial statement, latest by budget 2006–7.
- The rules prescribe the form for the quarterly review of the trends of receipts and expenditures. The rules mandate the Central Government to take appropriate corrective action in case of revenue and fiscal deficits exceeding 45 per cent of the budget

estimates, or total non- debt receipts falling short of 40 per cent of the budget estimates, at the end of first half of the financial year.

Budget Documents

The Budget Division coming under the Department of Economic Affairs of Finance Ministry of Government of India is responsible for the preparation and submission of the Central Government Budget to the Parliament. The Budget is called Annual Financial Statement. The Budget is caused to be presented before both the houses of the Parliament by the President. It is presented by the Finance Minister with Budget speech. The Budget Speech of the Finance Minister comprises of two parts. Part A provides an overview of the economy, highlights the concerns and priorities of the Government including some of the major programmes and flagship schemes and the Budget Estimates for the ensuing financial year. Part B of the speech deals with tax proposals in the Budget.

Along with Budget Speech and Annual Financial Statement (AFS) the following documents are submitted:

A. Demands for Grants (DG)

B. Finance Bill

C. Statements mandated under FRBM Act:

   i. Macro-Economic Framework Statement

   ii. Medium-Term Fiscal Policy cum Fiscal Policy Strategy Statement

D. Expenditure Budget

E. Receipt Budget

F. Statement of Revenue Forgone

G. Expenditure Profile

H. Budget at a Glance

I. Memorandum Explaining the Provisions in the Finance Bill

J. Outcome Budget

Annual Financial Statement (AFS), Demands for Grants (DG) and Finance Bill are submitted as per the mandate of the Constitution. Macro-Economic Framework Statement and Medium-Term Fiscal Policy cum Fiscal Policy Strategy Statement presented as per the provisions of the Fiscal Responsibility and Budget Management Act,2003. Other documents are in the nature of explanatory statements supporting the mandated documents.

A. Demand for Grants

As seen earlier the AFS contains the estimated expenditure and receipts. It has the estimation for both Charged Expenditure and the expenditure to be voted by the Parliament. The expenditures other than the Charged Expenditure are called Voted Expenditure. The expenditures charged from Consolidated Fund of India without the subject to vote/approval of the Parliament are called Charged Expenditures.

The expenditure to be voted by the Parliament is presented to the Parliament as a demand and the Parliament grants it. Hence the submission before the Parliament for approval is called Demand for Grants. It is presented ministry wise, in some cases department wise. For Union Territories without Legislature, a separate Demand is presented for each of such Union Territories.

The Constitution prohibits voting on Charged Expenditure at the same time discussion on Charged Expenditure is not prohibited. Moreover the ministries may have both Charged Expenditures and Voted Expenditures. Hence both are submitted in the form of Demand for Grants but Charged Expenditures are not subject to vote. The Ministry/Departments having both the expenditures present them separately. Where the provision for a service is entirely for expenditure charged on the Consolidated Fund of India like interest payments a separate Appropriation, as distinct from a Demand, is presented for that expenditure and it is not required to be voted by the Lok Sabha.

B. Finance Bill

At the time of presentation of the Annual Financial Statement before the Parliament, a Finance Bill is also presented for imposition, abolition, remission, alteration or regulation of taxes proposed in the Budget. It is a Money Bill as defined in Article 110 (1)(a) of the Constitution. The rates of Personal Income Tax, Corporate Income tax, Customs duties etc are fixed by this bill. It also contains other provisions relating to Budget that could be classified as Money Bill. Chapter VII of Finance (No.2) Act, 2004 (Relating to Levy of Securities Transactions Tax) is an example for this.

C. Statements mandated under FRBM Act

i Macro-Economic Framework Statement

The Macro-economic Framework Statement is presented to Parliament under Section 3 of the Fiscal Responsibility and Budget Management Act, 2003 and the rules made there under. It contains an assessment of the growth prospects of the economy along with the statement of specific underlying assumptions. It also contains an assessment regarding the GDP growth rate, the domestic economy and the stability of the external sector of the economy, fiscal balance of the Central Government and the external sector balance of the economy.

ii. Medium-Term Fiscal Policy cum Fiscal Policy Strategy Statement

The Medium-Term Fiscal Policy Statement cum Fiscal Policy Strategy Statement is presented to Parliament under Section 3 of the Fiscal Responsibility and Budget Management Act, 2003. It sets out the three-year rolling targets for six specific fiscal indicators in relation to GDP at market prices, namely

i.Fiscal Deficit
ii. Revenue Deficit
iii. Primary Deficit
iv. Tax Revenue
v. Non-tax Revenue and
vi. Central Government Debt

The Statement includes the underlying assumptions, an assessment of the balance between revenue receipts and revenue expenditure and the use of capital receipts including market borrowings for the creation of productive assets. It also outlines for the existing financial year, the strategic priorities of the Government relating to taxation, expenditure, lending and investments, administered pricing, borrowings and guarantees. The Statement explains how the current fiscal policies are in conformity with sound fiscal management principles and gives the rationale for any major deviation in key fiscal measures.

D. Expenditure Budget

Summary of the revenue and capital expenditure estimates made for a scheme/programme are shown on a net basis. To understand the objectives underlying the expenditure proposed for various schemes and programmes in the Expenditure Budget, suitable explanatory notes are included.

E. Receipt Budget

Estimates of receipts included in the Annual Financial Statement are further analysed in this document. The document provides details of tax and non-tax revenue receipts and capital receipts and explains the estimates. The document also provides a statement on the arrears of tax revenues and non-tax revenues, as mandated under the Fiscal Responsibility and Budget Management Rules, 2004. Trend of receipts and expenditure along with deficit indicators, statement pertaining to National Small Savings Fund (NSSF), Statement of Liabilities, Statement of Guarantees given by the government, statements of Assets and details of External Assistance are also included in Receipts Budget. This document also shows liabilities of the Government on account of securities(bonds) issued in lieu of oil and fertiliser subsidies in the past.

F. Statement of Revenue Forgone

It gives estimates of tax revenue foregone because of tax incentives given to the tax payers by the Central Government by way of special tax rates, exemptions, deductions, rebates, deferrals and credits. The revenue forgone is also called as tax expenditure. This was earlier called 'Statement of Revenue Foregone' andbrought out as a separate statement in 2015–16. This has been merged in the Receipts Budget from 2016–17 onwards.

G. Expenditure Profile

Earlier it was called Expenditure Budget Volume I. After the classification of plan and non plan expenditure was abolished it is renamed as expenditure profile. It gives an aggregation of various types of expenditure and gives reconciliation of expenditure presented as per different accounting practices. Statement of some specific heads like gender budgeting, schemes for the welfare of children and Scheduled tribes and scheduled castes etc form part of this document.

H. Budget at a Glance

Aggregated details like sources of revenue, application of expenditure, revenue deficit, and fiscal deficit are given in this document. It is a summary of the Budget figures.

H. Memorandum Explaining the Provisions in the Finance Bill

It facilitates understanding of the taxation proposals contained in the Finance Bill. The provisions and their implications are explained in this document.

I. Outcome Budget

From financial year 2017–18 the Outcome Budget of all ministries are combined and brought out by Finance Ministry in association with NITI Aayog. It has clearly defined outputs and outcomes for various Central Sector Schemes and Centrally Sponsored Schemes with measurable indicators against them and specific targets for the ensuing financial year.

Related Terms

Countervailing Duty

To encourage export, countries give subsidy to exporters. So, the cost of production for exporters comes down. Hence, exporters are able to export to other countries at a cheaper rate. It largely affects producers of the importing country. To counterbalance (countervail) this, importing countries impose duty on imported goods to raise the price of subsidised product to offset its lower price. This is called countervailing duty.

Anti-Dumping Duty

Dumping refers exporting goods to other country in large quantity at a cheaper rate. There are two types of dumping:

1. Price Dumping

It refers to selling goods in a foreign country at a lower price than in the home country.

2. Cost Dumping

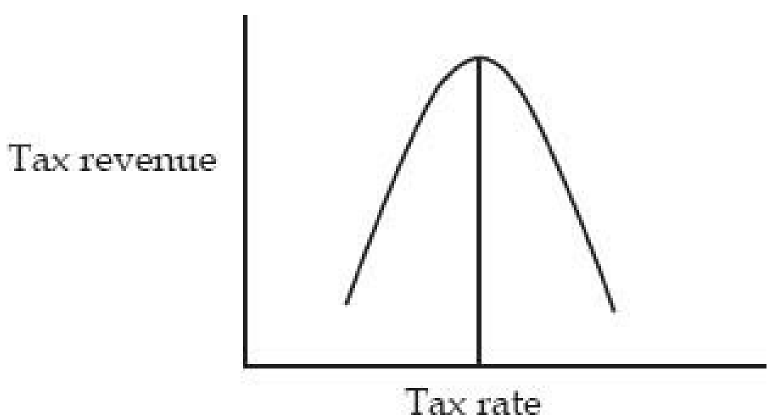
It refers to selling goods in foreign countries at a price lower than cost of production. It is mainly aimed at wiping out the domestic producers from the market. It is also called **predatory dumping.**

Duty imposed on dumped goods is called Anti-Dumping Duty. Please remember that countervailing duty is to counter low cost and low price because of subsidy but anti-dumping duty is to counter voluntary low price to capture market.

Laffer Curve

Laffer curve explains the relationship between tax rate and tax revenue. It says that at lower as well as higher rate of tax, the tax revenue is low but tax revenue is high at optimal rate of tax. Lower rate leads to lower tax collection. At higher rate of tax, there is high tax evasion and so there also the tax revenue is low. But, at optimal rate, there is no tax evasion and so the tax revenue reaches its maximum. The following figure 5.6 explains this.

Figure 5.6



Off-budget Liabilities

These liabilities arise not because of borrowing or use of the public money by government. These are money liable to be paid by the governments to various entities as a policy matter. For example, the government has a stake in keeping prices (inflation) at control. So, it does not allow the Oil Marketing Enterprises (OMEs) to raise prices when the price of crude oil rises in the international market. In this regard, oil marketing companies incur some losses. To bear these losses in part, the Government issues bonds to OMEs. These bonds are interest bearing and have to be paid as money at the time of maturity. When these liabilities are not considered in calculation of deficits in the budget, though are equivalent to borrowed expenditure, come to be called as off-budget liabilities.

Fiscal Slippage

If the actual fiscal deficit is more than what was expected it is called as fiscal slippage. For example in the budget, estimated fiscal deficit was 4.5 per cent but the actual deficit at the end of the financial year is 7 per cent, then it is called fiscal slippage.

Fiscal Consolidation

Fiscal consolidation refers to long term permanent strategies to eliminate deficit by increasing the revenue and reducing the expenditure. The strategies dominated by revenue increasing method are preferred.

Fiscal Destination vs Origin Principle

These principles are used in levy of indirect taxes. In destination principle the tax is levied at final destination. For example tax on the consumer. It is levied on him where he consumes irrespective of the fact where the good was produced. For example, take a sweet produced in Maharashtra but sold in Nagaland, as per destination principle tax is levied in Nagaland. In origin principle it is taxed at the origin . In this example it is levied in Maharashtra itself. GST is an example of destination-based tax and excise duty is an example of origin-based tax.

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1 Budget speech 2010–11

2 *Control over Public Finance in India* S. P. Ganguly, second revised edition, 2006, p.39

3 http://www.divest.nic.in/Nat_inves_fund.asp

4 *Control over Public Finance in India* S.P.Ganguly, second revised edition 2006, p.47

5 This deadline is shifted often. Please keep a watch on the newspapers to know the current deadline.

CHAPTER 6

Constitution and Indian Economy

The Constitution of India is a socio-political and economic guide to steer the nation. It forms the basis to conduct the country in these areas. The Preamble sets out the principles governing the country and the subsequent chapters give detail guidance. In this chapter constitutional provisions related to Indian Economy directly and indirectly are dealt with.

General Provisions

The Preamble and the chapters on Fundamental Rights and Directive Principles of State Policy deal with the social and economic welfare of the citizens of the country. The Preamble states the overall philosophy of the Constitution. The Fundamental Rights are the rights available to the citizens of the country including the economic sphere. The Directive Principles of State Policy gives direction to the Government to protect and enhance the welfare of the citizens.

Preamble

The Preamble calls for securing economic justice and equality of status and opportunity. The phrase equality of opportunity has an economic impetus attached to it. It is to ensure social and economic inclusion. The multidimensional poverty approach which we have seen earlier encompasses social status and inclusion. It is enshrined in the Constitution of India.

Fundamental Rights

The call for equality of status and opportunity made in the Preamble is further strengthened by Article 16. It calls for equality of opportunity in matters of public employment and prohibits discrimination based on social status like religion and race. According to Article 21A the state shall provide free and compulsory free education to all children of ages 6 to 14. Based on this article the Government had passed Right to Education Act in 2009. Article 23 prohibits human trafficking, beggar and other forms of forced labour. Article 24 prohibits child labour in factories, mines or any other hazardous employment. It shall go a long way in building the human capital of the country. It is to ensure dignity and social inclusion of citizens. Articles 29 and 30 ensure social inclusion by protecting the right and interests of minorities.

Directive Principles of State Policy

Article 39 calls the state to frame a policy to ensure adequate means of livelihood to all citizens irrespective of gender; control and ownership of community resources' distribution to serve common good to the best; operation of economic system does not result in concentration of wealth and means of production; equal pay to all genders; protection of health and strength of workers and children irrespective of gender; to give opportunities and facilities for children to develop in a healthy manner in conditions of freedom and dignity; protection of children against exploitation and against moral and material abandonment.

Article 41 calls to make effective provision to ensure right to work and education. In addition it calls for assistance in case of unemployment, old age, sickness and disablement and in other cases of undeserved want. Article 42 calls for securing humane condition of work and maternity relief. Article 43 calls the State to endeavour to secure to all workers work, a living wage, conditions of work ensuring a decent standard of life and full enjoyment of leisure and social and cultural opportunities. In addition it calls the State to endeavour to promote cottage industries in rural areas. Article 43A calls for measures to ensure workers' participation in the management in which they work.

Article 45 calls for the State to ensure childhood care and education up to age of six. As per Article 46 the State shall make policies to promote with special care the educational and economic interests of the weaker sections of the people like the Scheduled Castes and the Scheduled Tribes and to protect them from social injustice and all forms of exploitation.

Article 47 demands the State to treat the raising of the level of nutrition and the standard of living of its people and the improvement of public health as its primary duties. It also calls for prohibition.

Article 48 calls the State to endeavour to organise agriculture and animal husbandry on modern and scientific line. Article 48A calls the state to endeavour to protect and improve the environment and to safeguard the forests and wild life of the country.

Financial Matters

Apart from giving overall and general guidelines the Constitution specifically deals with the financial matters to ensure that the resources of the country are effectively utilised. It says how tax should be imposed, how the receipts of the Government needs to be credited and how it is to be spent etc. Those provisions are dealt below.

Money Bill

The money bill is defined in Article 110. A bill dealing with tax (tax by local body or local authority for local purpose is specifically excluded), borrowing, giving guarantee and amendment of law related to financial obligation of Government of India, Consolidated Fund of India, Contingency Fund of India, Public Accounts of India, declaring of any expenditure as charged expenditure, audit of the accounts of the Union or of a state is called Money Bill. Bills relating to only imposition fine, pecuniary penalties are excluded from the definition of Money Bill. When a question arises whether a Bill is a Money Bill or not, the decision of the Speaker of the House of the People (Lok Sabha) shall be final. At the time of transmitting the bill to Council of States (Rajya Sabha) and presenting to the President for assent the Speaker of the House of the People (Lok Sabha) has to certify that it is a Money Bill. The President has to give assent to the Money Bill and he has no power to return the bill.

A money bill can be introduced only in the House of the People and cannot be introduced in the Council of states. After a Money Bill has been passed by the House of the People it shall be transmitted to the Council of States for its recommendations and the Council of States shall within a period of 14 days from the date of its receipt of the Bill return the Bill to the House of the People with its recommendations. If not returned within this stipulated time it shall be deemed to have been passed by both Houses in the form in which it was passed by the House of People. If it is received within 14 days the House of the

People may thereupon either accept or reject all or any of the recommendations of the Council of States. If it accepted the recommendation the bill shall be deemed to have been passed with such amendments. If not accepted it shall be deemed to have been passed by both Houses in the form in which it was passed by the House of People.

Annual Financial Statement

As per Article 112 every financial year the President, causes to be laid before both the houses of Parliament a statement of the estimated receipts and expenditure of the Government of India. It is shortly called "Annual Financial Statement". It is called Budget in the common parlance. It is submitted by the Finance Minister of Government of India.
The estimates of expenditure have to show the following separately:

a. The sums required to meet charged expenditure out of Consolidated Fund of India
b. The sums required to meet other expenditure out of Consolidated Fund of India

And it has to distinguish revenue expenditure from other expenditure. It means the revenue expenditure and capital expenditure has to be shown separately.

The Revenue Budget consists of the revenue receipts of the Government (Tax revenues and Non Tax revenues) and the revenue expenditures. Tax revenues comprise proceeds of taxes and other duties levied by the Union. The estimates of revenue receipts shown in the Annual Financial Statement take into account the effect of various taxation proposals made in the Finance Bill. Other non-tax receipts of the Government mainly consist of interest and dividend on investments made by the Government, fees and other receipts for services rendered by the Government.

Revenue expenditure is for the normal running of Government departments and for rendering of various services, making interest payments on debt, meeting subsidies, grants in aid, etc. Broadly, the expenditure which does not result in creation of assets for the Government of India, is treated as revenue expenditure. All grants given to the State Governments/Union Territories and other parties are also treated as revenue expenditure even though some of the grants may be used for creation of capital assets.

Capital receipts and capital payments together constitute the Capital Budget. The capital receipts are loans raised by the Government from the public (these are termed as market loans), borrowings by the Government from the Reserve Bank of India and other parties through the sale of Treasury Bills, the loans received from foreign Governments and bodies, disinvestment receipts and recoveries of loans from State and Union Territory Governments and other parties. Capital payments consist of capital expenditure on acquisition of assets like land, buildings, machinery, equipment, as also investments in shares, etc., and loans and advances granted by the Central Government to the State and the Union Territory Governments, government companies, corporations and other parties.

The AFS contains the following three statements:

Statement I: Relates to the Consolidated Fund of India and shows Revenue Account Receipts, Revenue Account Disbursements, Capital Account Receipts and Capital Account Disbursements. The expenditures other than charged expenditure proposed is submitted to the Vote of the House in the form of Demand for Grants under Art. 113 (2). It also shows the gross tax revenue of the Union and the States' share as also the receipts and expenditure of the UTs without legislature.

Statement IA: Shows disbursement charged on the Consolidated Fund of India. The expenditure charged on the CFI has been enumerated under Article 112(3)and any other expenditure declared by the Constitution or by Parliament by law to be so charged, like the Central Vigilance Commission are shown.

Statement II: Depicts Contingency Fund of India Receipts and Disbursements. The corpus of the Fund is ₹ 1500 crore.

Statement III: Shows Public Account of India Receipts and Disbursements relating to National Small Savings Fund, Postal Insurance, Provident Fund, various revenue funds including of Railways, Money Orders, deposits not bearing interest etc.

Charged Expenditure

Article 112(3) gives list of charged expenditure. They are

1. Emoluments and allowances of the President and other expenditure relating to his office
2. Salaries and allowances of the Chairman and the Deputy Chairman of the Council of States (Rajya Sabha) and the Speaker and the Deputy Speaker of the House of People (Lok Sabha)
3. Salaries, allowances and pensions of the judges of the Supreme Court
4. Pensions of the judges of high courts.
5. Salary, allowances and pension of the Comptroller and Auditor General of India
6. Salaries, allowances and pension of the chairman and members of the Union Public Service Commission.
7. The debt charges for which the Government of India is liable, including interest, sinking fund charges and redemption charges and other expenditure relating to the raising of loans and the service and redemption of debt.
8. Any sum required to satisfy any judgment, decree or award of any court or arbitral tribunal.
9. Any other expenditure declared by the Parliament to be so

charged.

Administrative expenses of the Supreme Court, the office of the Comptroller and Auditor General of India and the Union Public Service Commission including the salaries, allowances and pensions of the persons serving in these offices are also expenditure charged on the Consolidated Fund of India but they are not listed in Article 112. These expenditures are stated as charged expenditure in the respective chapters.

Charged expenditure means they are pre- decided and are not subject to variation unless otherwise altered by respective/relevant law. The Annual Financial Statement cannot alter it. It is not subject to the vote of the Parliament but discussions can be done on these expenditures.

Demand for Grants and Appropriation

Expenditure other than the charged expenditure shall be submitted to the house of people on the recommendation of the President. It is called Demand for Grants. The house of people shall assent or refuse to assent or assent subject to a reduction of amount. After the Demand for Grants are submitted an appropriation bill shall be introduced in the House of People to appropriate charged expenditure and demand for grants out of the Consolidated Fund of India.

Supplementary, additional or excess grants

If the amount appropriated through appropriation bill is found to be **insufficient** for particular service or additional fund is required for some **new service** not contemplated in the annual financial statement or if any money has been **spent excessively** for that service another statement showing the estimated expenditure shall cause to be laid before both the houses of Parliament or House of People and the procedures and conditions applicable to Annual Financial Statement are applicable to this too.

Votes on account: Out of the estimated expenditure for the period starting from the first day of financial year till passage of appropriation bill the House of People may grant expenditure in advance. It is called Votes on Account.

Votes of credit: The House of People can grant expenditure for meeting an unexpected demand upon the resources of India when on account of the magnitude or the indefinite character of the service the demand cannot be stated with the details ordinarily given in an annual financial statement. It is called votes of credit.

Exceptional grant: The House of People can make an exceptional grant even if it is not part of current year expenditure.

For the above three grants the Parliament shall have the power to authorise withdrawal of money from Consolidated Fund of India. The procedures and conditions applicable to Annual Financial Statement are applicable to this also.

Imposition of Tax

Article 27 says no person shall be compelled to pay taxes for the promotion or maintenance of any particular religion or religious denominations. Article 265 says no tax shall be levied or collected without the authority of law. It means a law is necessary to levy and collect tax.

Spending

The Union Government and State Governments can spend for any purpose irrespective of the fact that whether the respective governments have power to enact law on those subjects. It means the Union Government can spend on the subjects that come under State subjects and vice versa. (Article 282)

Borrowing

The Union Government can borrow and give guarantee upon the security of the Consolidated Fund of India subject to the limits imposed by the law made by the Parliament. It can also lend or give guarantee to state governments subject to such limits. However, so far no such law has been enacted by the Parliament. (Article 292)

The state governments permitted to borrow or give guarantee upon the strength of the Consolidated Fund of the State subject to the limit set by State Legislature. If any due is pending to be paid by the State to Union Government against the loan or guarantee given by the Union the state cannot borrow without the consent of the Union. The Union may give consent subject to such conditions it imposes. (Article 292)

Funds and Accounts

To ensure common control of the tax and other receipts including borrowed funds and expenditure the Constitution established funds. It also laid down procedure for credit and appropriation of money out of those funds. To meet unforeseen expenditures also a separate fund is established.
Consolidated Fund of India: It is formed as per Article 266. In this fund the following receipts shall be credited.

a. All revenues net of tax and duties assigned to states
b. All loans raised by the Government of India by the issue of treasury bills, loans or ways and means advances (borrowings) and
c. All money received by the Government of India in repayment of loans (recovery of loan and interest)

Public Accounts of India: All other public money received by or on behalf of the Government of India shall be credited to the public account of India. That is money other than those credited to Consolidated Fund of India needs to be credited to Public Accounts of India.

Contingency Fund of India: As per Article 267 the Parliament may by law establish "the Contingency Fund of India" in the nature of an imprest. Imprest means loan or advance. Money can be credited from time to time in this account as per the law enacted in this respect. It shall be placed at the disposal of the President to enable advances to be made by him out of such Fund for the purposes of meeting unforeseen expenditure pending authorisation of such expenditure by Parliament by law.

The Contingency Fund of India Act, 1950 was enacted with ₹ 15 crore and the Fund is held by Finance Secretary on behalf of The President. In 2005 it was raised to ₹ 500 crore.

Finance Commission

As per Article 280 the President constitutes a Finance Commission every five years with one chairman and four members. It can be constituted earlier than five years. The Finance Commission Act 1951 defines the qualification and eligibility and terms of the chairman and members.
It shall be the duty of the Commission to make recommendations to the President as to—

a. 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 this chapter and the allocation between the States of the respective shares of such proceeds;
b. the principles which should govern the grants in- aid of the revenues of the states out of the Consolidated Fund of India;
c. the measures needed to augment the Consolidated Fund of a state to supplement the resources of the Panchayats in the state on the basis of the recommendations made by the Finance Commission of the state;

d. the measures needed to augment the Consolidated Fund of a state to supplement the resources of the municipalities in the state on the basis of the recommendations made by the Finance Commission of the state;
e. any other matter referred to the Commission by the President in the interests of sound finance.

The recommendation of the Finance Commission along with explanatory memorandum of action taken on the recommendation is to be tabled in Parliament.

Grants in aid

In addition to devolution of tax from the Centre to States under Article 275 the Centre can pay out of the Consolidated Fund of India to

a. The States which are in need of assistance the Parliament by Law determine. This amount need not be uniform for all states and need not be paid to all states. It is to be decided by the Parliament to which state and what amount needs to be paid.
b. Capital and recurring expenditures to states to meet the costs of schemes of development undertaken with the approval of the Centre for the purpose of promoting the welfare of the Scheduled Tribes or raising the level of administration of the scheduled areas to that of rest of the areas of the State.

This amount is paid to provide additional revenue to the states. So it is called grants-in-aid of the revenue of States. The basic principle governing this is being recommended by the Finance Commission.

Comptroller and Auditor- General of India

CAG is to ensure that financial prudence and procedures and conditions laid down by the Constitution and laws enacted by the Parliament and State Legislative assembly are followed.

The Tax Regime of Centre and States

In general the legislative jurisdiction of the Centre and the state is dealt in the Article 246 read with Seventh chedule to the Constitution. The Centre has exclusive jurisdiction on the subjects in List I (Union List). The states have exclusive jurisdiction on the subjects in List II (State List). Both Centre and the states have common jurisdiction on the subjects in List III (Concurrent List) subject to other provisions of the constitution. The same is applicable for tax jurisdiction also. Here the subjects relevant to tax alone are listed.

List I (Union List) of 7th Schedule – Centre

1. Tax on income, other than agriculture income (Entry 82)
2. Customs duties including export (Entry 83)
3. Duties of excise on the following goods manufactured or produced in India (Entry 84)
   (a) petroleum crude;
   (b) high speed diesel;
   (c) motor spirit (commonly known as petrol);
   (d) natural gas;
   (e) aviation turbine fuel; and
   (f) tobacco and tobacco products
4. Corporate Income Tax (Entry 85)
5. Taxes on Capital value of assets except agricultural land of individuals and companies (Capital Gain Tax) and taxes on the capital of companies (Entry 86)
6. Estate duties other than agricultural land (Entry 87)
7. Succession duties other than agricultural land (Entry 88)
8. Terminal taxes on goods or passengers carried by railways, sea or air (Entry 89)
9. Tax on railway freight and fare (Entry 89)

10. Taxes other than Stamp duties on transactions in stock exchanges and future markets (Entry 90)
11. Rates of Stamp duties on financial documents (Entry 91)
12. Taxes on the sale or purchase of goods in the course of interstate trade, other than Newspapers (Entry 92A)
13. Taxes on the consignment of goods in the course of interstate trade or commerce. (Entry 92B)

List II (State List) - State

1. Land revenue (Entry 45)
2. Taxes on agricultural income (Entry 46)
3. Succession and estate duties on agricultural land (Entry 47 and 48)
4. On land and buildings (Entry 49)
5. On mineral rights (Subject to any limitations imposed by the Parliament) (Entry 50)
6. Excise duty on alcoholic liquors and narcotics but not including medicinal and toilet preparations (Entry 51)
7. On the consumption and sale of electricity (Entry 53)
8. Taxes on the sale of petroleum crude, high speed diesel, motor spirit (commonly known as petrol), natural gas, aviation turbine fuel and alcoholic liquor for human consumption, but not including sale in the course of interstate trade or commerce or sale in the course of international trade or commerce of such goods (Entry 54)
9. Taxes on goods and passengers carried by road or on inland waterways (Entry 56)
10. On vehicles, animals and boats (Entry 57 and 58)
11. Tolls (Entry 59)
12. On professions, trades, callings and employments (Entry 60)

13. Capitation taxation (Entry 61)
14. Taxes on entertainment and amusement to the extent levied and collected by a Panchayat or a Municipality or a Regional Council or a District Council. (Entry 62)
15. Stamp duties except those on financial documents (Entry 63)

Concurrent Tax Jurisdiction

Interestingly, no tax is placed in the Concurrent List. However the Article 246-A Special provision with respect to Goods and Service Tax (GST) introduced by 101st Amendment gives concurrent power to both Centre and the States. It says both the Parliament and the Legislature of every state have power to make laws with respect to GST. However the GST imposed on the supply of goods and services in the course of interstate trade or commerce, called Integrated GST(IGST), is in the exclusively domain of Centre. The Parliament had enacted laws related to Central GST (CGST) and IGST. The states had enacted laws relating to State GST (SGST).

Taxes on professions, trades, callings and employments not exceeding ₹ 2,500 per annum is leviable by states or local bodies as per Article 276 by a law of State Legislature. Though it is in the nature of tax on income (falling in the Union List) the power is given to the States. At the same time the law made by the states cannot limit the power of the parliament to make law with respect to tax on income arising out of professions, trades, callings and employments.

Rental arrangement

Article 252 has the provision for the enactment of law on State subjects by the Parliament on the request of legislatures of two or more States. Under this article, any tax coming under the States' domain can be handed over to Parliament regulation. It is called rental arrangement. As of now, there is no such arrangement.

Protections/Restrictions available to Union and States on taxation

As per Article 274 amendments or bills to impose or vary taxes and duties assigned to the states or proceeds of them payable out of Consolidated Fund of India to the States shall not be introduced without prior recommendation of the President. The property and income of the state incidental to the ordinary functions of Government is exempted from tax imposed by Union Government. However, income and property related to trade or business carried on by or on behalf of the state government is not exempt from taxation of Union.

By Article 286 the states are restricted from imposing tax on sale or purchase of goods outside the state and on export and import.

A state cannot impose tax on water or electricity stored, generated, consumed, distributed or sold by any authority established by law of the Parliament for regulating or developing any interstate river or river- valley without assent of the President.

The properties of the Union are not subject to property tax levied by the States or any other authority as per Article 285. The state government cannot impose tax on the electricity consumed by or sold to Government of India and the Railways (Article 287).

Devolution of Tax Revenue

Devolution of tax means sharing of tax revenue of Centre with the States. It is visible that most of the taxes which are capable of yielding more revenue are in the Union list apart from GST. The GST divided the tax jurisdiction of indirect taxes equally between the Centre and the state. However all put together the tax revenue of the Centre is more than that of the states. At the same time socio economic expenditure to be incurred by the states are more compared to the

Centre. It leads to mismatch between own source of revenue and required expenditure. To overcome this imbalance the constitution has mechanism for tax devolution from the Centre to the States and distribution of states' shares among all States. They are the Finance Commission, Goods and Service Tax Council and Parliament. These three institutions are vested with these responsibilities and powers. Now 80th and 101st amendments of the Constitution govern this mechanism.

Though various Finance Commissions were recommending the devolution of taxes they were bound by the constitutional provisions as to what are the taxes shareable between the Centre and the States. Not all the taxes were shareable. The taxes like the corporate income tax were not shareable between the Centre and the States. The states were demanding share in all taxes collected by the Centre. The 10th Finance Commission recommended for a constitutional amendment to enable sharing of all taxes. As per the recommendation 80th Constitutional amendment was brought in. From 11th Finance Commission tax devolution is recommended based on 80th amendment by sharing of all taxes.

The devolution of taxes between the Centre and the States is governed by the Articles 270, Article 268, Article 269 and 269A.

Devolution as per Article 270

The Article 270 says that all taxes and duties, referred in the Union list are shareable between Centre and the states except;

a. Stamp duties come under Article 268
b. Taxes come under Article 269
c. Taxes come under Article 269A
d. Surcharge and Cess

The share is decided by the Finance Commission.

a. Stamp duties come under Article 268

As per Article 268 stamp duties are levied (imposed) by the Union government but collected and appropriated by the states. The Union Government doesn't have any share in this. Its role is confined imposition of this tax. In case of Union Territories the stamp duty is collected and appropriated by the Centre.

b. Taxes come under Article 269

As per this Article the power to impose and collect the following taxes is with the Centre and the revenue has to be shared among States.

a. Interstate sale and purchase of goods other than newspapers and
b. Interstate consignment except as provided in Article 269A.

Interstate consignment refers to transportation of goods from manufacturer to franchise to be sold to ultimate consumers. The franchise sells commodity on commission basis. It means the sales does not take place between manufacturers and franchise.

These taxes are assigned to the states in which these are leviable and shall be distributed among those states as per the law enacted by the Parliament.

c. Taxes come under Article 269A

Goods and Service tax is levied and collected by the Government of India on supplies in the course of interstate trade and commerce. GST levied on supplies in the course of the interstate trade and commerce is called Integrated GST (IGST). It shall be apportioned between the Union and the states in the manner as provided in the law by parliament on the recommendation of GST council.

d. Surcharge and Cess

The surcharge and cess are imposed and collected by the Centre and appropriated by the Centre. It is not shareable with the States.

Article 271 - Surcharge is levied as per Article 271 of the Constitution. It is a tax additionally levied as a percentage of existing tax amount on taxes referred in the Union list for the purpose of the Union. It is a tool to generate revenue exclusively for the Union. It is not shareable with the states. The tax on which it is additionally levied may be shareable but this additional tax levied as surcharge is not shareable. For example income tax is shareable between the Centre and the states but surcharge on Income Tax is not shareable.

For example, corporate income tax up to ₹1 Cr is 30 per cent on domestic companies and surcharge is 10 per cent if income exceeds ₹1 Cr.

Note: the tax rate given here is an example. It keeps changing.

Article 270 - Cess is a tax additionally levied as a percentage of existing tax amount or as a percentage of value of the goods and service or as a fixed amount of quantity of goods for specific purpose. It is leviable by a law made by the Parliament as empowered by Article 270 of the Constitution. One example is GST cess. GST cess is a compensation cess imposed additionally on GST. It was decided to impose it for a period of five years from GST implementation. The states realised that implementation of GST will result in lesser revenue compared to the revenue they were generating through various indirect taxes subsumed into GST. To compensate the losses GST cess is imposed. GST (Compensation to States) Act 2017 is enacted towards this end.

Let us take GST rate as 12 per cent. Then 3 per cent of education cess on 12 per cent is equal to 0.36 per cent. Therefore, total tax rate is 12.36 per cent.

The tax amount collected as cess should not be used for purposes other than the purposes for which it is levied as the Constitution says it is leviable for specific purposes.

Emergency and Tax Devolution

While the Proclamation of Emergency is in operation the President by order can direct that the provisions of Article 268 to 279 have effect subject to such exceptions and modifications as he thinks fit. It shall extend at the maximum till the end of the financial year in which such Proclamation of Emergency ceases to operate.

GST Council

Under Article 279A Goods and Services Tax Council was constituted. It has representation from the Centre and all the states and three Union Territories having legislative assembly.

The Goods and Services Tax Council consists of the following members:—

a)	The Union Finance Minister	Chairperson
(b)	The Union Minister of State in charge of Revenue or Finance	Member
(c)	The Minister in charge of Finance or Taxation or any other Minister nominated by each State Government **Note:** UTs having legislative assembly also have membership. Hence total members from the states (28+3=31)	Members

The total number of members is 32 (31+1). One Minister is chosen as Vice –Chairperson of the council amongst the Minister in charge of Finance or Taxation or any other Minister nominated by each State Government for such period as they may decide.

Though the Parliament and the state legislatures are given power to enact laws relating to GST important aspects related to GST like the rate, goods and services to be exempted etc., shall be recommended by the GST Council only. It is stated in the Constitution that while discharging the functions conferred by Article 279A, the Goods and Services Tax Council shall be guided by the need for a **harmonised structure** of goods and services tax and for the development of a **harmonised national market** for goods and services.

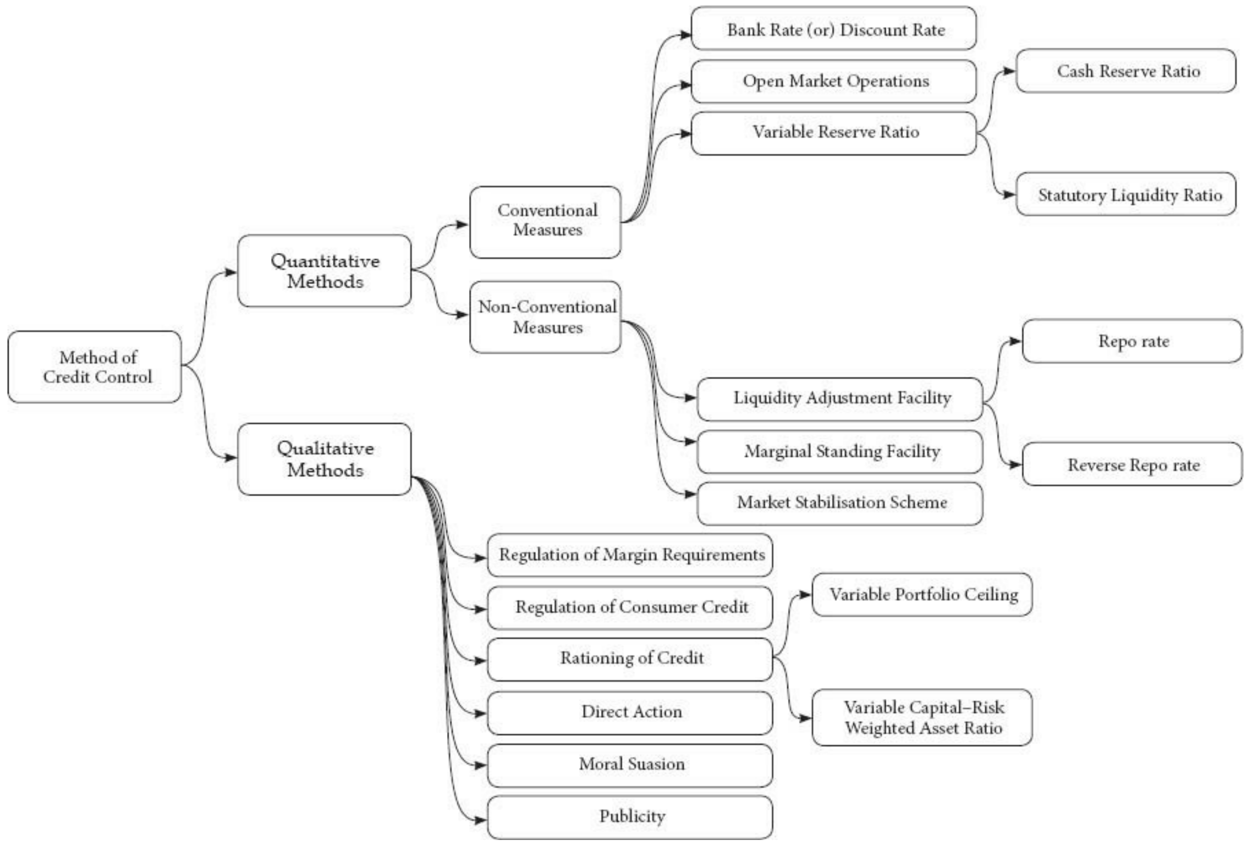
Half of the total membership that is 16 constitutes the quorum at its meeting. The weights assigned to the Centre for the purpose of voting in the council meeting is 1/3 and to all the states put together 2/3 of the total votes cast. Not less than ¾th majority of vote cast is needed for making decision in the council meeting.

The powers to recommend principles of levy, principles govern the place of supply and apportionment of IGST levied is important power given to GST council. On its recommendation in this regard the Parliament by law apportions the IGST among the states. Generally the power to recommend tax devolution is with Finance Commission. The power to recommend IGST devolution is with GST council.

CHAPTER
7

Indian Financial System-Money Market

Mind Map 7.1



The financial system of India refers to the institutions of borrowing and lending of funds or demand for and the supply of funds of all individuals, institutions, and companies and of the Government[1]. The Indian financial system can be classified into two broad categories.

1. Money Market
2. Capital Market

Money Market

The Money Market is the market for borrowing and lending of short – term funds, say up to three years. The deposit and withdrawal of money also forms part of the money market. The commercial banks, regional rural banks, and bill markets together form the money market.

Capital Market

The Capital Market is the market for borrowing and lending of medium and long term funds, say above three years. The market to raise investment also forms part of capital market. Stock exchanges and development financial institutions form capital market.

This chapter covers Reserve Bank of India and its functions, composition of money market, banking schemes and sub markets.

Reserve Bank of India (RBI) and its Functions

It is the apex regulatory body of the Indian banking system. It keeps the cash reserves of all scheduled banks and hence is known as the Reserve Bank. It is also called the central bank and was established in 1935 under RBI Act 1934. It was owned by private with government share and was nationalised in 1949.

General superintendence and direction are carried by Central Board of Directors. Apart from Central Board, RBI has four local boards (Chennai, Mumbai, Calcutta and New Delhi).

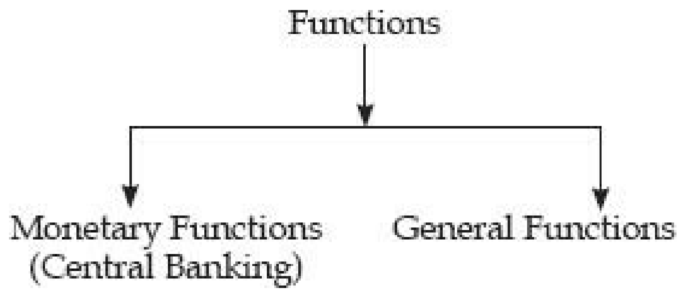
Functions of RBI

The Preamble of the Reserve Bank of India describes the basic functions of the Reserve Bank as:

"...to regulate the issue of bank notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage."[2]

The functions of RBI can be classified as in Figure 7.1.

Figure 7.1



1. Monetary Functions

Monetary functions are those concerned duly with money like issue of money, quantity of money, control of money supply etc. The following are the monetary functions.

1.1. Bank of Issue

Issue of new money is the exclusive right of RBI. All notes except ₹1 note and coins are issued by RBI. One rupee note and coins are issued by the Ministry of Finance but circulated by RBI. It also exchanges or destroys old damaged currencies.

To issue money, RBI keeps ₹115 cr in gold and ₹85 cr in foreign securities as backup. This is called Minimum Reserve System and is followed since 1957. The amount of new money is based on the prevailing economic condition, the need of the economy etc. RBI ensures that the issue of new money does not lead to inflation.

1.2. Banker and Debt Manager to Government

RBI acts as a banker to both the Centre and state governments (except Sikkim)[3]. It keeps deposits of governments and lends to governments. RBI carries out lending and borrowing operations by issuing government securities on behalf of the government. Though RBI is not a banker to Sikkim and Jammu and Kashmir it manages their public debt to some extent.

1.3. Banker's Bank

RBI is the banker of all banks. It keeps the reserves of banks like Cash Reserve Ratio (CRR) with it. It provides financial assistance to banks against mortgaged securities and rediscounts bills of exchange.

Usually, banks and other financial institutions borrow and lend among themselves when there is enough liquidity (money supply) in the market. RBI facilitates and regulates it. Suppose if there is liquidity crunch, the only avenue to borrow money is the RBI. As RBI provides enough money to banks, it is called the lender of the last resort. This happens very rarely in the economy of any country.

1.4. Custodian and manager of Foreign Exchange

RBI is responsible for keeping the foreign exchange (foreign currency) that flows into the country and keeps the foreign exchange rate stable to a certain extent.

1.5. Controller of Credit

RBI acts as controller of credit. Control of credit refers to control of lending and deposit creating capacity of the banks. These controls result in control of money supply. Control of money supply is essential to control inflation and thereby promote economic growth because both partly depend on money supply. This role is elaborated subsequently under the head 'Methods of Credit Control'

2. General Functions

General functions are aimed at general regulation of banking system to ensure a vibrant and prudent banking system. These functions are classified as Supervisory Functions and Promotional Functions.

2.1. Supervisory Functions

Under supervisory function, RBI issues licence to banks. It issues policies and guidelines for management and method of working, amalgamation, reconstruction and liquidation of the banks. It calls for returns and information from the banks. It carries out periodical inspections of players in the money market.

As a part of supervisory function, RBI ensures transparency in the working of banking system. The recent initiative in this regard is **Base rate**, which was introduced on July 1, 2010. Base rate is the minimum rate below which banks cannot lend. For example, if IOB announces its base rate as 8 per cent, it cannot lend below 8 per cent to any of its customers. But each bank has right to fix its own base rate. The exception to this are the loans to Differential Interest Rate (DIR) scheme, loans to banks' own employees and loans to banks' depositors against their own deposits can be lent below the base rate.

2.2. Promotional Functions

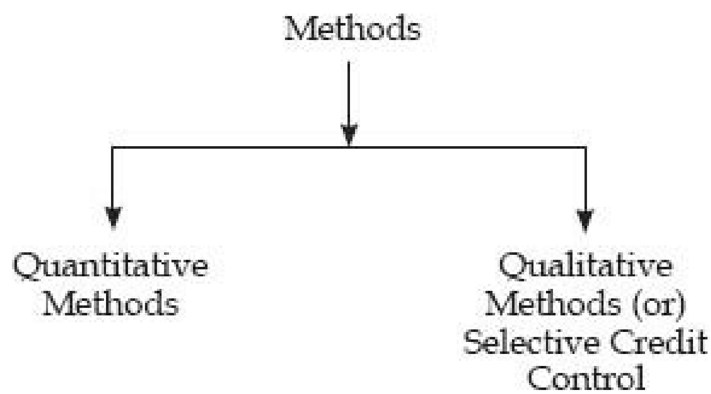
RBI works towards promotion of the Indian financial system. It takes care of branch expansion and promotes banking habit of people. It establishes and promotes new specialised agencies.

Controller of Credit and Methods of Credit Control

The methods of credit control are of two types. One is Quantitative method and another one is Qualitative Method as shown in figure 7.2. Both methods use conventional and non-conventional measures or tools.

The conventional tools or measures are those which are being used for a long time. Non-conventional measures are those which have been introduced recently, say after the 1990s reform.

Figure 7.2



CC.1. Quantitative Methods

Quantitative methods aim at controlling the cost and quantity of credit. It does not discriminate between different sectors and end use of credit. These measures are applicable for the whole of the economy.

CC.1.A. Conventional Measures

The conventional tools used are Bank Rate, Open Market Operation and Variable Reserve Ratio.

CC.1.A. 1. Bank Rate Policy (or) Discount Rate Policy

Before learning what is bank rate and its operation, it is better to know what is bill of exchange and discount.

Bill of exchange denotes a written document that assures payment of money by purchaser to seller for the goods purchased at a future date.

Discount here implies the process of converting a bill into money at an earlier date than that is mentioned in bill of exchange (maturity date). The discount is carried if the receiver of bill of exchange needs money urgently. In this process, the receiver can approach a bank.

The bank accepts the bill of exchange and pays. For that, it deducts some percentage of money as interest. For example, for a bill of exchange of ₹1000 the bank may pay ₹920 after deducting 8 per cent interest.

The bank will receive full amount from purchaser, on the maturity date. Otherwise, the bank will convert these into money at a lesser discount rate from RBI. For example, at 6 per cent and will receive ₹ 940. The profit for bank is ₹20. This is called rediscount. This rate is called bank rate or discount rate. Apart from bills of exchange, the commercial banks get their government securities discounted from RBI.

To be precise, the bank rate or the discount rate is the rate fixed by the central bank at which it rediscounts first class bills of exchange and government securities held by commercial banks.

By varying the bank rate, the RBI controls the credit. If RBI offers discount at a higher rate (increases the bank rate) the bank's profit may be affected. So, it will not approach RBI for discounting or will charge higher discount rate from customer. So the customer may not discount his bill. Hence, the money supply will be low. The reverse is the case when RBI reduces the bank rate. So, depending on the economic condition, RBI alters the bank rate. If there is high inflation, the bank rate will be high and vice versa.

CC.1.A. 2. Open Market Operations

This method refers to the sale and purchase of securities, bills and bonds of the government as well as private financial institutions by the Central bank. The financial instruments like securities, bills and bonds are written documents that are issued to banks and public against money given by them. If the central bank sells these instruments, banks and public will buy it and pay money to the Central bank. If the Central bank buys these instruments from instrument holders, it will pay money to the latter.

Through buying of financial instruments, the money supply is increased. The banks will have more money with them. The public who sold will deposit the money with the banks. So the resource of banks increases which in turn helps to increase their lending capacity. When there is more money supply, the interest will come down. Therefore, more people will borrow from banks. The reverse is the case when the Central bank sells financial instruments.

CC.1.A. 3. Variable Reserve Ratio

In these methods, the reserves that scheduled banks have to maintain are varied to control the credit creation. There are two types of reserves.

CC.1.A.3. i. Cash Reserve Ratio (CRR)

Scheduled banks are required to keep certain percentage of their Net Time and Demand Deposits with RBI under RBI Act 1934. It can be shown in a formula.

Cash Reserve Ratio =Cash reserve/Net time and demand deposits × 100

This is aimed to have control over banks credit. The ratio was 3 – 15 per cent. Within this range, the RBI fixed the CRR. If this ratio is increased, the banks have to deposit more money with the RBI. So, the resource available to banks for lending will come down. The money supply will come down. The reverse is the case when the ratio is decreased. As per RBI (Amendment) Bill 2006 enacted in June 2006, the Floor and Ceiling condition of 3-15 per cnet was removed.

CC.1.A. 3.ii. Statutory Liquidity Ratio (SLR)

Scheduled banks are required to keep certain percentage of their net time and demand deposits in their vault itself. It need not be deposited with RBI. This reserve is a precautionary measure. It prevents bank from lending all its deposits which is too risky and it is mandatory under Banking Regulation Act 1949. The ratio is 25 – 40 per cent of Net Time and Demand Deposits. This reserve was to be kept in the form of cash, gold, and bond. As in the case of CRR, this reserve is varied to control the credit. Now the floor and ceiling of 25–40 per cent is removed.

CC.1.B. Non-Conventional Measures

The non-conventional measures are Liquidity Adjustment Facility (LAF), Marginal Standing Facility (MSF) and Market Stabilisation Scheme (MSS).

CC.1.B. 1. Liquidity Adjustment Facility (LAF)

It is a short term credit control measure. It is to absorb the excess liquidity (money supply). It has two instruments, namely Repo rate and Reverse Repo rate.

CC.1.B. 1. i. Repo Rate

It is the rate at which commercial banks borrow from RBI by mortgaging their dated Government securities and Treasury bills. If repo rate is increased, the banks have two options either to reduce the borrowing from RBI or borrow at higher rate from RBI and charge higher interest rate from customer. If banks borrow fewer amounts, the credit creating capacity of banks will come down and money supply will come down. If bank borrows and charges higher interest rate, the customer will borrow less. The money supply will come down. If the repo rate is decreased the reverse will be the case.

Take an example; the repo rate is 6.5 per cent and the banks borrow from RBI at this rate and raise deposits at 4.0 per cent of interest from customers. Deposit is also a source of fund for banks to lend. Assume that the average of repo rate and deposit rate result in 6 per cent of cost to banks. This is called cost of fund. And the bank lends to its customer at 10 per cent. In this the banks earn 4.0 per cent profit. Now, the RBI raises repo rate from 6.5 per cent to 7.5 per cent. The banks will reduce or stop its borrowing from RBI because if it borrows at 7.5 per cent and lends at 10 per cent its profit will come down. Otherwise, it will borrow at 7.5 per cent from RBI and may lend at 11 per cent to its customer to keep its profit at 4.0 per cent level. It means the interest rate is increased. Now the customer will not borrow at this higher rate or will reduce his borrowings. Hence, the money supply will come down.

CC.1.B. 1. ii. Reverse Repo Rate

It is the rate at which RBI borrows from commercial banks by mortgaging its dated Government securities and Treasury bills. If the reverse repo rate is increased, the banks have two options either to lend to RBI or lend to customers at higher interest rate. If banks lend to RBI, the money available with the bank to lend to its customer will come down. The credit creating capacity of banks and money supply will come down. If the banks raise interest rate on loans to customers at higher rate, the customer will borrow lesser amount. So, the money supply will come down.

Take an example; the reverse repo rate is 8.0 per cent. The banks lend at 10 per cent to its customer when its cost of fund is 7 per cent and earns 3 per cent profit. Now, RBI raises the reverse repo rate from 8 per cent to 9 per cent. The bank will shift its lending from customer to RBI because it can earn higher interest rate of 2 per cent. Though the profit in lending to RBI is less than lending to customers, the banks will prefer RBI. This is because banks have an advantage in lending to RBI, as it is a reliable customer and loan is of short term nature and can lend in bulk. It can earn profit quickly. In this situation, if customers want to get loan from banks, it will charge higher interest from customer because it involves risk and cost. So, it will lend to the customer only if it can get higher return than the return it gets from

RBI. So, the interest rate to the customer may increase from 10 to 11 per cent. Now the customer will not borrow at this higher rate or will reduce his borrowings. So, the money supply will come down.

CC.1.B.2. Marginal Standing Facility (MSF)

It is a loan facility given by RBI to banks which have current and SGL (Subsidiary General Ledger) account with RBI. It is a loan for overnight (one day). This facility was made available from May 9, 2011. It is more similar to Liquidity Adjustment Facility (Repo and Reverse Repo), but there are many differences.

The loan is given against the mortgage of eligible securities, which are Government dated securities, Treasury bills and State Development Loans. The loan size will be minimum ₹ 1 crore and further amount is in multiples of ₹ 1 crore. The interest rate for MSF is Repo rate plus 1 per cent. Usually, the Reverse Repo rate is Repo rate minus 1 per cent. Therefore, the Repo rate acts as an anchor rate. The Repo rate stands in the middle. The MSF rate stands above and Reverse Repo rate stands below the Repo Rate.

CC.1.B. 3. Market Stabilisation Scheme

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

CC.2. Qualitative (or) Selective Credit Controls

These methods control the use and direction of credit. These methods discriminate between sectors. They control the credit flow to a particular sector or to particular end use. As of now the RBI is not using this method for control of credit. It mostly uses the quantitative control method.

CC.2. 1. Regulation of Margin Requirements

Margin is the amount that has to be contributed by borrower towards the purpose for which she/he borrows. For example, if someone wants to buy a machine she/he cannot get the full amount as loan.She/he has to contribute a certain amount to purchase the machine.

By varying this amount, the offtake of loan can be controlled. If the margin is high the offtake of loan will be low and vice versa. Different margin is fixed for different sectors. If RBI wants to control flow of credit to a particular sector, it will fix a high margin and vice versa. This is primarily aimed to prevent excessive use of credit to purchase or carry securities by speculators.

CC.2. 2. Regulation of Consumer Credit

Consumer credit refers to credit to a consumer to purchase durable consumer goods on installments and hire purchase. Two devices are available under this method. They are i) Minimum down payment, ii) Period of repayment.

Minimum down payment refers to the amount initially to be paid by the purchaser. If this amount is fixed high, the purchase will come down and vice versa. So is the demand for credit. If the number of installment is reduced, the consumer has to pay more money per installment. This will discourage credit off take and vice versa. Therefore, higher minimum down payment and less number of installments reduce money supply and vice versa.

CC.2. 3. Rationing of Credit

In this method, the maximum amount of credit flow to a particular sector is controlled. There are two methods of rationing of credit. They are:

CC.2. 3.a. Variable Portfolio Ceiling

CC.2. 3.b. Variable Capital–Risk Weighted Asset Ratio

CC.2. 3.a. Variable Portfolio Ceiling

The maximum amount of credit for various portfolios (various sector) is fixed. Different ceiling for different sector is fixed.

CC.2. 3.b. Variable Capital – Risk Weighted Asset Ratio

Capital to Risk Weighted Asset Ratio (CRAR) is also called Capital Adequacy Ratio (CAR). It signifies the availability of sufficient capital as a percentage of risk weighted assets. It is expressed in formulaic form as follows:

CRAR = Capital / Risk weighted assets × 100

The balance sheet of banks that shows their financial position consists of two sides. One side shows the liabilities and the other shows assets. Liabilities refer to the amount of money the bank has to pay to others. So the shareholders money, that is capital, which the bank is liable to pay if claimed by shareholders, is shown on the liabilities side. The assets refer to the amount of money that has to be paid by others to banks. So, the loans lent by banks are listed on the asset side.

The RBI in its monetary policy assigns some risk to loans. This is based on the likely chance of a loan be repaid or not repaid. For example, a bank can expect surely that a loan paid to a rice vendor will be repaid but cannot expect a loan paid to a stock broker because stock exchange trading is a risky one. It means, lending to the stock broker is highly risky. So, the loan to the rice vendor may be assigned a risk of 100 per cent and the loan to stock broker may be assigned a weight of 150 per cent. So, a loan of ₹1000 to the rice vendor will be considered as ₹1000 (100/100*1000=1000) but loan to the stock broker will be considered as ₹1500 (150/100*1000=1500). This is called risk weighted asset.

The capital is more or less fixed. If the capital to risk weight ratio is changed by RBI, only the asset has to be adjusted. That is the amount of loan has to be changed. So, credit can be controlled.

If the risk assigned to a particular sector is high, it will reach the ceiling with low amount of credit and vice versa. So, by varying the ceiling and Capital to Risk Weighted Asset Ratio (CRAR) the flow of credit can be controlled.

RBI uses this Capital to Risk Weighted Asset Ratio as norm to ensure that banks do not lend beyond their capacity. This ratio is fixed under the Basel norm. It is elaborated later.

CC.2.4. Direct Action

In this case, the Central bank issues certain policy decisions from time to time based on the prevailing situation in the economy. For example, the Central Bank may require scheduled banks to send proposals for loans beyond a certain amount to be scrutinised by the Central Bank. This has to be followed by the scheduled banks.

CC.2.5. Moral Suasion

Moral suasion refers to methods of persuasion, methods of request, methods of informal suggestion and methods of advice to commercial banks, about dos and don’ts by calling a meeting. The banks are morally bound to follow this but it is not mandatory.

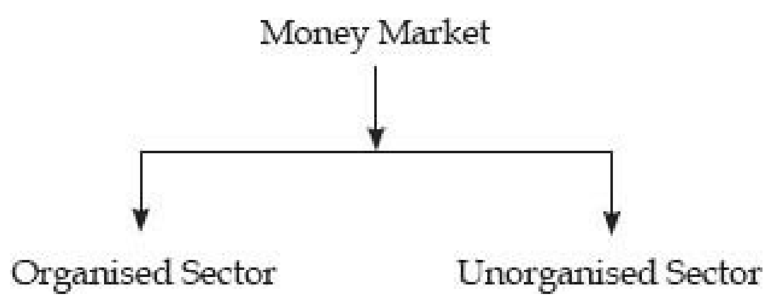
CC.2.6. Publicity

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

Composition of Money Market

Money market of India has participants both from organised and unorganised sector as shown in figure 7.3. The organised sector is characterised by registration, approval and licence from market regulators and proper maintenance of accounts. The unorganised sector is devoid of these aspects.

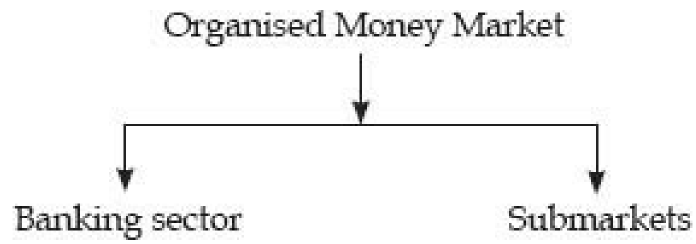
Figure 7.3



Organised sector

Organised sector consists of banking and sub markets as shown in figure 7.4. Banking sector carries out both, deposit taking and lending operations. The sub markets do the money transaction among banks and generate necessary capital for banking sector and commercial sector.

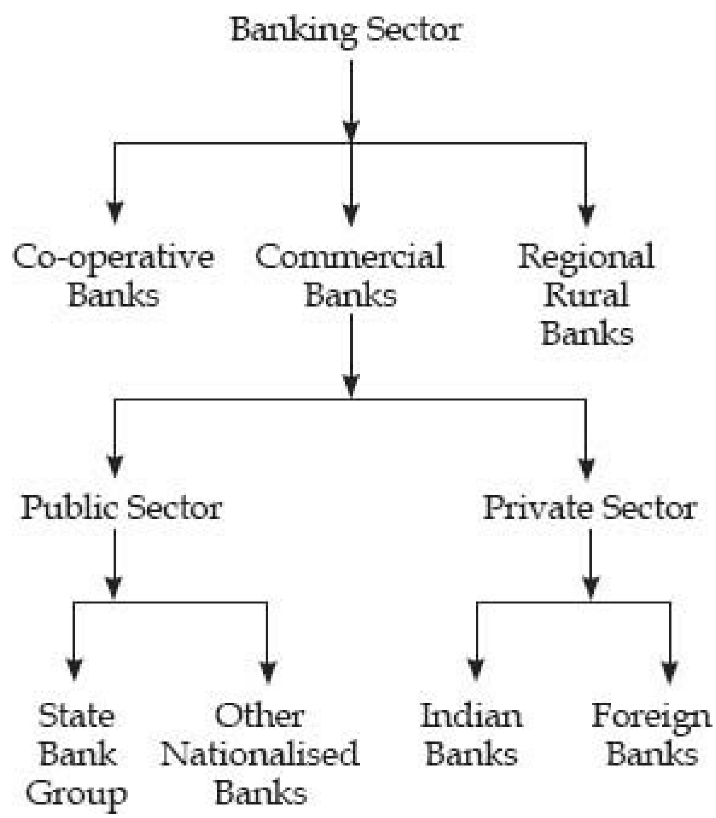
Figure 7.4



Banking Sector

Banking Sector consists of commercial banks, Regional Rural Banks and cooperative banks. It is shown in figure 7.5 in the next page.

Figure 7.5



Commercial Banks

Commercial banks are run on commercial basis. They accept deposits, give loans and provide other financial services to earn profit. These are regulated under the Banking Regulation Act 1949.

Commercial banks consist of both public sector and private sector banks.

Public Sector Banks

Public sector banks are those banks in which the majority of ownership is with the government. The majority of ownership implies a share holding of more than 51 per cent.

All public sector banks were not started by Government of India. Some banks which were in private hands were nationalised and made into public sector banks.

State Bank Of India

Its previous name was Imperial Bank of India. It was created in 1921 by amalgamating the three Presidency Banks of Bengal (1806), Bombay (1840) and Madras (1843). Imperial Bank of India was partially nationalised on July 1, 1955 and renamed as State Bank of India (SBI). In 1959, eight banks of former princely states were brought under SBI as its associates. They are:

1. The State Bank of Bikaner
2. The State Bank of Jaipur
3. State Bank of Hyderabad
4. State Bank of Indore
5. State Bank of Mysore
6. State Bank of Saurashtra
7. State Bank of Patiala and
8. State Bank of Travancore

Among these banks, State Bank of Bikaner and State Bank of Jaipur were merged together and called State Bank of Bikaner and Jaipur. State Bank of Saurashtra and State Bank of Indore were merged with the parent bank, State Bank of India .

On April 1, 2017 all associate banks and Bharatiya Mahila Bank were merged with SBI. SBI is the largest public sector bank in the country. Previously major part of SBI’s share was held by RBI. To endow RBI with only the regulatory functions, and to unload its administrative work, RBI’s share holding was transferred to the Government of India.

Other Nationalised Banks

Before nationalisation, the banks were mainly concentrated in the urban area, while the rural areas lacked the banking facility. Though there were some bank branches in rural areas, they were used only to mobilise the deposits of rural area and that money was used to lend in the urban area. Even in the urban area, the banking facilities were enjoyed by rich people. The poor people were left out of the banking net. The banks were mainly owned by industrialists who used these banks to mobilise deposits of people and themselves got loan from these banks. To make the banking facilities available to all, private banks were nationalised.
The nationalisation was carried out in two stages. On July 19, 1969 14 large commercial banks, which had reserves of more than ₹50 crore, were first nationalised. They are:

1. Central Bank of India
2. Bank of India
3. Punjab National Bank
4. Canara Bank
5. United Commercial Bank (now known as UCO Bank)
6. Syndicate Bank
7. Bank of Baroda
8. United Bank of India

9. Union Bank of India
10. Dena Bank
11. Allahabad Bank
12. Indian Bank
13. Indian Overseas Bank
14. Bank of Maharashtra

Secondly, six banks were nationalised on April 15, 1980 which had reserves of more than ₹200 cr.

1. Andhra Bank
2. Punjab and Sindh Bank
3. New Bank of India
4. Vijaya Bank
5. Corporation Bank
6. Oriental Bank of Commerce

In September 1993, New Bank of India was merged with Punjab National Bank. Then the total of nationalised banks came to 19.

Dena Bank and Vijaya Bank were merged with Bank of Baroda from April 1, 2019. Then the total nationalized banks came to 17.

Public Sector Banks

All nationalised banks are Public Sector Banks (PSB). The IDBI which was a development financial institution was converted into a bank. It was added to PSBs.

India Post Payments Bank was set up on September 1, 2018 in New Delhi. The government has a 100 per cent share holding in it

Therefore, there are a total of 20 public sector commercial banks including SBI, India Post Payments Bank and IDBI.

Merger of few more banks is in process. Please keep an eye on the newspapers to be updated.

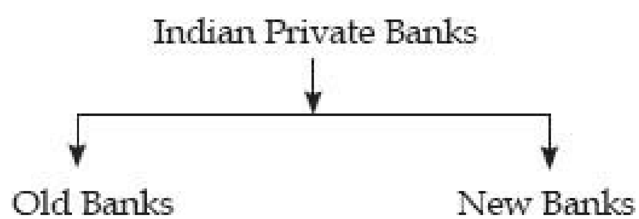
Private Sector Banks

Indian private sector banks consist of both Indian banks as well as foreign banks.

Indian Private Banks

Indian banks are classified as old and new private sector banks as shown in figure 7.6. This classification is done by RBI for the convenience of comparing performance of all Indian banks.

Figure 7.6



Old Banks

The banks except those were nationalised, continued to be in the hands of privates. These private banks and those banks which were set up before 1990s are called Old Banks.

New Banks

Banks set up in the private sector in 1990s and after are called New Banks.

The RBI issued final guidelines for new set of banks called Small Banks and Payment Banks. The RBI observes “Both payments banks and small banks are “niche” or “differentiated” banks; with the common objective of furthering financial inclusion.[4]" Both Small banks and Payment banks can have all India operations.

The small bank will primarily undertake basic banking activities of acceptance of deposits and lending to un-served and under served sections, including small business units, small and marginal farmers, micro and small industries and unorganised sector entities. The Small banks will be required to extend 75 per cent of its credit to priority sector.

Payment banks can accept deposits of both current and savings bank account from individuals, small businesses and other entities subject to maximum of ₹1 lakh per individual, initially. However, they cannot accept non-resident Indian deposits. They can issue ATM/Debit cards but cannot issue credit cards but will have a widespread network of access points particularly to remote areas, either through their own branch network or through Business Correspondents (BCs) or through networks provided by others. They will add value by adapting technological solutions to lower costs." [5]

Local Area Bank in Private Sector

Privates were allowed to set up banks to operate in limited areas. These are called Local Area Banks (LAB). The branches can be set up within the limits of geographicallythree contiguous districts. Backward and less developed districts are considered for area of operation of these LABs. These were set up to meet the local credit needs by exploiting local resources itself.

They are registered under the Companies Act 1956. The required minimum paid up capital is ₹5 crore. The promoter should contribute at least ₹2 crore. These Local Area Banks are regulated under RBI Act 1934, Banking Regulation Act 1949 and Regional Rural Bank (RRB) Act 1976.

Foreign Private Banks

After 1991 economic reforms, India opened the door for foreign banks. They set up either branches or subsidiaries. Citibank, Barclays, and ABN Ambro are few foreign banks to be mentioned.

Indian Banks Abroad

Like foreign banks set up in India, Indian banks set up their branches or subsidiaries in foreign countries. Both public and private sector banks have branches abroad. Offshore banking units are located in Bahamas, Cayman Islands, Channel Islands and Mauritius. Offshore banks are banks located in a country that has more generous tax laws.

Classification of Banks

Banks are classified into scheduled and non-scheduled banks. All commercial banks, regional rural banks, and state cooperative banks are classified like this.

1. Scheduled Banks

Scheduled banks are those listed in the 2nd Schedule of RBI Act 1934. A bank to be included in this list has to fulfill the following two conditions:

i. The paid up capital and collected funds of bank should not be less than ₹5 lakh.

ii. Any activity of the bank will not adversely affect the interest of depositors.

Any bank which fulfilled these conditions and got listed in the second schedule if found violating these conditions would be de-scheduled. Scheduled bank enjoys the following facilities:

They are eligible for obtaining debts / loans on bank rate from RBI.

They get automatic membership of clearing house.

They can avail the facility of rediscount of first class exchange bills from RBI.

2. Non-Scheduled Banks

The banks which are not included in the second schedule are called non-scheduled banks. Like scheduled banks, these banks also have to follow the conditions regarding Cash Reserve Ratio (CRR) but can keep the reserve in its custody and need not deposit with RBI. These banks are not eligible for loan from RBI, but become eligible under emergency conditions.

Regional Rural Banks (RRB)

These banks were established since 1975, under RRBs Act 1976. RRBs were set up in all states except Sikkim and Goa. Totally 196 banks were set up by public sector banks. The public sector bank which set up a particular RRB is called the sponsor bank of that RRB. For example Pandian Gram Bank was set up by Indian Overseas Bank. Hence Indian Overseas Bank is called sponsor bank of Pandian Gram bank.

The purpose is to further increase credit flow to rural areas. RRBs were established to lend to weaker sections called target group such as landless labourers, artisans and craftsmen at concessional rates. From 1997, RRBs were freed to lend outside the target group.

Since April 1987, no new RRBs have been opened due to the Kelkar committee's recommendations. Many of the RRBs became unviable or less profitable. To solve the problem, weak banks are being merged with the efficient banks. The merging of RRBs is going on. Now, they, gain more autonomous power also.

Cooperative Banks

Cooperative banks are established by state laws. These banks are called as cooperative banks because these have cooperation of stakeholders as motive. If some individuals come together, they can establish a cooperative bank. Cooperative banks are established with the aim of funding agriculture and allied sectors and to finance village and cottage industries. Along with lending, cooperative banks accept deposits. They operate on the principle “one person one vote” in decision-making. NABARD (National Bank for Agriculture and Rural Development) is the apex body of cooperative sector in India.

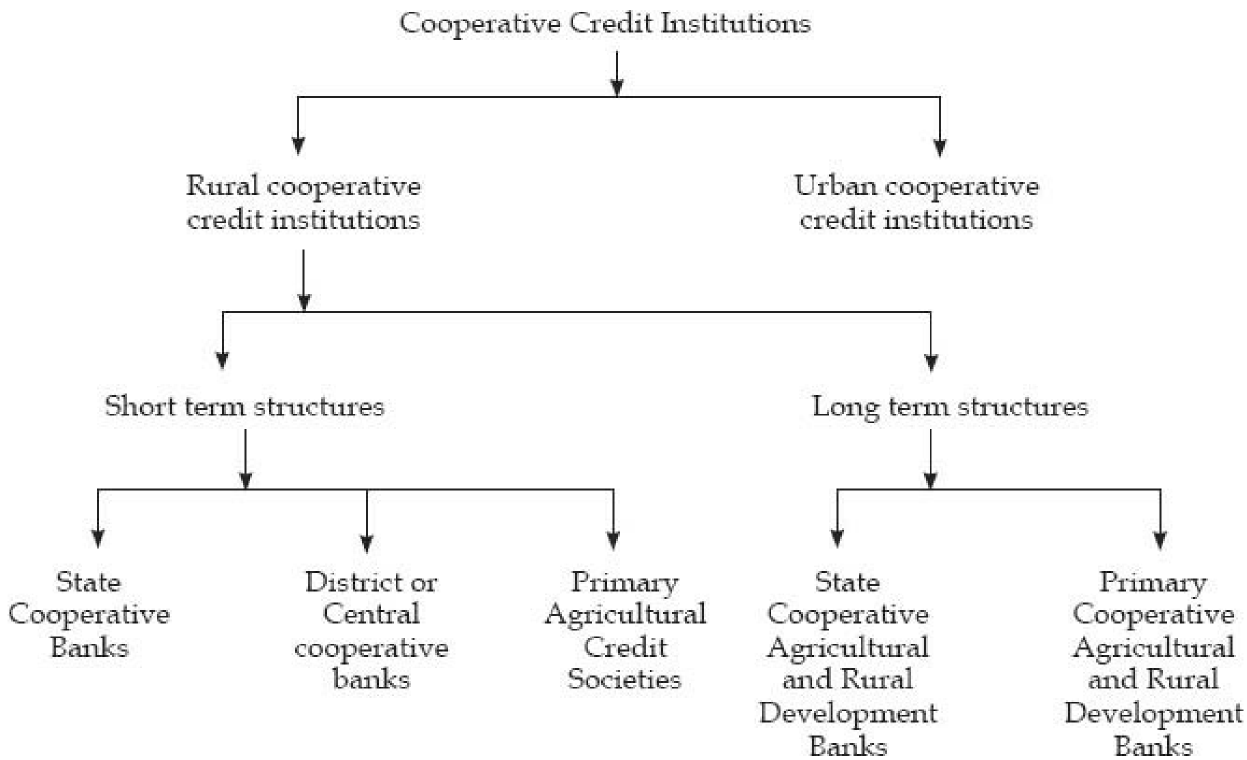
NABARD

NABARD is also called as the National bank. Previously, the functions of NABARD viz., financing of agriculture and refinancing of cooperative banks and RRBs was done by Agriculture Refinance Development Corporation (ARDC) of RBI. NABARD was set up in July 1982. It took over the functions of Agriculture Refinance Development Corporation (ARDC).

The Composition of Cooperative Banks

The cooperative banks are divided into urban and rural. Further, they are divided into short term and long term structure. It is shown in figure 7.7.

Figure 7.7



Short Term Structures

Short term structures lend up to one year. They lend for cultivation activities and provide working capital to buy seeds, fertilisers, etc. The short term structure cooperative banks have a 3 tiered set up. They are:

a. State Cooperative Bank
b. Central or District Cooperative Bank
c. Primary Agricultural Credit Societies

State Cooperative Bank (SCB)

Each state has its own State Cooperative Bank. It is the apex body for cooperative banks in a particular state. They act as a mediator or as an intermediary between RBI and NABARD on the one side and Central or District Cooperative Bank and Primary Agricultural Credit Societies on the other side. They get loans from RBI at concessional rates. It gives grants to cooperative banks in the state.

Now, the intermediation of these banks is abolished by a memorandum of under-standing between RBI and these banks. Now, RBI has direct dealing with low tier cooperative banks.

Central (or District) Cooperative Bank

This cooperative bank operates at district level. Its operational area is limited to one district. There are two types of Central (or District) Cooperative Banks.
They are:

a. Cooperative Banking Union
b. Mixed Central Cooperative Bank

The membership of Cooperative Banking Union is open only to cooperative societies. But, the membership of Mixed Central Cooperative Bank is open both to cooperative societies and individuals.

The Central (or District) Cooperative Banks get loan from SCBs (State Cooperative Bank). They grant loans to PACs (Primary Agricultural Credit Societies) and individuals.

Primary Agricultural Credit Societies

These cooperative banks operate at village level. They provide short term loan to agriculture (one year, sometimes three years). PACs give loans to its members that are individuals.

Long Term Structures

Long term structures lend to meet medium and long term fund requirements. It ranges from one and a half years to 25 years. They lend for land development, construction of wells, purchase of pump

sets, redemption of old debts, etc. These banks initially were called mortgage banks. Earlier they were called Land Development Banks. Now they are called Cooperative Agricultural and Rural Development Banks (CARDBs).
It is a two-tiered structure. They are:

1. State Cooperative Agricultural and Rural Development Banks
2. Primary Cooperative Agricultural and Rural Development Banks.

Urban Cooperative Credit Institutions

The cooperative banks set up in the urban and semi urban areas are called Urban Cooperative Credit Institutions. They mainly lend to small borrowers and businesses.

Sub Markets

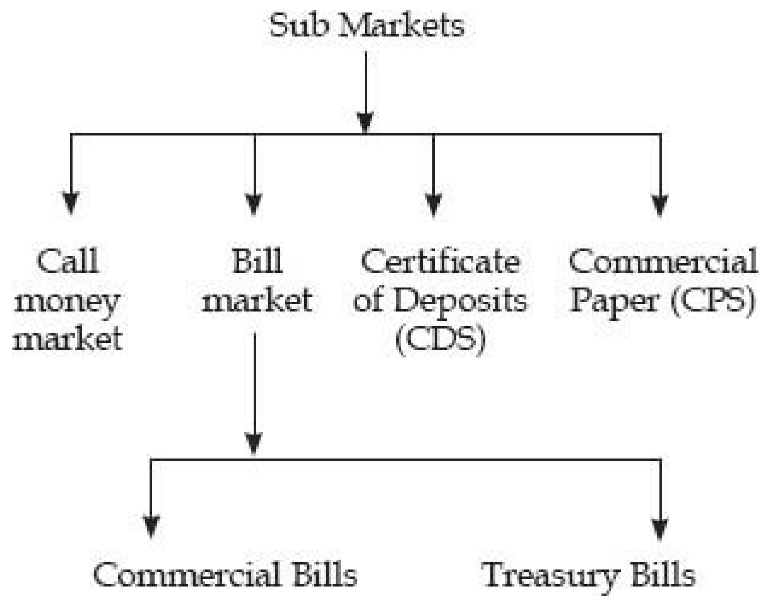
Government, financial institutions and industries need resources for investment and to meet shortage if any in the money for regular activities. Sub markets are markets to generate resources needed to meet these needs.

Composition of Sub Markets

The sub market is divided into various segments. It is based on the financial instruments used in this market.

It is diagrammatically shown in figure 7.8.

Figure 7.8



Call Money Market

It is also known as money at call and short notice market. It deals in loans for a period ranging from one to 14 days. It is an inter-bank borrowing and lending market. One bank demands money from another bank to cover its cash reserve requirements with RBI every fortnight and to gain from foreign exchange market. The rate at which funds are borrowed in these markets is called call money rate.

It has two segments. They are as follows:

The Call Market (or) Overnight Market

It is a market for borrowing and lending of money between banks within one day.

Short Notice Market

It is a market, for borrowing and lending of money between banks up to 14 days.

Bill Market (or) Discount Market

In bill market, short term funds (usually 90 days) are bought and sold. The bill market consists of two markets, one is commercial bill market and another is Treasury bill market as shown in figure 6.8.

Commercial Bill Market

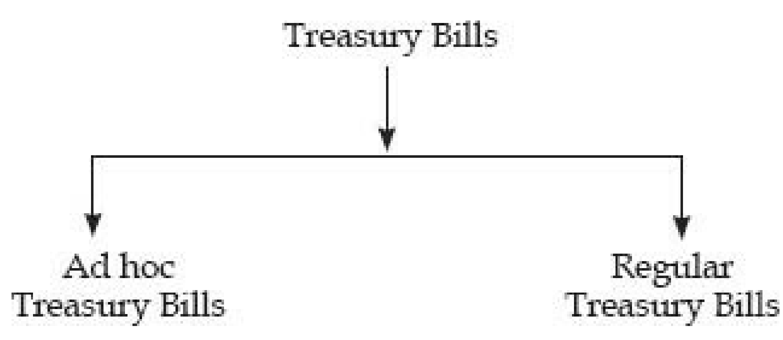
Commercial bills are bills other than treasury bills. They are issued by industries and traders.

Treasury Bill Market

Treasury bills are securities issued by the Government treasury. They are of short term in nature. In this regard, they differ from market loans. They are non-interest bearing (zero interest/ zero coupon). These kinds of bonds are called Zero coupon bonds. They are issued at a discount rate. For example, a security worth of ₹1000 may be issued against receipt of amount lower than ₹1000. The purchaser of security can redeem the full ₹1,000 at a particular date (maturity date). This is called redemption **at par** (original value).

There were two types of Treasury Bills. They are shown in the following figure 7.9.

Figure 7.9



Ad hoc Treasury Bills

It was issued for a particular end or case in hand. Till 1991–92, there was only Treasury bill of 91 days. It was called as ad-hoc Treasury bill. It was discontinued from 1997–98. To replace it ways and means advance was introduced.

Regular Treasury Bills

These bills are issued regularly to meet budgetary expenditure. There are a number of Treasury bills with differing maturity. In 1998–99, 182 days Treasury bills were introduced. But it was replaced by 364 days Treasury bills. Again 182 days treasury bills were reintroduced. The 14-day Treasury bills were introduced in 1999–2000.

Dated Government Securities

The government securities with long term maturity are called Dated Government Securities. The Government of India sells dated securities of five years maturity and 10 years maturity on an auction basis. There are dated Government securities with 30 years maturity period.

Certificates of Deposits (CDs)

Certificates of Deposits (CDs) are issued by commercial banks and financial institutions to raise additional funds. These are issued in multiples of ₹25 lakh, subject to a minimum amount of ₹1 crore. The maturity period range from three months to one year in the case of banks and one year to three years in the case of other financial institutions.

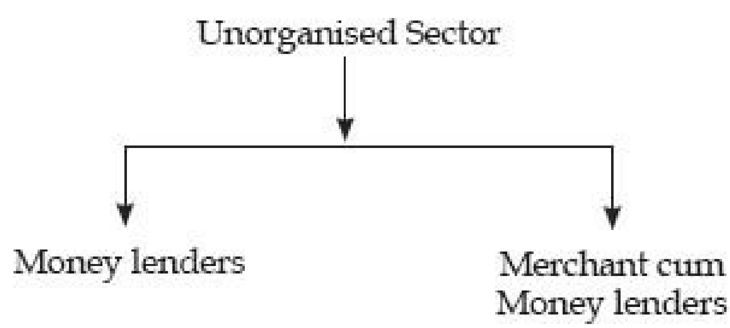
Commercial Papers (CPs)

It was introduced in 1990. Commercial Papers (CPs) are issued by Corporate, Primary Dealers (PDs) and the All-India Financial Institutions (FIs) to raise funds. These are issued in denominations of ₹5 lakh or multiples of it, subject to a minimum amount of ₹1 crore. The maturity period is three to six months.

Unorganised Sector

The unorganised sector banking is not a registered and regulated one. They do not maintain proper accounts. The unorganised sector has two types of participants. It is shown in the following figure 7.10.

Figure 7.10



The interest rate is usually high in unorganised sectors. The lending and borrowing operation is less cumbersome because many of the procedures followed by banks are not followed in unorganised sectors.

Money Lenders

The money lenders are exclusively engaged in money lending operations. It is their source of livelihood.

Merchant cum Money Lenders

The merchant cum money lenders are engaged in merchandising and money lending. They lend to producers of the product in which they merchandise. The producers have to sell their products only to the lender. In this case merchant cum money lenders usually purchase products at low price.

Banking Schemes

Many schemes were launched in the banking sector after nationalisation of banks. These schemes were launched to enhance spread of banking services to all the regions of the country and to increase banking habits among people.

Lead Bank Scheme

In this scheme, any one bank is selected in a district. That bank is designated as Lead bank of the district. It coordinates the activities of all banks in that district to avoid duplication of banking works, to ensure the same person does not get loan from different banks, and to ensure the banking benefits to all sections of people.

Service Area Approach (1988)

It operated under Lead Bank Scheme. Each semi-urban and rural branch is allotted a specific area (cluster of village) to implement banking scheme.

Differential Rate of Interest Scheme (1972)

Public sector banks were directed to grant at least 1 per cent of their total deposits of previous year to weaker sections of society at a concessional rate of 4 per cent. At least 40 per cent loan under this scheme to SC/ST people is made compulsory.

Social Banking

Financing of poverty reduction and employment programme of government by banks is called social banking. Under this scheme, beneficiaries of government's self-employment programme and those who got training from government programme are provided with loan.

Priority Sector Lending

Priority sectors are those sectors which substantially contribute to national income but get less credit from the banking sector. The priority sector list is provided by the RBI. The list is being revised frequently. A target of 40 per cent of Adjusted Net Bank Credit (ANBC) or credit equivalent amount of Off-Balance Sheet Exposures (OBE), whichever is higher, had been stipulated for lending to the priority sector by domestic Scheduled Commercial Banks (SCBs) (both public and private sector). Within this, sub-targets of 18 per cent and 10 per cent of ANBC or credit equivalent amount of OBE, whichever is higher, had been stipulated for lending to agriculture and the weaker sections respectively.[6]

The sub target of 18 per cent for agriculture was further sub divided into 13.5 per cent of direct lending and 4.5 per cent of indirect lending. But from April 2015 this sub division was abolished.

A target of 8 per cent of ANBC or Credit Equivalent Amount of Off-Balance Sheet Exposure, whichever is higher, has been prescribed for small and marginal farmers within agriculture, to be achieved in a phased manner i.e., 7 per cent by March 2016 and 8 per cent by March 2017.

A target of 7.5 per cent of ANBC or Credit Equivalent Amount of Off-Balance Sheet Exposure, whichever is higher, has been prescribed for Micro Enterprises, to be achieved in a phased manner i.e. 7 per cent by March 2016 and 7.5 per cent by March 2017.

The priority sector lending target for RRBs is 60 per cent.

Foreign banks with 20 branches and above already have priority sector targets and sub-targets for agriculture and weaker sections, which are to be achieved by March 31, 2018 as per the action plans submitted by them and approved by RBI. The sub-targets for small and marginal farmers and micro enterprises would be made applicable post 2018 after a review in 2017. Foreign banks with less than 20 branches will move to Total Priority Sector Target of 40 per cent of ANBC or Credit Equivalent Amount of Off-Balance Sheet

Exposure, whichever is higher, on par with other banks by 2019–20, and the sub-targets for these banks, if to be made applicable post 2020, would be decided in due course.[7]

Export credit up to 32 per cent of ANBC or Credit Equivalent Amount of Off-Balance Sheet Exposure, whichever is higher, will be eligible as part of priority sector for foreign banks with less than 20 branches. For other banks, the incremental export credit over corresponding date of the preceding year will be reckoned up to 2 per cent of ANBC or Credit Equivalent Amount of Off-Balance Sheet Exposure, whichever is higher.[8]

Shortfalls in the priority sector have to be deposited with NABARD's Rural Infrastructure Development Fund and other eligible funds with NABARD, NHB and SIDBI. NABARD lends this amount to state governments for rural development activities.

NHB lends for housing and SIDBI lends for small industries.

Adjusted Net Bank Credit (ANBC) refers to net bank credit plus non-SLR bonds held to maturity. Net bank credit here denotes the difference between outstanding gross deployment of bank credit at the start of the financial year and end of the financial year.

ANBC = Credit outstanding at the end of financial year – Credit outstanding at the start of financial year

Non-SLR bond means the bonds which are not qualified to be invested for the purpose of Statutory Liquidity Ratio (SLR) stipulated by RBI. RBI classifies bonds which are eligible for SLR and other bonds are considered as non- SLR bonds. Investments in these bonds are considered equal to credit given to corporate sector by banks. Held to maturity implies that the investment is made to keep it invested till maturity date and not for trading purpose.

Off balance sheet exposure means assets and liabilities which are not qualified as assets and liabilities at present but likely to become so in future. RBI observes: "Off-Balance Sheet exposures refer to the business activities of a bank that generally do not involve booking assets (loans) and taking deposits. Off-balance sheet activities normally generate fees, but produce liabilities or assets that are deferred or contingent and thus, do not appear on the institution's balance sheet until and unless they become actual assets or liabilities". For example, a bank guarantee loan availed by someone from some other financial institution. Actually this is not the liability of the bank. But if the person who availed the loan fails to repay, the bank becomes accountable and the loan becomes the liability of bank. These types of liabilities and assets are called off balance sheet exposure.

Financial Inclusion

Financial inclusion means including the people, hitherto excluded, into the financial system. The inclusion is to be done on both supplying end (saving account) and receiving end (loans from financial institutions). Towards this end the RBI started "No-frills account" drive. The banks were requested to open "No-frills account" with low or minimum balance.

No-frills mean, basic features alone are included without anything unnecessary especially things added to make something more attractive or comfortable.[9] No-frills account refers to accounts without premium services that are charged some amount. This reduces the cost of holding accounts. It enables even poor people to hold bank accounts.

In place of No-frill accounts Basic Savings Bank Deposit Account (BSBDA) was introduced. This account shall not have the requirement of any minimum balance. No charge will be levied for non-operation/activation of in-operative 'Basic Savings Bank Deposit Account'. These accounts are now opened under Prime Minister Jan Dhan Yojana with the aim of opening at least two accounts per family.

Promotion of Micro Credit

Micro Credit is defined as provision of thrift, credit and other financial services and products of very small amount to the poor in rural, semi-urban and urban areas for enabling them to raise their income levels and improve their living standards. Micro Credit Institutions are those which provide these facilities[10]. The self-help group and bank linkage is a medium to promote micro credit.

Related Terms

Basel Norms

Basel norms are fixed by Bank for International Settlements. It is located in Basel, Switzerland and acts as a coordinating agency for Central Banks of various countries. It is necessitated by globalisation. Many banks operate internationally. These norms are for individual banks and Systemically Important Financial Institutions (SIFI). Its implementation is done by Central Banks of the respective countries. In India it is by RBI.

SIFIs are whose "… failure may trigger a relatively large number of simultaneous failures within the financial sector, and as a result, large losses to the entire economy".[11] It defines these institutions from the point of failure. Does it mean we can identify these institutions only after failure? The answer is yes and no. There is no pre-known definition. At the same time there are few indicators to identify them. The financial institutions which are big in size, receiving short term funds and lending for long term purpose are prone to failure. These are few indicators based on which it can be identified. But these are not exhaustive indicators.

These norms are developed by Basel Committee on Banking Supervision (BCBS). So far three set of norms were developed. They are called Basel I, Basel II and Basel III. Basel I and II were implemented while Basel III is in implementation.

BIS describes Basel III norms as follows:

Basel III is a comprehensive set of reform measures developed by the Basel Committee on banking supervision to strengthen the regulation, supervision and risk management of the banking sector. These measures aim to:

- Improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source
- Improve risk management and governance
- Strengthen banks' transparency and disclosures.”[12]

There are two components in Basel III. They are:

1. Capital
2. Liquidity

1. Capital

The capital consists of three pillars. They are:

Pillar 1: Capital, risk coverage and containing leverage

Pillar 2: Risk management and supervision

Pillar 3: Market discipline

Pillar 1: Capital, Risk Coverage and Containing Leverage

Basel III norm fixed norms about type and quantum of each type of capital. This ensures the quality of capital. Capital is a liability the bank owes to investors. Capital norms are fixed in proportion to assets. Assets are the investments made by banks including loan. The total capital to risk weighted asset ratio must be at least 8 per cent at all times.

The breakup of capital requirement is as follows:

1. Tier 1 Capital (6.0 %)
    a. Common Equity Tier 1 (4.5 %)
    b. Additional Tier 1(1.5 %)
2. Tier 2 Capital (2 %)

Tier 1 capital consists of the share capital and disclosed reserves or retained earnings. Share capital is the share investment made by public and others. Disclosed reserves or retained refer to the undistributed profit. Common equity Tier 1 means the share capital held by common public.

Additional Tier 1 capital consists of investments that are debt in nature but do not have maturity period. It can be realised if the issuer wishes to do so. Tier 2 capital is similar to additional Tier 1 capital but has maturity period of at least five years. Both of them have right to claim next to depositors and general creditors and they are neither secured nor guaranteed by issuer.

Over and above this 8 per cent there is a need to maintain capital conservation buffer of 2.5 per cent. This capital can be withdrawn during financial stress but when the minimum capital requirement of the above said 8 per cent approaches, the Central Bank can impose restrictions regarding discretionary distribution of capital in the form of dividend and bonus. Usually the banks have the habit of indulging in this kind of discretionary distribution to show as if they are in strong position. To avoid this, restriction can be imposed.

During the period of high credit growth, on a temporary basis, the central banks can stipulate additional capital requirement to avoid unfettered credit growth which may result in credit bubble. It is called **Counter cyclical capital buffer.** Normally it can be from 0 to 2.5 per cent and there can be an add-on of 2.5 per cent more, in total 5 per cent. During normal time it must be zero. [13]

Leverage Ratio is part of the Pillar 1. It is the ratio between capital measure and exposure measure.

Leverage Ratio = Capital measure / Exposure measure

Capital measure refers to Tier 1 capital and Exposure Measure refers to the assets created by banks and financial institutions. The total assets are adjusted to take care of some unusual exposures and after adjustments this exposure measure is arrived for this purpose. The banks are expected to maintain a leverage ratio of at least 3 per cent.

Pillar 2: Risk Management and Supervision

It calls the banks to have an internal assessment process to assess the capital adequacy, risk exposure and to device risk management technique. It also calls Central Banks to have a review process to review banks.

Pillar 3: Market Discipline

Market discipline warrants disclosure of certain details like capital adequacy, risk exposure and risk assessment procedure. The disclosure of details should be on the line of details submitted to regulatory authority. It brings transparency and gives confidence to market participants.

2. Liquidity

The liquidity consists of two key principles. They are:

A. Liquidity Coverage Ratio (LCR)
B. Net Stable Funding Ratio (NSFR)

A. Liquidity Coverage Ratio

As per this norm a bank has to have adequate stock of unencumbered high-quality liquid assets (HQLA) that can be converted into cash easily and immediately in private markets to withstand liquidity crisis, if it happens, for a period of 30 days. Here, assets are nothing but the investments made by banks including loans. It has to be implemented from the year 2016 starting with 60 per cent coverage to 100 per cent by 2019.

B. Net Stable Funding Ratio (NSFR)

It is the ratio between required stable funding and available stable funding.

NSFR = Available amount of stable funding/Required amount of stable funding

The words stable funding indicates the maturity and certainty of funds. It should be of long term, stable and certain. Required fund indicates the liabilities and available funds indicate assets. It will require banks to maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities. It means there should be a match between the nature of funding and nature of assets. It tries to avoid the practice of creating long term assets while getting short term funds. In a situation of mismatch the banks and financial institutions cannot honour the short term fund givers like depositors. As on April 2014, the consultative process in this regard is going on.

Non-Performing Assets (NPA)

A loan or advance is asset of the bank. If its interest or principle or both remain overdue (unpaid) for a reasonable period then it is called Non-performing asset. The reasonable period varies for various types of loans and advances. The reasonable period is determined by RBI.

As per RBI guidelines Non-performing asset (NPA) is a loan or an advance where;

1. interest and/ or installment of principal remain overdue for a period of more than 90 days in respect of a term loan,
2. the account remains out of order' in respect of an Overdraft/Cash Credit (OD/CC),
3. the bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,
4. the installment of principal or interest thereon remains overdue for two crop seasons for short duration crops,
5. the installment of principal or interest thereon remains overdue for one crop season for long duration crops,
6. the amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken.
7. in respect of derivative transactions, the overdue receivables representing positive mark-to-market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.

Mark-to-market value of a derivative contract refers to the current market value of the derivative contract.

An asset which remained NPA for a period of 12 months or less is called **substandard asset,** an asset that has remained substandard asset for 12 months is called **doubtful assets**. A **loss asset** is one where loss has been identified by the bank or internal or external auditors of debtor or by RBI inspection as loss.

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1 http://www.rbi.org.in
2 http://www.rbi.org.in/scriptsAboutusDisplay. aspx#EP1
3 https://m.rbi.org.in//scripts/AnnualReportPublications.aspx?Id=1153
4 http://rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=31646
5
6 Economic Survey 2008–09, p.97
7 RBI notification on Priority Sector Lending- Targets and Classification dated 23.04.2015.

8 RBI notification on Priority Sector Lending- Targets and Classification dated 23.04.2015.
9 Oxford Advanced Learners Dictionary
10 http://www.rbi.org.in
11 http://www.bis.org/bcbs/events/bhbibe/ moore.pdf
12 http://www.bis.org/bcbs/basel3.htm
13 http://www.sidley.com/securities_and_ financial_institutions_update_122110/

CHAPTER

8

Indian Financial System-Capital Market

Capital market is a medium and a platform for long term funds. It helps to generate bulk fund for government and industries. The institutions in the capital market are called Non-Banking Financial Companies. This is evident from RBI's observation which runs as: "Housing Finance Companies, Merchant Banking Companies, Stock Exchanges, Companies engaged in the business of stock-broking/sub-broking, Venture Capital Fund Companies, Nidhi Companies, Insurance Companies and Chit Fund Companies are NBFCs"[1]. All the institutions listed in this observation are capital market institutions. But it is not necessary that all NBFCs are capital market institutions.

The RBI defines NBFCs as, "A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares/stock/bonds/debentures/securities issued by Government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, sale/purchase/construction of immovable property. A non-banking institution which is a company and which has its principal business of receiving deposits under any scheme or arrangement or any other manner, or lending in any manner is also a non-banking financial company (Residuary non-banking company)."[2]NBFCs are classified as deposit taking and non-deposit taking NBFCs .The NBFC companies differ from banks in the following aspects:

i. NBFCs can accept deposits but cannot accept demand deposits;
ii. NBFCs are not a part of the payment and settlement system and they cannot issue cheques drawn on itself and
iii. Bank deposits have an insurance cover of Deposit Insurance and Credit Guarantee Corporation but it is not available for NBFC deposits.

This chapter covers composition and functions of primary and secondary market.

Composition and Functions of Capital Market

The capital market can be classified as shown in figure 8.1 in the next page.

Securities Market

Securities market deals with shares (equity shares, preference shares, derivatives) and debt instruments (bonds, debentures etc.). Both **shares** and **debt** instruments are instruments of fund raising. But, there is a difference between them. In case of shares, the investors have a share in the capital and profit. In case of debt instruments, the investors do not have any share in the capital. They just lend to the company. The company is liable to pay interest on capital borrowed through bonds. Regardless of profit or loss, the debt instrument holders are entitled to receive interest income.

Debenture is also like a bond but there is a slight difference. Debentures are unsecured. It means there is no surety for debentures. The lender lends money to companies without any surety. In the case of bonds, there is some surety. It may be plant, machinery or building, etc.

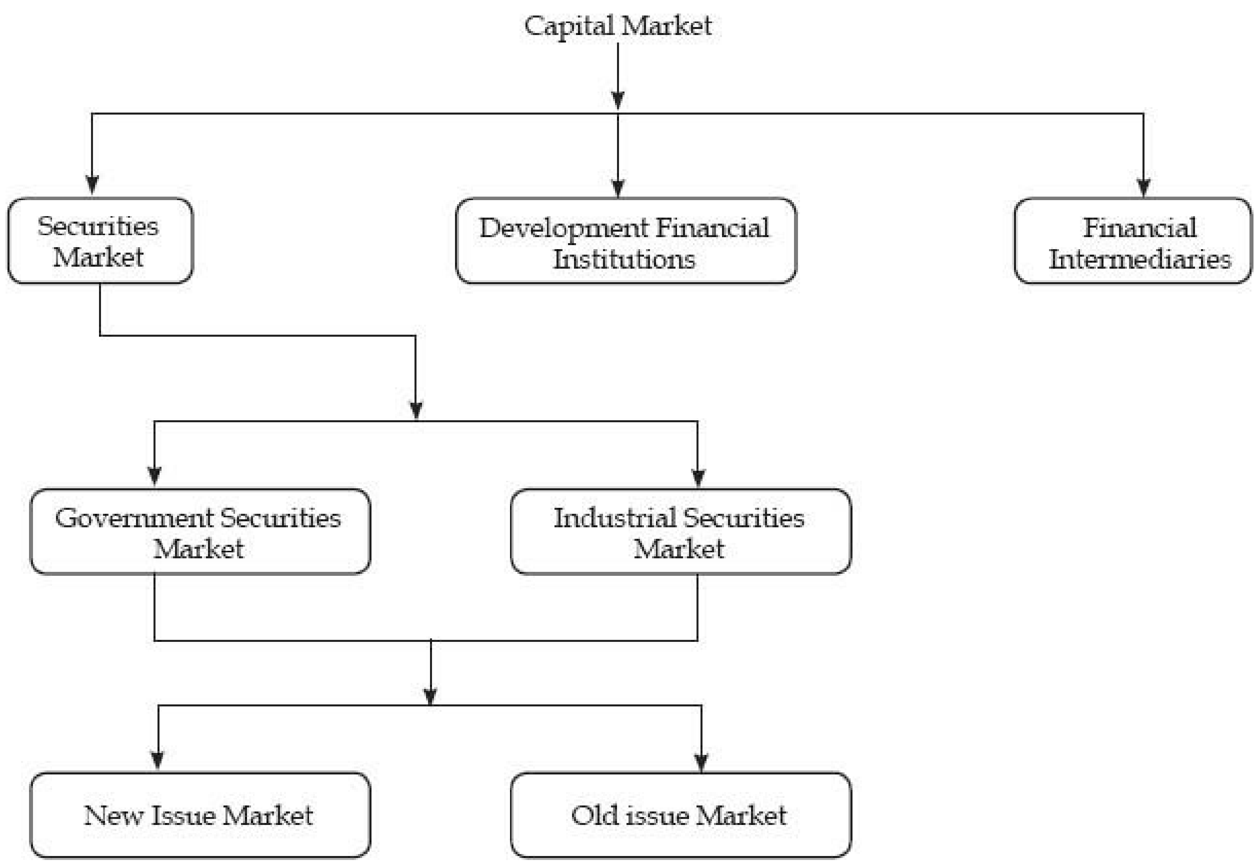
Shares are of two types. One is Equity share and the other is Preference share. **Equity shares** are shares that have claim over capital, profit and loss. It means, the equity shareholders have right to receive profit if the company earns profit and have to forego capital to the extent of loss in case the company incurs loss.

Preference shares are shares that have entitlement to a fixed amount of dividend or dividend at a fixed rate like that of interest on bonds. In the case of winding up (closing up) of company, these shares have the preferential right to get back the capital paid. They have the right to get back capital next to bond holders.

Government and Industrial Securities Market

Based on the fund raiser, we can classify securities market into two types. One is Government securities market and the other is Industrial securities market.

Figure 8.1



Government Securities Market

It is a market for government and semi government securities backed by RBI.

It is also known as Gilt Edged Market. Gilt edged means "of the best quality". The government securities are more reliable. That is why they are called Gilt edged securities.

Industrial Securities Market

It is a market for securities of industrial and commercial organisations.

Both the government securities and industrial securities are traded in primary as well as secondary market.

New and Old Issue Market

Further, based on the nature of issue (in layman's language issue means selling), the securities market can be classified as New issue market and Old issue market. The New issue market is also known as Primary market. The Old issue market also known as Secondary market.

In New issue market, the securities issued by the issuer are purchased by investors that are public. To put in another way, sale and purchase of new (fresh/ first time issued) securities is carried out. In old issue market the sale and purchase of securities that were already issued in the New issue market is carried out. In India, both New issue and Old issue markets are regulated by Securities and Exchange Board of India (SEBI).

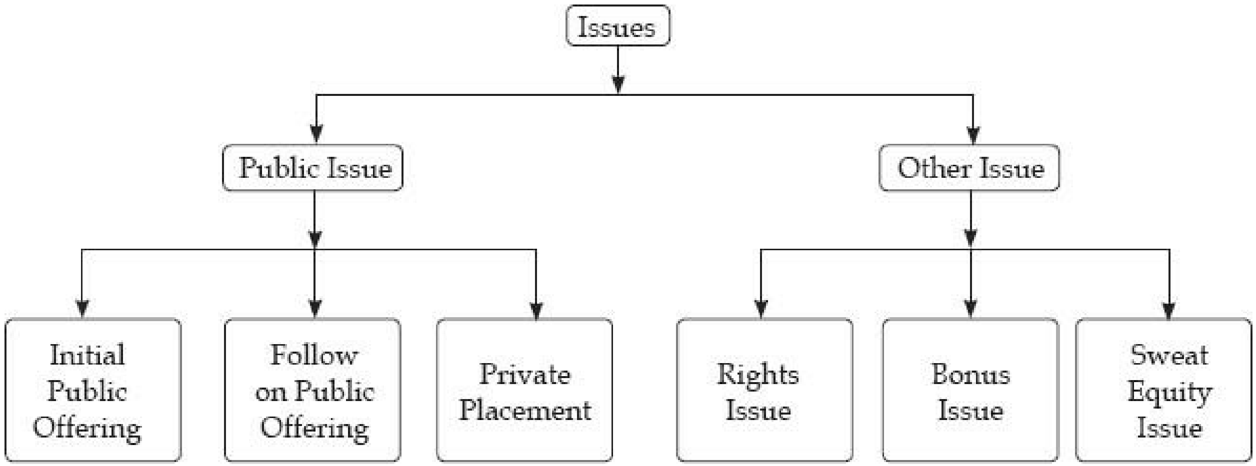
Securities and Exchange Board of India (SEBI)

It was established in 1988 for the development and regulation of securities market through a resolution of government. It was given statutory status in 1992. Its head office is in Mumbai and regional offices are in Kolkata, Delhi and Chennai.

New Issue Market

The issue of securities in new issue market can be classified as shown in figure 8.2 below.

Figure 8.2



Public and other issues

Public issue means issue of securities to public i.e. to all people, whoever wants to invest. In other issues, the securities are issued to a closed group of people.

Public Issues

In New issue market, if any company or financial corporation (issuer) issues shares for the first time, it is called as Initial Public Offering (IPO).The issuer may be an existing company or corporation or may be a new start up. And if any company or corporation that has already issued shares, issues shares again, to raise additional fund it is called as Follow on Public Offering (FPO).

Issue Process

There are two ways of issuing securities in the New issue market. One is declared price issue and another is Book building issue. In the case of declared price selling, the issuer offers shares at a pre-fixed price. In **Book building,** the price is not announced. First, the issuer offers the shares and gets application from public and then based on the demand fixes the price. If the demand is high, the price is fixed high and vice versa.

In both IPO and FPO, the issuer usually does not directly issue the security. The issuer appoints any one **Merchant banker** on behalf of it to carryout fund raising activities. The merchant banker issues the application to investors and receives the application and money from investors. It sends the applications and money to issuer for allocation of shares to applied investors.

The issuer can issue to the extent of Authorised capital. **Authorised capital** means the maximum amount authorised by Memorandum of Association (MoA) of a company that can be raised by the company. A company necessarily need not issue shares to the extent of authorised capital. It can issue less than the authorised capital. The actual amount issued by the issuer is called **Issued capital.**

After the company issues shares, the public subscribe (apply) to the shares. The subscription sometimes may be more than issued capital. If it is so, it means it is oversubscribed. The subscription sometimes may be less than issued capital. If it is so then it means it is undersubscribed. The actual amount subscribed is called **Subscribed capital**.

In the case of over subscription, the company allots shares to the subscriber based on some criteria. Usually, the small investors get preference. In this case the company can allot shares only to the extent of issued capital. In the case of under subscription, the company allots shares to all those who have applied. The remaining shares are purchased by underwriter. **Underwriter** means a financial intermediary who agrees to purchase the unsubscribed portion of issued capital.

The company usually collects the subscribed capital in installments. The portion of money demanded (called) from subscriber is known as **Called up capital**. The amount actually paid by subscribers when the money is demanded by issuer is known as **Paid up capital**.

Usually, the issuer does not demand thewhole amount from subscriber. A small portion of money is left un-demanded (uncalled).

The uncalled portion of money is called **Reserve capital.**

Once the issuer allots shares and shares are transferred to subscribers, the role of Secondary market comes in. Further selling and buying of these shares takes place in Secondary market. Before looking into Secondary market, let us continue with Primary market.

Other Issues

The issues that are not issued to public and issued to a closed group of people can be classified as other issues.

Private Placement

Private placement means offering shares directly to the financial institutions, mutual funds and high worth investors.

Private placements are made to Qualified Institutional Buyers (QIB). **Qualified institutional buyers** are those who are deemed financially sophisticated and are recognised by the security market regulator to need less protection from issuers than most of the public investors. Institutions like Mutual funds, Financial Institutions (FIs), scheduled commercial banks, insurance companies, provident funds, pension funds, State Industrial Development Corporations, etc., fall under the definition of being a QIB.

Rights Issue

Rights issue refers to offer of security to the existing shareholders in the Follow on Public Offering (FPO). It flows to the existing shareholders as a matter of legal right. So, it is called Rights issue.

Bonus Issue

Bonus issue refers to offer of shares against distributable profit to existing shareholders. The shareholders' share in the profit is converted as shares. It is also known as scrip issue or capitalisation issue.

Sweat Equity Issue

Sweat equity issue denotes the offer of shares to employees or Directors of the company which issues shares as recognition of their hard labour (sweat), which results in contribution to the company in the form of intellectual property rights, technical know- how, etc. It is usually issued at a discounted price. The Companies Act 1956 observes as follows: "Sweat equity shares means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called."

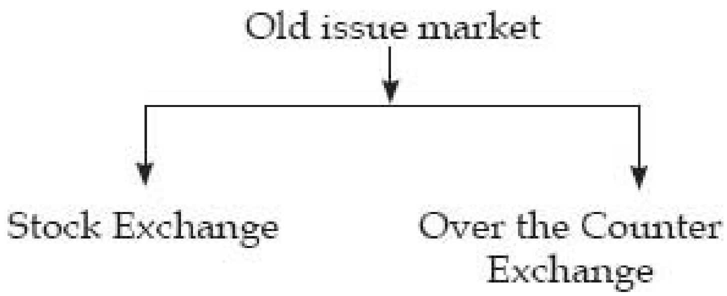
There are two other ways of incentivising the employees and directors of the company. They are Employees Stock Option Scheme (ESOS) and Employees Stock Purchase Scheme (ESPS). Under the ESOS the whole-time Directors, Officers or employees of the company are given an option to purchase the shares of the company at a future date at a predetermined price.

Under ESPS only the employees are offered shares as part of public issue or in some other way. Usually the share cost is deducted from the salary between the offer date and purchase date.

Old Issue Market

As already said, Old issue/Secondary market is a medium for buying and selling of securities issued in the New issue market. Stock exchange is synonymously used for Old issue market. But it is wider than that. There are two trading media in this as shown in figure 8.3.

Figure 8.3



Stock Exchange

Stock exchange is an institution for orderly buying and selling of listed securities. Listed securities means the securities accepted to be traded in stock exchanges.

Over The Counter Exchange

Over the counter exchange is a platform for trading in securities that are not 'listed' on a recognised Stock exchange.

Trading Process

The trading of shares in stock exchanges is mediated by stock broking companies. Both buyer and seller have to approach a broker. **Brokers** are registered members with stock exchanges to trade on behalf of clients. **Sub-brokers** are trading persons affiliated with brokers. They act like branches to brokers. They are subject to SEBI guidelines.

The types of trading are different based on time. In **Cash trading,** the sale and purchase of securities takes place in the prevailing price on the day of trading. In **Forward trading,** both buyer and seller agree to buy and sell respectively at a future date at a pre-agreed price, irrespective of the price that prevails on the day of trade. There are two types of forward trade. One is **Futures** and another one is **Options**. Though both are forward trade methods, there is a slight difference. In case of Futures, both buyer and seller have to execute the agreement. In case of Options, the buyer or seller can withdraw from the agreement. To have this option the buyer or seller has to deposit some amount as premium. In case he fails to execute the agreement, he has to forego the premium amount. The choice available to seller not to execute the agreement is called **Put option**. If it is available to buyer it is called **Call option.**

The futures and options are derivatives. **Derivatives** mean any agreement likefutures and options which doesn't have independent value. The agreement to trade in the future doesn't have any value. It has value only because of underlying securities which are to be traded.

Stock Exchanges

In India, there are small and big stock exchanges. The most prominent exchanges are National Stock Exchange (NSE) and Bombay Stock Exchanges (BSE).

National Stock Exchange (NSE)

It was established in 1993 on the recommendation of Pherwani Committee. Industrial Development Bank of India (IDBI) is the main promoter of this exchange. Other leading Financial Institutions are also promoters of it along with IDBI.

Bombay Stock Exchange (BSE)

It was established in 1887.It is Asia's oldest Stock Exchange. It was known as 'The Native Share and Stock Brokers Association'. It was owned by stock brokers. Now it is demutualised. Demutualised means that the stock brokers owned organisation have been made public owned organisation. The shares in the hands of brokers were transferred to public. This process is called **demutualisation**.

Index

Like wholesale price index which measures the rise/fall in the price of commodities, there are share price indices. The most prominent indices in India are Sensex, Nifty and Nifty Junior.

Sensex stands for **Sens**itive ind**ex**. This is an index of Bombay stock exchange. This measures the price movement of top 30 company shares. The top 30 companies are called Blue chip companies.

Nifty stands for **N**ational **I**ndex for fi**fty**. This and Nifty Junior are indices of National stock exchange. NIFTY measures price movement of top fifty companies. Nifty Junior is an **index** of next 50 top companies.

The top companies are selected on the basis of total value of all shares that are traded in the stock exchange.

Value of traded shares = Price of one share × Number of shares traded

This value is called **free float market capitalisation.** The value of all {both traded and non-traded (the shares that are kept for a long time)} shares is called **market capitalisation.**

Market capitalisation is the value of shares that were sold to public which are called outstanding shares. In formulaic form:

Market capitalisation = *Price* × *Total outstanding share*

For example if the price of a share is ₹200 and the total outstanding share of that company is 2000 then market capitalisation is 200 × 2000= ₹4,00,000. The price mentioned here is not actual price but price estimated on the basis of future prospects of the company and economic condition, etc.

Depositories

Depositories are institutions that keep securities of investors in electronic format (demat format). Demat stands for **de-mat**erialised. It means securities that were kept in paper (material) format now made as dematerialised (electronic) one. This electronic format is stored and maintained by these depositories. The change in ownership, whenever transfer of securities takes place, is done electronically. In India, there are two depositories one is National Securities Depository Limited (NSDL), Mumbai and other is Central Depository Services India Ltd (CDSL), Mumbai.

National Securities Depository Limited (NSDL) is the first depository in the country. It was established by UTI, NSE and IDBI. Central Depository Services India Ltd (CDSL) was established by BSE, Bank of India, Bank of Baroda, SBI and HDFC Bank.

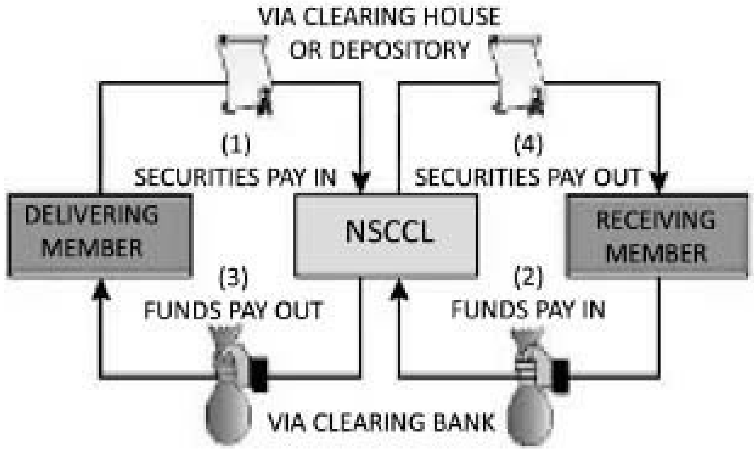
Clearing Houses

Clearing houses enable easy settlement of securities trade. Like depositories it also helps in change of ownership and delivery of securities.

Clearing Banks

Clearing banks mediate fund transfer between buyers and sellers. Both securities and fund transfer are made through National Securities Clearing Corporation of India Limited (NSCCL). It mediates between various depositories, clearing houses and clearing banks in settlement of securities and funds respectively. The schematic figure 8.4 explains this.

Figure 8.4



Securities paid by the delivering member to the clearing house/Depository on morning of T + 2

Funds are paid-in to the clearing bank by the Receiving Member on morning of T+2.

The pay-out for both funds and securities takes place in evening of T+2.

Source: http://otcei.net/clearing/

Rolling Settlement

In the above explanation to the diagram, T+2 represents Rolling settlement. Rolling settlement indicates that the trade executed in securities market is settled in few subsequent working days. 'T' stands for trade day, the day on which buyers and sellers agree to buy and sell. The number 2 represents two working days after the trade day in which settlement, that is delivery of securities and funds, takes place which is called settlement day.

Online Trading

The trading of shares is now made online. The online trading platform of Bombay is BOLT (BSE Online Trading) and of NSE is NEAT (National Exchange Automated Trading).

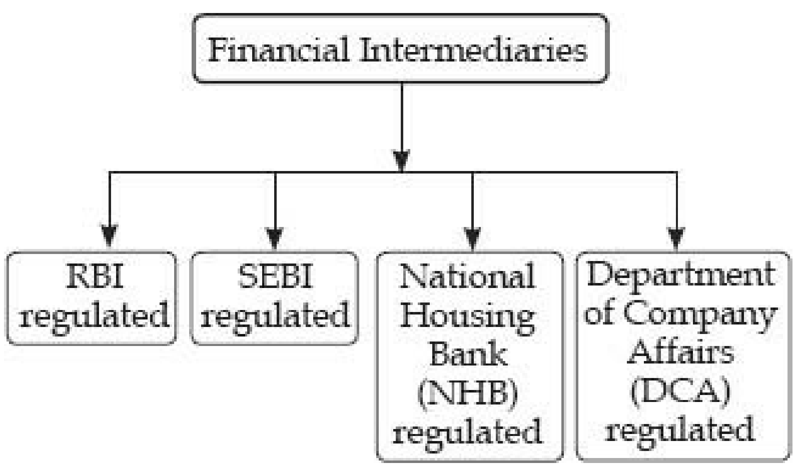
Development Financial Institutions

Development financial institutions provide long term loan (even more than 25 years) and entrepreneurial assistance to industries. The entrepreneurial assistance is in the form of technical advice, helping in feasibility study, etc. In India IDBI, Industrial Financial Corporation of India (IFCI), Exim Bank etc,. are some of the development financial institutions to be named.

Financial Intermediaries

The capital market institutions other than stock exchanges and development financial institutions can be called as Financial Intermediaries. The financial intermediaries can be classified as shown in the following figure 8.5.

Figure 8.5



RBI Regulated NBFCs

RBI regulated NBFCs were initially classified as:

i) Equipment leasing company

ii) Hire-purchase company

iii) Loan company

iv) Investment company

i. Equipment Leasing Company

Equipment leasing companies own machineries and equipment and lease them to clients. In return the equipment leasing companies get rental income.

ii. Hire-Purchase Company

Hire purchase refers to purchasing equipment, machinery etc., in installment payment system. Hire purchase companies finance this kind of purchase and recover money from clients in installment.
However, with effect from December 6, 2006 the above NBFCs registered with RBI have been reclassified as:

1. Asset finance company (AFC)
2. Loan company (LC)
3. Investment company (IC)

1. Asset Finance Company (AFC)

The RBI website defines AFCs as follows: "AFC would be defined as any company which is a financial institution carrying on as its principal business the financing of physical assets supporting productive/economic activity, such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipment, moving on own power and general purpose industrial machines. Principal business for this purpose is defined as aggregate of financing real/physical assets supporting economic activity and income arising there from is not less than 60 per cent of its total assets and total income respectively."[3]

2. Loan Company

The main business of loan companies is lending. They provide car loans, mortgage loans, gold loans, etc.

3. Investment Company

Investment companies are the companies which invest in shares to acquire stake in other companies to earn profit and not for the purpose of trading. To qualify as investment companies, their main business should be investment and major part of the income should come from investment.

SEBI regulated NBFCs

1. Venture Capital Fund
2. Merchant Banking Company
3. Stock Broking Company

1. Venture Capital Fund

Usually the financial institutions are hesitant to finance new products because the profitability of new products is uncertain and involves risks. So, to finance such products, separate type of financial companies who venture to finance them are established. They are called venture capital companies. The venture capital companies provide capital to companies that produce new products based on innovations and to new industries.

2. Merchant Banker

Merchant bankers manage and underwrite new issues, provide consultancy and corporate advisory services for corporate clients on raising funds and other financial aspects. In India, merchant banking services are carried out by commercial banks. The merchant banks are also called Investment Company.

Merchant Banker has been defined under the Securities and Exchange Board of India (Merchant Bankers) Rules, 1992 as, “any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities as manager, consultant, advisor or rendering corporate advisory service in relation to such issue management”.

3. Stock Broking Company

Stock broking companies are those who are registered with and recognised by SEBI to mediate or help investor in buying and selling of securities. The broking companies charge for mediation. It is called brokerage charge.

NHB Regulated NBFC

Housing loan companies are regulated by National Housing Bank. Housing loan companies finance construction and purchase of a house.

Department of Company Affairs (DCA) Regulated NBFC

Nidhi companies are regulated by DCA. Nidhi companies accept deposit and lendto its members. These companies are not regulated exclusively by DCA. Only the administrative matters are controlled by it and deposit and lending norms are regulated by RBI. Nidhi companies, therefore have two regulators: the Department of Company Affairs (DCA) and the Reserve Bank of India (RBI).

Related Terms

Face Value and Issue Price

Face value is the actual value of shares. Issue price refers to the price of a share including share premium. Premium is extra price a share claims in the market due to high demand for it. For example the face value of share may be ₹10 but due to high demand the share can be issued at say ₹700. Here the share premium is ₹690. The thing to be noted is the companies announce dividend only on face value. In this case, if a company says the dividend is 23 per cent it means 23 per cent of ₹10.

Short Selling

In short selling, the seller sells the securities without owning the securities. He borrows the securities and sells it.

Bull and Bear Trading

In bull trading, buyers buy more shares in the expectation that the securities price will rise in the future with a plan to sell at that time and earn profit.

In bear trading the sellers sell the securities, with the intention to avoid loss, in the expectation that the security prices will fall.

They are named after the animal sprit of bull and bear. The bull throws up the lives which it attacks and bear grounds the lives which it attacks. So rise (up) in price is associated with bull and fall (down) in price is associated with bear.

Securitisation

Securitisation is the method of converting existing assets into securities. Take the case of banks, their unrecovered loans are considered as Non- performing assets (NPA). These assets are sold to Asset Reconstruction Companies (ARCs). The asset reconstruction company divides the total assets into equal parts and sells to investors. The investors are entitled to flow of interest income from these assets and principal amount when repaid.

Buy Back

Buy back refers to the issuer buying the securities again to accumulate share in his hands.

Market Capitalisation - GDP Ratio

It is called as MC-GDP ratio. It is the ratio between total market capitalisation of all stock exchanges and GDP of the country.

Price Earnings Ratio

Price earnings ratio is the ratio between price of the share and earning (dividend income/ profit) per share.

Price earnings ratio = Price per share (P) / Earnings per share (E)

Net Asset Value (NAV)

Net asset value is the net value of the outstanding shares. Net value is the total asset value minus liabilities of the Mutual Fund. Total asset value is the total number of shares and price per share in the market.

Total asset value = Total number of shares × Price per share in the market.

Net asset value = Total asset value – liabilities

High Net Worth Individual (HNI)

High net worth individuals are those who have net financial asset of at least $ 1 million and those who have net worth at least $ 30 million financial asset are called **ultra-high net worth individuals**.

Transferable and Non-transferable

Securities are of two types. One is transferable and another one is non-transferable. The term non-transferable is often seen in our day to day life. In bus tickets and train tickets we can see these words ‘non - transferable’. It means that we cannot sell it to others. To put it in another way, we cannot change the ownership of these tickets. Likewise, in case of securities, if it is transferable we can change the ownership and in case of non-transferable securities the ownership cannot be changed.

Cumulative and Non-cumulative Shares

Cumulative shares are shares that are entitled to receive dividends of a particular year in the coming years as arrear if the company had not given dividend in that particular year. Non- cumulative shares don’t have that right.

Convertible- Non Convertible Securities

Convertible means one kind of securities can be converted into another kind of securities. For example, the bonds can be converted as shares. In the case of Non-convertible securities, this is not possible.

Mutual Funds (MFs)

While merchant banker primarily helps issuer, the mutual funds help investors. The mutual funds mobilise the savings of the people and invest in securities. The individuals lack expertise in stock market and have very small amount to invest. So the mutual funds collect money from public and create a large pool of money and with their expertise they invest in securities. They invest in product called Units. Units are made up of more number of securities.

The shares of various companies are pooled together. For example 10 shares of 10companies (totally 100 shares) are pooled together. The value of share of each company may be different. Assume that the total value of 100 shares is ₹7000. This may be divided into units of ₹10 each. So, totally 700 units are available. It means each unit has a small portion of all the 100 shares. The investor money is invested in these units. Their return depends on growth of all the 100 shares. In this way of investment, the small amount of money gets invested in many shares and not in single share. So the risk is spread out.

Hedge Funds

Hedge funds are similar to Mutual Funds. But in the case of Mutual Funds the fund is collected from public and invested by Mutual fund which is created by somebody else whereas in case of Hedge Funds it is not public but a handfull of investors who join together and form funds of their own and invest in different securities and use different investment strategies. These investors are sophisticated and financially well so, they do not need protection of SEBI and they are unregistered and unregulated.

Offer for Sale (OFS)

Offer for sale is also like FPO. While the FPO was to raise additional fund requirements, the OFS is to dilute the share holding of promoters in a listed company. As per the Securities Contract Regulations (Rules) 157 at least 25 per cent of all type of securities issued by a listed company should be in the hands of Public. To meet this requirement the companies approach public to sell their shares through OFS.

A Note on Commodity Exchange

The commodity exchange is a platform to buy and sell agricultural products, natural resources like iron ore, crude oil and precious metals like gold and silver.

There are many regional exchanges and six national exchanges. They are Multi Commodity Exchange (MCX), National Commodity and Derivatives Exchange (NCDEX), National Multi-Commodity Exchange (NMCE) and Indian Commodity Exchange (ICEX), the ACE

Derivatives Exchange (ACE) and the Universal Commodity Exchange (UCX). The apex body for these exchanges was Forward Markets Commission (FMC). Now it is merged with SEBI.

The commodity exchange is more akin to stock exchange. The concepts used in stock exchange and commodity exchanges are the same. For example derivatives trading exist in both the exchanges. In both the exchanges it carries the same meaning.

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1 http://www.rbi.org.in/scripts/FAQView.aspx?Id=71
2 http://www.rbi.org.in/scripts/FAQView.aspx?Id=71
3 http://www.rbi.org.in/scripts/FAQView.aspx?Id=71

CHAPTER

9

Money Stock Measures[1]

Money stock refers to the total amount of money available in an economy at a particular point of time. It is also called money supply. The money supply measure is necessary because the amount and nature of money supply has a greater influence and impact on the economy.

Reserve Bank of India, the monetary authority of India, has a long tradition of publishing monetary statistics dating back to July, 1935. The method of compilation of monetary data had undergone revision threice. The methodological changes were made on the recommendation of working groups formed by the RBI. The first working group was formed in 1961 and the second working group was formed in 1977[2] (Annexure). The third working group (Working group on money supply: Analytics and Methodology of Compilation) was formed in the year 1997 under the chairmanship of Dr. Y. V. Reddy (the then deputy governor of RBI). Now, RBI follows the method recommended by this third working group.

The recommendations of the third working group considered the changing circumstances of Liberalisation, Privatisation and Globalisation (LPG) era and to ensure that the Indian standards in this regard are close to the international ones.

Money

Before getting into the methods of the third working group, it is necessary to know what money is. Money does not include coins and currencies alone. It includes other financial assets too. But there is difference among economists in the definition of money and the financial assets to be included in the category of money. The third working group observes, "There is no unique definition of 'money', either as a concept in economic theory or as measured in practice… money has to have relationship with the activities that economic entities pursue. Money can, therefore, be defined for policy purposes as set of liquid financial assets, the variation in the stock of which could impact on aggregate economic activity."

Money is classified into different types of financial assets based on their liquidity. Liquidity refers to the ease at which we can spend a financial asset. For example the currency at hand can be spent very easily. The currency deposited in banks can't be spent easily because we have to go to the bank or ATM to draw money and then only we can spend it. It involves some delay and manual labour. So, it is considered less liquid than currency at hand.

Sectorisation of the Economy

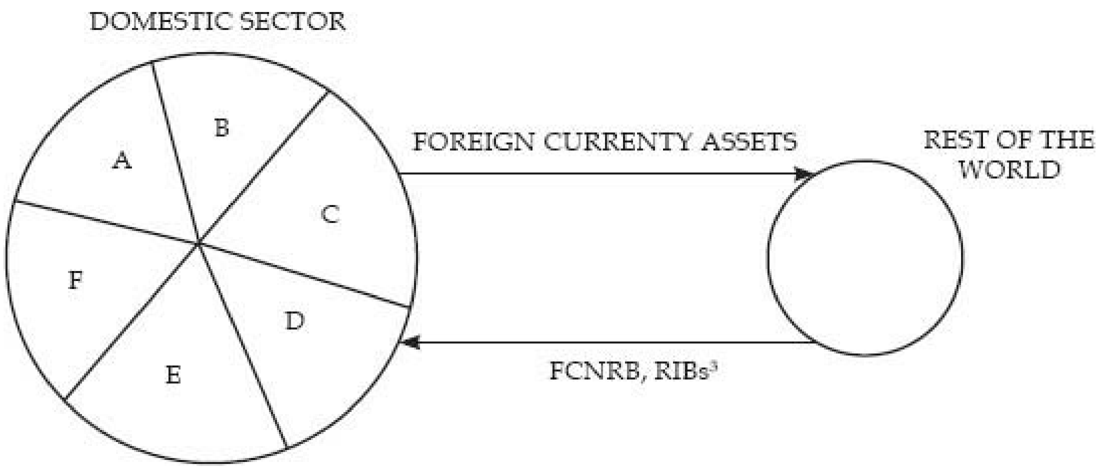
For the purpose of the compilation of monetary and liquidity aggregates, the third working group divided the economy into the domestic sector and rest of the world. The domestic sector was further divided into four exclusive sectors, viz.,

1. Households
2. Non-financial commercial sector
3. General government
4. Financial corporations

The financial corporation sector comprises the banking sector, consisting of the RBI and the banking systems in India and the other financial corporation sector. The other financial corporation sectors comprises development financial institutions such as term lending institutions and refinancing insurance corporations, mutual funds and non-banking financial companies accepting deposits from the public.

The domestic sector can also be classified as money issuing sector and money holding sector. Money issuing sector comprises RBI and banking systems in India. Money holding sector comprises households, other financial corporations and non-financial commercial sector. This is represented in chart 9.1.

Chart 9.1: Sectorisation of The Economy For Money Supply Compilation



A: HOUSEHOLDS	
B: RBI	B+C : BANKING SECTOR
C: BANKING SYSTEMS IN INDIA	B+C+D : FINANCIAL CORPORATIONS SECTOR
D: OTHERFINANCIAL CORPORATIONS	
E: GENERAL GOVERNMENT	B+C: MONEY ISSUING SECTOR
F: NON-FINANCIAL COMMERICAL SECTOR	A+D+F: MONEY HOLDING SECTOR

Monetary and Liquidity Aggregates

The third working group recommended two different financial aggregates namely, monetary aggregates and liquidity aggregates. The working group observes: "The partition between monetary and liquidity aggregates has been dictated by the fact while the first relates only to monetary liabilities of the Central Bank and depository corporations', i.e. the banking system, the latter also includes select items of financial liabilities of non-depository corporations, such as development financial companies and non-banking financial companies accepting deposits from the public apart from post office savings."

The development finance institutions which do not accept time deposit from public are called non-depository corporations.

Liquidity Aggregates include more number of financial assets than those included in the Monetary Aggregates.

Monetary Aggregates

The new monetary aggregates are of four types. They are:

1. Reserve money or Base money (M_0)
2. Narrow money (M_1)
3. Intermediate money (M_2) and
4. Broad money (M_3)

1. Reserve Money or Base Money (M_0)

The financial assets in the M0 category is called reserve money because these are held in reserve either by public and banks (Currency in Circulation) or by the RBI (Bankers Deposits with the RBI + Other Deposits with the RBI) and these are not available for the lending purpose of banks.

M_0= Currency in Circulation + Bankers Deposits with the RBI + Other Deposits with the RBI

Currency in circulation is the total amount of the Rupee notes issued by the RBI and the Rupee coins and small (paisa) coins issued by the Government of India. Currency in circulation is equal to the total of the currency held by both public and banks. Bankers deposit with RBI includes Cash Reserve Ratio (CRR) and excess reserve. The banks keep CRR with RBI as stipulated by the latter. Some banks keep more cash reserve with RBI than the stipulated amount. It is called **excess reserve.**

Other deposits with RBI comprise mainly

- Deposits of quasi-government and other financial institutions including primary dealers
- Balances in the accounts of foreign central banks and governments
- Accounts of international agencies such as the IMF etc, and
- Provident, gratuity and guarantee funds of RBI staff

Primary dealers are financial intermediaries operating in government securities (G-Secs) and other financial instruments.

2. Narrow Money (M1)

The financial assets included in the category of M_1 are fewer than those included in the category of M_2. That means, it defines money in a narrower sense. So, it is called Narrow Money.

M_1 = Currency with the Public + Demand Deposits with the Banking System + Other Deposits with the RBI

Currency with the public is equal to currency in circulation minus cash on hand with the banking system.

Demand deposits are those deposits that can be withdrawn by a depositor at any point of time.

There are two major types of demand deposits viz., current deposits and saving deposits.

The saving deposits have two components namely demand liability and time liability. Most part of the saving deposits is demand liabilities only. But few saving deposits can be withdrawn only on some performance or on some happenings. For example a saving deposit made in the name of a child may be deposited with a condition that it can be withdrawn only after the child become a major. This is an example for time liability portion of saving deposits.

In M_1, only demand liability portion is included. So, the above equation can be rewritten as follows:

= *Currency with the Public + Current Deposits with the Banking System + Demand liabilities portion of Saving Deposits with the Banking System + Other Deposits with RBI*

The second working group had apportioned saving deposits into demand and time liabilities on the basis of interest application on such deposits. This practice is continued by the third working group also.

3. Intermediate Money (M_2)

It is called intermediate money for the reason financial assets included in this category are more than those included in M1 but less than those included in M3.

M_2=M_1 *+ Time Liabilities portion of savings Deposits with the Banking system + Certificates of Deposit issued by Banks + Term Deposits (excluding Foreign Currency Non-Resident (Bank) (FCNR (B)) Deposits) up to one year maturity with the Banking system*

It can be rewritten as follows:

= Currency with the public + Current Deposits with the Banking System + Savings deposits with the banking system + Certificates of deposits issued by Banks + Term Deposits with the Banking System + Term Deposits (excluding FCNR (B) deposits) up to and including one year maturity with the banking system + Other deposits with the RBI.

4. Broad Money (M_3)

The financial assets included in the category of M3 are more than those included in the category of M2. That means, it defines money in a wider sense. So, it is called Broad Money.

M_3 = M_2 + Term Deposits (excluding FCNR (B) Deposits) over one year maturity with the Banking system + Call borrowings from 'Non – Depository' Financial Corporations by the banking system

Liquidity Aggregates

L1 = M_3 + All Deposits of Post Office Savings Banks excluding National Savings Certificates (NSCs)

L2 = L1 + Term Deposits with Term Lending Institutions and Refinancing Institutions (FIs) + Term borrowing by FIs + Certificates of Deposit issued by FIs

L3 = L2 + Public Deposits of Non-Banking Finance Companies (NBFCs)

Money Multiplier (Mb)

Money multiplier is the ratio between Broad money (M3) and Reserve money (M_0)

$M_b = M_3 / M_0 = M_3 \times 1/M_0$

It means the M_3 will get multiplied by $1/M_0$ times. For example, if Reserve Money is 20%, $1/ M_0$ will be 5 (1/20 × 100 = 5). Then M_3 will get multiplied five times in the economy. It means money supply will increase five times.

Annexure

RBI followed the following method since 1979 till implementation of current method.

M_1 (Narrow Money)

M_1 = Currency with the Public + Demand Deposits of banks + Other demand deposits with RBI

M2 (Intermediate money)

$M_2 = M_1$ + Post office Savings Deposits

M_3 (Broad Money)

$M_3 = M_1$ + Time Deposits of the Public with Banks.

M_4

$M_4 = M_3$ + Total Post office deposits.

1 This chapter is based on Report of Working group on 'Money Supply: Analytics and Methodology of Compilation' and an article named New monetary aggregation: An introduction, RBI Bulletin, October 1999.

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2 Methods of second working group are provided in the annexure

3 RIBs - Resurgent India Bonds is a special scheme of SBI to raise funds from abroad.

CHAPTER

10

Inflation And Deflation

The word 'Inflation' is often heard and seen in media. It is an important challenge for policy makers, politicians and common people. Inflation assumes such an importance due to its all round implications. In contrary, deflation is less heard because this is a rare phenomenon. So, inflation deserves elaboration. Before getting in to the subject matter of inflation, it is better to look into index numbers and price indices first.

This chapter covers index, measurement of inflation, weighted index numbers, types of inflation, impact of inflation, measures to control inflation and related terms.

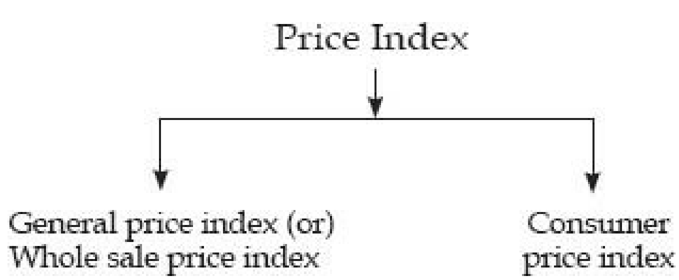
Index

An index number may be described as a specialised average designed to measure the relative change in the level of a phenomenon from time to time. S.P. Gupta observes ''An index number is a specialised average designed to measure the change in a group of related variable over a period of time''.[1]

Price Index

Price index is a specialised average that measures the changes in prices over a period of time. The price indices are of two types as shown in the figure 10.1.

Figure 10.1



General Price Index (GPI)

General Price Index measures the changes in average prices of goods and services. A base year is selected and its index is assumed as 100 and on this basis, price index for further period is calculated.

Consumer Price Index (CPI)

Consumer Price Index measures the average change in prices paid by ultimate consumers for a particular basket of goods and services over a period of time. CPI actually measures the increase in prices a consumer will have to pay for the designated commodity basket (which may be revised every 45 years to factor in changes in consumption pattern).[2]

Construction of Price Index

Price index is calculated by measuring rise in price of current year over price of base year.

Price Index = Current year's price / Base year's Price × 100

= P1 / P0 × 100

Example:

Take 2004–05 as base year.
Price of rice in 2004–05, ₹2/kg
Price of rice in 2005–06, ₹3/kg
Price of rice in 2006–07, ₹3.50/kg
Price index for 2005–06 = Price of rice in 2005–06/ Price of rice in 2004–05 × 100
= 3/2 × 100
= 150

Price index for 2006–07 = Price of rice in 2006–07/ Price of rice in 2004–05 × 100
= 3.50/2 × 100 = 175

Inflation

Shapiro defines inflation as "persistent and appreciable rise in the general level of prices”[3]. The economic survey of 2008–09 observes inflation as “... an upward movement in the general prices of goods and services and is estimated as the percentage rate of change in a price index over the reference time period”.

Measurement of Inflation

Inflation is measured with the help of general or wholesale price index in India[4]. The percentage of rise in the price index of a particular period from previous period price index is the rate of inflation.

Inflation = current period price index – last period price index / last period price index*100

In the above example,

Inflation[5] in the year 2006–07 = 175 – 150/150 × 100 = 16.6%

This is a simple index based calculation. Actually, inflation is calculated on the basis of weighted index numbers.

Note: Base year is used only to calculate the index number. The inflation is calculated as a percentage of rise in index number over last year.

Year-on-Year Inflation

Year–on-year inflation means rate of change of inflation over the corresponding period (week or month or quarter in relation to the frequency of the data) of the previous year. For example, the inflation on second week of January 2010 is computed by calculating the rise in index number over index number on second week of January 2009.

Weighted Indices

In India various weighted price index are calculated. They are:

1. Wholesale Price Index (WPI)
2. Consumer Price Index for Industrial Workers (CPI – IW)
3. Consumer Price Index for Urban Non – Manual Employees (CPI – UNME)
4. Consumer Price Index for Agriculture Labourers (CPI – AL)
5. Consumer Price Index for Rural Labourers (CPI - RL)

Among the above indices, until October 2009, only the WPI was used to calculate inflation and made public through the newspapers. The other indices were published only as index numbers and not as inflation. But now the inflation is also calculated based on new CPI indices. So, these two are called the **head line inflation**. The new CPI indices are elaborated later.

The weights in WPI are assigned on the basis of value of production of respective commodity groups for WPI, after adjusting for value of net imports. For other indices, the weights are assigned on the basis of consumer expenditure survey.

For example, the value of production of primary articles is 22.62 per cent of total value of output. So, primary commodities are assigned 20.118 per cent weight. In consumer expenditure survey, it was found that people spend 46.19 per cent of their total expenditure on food in the base year. So, food items are assigned with 46.19 per cent weight.

Reason for Assigning Weight

Weights are assigned to arrive at a realistic inflation rate. 46.19 per cent weight means if we take 177.77 points of price rise in CPI (IW), only 82.11 points ($46.19 \times 177.77/100 = 82.11$) of price rise get increased in the budget of an industrial worker on account of primary products. It is because out of his total consumption he spends only 46.19 per cent on primary commodities.

The table 10.1 page gives the details of various price indices regarding base year, number of commodities included, frequency of publication, etc.

Table 10.1: Salient Features of Price Indices

S. No			CPI- UNME	CPI – IW	CPI – AL	CPI- (RL)	WPI
1.	Weights allocated on the basis of		Consumer Expenditure Survey				Wholesale Transactions
		First	1958–59	1958–59	1956–57	1983	
		Latest	1982–83	2001	1983	1983	
2.	Base year of the Current Series		1984–85	2001	1986–87	1986–87	2011–12
3.	Number of items/ commodities in basket		146–365	120–160	260	260	697
4.	Number of Centres / villages		59	76	600	600	8,331 quotations
5.	Time lag of the index		2 weeks[6]	1 month	3 weeks	3 weeks	3 weeks
6.	Frequency		Monthly	Monthly	Monthly	Monthly	Monthly

Source: Economic Survey 2006–07, 2016–17(Volume 2) and Ministry of Commerce and Industry, GoI

Wholesale Price Index (WPI)

This index measures the change in the price of commodities supplied to the wholesale market. It is based on the value of production adjusted for net imports. The price for manufactured products is taken at ex-factory price and for minerals at ex-mines and for agricultural products at mandi price. Indirect taxes are excluded from the price.

Ex-factory and ex-mines price means price exclusive of transport and other charges like insurance.

WPI Food Index, a new index is also calculated based on this new WPI series. It is compiled by combining indices of primary food articles and manufactured food articles.

The following table gives details about weights assigned to different commodity groups within WPI.

Table 10.2: Commodity groups, weight and no. of articles

S. No	Commodity Groups	Weight	No. of Articles
1	Primary Products	22.62	117
2	Fuel& Power	13.15	16
3	Manufactured Products	64.23	564
	Total	100.00	697

The Authority responsible for Compilation and Release: Office of the Economic Advisor, Ministry of Commerce and Industry, GoI.

Old Consumer Price Indices

Before February 2011, India had only four consumer price indices viz. Consumer Price Index for Industrial Workers (CPI – IW), Consumer Price Index for Urban Non – Manual Employees (CPI – UNME), Consumer Price Index for Agriculture Labourers (CPI – AL) and Consumer Price Index for Rural Labourers (CPI - RL).

CPI for Industrial Worker CPI (IW)

This index measures the change in the price of commodity basket consumed by the industrial workers. The following table shows the weights for different commodities group in this index.

Table 10.3: Product groups and weightage of CPI (IW)

S. No.	Groups	Weights
1.	Food	46.19
2.	Pan, Supari, Tobacco & Intoxicants	2.27
3.	Fuel & Light	6.43
4.	Housing	15.27
5.	Clothing, Bedding & Foot wear	6.58
6.	Miscellaneous *	23.26

Source: Economic Survey 2005–06

* Medical care, education, transports & communications, recreation & amusement personal care & effects, laundry, domestic services, etc.

Authority for compilation & Release:

Labour Bureau, Shimla, Ministry of Labour.

Use: Used for wage indexation in government and organised sector.

CPI for Urban Non-Manual Employees (CPI – UNME)[7]

This index measures the change in the price of commodity basket consumed by non-manual employees like office goers.

CPI-UNME earlier compiled by the Central Statistical Organisation as an independent index has since been discontinued and is currently linked to the CPI-IW.[8]

Uses

Basically used for determining dearness allowances of employees of some foreign companies working in India in service sectors such as Airlines, Communications, Banking, Insurance & other financial services.

Used under the Income Tax Act to determine capital gains.

Used by Central Statistical Organisation (CSO) for deflating selected service sectors' contribution to GDP at factor cost at current prices to get the corresponding figures at constant prices.

Authority for compilation & Release: CSO – Central Statistical Organisation, Ministry of Statistics and Programme Implementation.

CPI for Rural Labourers and Agricultural Labourers (CPI – AL)

Consumer Price Index for rural labourers measures the change in the price ofcommodity basket consumed by rural labourers like agriculture labourers, labourers of village and cottage industries etc

Consumer Price Index for Agricultural Labourers (CPI – AL) is a subset of Consumer Price Index for Rural Labourers (CPI-RL). It is used for revising minimum wages for agricultural labourers in different states.

Authority for compilation and release of both indices: Labour Bureau, Shimla, Ministry of Labour.

New Consumer Price Indices

The above old consumer price indices cover only a segment of population like agriculture labour, industrial worker etc., and do not give a nationwide picture. Therefore, three new indices are introduced with base year of 2010 (January – December) covering all segments of population on all India basis. Now the base year is shifted to 2012. They are as follows:

- CPI (Rural)
- CPI (Urban)
- CPI (Combined)

These indices are published for all India as well as State / Union Territory level. These indices are released with one month time lag. The CPI (Combined) is computed by combining Rural and Urban index. From January 2012, these new indices are released.

Consumer Food Price Indices (CFPI) for three categories - rural, urban and combined are calculated separately on an all India basis with effect from May, 2014.

It is calculated based on the price of primary and manufactured food products like vegetables, cereal and products, pulse and products etc.

Table 10.4: Commodity groups and their weights for rural, urban and combined

S. No	Groups	Rural	Urban	Combined
1.	Food, Beverages and Tobacco	59.31	37.15	49.17
2.	Fuel & Light	10.42	8.40	9.49
3.	Clothing, Bedding & Foot wear	5.36	3.91	4.73
4.	Housing	–	22.53	9.77
5.	Miscella-neous	24.91	28.00	26.31
6.	Total	100	100	100

Source: Central Statistics Office, Ministry of Statistics and Programme Implementation, Government of India.

Types of Inflation

Inflation can be classified on the basis of rate of rise in prices and on the basis of causes.

Different Inflations Based on Rate of Rise in Prices

Based on rate of change in price level inflation is classified into different types.

1. Creeping Inflation

Price rise at very slow rate (less than 3 per cent) like that of a snail or creeper is called creeping inflation. It is regarded safe and essential for economic growth.

2. Walking or Trotting Inflation

Price rise moderately at the rate of 3 to 7 per cent (or) less than 10 per cent is called walking or trotting inflation. It is a warning signal to the government to be prepared to control inflation. If the inflation crosses this range, it will have serious implications on the economy and individuals.

3. Running Inflation

Running inflation means price rise rapidly like the running of a horse at a rate of 10–20 per cent. It affects the economy adversely.

4. Hyperinflation (or) Runaway (or) Galloping Inflation

The price rise at very fast at double or triple digit rate from 20 to 100 per cent or more is called Hyperinflation (or) Runaway (or) galloping inflation. Such a situation brings total collapse of the monetary system because of the continuous fall in the purchasing power of money.

Different Inflations Based on Causes

Based on causes inflation is classified into different types.

1. Demand Pull Inflation

Demand pull inflation arises due to higher demand for goods and services over the available supply. Higher demand for goods and services arises due to increase in income of the people, increase in money supply and change in the taste and preference of people etc. In other words, demand pull inflation takes place when increase in production lags behind the increase in money supply.

2. Cost Push Inflation

Price rise due to increased input costs like raw material, wages, profit margin, etc., is called cost push inflation.

Both demand pull inflation and cost push inflation are affected by forces of demand and supply. They are discussed below.

Factors Affecting Demand

a. Increase in Money Supply

Increase in money supply leads to price rise. More money available with people induces people to purchase more goods and services. It means there is an increase in demand. So, prices move upward.

For example, consider a person who goes to the market with more money and another one person with less money on a particular day. The former may buy more goods than the latter. Likewise, if all people have more money, all may purchase more goods. It leads to price rise in the market.

b. Increase in Disposable Income

The increase in the disposable income leads to higher spending on the part of households. It hikes the level of price.

c. Cheap Monetary Policy

Cheap monetary policy refers to loan availability at very low interest rates and at easy terms. It leads to more investment by investors with loaned money. It pushes up the demand for capital goods and rise in price of the same.

d. Increase in Public Expenditure

Increase in government expenditure over its income, leads to deficit budget. Increase in government spending increases the demand for consumption and capital goods and services. It increases the price of both goods and services.

e. Repayment of Public Debt

The repayment of public debt borrowed by the government to public leaves people with more money. It induces people to spend more. It ultimately leads to increase in price of goods and services.

Factors Affecting Supply

a. Shortage of Factors of production

The shortage in the factors of production viz., land, labour, and capital increases the cost of production. For example, shortage in the labour leads to higher wages. It increases the cost of production and price of goods and services.

b. Industrial Disputes

Industrial disputes lead to strike or lay off. It affects the production and supply of goods. It results in increased prices.

c. Natural Calamities

Natural calamities like earthquake, land slide and tsunami, affect production and supply of goods and services. The end result is price rise.

d. Artificial Scarcities

Artificial scarcities created by activities like hoarding and speculative trading in commodities in the commodities future market, results in price hike.

e. Increase in Exports

Increase in export of a particular commodity leads to shortage of goods in the domestic market. It pushes up prices.

f. International Factors

International factors like oil price hike, shortage in production of certain commodities leads to higher import prices.

Effects of Inflation

Inflation has an impact on all the economic units. It has a favourable impact on some and unfavourable impact on others. The effects are discussed under three different heads as under:

1. Redistribution of Income and Wealth

It redistributes income from one hand to another. It leads to loss for a group of people and gain to another group of people.

a. Debtors vs Creditors

In case of debtor and creditor, debtor is gainer and creditor is loser. Take an example. The debtor borrowed ₹100 for interest at the rate of 5 per cent a day and debtor is a mango vendor. He has to repay ₹105 on the next day. The price of mango on day one is ₹10 per mango. The debtor can buy 10 mangoes. On day two, the price of mango is ₹15. The debtor can sell 10 mangoes for ₹150. The debtor can repay his debt by selling only seven mangoes. So he gains ₹45 or three mangoes. The creditor can buy only seven mangoes with ₹ 105 he got back. Suppose, he purchased mango on day one instead of lending, he may have bought 10 mangoes. So he loses three mangoes. This relation holds true for private as well as public debt.

b. Producers vs Consumers

In inflationary situation, the producers stand to gain and consumers stand to lose. The producer's profit will increase as a result of inflation. The purchasing power of money held by consumer falls. So, they have to pay more money to purchase the same amount of goods and services what they bought before inflation. Here, the income of consumer gets transferred from consumers to producers.

c. Flexible Income Group vs Fixed Income Group

The flexible income groups like sellers, self-employed, and employees of private concerns whose salary is adjusted according to inflation do not get affected, but fixed income groups like daily wage earners lose as the purchasing power of their income diminishes.

d. Debentures or Bond Holders and Savers vs Equity Holders

The Debentures or Bond holders and Savers receive fixed periodical income from their financial assets. The purchasing power of their asset remains intact only if the interest rate is more than rate of inflation. Take an example where the interest rate is 8 per cent. The investor can earn ₹8 for ₹100 investment. Suppose, if the rate of inflation is 10 per cent she/he can buy fewer goods than that of her/his purchase before inflation with the invested amount.

The bond issuers gain, the bond holders lose. The fixed interest rate paid for the bonds are not enough to compensate the effect of inflation. So to avoid this, interest is fixed on the basis of inflation. It means the interest varies according to inflation. If inflation is 10 per cent the interest rate shall be adequate to compensate this 10 per cent. The interest rate may be 10 per cent or more. These types of bonds are called **Inflation indexed bonds.**

The security holders' income depends on the profit of the company. In inflationary situation, the companies earn more profit. So, the equity holders also earn more income.

2. Effects on Production and Consumption

The inflation may lead to fall in the demand for goods and services. It may curtail the amount of production. Inflation also leads to reallocation of resources. Sometimes, only few goods may experience price rise. In that case, the investment from other sectors may shift to these sectors.

In packaged items, in order to maintain same price per package, the producers reduce the quantity or quality or both instead of raising price. It means, less production and consumption.

3. Other Effects

a. Balance of Payment (BoP)

High price reduces the amount of export and increases import from other countries where goods are available at cheaper rate. It results in unfavourable balance of payment.

b. Exchange Rate

High import and low export means high demand for foreign currencies compared to domestic currency. This depreciates domestic currency.

c. Social and Political

Higher rate of inflation leads to social and political tension. The political parties and organised group of people call for strike, hartals and stage dharnas.

Measures to Control Inflation

The control of inflation needs a multi-pronged strategy. All the strategies need cooperation and harmony among them.

1. Monetary Measures

a. Credit Control

Credit control method is used by RBI to control inflation. It is discussed in detail in the chapter 5 named Indian Financial System- Money Market. RBI used Wholesale Price Index based inflation as a benchmark to control inflation. But now based on Urjit Patel Committee recommendation, RBI shifted targeting to newly introduced CPI (Combined). The reason is that the CPI (combined) measures the inflation in the consumer market. So it reflects the true and correct cost of living compared to WPI. The people expectation about future inflation is also based on price level in the consumer market.

b. Demonetisation of Currency

Demonetisation of currency refers to the declaration that hereafter currencies of particular denominations are invalid. It suddenly reduces the money to the extent of money kept in those particular denominations. It is resorted to only in extreme cases.

c. Issue of New Currency

In this case all the money in circulation is withdrawn by the government and new currency is issued. The new currency of a single unit will be made equal to many units of old currency. For example new currency of one rupee will be made equal to ₹100 of old currency. So the money supply is reduced to 1/100th. This too is resorted only under extreme cases.

2. Fiscal Measures

a. Reduction in Unnecessary Expenditure

Reduction of unnecessary government expenditure means less demand from the government side. It brings down the price level.

b. Increase in Direct Taxes

Increase in direct taxes like income tax reduces the disposable income available with people. It means low demand from households. Less demand leads to lower price.

c. Decrease in Indirect Taxes

Decrease in indirect taxes like excise duty, sales tax brings the prices down.

d. Surplus Budget

Surplus budget means less expenditure than receipts. It reduces the money supply and government demand for goods and services. The price level is brought down due to this.

3. Trade Measures

Trade measures refer to export and import of goods and services. In case of shortage of goods in domestic market, the supply can be increased through import of goods from foreign countries at low or nil import duty. The restriction in the form of import licenses has to be eased to increase import. The higher supply helps to bring down the price.

4. Administrative Measures

a. Rational Wage Policy

Rational wage policy helps to keep the cost of production under control. Cost control here refers to price control.

b. Price Control

Direct price control also helps in inflation control. Price can be controlled by fixing maximum price limits through administered price system and subsidy from the government.

c. Rationing

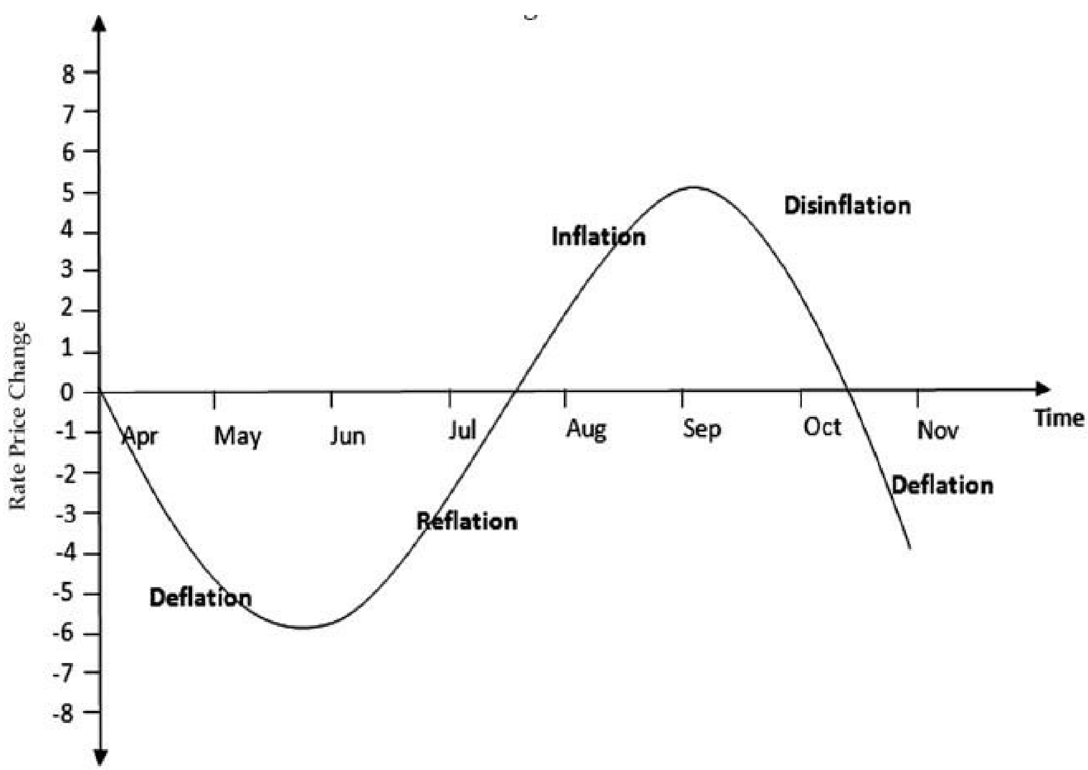
Rationing of goods in short supply keeps the demand under control so that price comes under control.

Related Terms

Deflation

Deflation is opposite to that of inflation. The persistent and appreciable fall in the general level of prices is called as deflation. The rate of change of price index is negative. The effects, causes and measures are also in the opposite direction.

Figure 10.2



Reflation

Reflation means deliberate action of government to increase rate of inflation to stimulate the economy. It is usually done to redeem the economy from deflationary situation.

Disinflation

The rate of inflation at a slower rate is called disinflation. For example, if the inflation of last month was 6 per cent and rate of inflation in the current month is 5 per cent it is termed as disinflation.

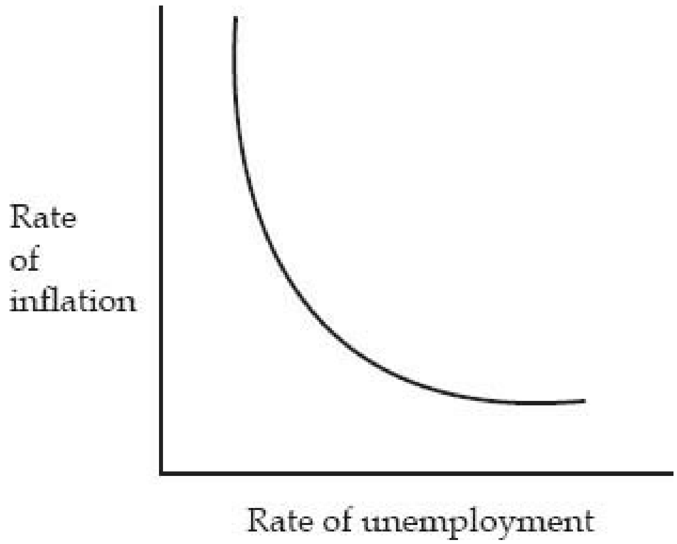
A Comprehensive Picture

The figure 10.2 in the previous page depicts the various rates of price changes in the economy. From the month of April to the end of May, the economy is seen experiencing negative rate of price change. It is called deflation. From the end of May to the mid of July, the price rate is seen recovering from negative zone. It is called reflation. From the mid of July, to the end of August, the price rate is seen moving upward in the positive territory. It is called inflation. From September to the mid of October, the rate of price change is declining but still in the positive territory. It is called disinflation.

Phillips Curve

The Phillips Curve shows the relationship between rate of inflation and rate of unemployment. It shows that the relationship is negative. That is at high rate of inflation the unemployment rate is low as show in figure 10.3 below.

Figure 10.3



Stagflation

Stagflation refers to the situation of coexistence of stagnation and inflation in the economy. Stagnation means low national income growth and high unemployment. The Phillips Curve shows that at high rate of inflation, there is low rate of unemployment. But stagflation proves the contrary.

Before the 1970s, it was considered that at the time of inflation, the economy will be booming. The 1970s, scenario proved contrary the existence of inflation and stagnation.

Base Effect

Base effect refers to the phenomenon of current year index being influenced by very low or high base period index. Consider the following example.

Case 1

Price index on January 7, 2007 = 110

Price index on January 7, 2008 = 120

Rate of inflation on January 7, 2008 = 120 – 110/110 * 100 = 9.09 %

Case 2

Price index on March 10, 2008 =180

Price index on March 10, 2009 =190

Rate of inflation on March 10, 2009 = 190 – 180/180 * 100 = 5.55%

In both the cases, the index number increased by 10, but the rate of inflation is different. The rate of inflation is low in second case compared to first case. This is because of the difference in base period index.

Core Inflation

The core inflation is the measure of price rice in the economy excluding the price rise of certain products. Those products are whose prices are very volatile and temporary in nature. Example for these products is fruits and vegetables. These products are seasonal. During the season they are available in plenty and prices are low but during the offseason these are scarce and prices are high. It means its prices are temporary and volatile. It is measured to study the long term trend in the price rise, so that, the long term policies can be framed to control inflation.

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1 *Statistical Methods*, S.P. Gupta, p. 516
2 Economic Survey 2008–09, p. 63
3 *Monetary Economics*, 5th revised edition, M.L.Jhingan, p.232
4 The International Monetary Fund (IMF) statistics reveals that 24 countries use WPI as the official measure to track inflation, compared to 157 countries which use CPI.

5 Officially Laspeyres's formula is used in index construction but for the simplicity a simple formula without weightage is used.
6 Two weeks time lag means the index of a particular month is published after two weeks. For example, index of October month is published in November second week.
7 It is discontinued from 2012
8 Economic Survey 2008–09, p.67.

CHAPTER

11

External Trade and Capital

External sector deals with export and import of goods and services, and financial capital between nations. The countries export goods and services over which it has advantage over other countries and import goods and services in which it lacks advantage over others.

This chapter covers balance of payment, foreign exchange, purchasing power parity, convertibility, barriers to trade, economic integration and related terms.

Balance of Payment[1]

The balance of payment of a country is a systematic record of all its economic transactions with the outside world in a given year[2]. The term 'all transaction' refers to transactions of the government as well as private. It is a double entry book keeping. Double entry book keeping involves recording each transaction twice consisting of two opposite entries with equal values: one with a credit entry (signifying inflow) and the other with a debit entry (signifying outflow). For example while importing the goods, the goods imported inflows. It is credited as 'import'. At the same time equivalent amount of money needs to be paid. It is debited as 'payable' in the name of the country from where the import was made.

It means, the incomings are credited and outgoings are debited.

The balance of payment is explained in detail with the help of the table 11.1.

I. Current Account

The external transactions are classified as current account and capital account transactions. This classification is similar to the classification of receipts and expenditure as revenue receipts and capital receipts and revenue expenditure and capital expenditure in public finance. Current account transactions are like revenue receipts and revenue expenditures and capital account transactions are like capital receipts and capital expenditures.

Current account transactions are single time and one way transactions. It means that the transaction, either receipt or payment, happens once and the transaction ends there. For example if a person exports goods he gives the goods and receives money and the transaction comes to an end with respect to the particular good exported.

1. Export

Export means the receipts against export of merchandise goods to other countries. The export receipts of services are not included here.

2. Import

Import refers to the payment for import of merchandise goods from other countries. The payments for import of services are not included here.

3. Trade Balance

The balance of trade is the difference between export receipts and import payments.

Trade balance = Export – Import

If the trade balance is positive it is called favourable balance of trade and if it is negative it is called unfavourable balance of trade.

4. Invisibles (net)[3]

The head of invisibles record the receipts and payments with respect to the following items.

A. Services

B. Transfer and

C. Income

A. Services

Export and import of services is accounted under this head. Services include travel, transportation, insurance, Government Not Included Elsewhere (GNIE) and miscellaneous services, which encompass communication services, construction services, financial services, software services, news agency services, royalties, management services and business services, etc. The software services comprise Information technology (IT) and IT-Enabled Services (ITES).

B. Transfers

Transfers include grants, gifts, etc., which do not have any quid pro quo. Without any quid pro quo means that it need not be compensated or reciprocated. Once it is received it need not be repaid.

C. Income

Income includes transactions regarding income from investments in the form of dividends, profit and interest from loans, rent from house property and income generated through employment.

Remittance is directly earned by labour which is a factor of production and incomes like dividend, profit and interest are earned by capital which is also a factor of production. So the income from both these heads is called factor income services.

Current Account Balance

Current account balance is the sum of the items 3 and 4 viz, trade balance and net invisibles.

Current account balance = Trade balance + Net invisibles.

If the current account balance is positive, it is said to be surplus which means favourable current account balance. If the current account balance is negative, it is said to be deficit also called as unfavourable current account balance.

II. Capital Account

Capital account transactions are two way and multiple transactions. It means paid money can be recovered through periodical income and/or by disposal of the asset created. Likewise the received money needs to be repaid periodically and settled finally by repaying the full amount. For example from the loan paid to a foreigner periodical interest income is received, the paid principal amount can be recovered from the debtor at the same time.

i. External Assistance (net)

External assistance means the transaction of official (government) bilateral and multilateral loans. The bilateral loans are loan transactions between two countries. Multilateral loans are official loan transactions between a country and multilateral bodies like World Bank, IMF and Asian Development Bank, etc.

ii. External Commercial Borrowings (net)

Commercial borrowing means loan transaction by commercial enterprises. It is also called as External Commercial Borrowing (ECB).

ECB refer to commercial loans in the form of bank loans, buyers' credit, suppliers' credit, securitised instruments availed from non-resident lenders with a minimum average maturity of three years.

Securitised instruments refer to debt securities like bonds and preference shares. Buyers' credit and suppliers' credit are called trade credits. Depending on the source of finance, such trade credits are classified as Suppliers' Credit or Buyers' Credit. Suppliers' credit relates to credit for imports into India extended by the overseas supplier, while buyers' credit refers to loans for repayment of imports into India arranged by the importer from a bank or financial institution outside India. It is to be noted that both of them are for the purpose of import and loan availed by importer. In the supplier's credit only two parties namely exporter and importer are involved in the buyer's credit; a third party namely bank or financial institution comes into the picture to finance the import.

ECB can be raised only for specific purposes, such as the import of capital goods, implementation of new projects, etc. This restriction is called **end use restriction.**

The heading External Commercial Borrowings also covers Foreign Currency Convertible Bonds (FCCB) and Foreign Currency Exchangeable Bonds.

FCCB are bonds issued by an Indian company expressed in foreign currency. The principal and interest in respect of these bonds are payable in foreign currency.

Foreign Currency Exchangeable Bonds (FCEB) are also expressed in foreign currency issued by an issuing company. These are issued to persons who are residents outside India. These are exchangeable into equity share of another company, called the Offered Company. The principal and interest in respect of these bonds are payable in foreign currency. The word 'Exchangeable' refers to the facility to convert bond of one company into equity share of another company.

iii. Short-term debt

Short-term debts are trade credits for a maturity of less than three years.

iv. Banking Capital

Banking capital comprises three components:

a. Foreign assets of commercial banks
b. Foreign liabilities of commercial banks and
c. Others

"Foreign assets" of commercial banks consist of (i) foreign currency holdings, and (ii) rupee overdrafts to non-resident banks.

"Foreign liabilities" of commercial banks consist of (i) non-resident deposits and (ii) liabilities other than non-resident deposits, which comprise rupee and foreign currency liabilities to non-resident banks and official and semi-official institutions.

"Others" under banking capital include transaction in balances of foreign central banks and international institutions like the IBRD, IDA, ADB, IFC, IFAD, etc., maintained with the Deposit Accounts Department (DAD) of the RBI as well as transaction in balances held abroad by the embassies of India in London and Tokyo.

Non- resident Deposits

The deposit received from non-resident Indians come under this head. At present, there are three types of NRI Deposit Schemes. They are:

- Foreign Currency Non-Resident (Banks) FCNR (B)
- Non Resident External Rupee Accounts NR (E) RA
- Non Resident Ordinary Rupee Account (NRO)

Foreign Currency Non-Resident (Banks) - FCNR (B)

These deposits are held in the following foreign currencies, US Dollar, Pound Sterling, Euro, Japanese Yen, Australian Dollar and Canadian Dollar. Only term deposits of one to three years maturity is allowed. The interest rates are pegged to LIBOR[4] / SWAP[5] of corresponding maturities.

Non-Resident External Rupee Account NR (E) RA

These deposits are held in Indian rupee. Term deposits with maturity of one to three years as well as saving deposits are allowed under this scheme. Its interest rate is also pegged to LIBOR/SWAP rate.

Non-Resident Ordinary Rupee Account (NRO)

It is the account held by Indians ordinarily living abroad. An Indian who was Indian resident but migrated abroad can shift his account to this category. It is held in Indian rupee. NRO accounts can be opened as current, savings, recurring or fixed deposit accounts.

v. Foreign Investments

There are two types of foreign investments. One is foreign direct investment and another is portfolio investment. Portfolio investment is also called as rentier investment.

Table 11.1: Balance of Payment

S. No.	Item	2009–10	2010–11
I	Current account 1 Exports 2 Imports 3 Trade balance 4 Invisibles (Net) A. Services B. Transfer C. Income Current account balance	 18244 300644 –118202 80022 36016 52043 -8038 -38180	 2236151 383481 –127322 7269 44081 53140 –17952 –48053
II	Capital account i. Exteral assistance ii. External commercial borrowings iii. Short-term debt iv. Banking capital of which non-resident deposits v. Foreign investment A. FDI B. Portfolio investment vi. Other flows Capital account balance Capital account balance (including errors & ommissions)	 2890 2000 7558 2083 2923 50362 17966 32396 –13259 51634 51622	 4941 12160 12034 4963 3238 42127 11834 30293 –12484 63740 61104
III	Errors & omissions	–12	–2636
IV	Overall balance	13441	13050
V	Reserves change (-indicates increase, + indicates decrease)	–13441	–13050

Source : Reserve Bank of India (RBI).

A. Foreign Direct Investment (FDI)

Investment through the mode other than the stock exchange is called foreign direct investment in India. There is no prescribed size to treat an investment as foreign direct investment in India. FDI includes the following:

- Shares acquired by way of IPO
- Shares acquired by way of preferential allotment
- Shares acquired by way of offer for sale through private arrangement
- Transfer of shares by way of offer for sale through private arrangement

In all these purchases there is direct contact between the securities buyer and the seller company.

Aravind Mayaram Committee on FDI and FII has suggested that the investment in a company above 10 per cent needs to be treated as FDI.

B. Portfolio (or) Rentier Investment

Investment through stock exchange that is through secondary market is called portfolio investment. Portfolio investment refers to investment in various financial instruments like shares, debentures of a company through secondary market. There are three major types of portfolio investment. They are:

- Foreign Institutional Investment (FII)
- Depository Receipts
- Offshore Funds

Foreign Institutional Investment

It is the portfolio investment by foreign institutions like mutual funds, insurance cos, pension funds, etc., in shares and debentures.

Depository Receipts

Companies of a country can go abroad to sell their shares in foreign capital market. When a foreign investor buys shares of domestic companies abroad (in capital market), he is issued a receipt by a custodian bank. This receipt represents a certain number of underlying shares of domestic companies and hence they are called depository receipts.

The depository receipts raised by Indian companies in the American market are called American Depository Receipts (ADRs) and those that are raised in some other countries are called Global Depository Receipts (GDR). The depository receipts raised by foreign companies in Indian market are called Indian Depository Receipts (IDRs).

Offshore Funds

Offshore funds, also called international funds, are mutual fund schemes investing in international markets. The investments invested through these funds are included here.

vi. Other Flows

Other flows include delayed export receipts, leads and lags in export receipts (the difference between the customs data and the banking channel data), funds held abroad, and other capital transactions not included elsewhere such as flows arising from cross-border financial derivative and commodity hedging transactions, and sale of intangible assets such as patents, copyrights, trademarks, etc.

The difference between the customs data and the banking channel data arises because banking channels data relies on foreign exchange release/receipt returns which are actual cash outgo and cover all flow and customs data are based on bills of entries (import document filed with the customs), which might remain somewhat incomplete for a number of reasons in the short run. Defense imports are not reflected in the customs data.

Capital Account Balance

It is the sum of items i to vi above.

Capital account total (net) = External assistance (net) + Commercial Borrowings (net) + Nonresident deposits (net) + Foreign investments (net) + Other flows (net).

If the capital account balance is positive, it is said to be surplus. Surplus capital account balance means favourable capital account balance. If the capital account balance is negative, it is said to be deficit. Deficit capital account balance means unfavourable capital account balance.

Capital account balance is calculated with and without errors and omission.

III. Errors and Omission

Errors and omission means the difference between debit and credit entries of all transactions. It was already said that each transaction is entered twice in double entry book keeping by recording each transaction twice consisting of two opposite entries with equal values: one with a credit entry (signifying inflow) and the other with a debit entry (signifying outflow). Ideally speaking in this system both debit side and credit side should be equal but as the data is compiled from various sources some mismatch if found to happen. This is called errors and omission.

IV. Overall Balance / Balance of Payment

The overall balance is the sum of current account balance and capital account balance.

Overall balance = Current account balance + Capital account balance

If there is a positive balance it increases the reserve and vice-versa.

V. Reserves

Reserve means foreign exchange reserve. The sum of current and capital account balance is the balance of payment.

Balance of payment = current account balance + capital account balance

The balance is added to foreign exchange reserve if the balance of payment is in surplus. The balance is deducted if the balance of payment is in deficit. It means payment is made out of old balance (foreign exchange reserve).

The foreign exchange reserve consists of

Foreign Currency Assets

Gold Stock of RBI

SDR (Special Drawing Right) holdings of the government

Reserve Tranche

Foreign Currency Assets

Currencies of various countries are held in foreign exchange reserve. It is expressed in US Dollar or Indian rupee terms after converting currencies of various countries by their respective exchange rate against the US Dollar or Indian Rupee respectively. Apart from currency it also includes foreign currency deposits held by RBI with foreign central banks, the BIS and non-resident deposit taking institutions as well as deposit agreements with IMF Trust Accounts that are readily available to meet a BoP financing need. The securities issued by non-residents and financial derivatives having underlying foreign currency assets also form part of foreign currency assets.

Gold Stock of RBI

The RBI has gold stock as a back up to issue currency and to meet unexpected balance of payment problem. Its value is expressed in terms of US Dollar or Indian Rupee.

SDR Holdings

SDR is a reserve created by International Monetary Fund (IMF) to help countries that have Balance of Payment problem. The member countries have to contribute to this account. The contribution is in proportion of their IMF quota (membership fee).

The detailed explanation of SDR is followed by next topic namely Reserve Tranche.

Reserve Tranche

Tranche means portion or slice. Reserve tranche means a portion of fund. It consists of India's quota (member subscription fee) to IMF and lending to General Resource Account of IMF. General Resource Account is the pool of member counties' quota payment.

A member is required to pay 25 per cent of its quota in SDRs or in foreign currencies acceptable to the IMF (*i.e.*, hard currencies). This is termed "reserve position in the IMF or reserve tranche" and is part of the member country's reserve assets. If any money was lent in foreign currency or SDR over and above the quota to IMF's General Resource Account it also form part of reserve tranche.

SDR

SDR has two dimensions. One, it is an exchange rate system and another it is a loan arrangement.

As an exchange rate system, the SDR is an average exchange rate derived from a basket of five currencies viz, US Dollar, Euro, UK Pound Sterling, Japanese Yen and Chinese Renminbi (RMB). In this system, these five currencies are assigned different weightage as per their importance in world economy and an exchange rate is derived which is called as SDR. The exchange rate of a country is expressed against SDR. For example; ₹30 = 1 SDR. You may see quota of India in IMF as SDR 4158.2 million (or something else if altered). Here India's quota is expressed in SDR, in place of Indian rupee or US Dollar.

As a loan arrangement, the member countries are entitled to get loan from IMF's Special Drawing Account. This loan amount is up to 200 per cent of the member's quota with IMF. It is also known as paper gold. In this arrangement IMF does not lend directly. It is the member countries, who are in strong position, lend their SDR holdings to member countries who are in Balance of Payment problem.

Foreign Exchange

Exchange Rate

It is the rate at which home currency is exchanged for one unit of foreign currency. For example ₹50 = US $1. M.L. Jhingan defines exchange rate as follow. "The foreign exchange rate or exchange rate is the rate at which one currency is exchanged for another. It is the price of one currency in terms of another currency". The exchange rate varies (either depreciates or appreciates) depending upon the demand for and supply of currencies.

Depreciation

Increase in the exchange rate i.e. fall in the external value of domestic currency because of additional demand for foreign currency (less supply of foreign currency) or excess supply of (less demand of) domestic currency is called depreciation.

For example,

On day one the exchange rate is ₹50 = US $1

On day two the exchange rate is ₹52 = US $1.

It refers to Rupee depreciation.

Appreciation

Fall in the exchange rate i.e increase in the external value of domestic currency, due to additional demand for home currency (or less supply of home currency) or less demand for (or more supply of) foreign currency is called Appreciation.

For example,

On day one the exchange rate is ₹50 = US $1

On day two the exchange rate is ₹48 = US $1.

It refers to Rupee appreciation.

Devaluation

Reduction in the external value of home currency is called Devaluation. For example, changing the exchange rate from ₹50 = US $1 to ₹75 = US $1 is called devaluation. Devaluation is aimed at increasing export of the country. It is usually resorted to correct the deficit in the balance of trade or current account balance.

How Export Increases

Both depreciation and devaluation helps to increase export. This can be clearly illustrated by the following example:

Consider price of rice per kg is ₹25, and consider that a foreigner wants to import rice from India. When the exchange rate is ₹50 = US

$1 with US $1 foreigner can import 2 kg of rice.

After devaluation i.e. ₹75 = US $1, with $1 the foreigner can import 3 kg of rice. It means rice is available at a cheaper rate. So, he will buy more rice. So export increases. Devaluation also increases the profit of the exporter. The reverse happens to import and hence the import will decrease.

For example, consider that a rice exporter earns ₹1 per kg as profit, before devaluation he earns ₹2 by exporting two kg and earn ₹3 after devaluation by exporting three kg. Opposite is the case with appreciation and revaluation.

Revaluation

Increase in the external value of currency is called Revaluation. For example changing the exchange rate from ₹50 = US $1 to ₹25 = US $1 is called revaluation. Revaluation is aimed at decreasing export of the country. It is usually resorted to correct the surplus in the balance of trade or current account balance. Surplus in the home country mean deficit for some other countries. To correct it, revaluation is carried out. It is very rarely done.

Note: While depreciation and appreciation takes place automatically due to movement in the demand and supply of currencies in the market, devaluation and revaluation are done voluntarily either by the government or monetary authority.

Purchasing Power Parity (PPP)

PPP, proposed by Gustav Cassel, is a method of determining exchange rate. Purchasing Power Parity refers to the equality of buying capacity. Based on the buying capacity (purchasing power) of respective currencies in their home country, the exchange rate is determined.

For example, if with ₹25 a bundle of goods can be purchased in India, which can be purchased by $1 in US, then exchange rate is ₹25 = US $1.

Converting Prevailing (BOP based) Exchange Rate into PPP

PPP exchange rate can be calculated from the prevailing exchange rate using price index of selected basket of commodities in two countries.

PPP exchange rate =Domestic price index of a basket of commodities/Foreign Price index of the same basket of commodities × Prevailing market exchange rate

= 25/50 × 50 = 25

The basket of commodities ought to be mix of both internationally traded goods and non-traded goods . The commodities chosen must be commonly used in all the countries whose purchasing power is compared.

Need for PPP

It is customary to compare level of development of different countries based on living standard of people. The standard of living is measured by proxy variable, namely per capita income. People in countries with high per capita income are considered to be enjoying high standard of living and such countries are considered developed countries. Later it was realised that standard of living is not in the amount of money they have but the amount of goods they can have with that money i. e. purchasing power of money.

To compare the income of the two countries, it is necessary to convert the income in different currencies into a single common currency. As of now, the common currency is US Dollar. The conversion is done with the help of trade based prevailing exchange rate. The trade based exchange rate does not reflect the true purchasing power of different currencies because all the goods needed are not traded. So, the trade based exchange rate fails to reflect the purchasing power of money to buy non-traded goods. Apart from that, the trade is not a free flowing one. It is subject to many manipulations and obstructions and so is the exchange rate. To overcome this problem, the PPP based exchange rate is used to convert the income of different currencies in to a common currency, namely US PPP$.

Apart from the above cited reasons, it is important to note that the price of goods and services in developed countries is very high compared to developing and less developed countries. It is like the difference in price of goods and services between urban and rural areas. It means, the purchasing power of money in developed countries is lower than that of developing and less developed countries. So, in developing and less developed countries, less money is enough to buy more goods than that is possible in developed countries. So, with less money they enjoy high standard of living.

The trade based exchange rate does not reflect this reality. So, the PPP based exchange rate is used to compare the standard of living of people and stage of development.

Take an example;

The per capita income of India is ₹400. The same in US dollar is $8 when trade based exchange rate is ₹50 = $1. The same in PPP based exchange rate is $16, if PPP based exchange rate is ₹25 = PPP US $1.

It is vivid that the PPP based exchange rate reflects higher standard of living than trade based exchange rate system.

It is important to note that the PPP$ is a unit of account and not a medium of exchange. It means the PPP$ can be used for measurement of income and cannot be used to purchase or sale of goods.

Convertibility

As said in the previous passages, exchange rate is not free market determined. It is subject to some restrictions like trade. Removing these restriction leads to convertibility.

Facility of exchanging domestic currency for foreign currency at market determined exchange rate without restriction on either rate or quantum of money exchanged is called convertibility.

The committee on fuller capital account convertibility observes as, "Currency convertibility refers to the freedom to convert the domestic currency into other internationally accepted currencies and vice versa. Convertibility in that sense is the obverse of controls or restrictions on currency transactions. While current account convertibility refers to freedom in respect of payments and transfers for current international transactions, capital account convertibility (CAC) would mean freedom of currency conversion in relation to capital transactions in terms of inflows and outflows."

Convertibility in India

The convertibility in India is a gradual one. Like other reforms it was also introduced in 1990s. Convertibility in current account was introduced first and then it was introduced in the capital account.

Current Account Convertibility

Current account convertibility refers to the freedom of converting home currency into foreign currency with respect to transactions in current account.

Budget 1992–93 introduced Liberalized Exchange Rate Management System (LERMS). In this system, 60 per cent of foreign exchange earnings are convertible at open market rate, and remaining 40 per cent at RBI fixed rate.

In 1993–94, government introduced full convertibility in trade account.

In 1994–95 budget, full convertibility in current account was introduced. But this was not satisfactory to the IMF. So government introduced further relaxations in August 1994. India got affiliation to the Article VIII of IMF.

Capital Account Convertibility

Capital account convertibility means the freedom to convert home currency into foreign currency regarding transactions in capital account.

The committee on fuller capital account convertibility observed as follows: "For the purpose of this committee, the working definition of CAC would be as follows: CAC refers to the freedom to convert local financial assets into foreign financial assets and vice versa. It is associated with changes of ownership in foreign/domestic financial assets and liabilities and embodies the creation and liquidation of claims on, or by, the rest of the world. CAC can be, and is, coexistent with restrictions other than on external payments."

Fuller capital account convertibility does not mean 100 per cent freedom. There will be some restrictions. That is why committee on fuller capital account convertibility observed as above.

To bring capital account convertibility, the Government of India formed Capital Account Convertibility Committee – 1 (1996) and Committee on Fuller Capital Account Convertibility II (2006).

Capital Account Convertibility Committee

This committee was formed under the chairmanship of S.S. Tarapore the then deputy governor of RBI. It gave green signal to introduce Capital Account Convertibility. It recommended the introduction of CAC in a phased manner throughout the period of 1997–2000.

Government accepted it but, the East Asian crisis halted its implementation.

Committee on Fuller Capital Account Convertibility II

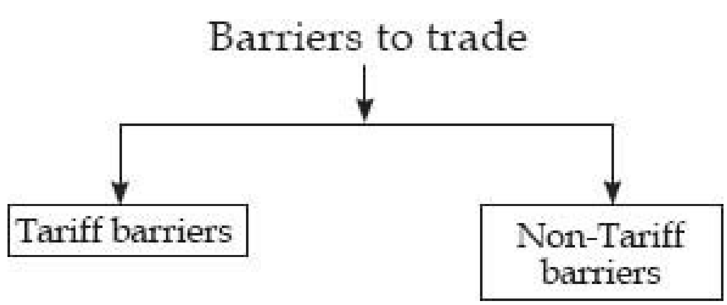
After a decade, another committee was formed, again under the chairmanship of S.S. Tarapore in 2006. This time also, its approach was the same.

It recommended capital account convertibility implementation in a phased manner, in three phases from 2006 to 2011.

Barriers to Trade

The policy instruments which obstruct trade are called as barriers to trade. They are of two types namely, tariff barriers and non-tariff barriers as shown in the following figure 11.1.

Figure 11.1



Tariff Barriers

Tariff refers to the duty on import and export of goods. M.L. Jhingan observes "But for practical purposes, a tariff is synonymous with import duties or custom duties".

The reason for imposing tariff on import and export is different. The tariff on import is to make the price of imported goods equal to domestic goods. It increases the price of imported goods. So import is discouraged. If it is imposed on export goods its aim is to discourage export and make the goods available in domestic market which otherwise may be exported. The common purpose for tariff on import and export is to generate resource for government.

If tariff obstructs free flow of trade, it is called tariff barrier.

Non-Tariff Barriers

The instruments and executive operations that obstruct free flow of trade other than tariff is called non-tariff barriers. "Non-Tariff Barriers (NTBs) are obstacles to imports other than tariffs. They are administrative measures that are imposed by a domestic government to discriminate against foreign goods in favour of domestic goods." M.L Jhingan observes.

The major non-tariff barriers are explained below:

a. Quota

It fixes a limit on the amount of trade that can take place. In this system only a fixed quantity is allowed to be exported to any country and imported from any country.

b. Production Subsidies

Production subsidies are given by government to producers of exportable goods for the production of goods and services. They are in the form of raw materials at low cost, credit at low interest rates, tax concessions, etc.

c. Export Subsidies

Export subsidies are given in the post production stage. They are in the form of transport subsidies and low cost shipment credits.

d. Health, Sanitary & Safety Regulations

It refers to import restrictions on health and safety grounds. The countries that want to restrict import fix higher level of norms. The norms include, for example, the residue of pesticides in food products, level of germs etc.

e. Packaging Requirements

By fixing packaging requirements, high restriction is imposed on trade. The standards push up the cost of product. So the import comes down. Sometimes, the cost of packaging exceeds the cost of product because of higher packaging requirement.

Economic Integration

Economic integration refers to the cooperation that exists between countries in the trade and other economic front such as investment, monetary policy, etc. The level of integration varies between countries. On the basis of level of integration, there are various names for it. Though it is difficult to differentiate them, it is explained in the following passage.

Preferential Trade Agreement (PTA)

It is an agreement between two or more countries where the agreeing parties reduce the level of tariff imposed on traded goods among themselves. It is the first level of economic integration. The aim is to bring down the level of tariff and thereby increase the flow of trade. The parties to the agreement maintain their own tariff level with third parties.

Free Trade Agreement / Area (FTA)

Free trade agreement/area is an improved level of economic integration compared to preferential trade agreement. In this arrangement, the parties involved in the agreement abolish tariff on most of the goods and services and keep tariff on some items at a minimal level. Some goods which are identified as “sensitive goods” are continued to be traded at existing tariff level.

In recent times, the free trade agreement is called with different names. They are: comprehensive economic cooperation agreement, comprehensive partnership agreement and economic cooperation framework agreement. But all of them are in the nature of Free Trade Agreement. It is evident from the following comment made by *Korea Joongang Daily* on India Korea Comprehensive Economic Partnership Agreement: “The agreement, which got its unusual name at the request of the Indian side, is equivalent to a free trade agreement”[6]. But it cannot be refuted that there are some variations in all these agreements. These agreements cover foreign investment front apart from trade and services.

In this arrangement also, the parties to the agreement follow their own independent trade relation with third parties.

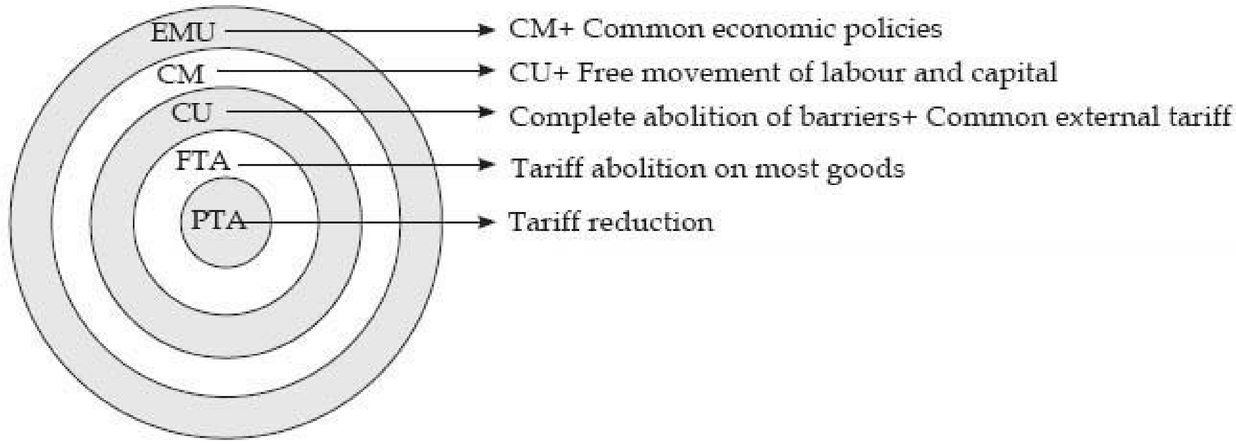
Customs Union (CU)

It is a still higher level of integration. In this, the member countries abolish barrier to trade and service among them, and as a whole, they maintain a common tariff against third parties.

Common Market (CM)

In addition to provisions of customs union, a free flow of labour and capital is also allowed in common market.

Figure 11.2



Economic and Monetary Union (EMU)

In this arrangement, in addition to common market's provision, the monetary and fiscal policies are harmonised among member countries. Common currency is an important feature of this union.

All the above economic integrations are illustrated in figure 11.2.

Related Terms

Comparative Advantage

Comparative advantage theory says that a country has to produce and export the goods in which it has comparative advantage.

Let us see comparative advantage with an example. In the example, the theory is explained with slight modification without affecting the essence of the theory.

Assume that India and Bangladesh produce rice and wheat. In India, the cost of production of one kg rice is ₹25 and cost of production of wheat is ₹60, and in Bangladesh the cost of production of rice is ₹50 and of wheat is ₹75. It is tabulated in table 11.2.

Table 11.2: Cost of production

Produce	Cost of production in ₹	
	India	Bangladesh
Rice	25	50
Wheat	60	75

In both products, India has advantage compared to Bangladesh because both rice and wheat are cheaper in India. In case of rice, the cost of production in India is 50 per cent of Bangladesh's cost of production. But in case of wheat, India's cost of production is 80 per cent of Bangladesh's cost of production. It means, India has comparatively more advantage in rice production than that of wheat production. So, India has to specialise in rice production.

From Bangladesh's point of view, in the case of rice, the cost of production is 100 per cent more than that of India. But, in the case of wheat the cost of production is only 25 per cent more than that of India. So, though Bangladesh has disadvantage in both products, it has comparatively less disadvantage in production of wheat. So, Bangladesh has to specialise in wheat production.

Before external trade i.e. export, within India, with 1 kg of rice, a buyer can purchase only 0.41 kg of wheat (60/25 = 0.41). In Bangladesh, with 1 kg of wheat, a buyer can purchase only 1.5 kg of rice (75/50 =1.5).

Suppose, they enter into trade after specialistion and fix price at 1 kg of rice equal to 0.60 kg of wheat. In terms of wheat the price is 1 kg of wheat equal to 1.66 kg of rice.

By exporting 1 kg of rice, India can get 0.60 kg of wheat, i.e 0.19 kg more than what it would have got in internal trade. Bangladesh, with 1 kg of wheat, can get 1.66 kg of rice i.e., 0.16 kg more than what it would have got in internal trade. So, external trade benefits both.

Rule of Origin

It is a term used in all trade agreements. It is aimed at preventing third parties from routing their products through member countries to take advantage of low tariff and allowing only goods that are originated from parties to the agreement. Rule of origin is usually determined by two criteria namely, i) value addition or local content requirement and ii) change of tariff heading at four digit level.

Value addition requirements stipulate that the goods which are not fully originated from the partner countries should have a value addition in terms of raw material, labour cost etc, as agreed by the member countries, usually of 30 per cent.

Tariff heading represents the code assigned to various products under Harmonised Commodity Description and Coding System of World Customs Union which is called as Harmonised Coding System. The first four digits of the code are called Heading. The subsequent digits are called as subheading. Change of tariff heading means, a product that does not originate from a country should be codified in different heading when exported, i.e., a product should be converted into another product. For example, the code of live bovine animals is 0102. To be exported, it may be processed and converted as frozen meat of bovine animals, for which code is 0202.

Debt Service Ratio

The amount of a country's debt service (repayment of principal and interest) as a ratio of its total export earning is called Debt Service Ratio. It can be written in formulaic form as follows:

Debt service ratio = Debt service / Total export earning

NEER and REER

NEER stands for Nominal Effective Exchange Rate and REER stands for Real Effective Exchange Rate. Usually the exchange rate is determined for a domestic currency against a single foreign currency. The effective exchange rate (EER) is fixed against a basket of currencies. For NEER and REER the basket is SDR currencies.

The REER is arrived from NEER the way real GDP arrived from nominal GDP after correcting it for price change.

NEER = Domestic currency exchange rate in terms of SDR/ Foreign Currency exchange rate in terms of SDR

REER = NEER × Domestic price index / Foreign price index

The price index is CPI (combined). The way it is calculated by the basket of SDR currencies there are two other EERs. One is based on top six trading partners' currencies and another is based on next 36 top trading partners' currencies.

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1 The contents of this part is based on Balance of Payments Manual for India, September 2010, RBI

2 M.L. Jhingan International Economics

3 Net means the difference between inward flow and outward flow.

4 LIBOR stands for London Interbank Offer Rate. It refers to the interest rate in the London call money market.

5 Swap is a common arrangement for exchanging one with another in financial market instruments like debt, share, etc. Exchange can be between shares, between debentures, etc. Here SWAP is the exchange of loan in one currency to loan another currency. The interest rate difference between these loans is called SWAP rate, generally as SWAP. http://www.swap-rates.com/Definitions. html observes as, "Swap is a debit or credit paid or earned as a reflection of the varying interest rates applicable to currency pairs. When trading the USD for example, swap rates will be determined based on the interest rates of the countries being represented by this pair. Depending on whether you are long or short and which country has higher interest rates, you may be charged or credited interest. Essentially, when a trader holds a position over night they are subject to the interest rates applicable to the currency pair they are trading. 'Swap' is also commonly referred to as 'rollover rates'."

6 India to sign deal next week July 31 2009, *Joongang daily*

CHAPTER 12 World Trade Organisation (WTO)

WTO is an international organisation established to promote multilateral trade. It is the successor to the erstwhile GATT (General Agreement on Tariffs and Trade). It came into force on January 1, 1995 and has played a pivotal role in facilitating international trade.

This chapter covers formation of WTO, principles and structure of WTO and agreements of WTO.

From GATT to WTO

GATT is a forum for international trade. Actually, it was intended to be established as an organisation (International Trade Organisation) but the US Parliament refused to accede to it. So, it came into force, as an agreement short of an institution, in 1947.

It was established with an aim to ensure free trade among world countries by way of reduction of tariff and other barriers to trade. Under the aegis of GATT, eight rounds of negotiations were held between 1986 and 1994 among members, to ensure free trade. The last one was the Uruguay round.

The Uruguay round included the service trade, intellectual property rights, textiles and agriculture in its negotiation. As a result of conclusion of Uruguay Round (8th round), WTO has been established. This brought many amendments to GATT. This amended version now forms the basis for WTO.

Principles of WTO

The two main principles of WTO are Most Favoured Nation (MFN) and National Treatment (NT).

The principle of MFN calls the member countries to treat all nations on equal footing in the policies concerning import and export of goods and services. The principle of National Treatment calls to treat imported goods and services equal to domestic goods and services in domestic sale and consumption.

Structure of WTO

Ministerial Conference is the top level decision making body. It meets once in two years. The trade and commerce ministers, by whatever name called in member countries, form this council.

Next is the General Council. It is functioning under the Ministerial Conference. The ambassadors or other representatives appointed by member countries constitute this council. The General Council also acts as **Dispute Settlement Body (DSB)** and Trade Policy Review Body. It meets many times in a year as and when required. As a DSB, it helps the member countries in solving their disputes arising out of trade. It also reviews the trade policies adopted by member countries to check if they are compatible with WTO's agreements and their impact on trade.

The Council for Trade in Goods is called Goods Council. It looks after the working of GATT agreement. The Council for Trade in Service is called Service Council. It looks after implementation of General Agreement on Trade in Services (GATS).TRIPS Council looks after issues related with Trade Related Aspects of Intellectual Property Rights (TRIPS) Agreement implementation. Apart from this, there are many working committees and working groups that enable smooth functioning of WTO and its agreements.

Agreements

As a result of the Uruguay round 20 agreements were signed. Here, we are going to have a look about few important agreements - the WTO agreement, Agreement on Agriculture (AoA), Trade Related Aspects of Intellectual Property Rights (TRIPS), Trade Related Aspects of Investment Measures (TRIMS), General Agreement on Trade in Services (GATS)

1. WTO Agreement

The WTO was established under this agreement. It is an umbrella agreement. Other agreements are annex to this agreement. The latest agreement added to the annex is Trade Facilitation agreement.

2. Agreement on Agriculture (AoA)

Agreement on Agriculture calls for freeing agriculture trade. The commitments under this agreement are based on Special and Differential treatment. **Special and Differential treatment** means flexible and lesser commitment on the part of developing and less developed countries compared to developed countries in fulfilling the obligation under this agreement. This agreement also has special safeguard mechanism. **Special safeguard mechanism** means, the optionavailable to countries to impose additional duties on imported products when there is surge in imports or products are imported at lower price. The main components of this agreement are Market access, Domestic support or Domestic subsidies and Export subsidies.

Market Access

Market access provision calls for provision of access to imported agricultural goods in the member countries. There are two provisions. One is tariffication and tariff reduction and the another is minimum market access.

Tariffication means converting non tariff barriers into tariffs that ensures same level of protection. Tariff reduction calls for 36 per cent tariff reduction by developed countries over 6 years period and 24 per cent by developing countries over the period of 10 years. The least developed countries do not have any commitments.

Minimum access calls for at least a minimum of 5 per cent of imported agriculture products in domestic consumption by the year 2000 in developed countries and 2004 in developing countries. The less developed countries are exempted from this obligation.

Domestic Support or Domestic Subsidies

This provision calls for reduction of domestic subsidies that result in lower price of exported products and distort free trade. These subsidies are called **Amber Box subsidies.**

Under this provision, the Aggregate Measurement of Support (AMS) is to be reduced by 20 per cent over a period of six years by developed countries and 13 per cent over a period of 10 years by developing countries over the base period of 1986-88.

Aggregate Measurement of Support stands for the total of product specific subsidies and non-product specific subsidies provided by a country in a year. Product specific subsidies are subsidies given to particular product.

For example, cotton, rice, etc. Non-product specific subsidies are subsidies given in general and not specific to any product, say fertiliser subsidies that benefit all agricultural products.

In the calculation of AMS, the subsidies are not included when the support is within the de-minimis[1] level. **De-minimis** level here refers to the minimum level prescribed by AoA. The de-minimis level for developed countries in case of product specific subsidies is 5 per cent of total value of that particular product produced in a year, for developing countries it is 10 per cent. For non-product specific subsidies, it is 5 per cent of total value of all agricultural products produced in that country in a year for developed countries and 10 per cent for developing countries.

Apart from de-minimis subsidies, following three categories of subsidies are also not included in the calculation of AMS. They are: Green box subsidies, Special and Differential treatment box (S&D Box) subsidies and Blue box subsidies.

Green Box Subsidies

Green box subsidies are those subsidies which don't distort or distort the free trade or production very minimally. The Annex 2 to AoA observes "Domestic support measures for which exemption from the reduction commitments is claimed shall meet the fundamental requirement that they have no, or at most minimal, trade-distorting effects or effects on production."[2]

These supports shall be provided through publicly funded government programme and these supports shall not provide price support to the producer. The examples of these kinds of supports are expenditure on agricultural research, training and pest control, etc.

Special and Differential Treatment Box (S&D Box) Subsidies

The assistance which is essential for rural development and uplift of poor farmers are called S&D box subsidies. While Green box subsidies are available to all countries, Special and Differential treatment box subsidies are not available to developed countries. These subsidies are government assistance to encourage agricultural and rural development which is in the nature of rural development programmes of developing countries, agricultural investments subsidies which are generally available to low- income or resource poor producers in developing countries.

Blue Box Subsidies

Blue box subsidies are direct payments under production limiting programmes.

Export Subsidies

The subsidies that subsidise export are called export subsidies. These are direct subsidies given by government or government agencies either in cash or in kind to producers of agriculture products against export performance and export of non- commercial agricultural product at lower price and transport subsidies, etc.

The developed member countries have to reduce subsidised export in value terms by 36 per cent and in terms of volume by 21 per cent over a period of 6 years below the level of 1986-90. For developing countries, it is 24 per cent and 14 per cent respectively over a period of 10 years.

3. Agreement on the Application of Sanitary and Phytosanitary Measures

This agreement sets basic rule to ensure food safety and life/health of plant and animals in member countries. Under this agreement member countries are allowed to set health and hygienic standards of imported products. The standards set should be non-discriminatory, scientifically justifiable and to the extent required and not prohibitive in nature.

4. Trade Related Intellectual Property Rights (TRIPS)

Intellectual properties are knowledge oriented creations, inventions and innovations. The WIPO (World Intellectual Property Organisation) observes as: “Intellectual property (IP) refers to creations of the mind: inventions, literary and artistic works, and symbols, names, images, and designs used in commerce”[3]. The intellectual property rights refer to the recognised ownership of the intellectual property to creator, inventor and innovator. The ownership is ensured through copyrights, patents, etc. TRIPS cover copyright and related rights, trademarks including service marks, geographical indictors, industrial designs, patents, lay out designs (topographies) of integrated circuits, trade secrets.

Copyright

Copyright is related with literary and artistic works like books, lectures, sermons, music etc. The copyright refers to the right conferred on creator, author and producer etc. These rights are protection rights and authorisation rights. The protection right signifies the right of the author to protect his work from being copied by others. The authorisation right denotes the right of author to allow others to reproduce, copy etc., against which he can claim pecuniary benefit.

Trademark

Trademark refers to the symbols that give unique identity to products of particular producer. The Trademarks Act 1999 observes as follows ““trademark” means, a mark capable of being represented graphically and which is capable of distinguishing the goods or services of one person from those of others and may include shape of goods, their packaging and combination of colours”[4]

If trademark rights are conferred to any one, others are prevented from copying or using of that trademark.

Geographical Indicator

Geographical indicator denotes the unique identity attached to a particular product for the reason that particular product is produced in a particular geographical location. It may be a natural product or man made product. For example, Banaras silk sarees, Coimbatore wet grinder, etc.

The Geographical Indications of Goods (registration and protection) Act, 1999 observes "geographical indication", in relation to goods, means an indication which identifies such goods as agricultural goods, natural goods or manufactured goods as originating, or manufactured in the territory of a country, or a region or locality in that territory, where a given quality, reputation or other characteristic of such goods is essentially attributable to its geographical origin and in case where such goods are manufactured goods one of the activities of either the production or of processing or preparation of the goods concerned takes place in such territory, region or locality, as the case may be"[5].

If geographical indication is given to any product others cannot use that name. For example, if Banaras silk saree is conferred with geographical indication, others can also produce silk sarees but cannot claim that their saree is Banaras silk saree.

Industrial Designs

Designs when recognised, as it belongs to anybody, cannot be used by others. The Designs Act, 2000 observes "design" denotes only the features of shape, configuration, pattern, ornament or composition of lines or colours applied to any article whether in two dimensional or three dimensional or in both forms, by any industrial process or means, whether manual, mechanical or chemical, separate or combined, which in the finished article appeal to and are judged solely by the eye"[6].

Patents

Patent is recognition of invention and conferment of certain exclusive rights to inventor. The **exclusive right** here refers to the right for production and marketing only by inventor and, if he wishes, to authorise others to produce the product using the invention made by him.

Patents are of two types namely Product patent and Process patent. **Product patent** is the right to produce the product and right to authorise others to produce that particular product that is available only to inventor. Others cannot produce that product without authorisation. **Process patent** means, the inventor has sole right regarding the processing method and not for the product. Others can produce the product using different processing method.

Topographical Design (Integrated Circuit Layout Design)

Layout design means design of integrated circuits, transistors and other circuits. If recognised and if the right is conferred to designer, others cannot reproduce it, import it or distribute it.

Trade Secret

Trade secret refers to the information regarding process, formula, etc. The WIPO observes "Broadly speaking, any confidential business information which provides an enterprise a competitive edge may be considered a trade secret. Trade secrets encompass manufacturing or industrial secrets and commercial secrets"[7]. For example, a company may use an efficient method of production that leads to cost reduction. It is a trade secret.

5. Trade Related Aspects of Investment Measures

(TRIMS)

TRIMS are essentially to promote investment and equality among countries in the sphere of foreign investments. It calls for countries to avoid unnecessary conditions attached with foreign investments like employment opportunities for local people, limit to imported contents of products produced, etc.

6. General Agreement on Trade in Services (GATS)

GATS call for liberalisation of trade in service sector. This is counterpart of GATT which covers merchandise trade. This agreement covers only commercial service excluding air transport service and excludes government services which are not in the commercial nature. The services are classified into four modes.

Mode 1 (Cross border supply): Cross border supply is the export of service across border from domestic country like BPO and banking services through e- media, etc.

Mode 2 (Consumption abroad): Consumption abroad refers to the services availed by citizens of one country in another country like foreign tour, medical treatment in foreign country, study abroad etc.

Mode 3 (Commercial presence): It denotes the commercial establishments that provide service in foreign country by establishing subsidiary or holding company in foreign country.

Mode 4 (Movement of Natural Persons): It signifies the services provided by professionals like Doctors, Accountants, and Lawyers, etc with their physical presence abroad.

This agreement calls for non-discriminatory non-prohibitory and transparent policies related to service trade. This also calls for minimum market access as agreed by member countries.

7. Trade Facilitation Agreement

The Trade Facilitation Agreement contains provisions for expediting the movement, release and clearance of goods, including goods in transit. It also sets out measures for effective cooperation between customs and other appropriate authorities on trade facilitation and customs compliance issues. It further contains provisions for technical assistance and capacity building in this area. This agreement was concluded in December 2013, at the Bali Ministerial Conference. The Trade Facilitation Agreement entered into force from February 22, 2017 as two-thirds of members have completed their domestic ratification process.[8]

WTO Rounds

WTO was born out of the Uruguay round of negotiation as said at the outset. Under WTO, a new round of negotiation was started and named as Doha Round. This fresh round actually started in the year 2001 but declaration and decisions were made in the Doha ministerial conference and named after Doha as the Doha development round. This round is continuing. This round is concerned with implementation of agreements made in the Uruguay round of negotiation. It covers a whole range of issues from agriculture to e-commerce.

Related Terms

Peace Clause

The Agreement on Agriculture (AoA) has a clause under Article 13 of AoA. This clause restrains other countries from taking counter measure against some of the subsidies given like Green Box Subsidies. This clause also calls for due restraint in taking action against export subsidies and product specific subsidies.

Swiss Formula

Swiss formula gives the rate of tariff reduction. It calls for higher rate of reduction for countries which have higher initial tariff and lower rate for countries which have lower initial tariff. For example, a country with 60 per cent tariff has to reduce its tariff at a higher rate than a country with 30 per cent. It means, the former has to reduce its tariff speedily.

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1 *De-minimis* means 'of little or small importance'
2 http://www.wto.org/english/docs_e/ legal_e/14-ag.pdf
3 http://www.wipo.int/about-ip/en/
4 http://ipindia.nic.in/tmr_new/tmr_act_rules/ tmr_act.pdf
5 http://ipindia.nic.in/ipr/gi/gi_act.PDF
6 http://ipindia.nic.in/ipr/design/design_act. PDF
7 http://www.wipo.int/sme/en/ip_business/ trade_secrets/trade_secrets.htm
8 https://www.wto.org/english/tratop_e/ tradfa_e/tradfa_e.htm

Further Readings

Yes, this book is an 'appetiser' for Indian Economy. It explains the very basic concepts related to Indian Economy. The intention is to help beginners. Having said that, the question now arises, yes, I started off with this book, what to read further? There are 'n' number of sources to read. The first and foremost which readily comes to the mind of everyone is internet. But, the internet is loaded with umpteen number of materials, far and wide. Finding the most relevant information we need is a tough task. So, I thought to give some ready reference for you, both from the internet as well as printed material. Of course, the following are only suggestions with the intent to increase your understanding of Indian economy better. These are starters for Indian economy. Therefore, if you are preparing for competitive exams, you can stop reading these starters for the time being as you may run short of time. For that purpose, you can go for books which throw critical analysis and opinions (which are suggested in the last part of this suggestion) as the main course of your meal.

Starters

For national income, read Press note, New series estimates of national income, Consumption expenditure, saving and capital formation (base year 2011-12) , dated 30.01.2015 of Ministry of Statistics and Programme Implementation, Government of India. Available at http://mospi.nic.in/Mospi_New/upload/nad_press_release_30jan15.

For chapter on Human Development read Human Development Report 2010 or any subsequent year. It is available at http://www.undp.org/content/undp/en/home/librarypage/hdr/hu (Navigation: UNDP.org >> Home >> Research & Publication >> Human Development Reports)

To know further about Poverty and Unemployment and some other socio economic concepts which are not covered in this book, read e-book Concepts and Definitions Used in NSS, available at http://mospi.nic.in/Mospi_New/upload/nsso/concepts_golden.pdf? status=1&menu_id=49 (Navigation: mospi.nic.in >> Home >> National Sample Survey Office >> Survey Design and Research div. >> Major NSS concepts >> Concepts and Definitions used in NSS) and Report of The Expert Group to Review the Methodology for Estimation of Poverty available at http://planningcommission.nic.in/eg_poverty.htm(Navigation Planning commission.nic.in >> Home >> Reports >> General Reports). To enrich your knowledge on Indian Financial System, read e - books published on the occasion of Platinum Jubilee celebration of RBI – Brochure explaining RBI's Role and Functions in brief and Reserve Bank of India: Functions and working. Both the books flow on the same line but the first one deals with the functions of RBI briefly and the later one deals elaborately. These are available at http://www.rbi.org.in/scripts/AboutusDisplay.aspx(Navigation rbi.org.in>> Home >>About us).

For Money Stock Measures in India, refer to Report of Working group on 'Money Supply: Analytics and Methodology of Compilation' and an article named New MonetaryAggregation: An introduction, RBI Bulletin October 1999.

For Chapter on Inflation and Deflation, read manual on Compilation of Wholesale Prices in India available at http://eaindustry.nic.in/WPI_Manual.html and WPI compilation Manual available at http://eaindustry.nic.in/WPI_Manual.pdf (Navigation eaindustry.nic.in >> Home >> WPI compilation Manual) and Manual on Consumer Price Index available http://mospi.nic.in/mospi_new/upload/manual_cpi_2010.pdf. (Navigation: mospi.nic.in Home >> Central Statistics Office >> Statistical Manuals).

To know more about the concepts related to Balance of Payments read Balance of Payments Manual For India http://www.rbi.org.in/scripts/Occasional Publications.aspx?head=Balance%20of%20Payments%20Manual%20for%20India (Navigation: rbi.org.in >> Home>> Publications >> Occasional)

There are some sources on Indian economy which are not topic specific. ET in the class room, published in Economic Times which comes in question and answer format helps in better understanding of concepts especially new emerging concepts. *Oxford Companion to Economics in India* edited by Kaushik Basu is an encyclopedia on Indian economy. It is a collection of many articles written on various issues related to the Indian economy. It gives factual as well as conceptual clarity. Arthapedia is an authentic source for basic concepts. It is a portal for facilitating understanding of the Indian Economy and its governance by explaining the concepts used in the economic policy domain in India. This portal is managed by government economists of India (known as Indian Economic Service (IES) Officers) and is intended to cater to the requirements of their counterparts in other countries as well as to academicians, economists, policy practitioners, financial journalists, students and to any interested citizen, both within the country and abroad.

Main Course

For the main course of your Indian Economy, read the following book or books. The book, *Indian Economy Performance and Policies* authored by Deepashree published by Ane Books Pvt Ltd is a simple book. In fact, itis written for B.Com Final year students of Delhi University. Students of need to have an overall view of Indian economy and must constantly update themselves by reading current issues.From that angle, this book is enough.

Indian Economy by Misra and Puri is still a higher level book. It has very good readability. *Indian Economy* by Ruddar Datt and K.P.M Sundaram is for ultimate readers. It is a wonderful book, as it critically analyses Indian Economy threadbare with credible data. It is, of course, a sociopolitical and economy reader on India. Though it has biased opinion in some of the areas, it is undoubtedly a comprehensive book on Indian economy.

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