PRRC 2023

Economics

(Class Handouts)

ForumIAS

PRRC Economic Lecture #1

National Income Accounting

- set of rules and techniques that are used to measure the economic activity of a country during a given period.
- Provides conceptual framework to measure GDP, GNP etc.

Types of economic system

- Resources are scarce/limited. Resources can be put to alternative/competing usages. This gives us the problem of choices on how to use the resources.
- Every country/nation faces three fundamental problems
    - What to produce?
    - How to Produce?
    - Whom to Produce?
- We have 3 types of economic system
    - Capitalism / Market Economy
    - Socialism / Command Economy
    - Mixed Economy

S.No.	Features	Capitalism	Socialism	Mixedism
1	Ownership of Means of Production	Private Ownership	Public Ownership	Private Ownership and Public Ownership
2	Economic Motive	Profit	Social Welfare	Social Welfare and Profit Motive
3	Solution of Central Problems	Free Market System	Central Planning System	Central Planning System and Free Market System
4	Government Role	Interanal Regulation only	Complete Involvement	Limited Role
5	Income Distribution	Unequal	Equal	Less unequal
6	Nature of Enterprise	Private Enterprise	Government Enterprise	Both Private and State Enterprises
7	Economic Freedom	Complete Freedom	Lack of Freedom	Limited Freedom
8	Major Problem	Inequality	Inefficiency	Inequality and Ineffiency

Four Factors of Production

- Land (raw material) - Natural resource such as land, water, minerals, etc. The return for the natural resources is called "**Rent**".
- Labour - human labour which may be physical or mental i.e. it can be unskilled, semi-skilled or skilled. When a human being provides his labour to the enterprise, in return he/she expects "**wages**"
- Capital – Physical capital such as building, machinery, equipment & Financial capital (money). The return for capital is called "**Interest**"

- Entrepreneur – Person starting an enterprise by bringing together land, labour and capital. The return for entrepreneur is called "**profit**"

Types of Goods

- Intermediate Goods – used as input in further production. Eg – steel sheets, cotton yarn etc.
- Final Goods – meant for final use. Will not undergo any further transformation in production process. They are of two types:
  - Consumption Goods - consumed by the ultimate consumers. Eg – clothing, food etc
  - Capital goods – durable goods (tools, implements, machines etc.) used in further production of commodities. They themselves don't get transformed in production process.

- **Normal Goods**
  - The normal goods is one whose demand increases with rise in consumer income and demand decreases with decline in consumer income.
  - a consumer's demand for a normal good moves in the same direction as the income of the consumer
  - e.g. - electronics goods, organic food, clothes etc.
- **Inferior goods**
  - As the income of the consumer increases, the demand for an inferior good falls, and as the income decreases, the demand for an inferior good rises.
  - Examples of inferior goods include low quality food items like coarse cereals.
- **Veblen Goods**
  - A Veblen good is a good for which demand increases as the price increases.
  - Luxury goods, status symbol
  - e.g. - swiss wrist watches, wines, designer handbag, iphones etc.
  - They do not follow law of demand
- **Giffen Goods**
  - low income, non-luxury product for which demand increases as the price increases and vice versa
  - Poor man's good
  - Demand for Giffen goods is heavily influenced by a lack of close substitutes and income pressures.

Four Sectors of Economy

- Private Sector
- Government Sector
- Household Sector
- External Sector

Circular Flow of Income in economy

- It describes the movement of goods or services and income among the different sectors of the economy

ForumIAS

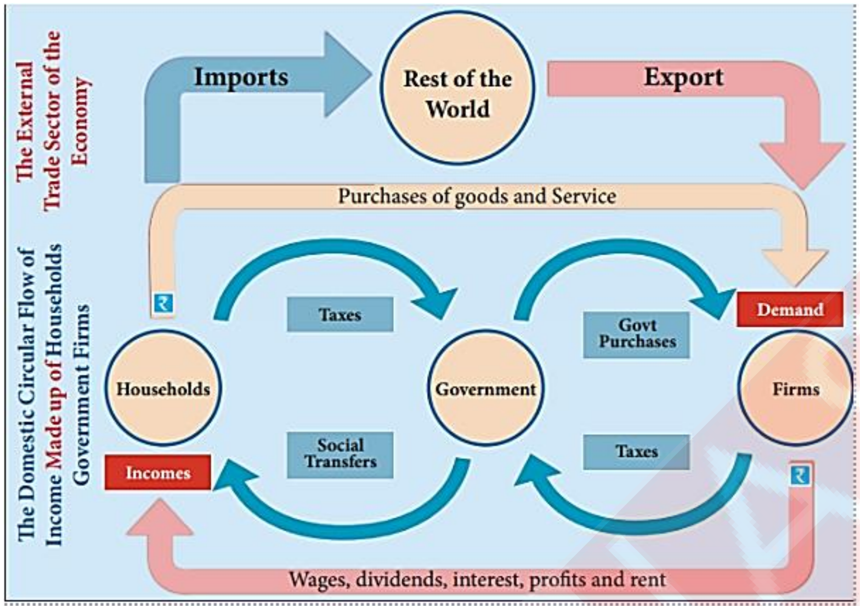


Fig – Circular Flow of Income in four sector economy

Methods of Measuring National Income

There are three methods that are used to measure National Income:

1. Production Method (Value added Method)
   - In this method, money value of aggregate output from all sectors of an economy in an year is calculated.
   - Value added by firm = value of production of the firm – value of intermediate goods used by the firm
   - Items not included in calculation – intermediate goods which are consumed in production process to avoid double accounting.
   - Items to be included – Production for Self-Consumption (consumption of self produced food grains by farmers)
2. Income method (Factor earning Method)
   - In this method, national income is calculated by adding up all the incomes (payment made to factors of production) generated in the course of producing national product.
   - It includes – Rent (land), Wages (labour), Interest (capital) & Profits (Enterpreneur)
   - Items not included in calculation – Transfer Payments, second hand goods, windfall gains such as lotteries, illegal income or black money.
   - Items to be included - Imputed value of rent for self occupied houses or offices is to be included.
3. Expenditure Method
   - In this method, GDP is calculated by adding spending done by four sectors of economy in purchasing goods and services.
   - GDP = C + G + I + (X-M)
     - C = Private Final consumption expenditure (by households)
     - G = Government Final consumption expenditure (by govt)
     - I = Private Investment Expenditure
     - X = Exports, M = Imports

- Items not included in calculation
    - o Second hand goods
    - o Purchase of shares and bonds in secondary market
    - o Transfer Payments
    - o Expenditure on intermediate goods

Few Concepts

- Factor Price & Market Price
    - Factor Price - Total cost of all factors of production (such as labour, capital, land etc.) used in producing goods or services. It is the price of the commodity from the producers side. It includes government subsidies.
    - Market Price – It is the price at which a product is sold in the market. It includes the cost of production in the form of wages, rent, interest, input prices, profit etc. It also includes the taxes imposed by the government. It excludes Government subsidy.
    - Market Price = Factor Price + Indirect Taxes – Subsidies
- Gross Vs Net
    - Factors of production undergo wear and tear (reduction in value of asset over time). This wear and tear is called Depreciation. A part of capital is used for this wear and tear which is not used in production of goods and services
    - Gross – Depreciation = Net
    - e.g. GDP – Depreciation = NDP

Various Macroeconomic Aggregates

- Gross Domestic Product (GDP)
    - GDP is the **total market value** of all the **final goods and services** produced **within the domestic territory of a country** for a given time period, normally a year.
        - Only 'final' goods and services (and not intermediate goods) are included in the calculation of GDP.
        - Domestic Territory of a country
            - political frontiers of the country including its territorial waters, ships, aircrafts, fishing vessels operated by the residents of the country, embassies and consulates located abroad etc.

Nominal GDP

- total market value of all the final goods and services produced within a country in a given period using that year's prices (also called "current prices").
- Nominal GDP at current prices = Final goods and services produced in an year * Prices of goods and services in that year
- It measures growth in value (quantity and price both)

Real GDP

- total market value of all the final goods and services produced within a country in a given period (Current year) using Base year's prices (also called "constant prices").
- It is inflation adjusted GDP
- It truly reflects the real change in physical output of a country

Potential GDP

- It is the real value of goods and services that can be produced when a country's factors of production are 'fully employed'.

- It is the maximum sustainable level of output that an economy can produce. When an economy is operating at its potential (trend), there are high levels of utilization of the labour force and the capital stock.

- Gross National Product (GNP)
    - GNP is the total market value of all the finished goods and services produced by the country's residents, irrespective of their location.
    - It measures the output/earnings made by Indian residents only whether in India or abroad. It does not include output/earnings made by foreign residents in India
    - GNP = GDP + Net Factor Income from abroad (NFIA)
        - NFIA = income earned by the domestic factors of production employed in the rest of the world – Factor income earned by the factors of production of the rest of the world employed in the domestic economy.
- Net National Product (NNP)
    - Factors of production under go wear and tear. This wear and tear is called Depreciation. A part of capital is used for this wear and tear which is not used in production of goods and services.
    - Net National Product (NNP) = Gross National Product (GNP) – Depreciation
    - NNP (@Factor Cost) = NNP (@Market Price) – Taxes + Subsidies
- Personal Income
    - Personal Income is the part of National Income which is received by the households.
    - Personal income (PI) ≡ NI – Undistributed profits – Net interest payments made by households – Corporate tax + Transfer payments to the households from the government and firms.
- Personal Disposable Income
    - income that is available to the households that they can spent as they wish.
    - Personal Disposable Income (PDI) = PI – Personal tax payments – Non-tax payments (such as fines etc.)
- National Disposable Income
    - National Disposable Income = Net National Product at market prices + Other current transfers from the rest of the world
- Per Capita Income
    - Per Capita Income = National Income/ Total Population
    - It is the average income of a person of a country in a particular year.

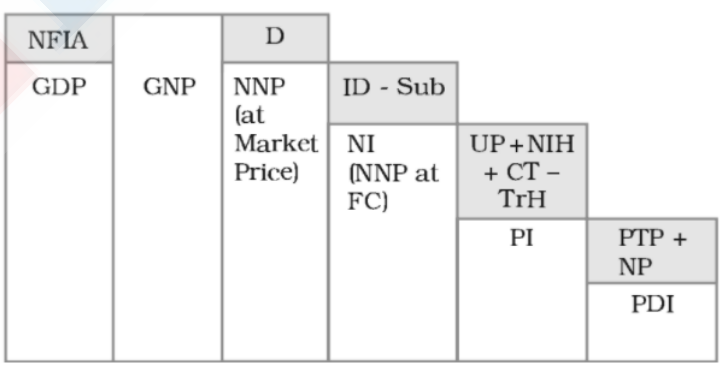


Fig - Diagrammatic representation of the subcategories of aggregate income.

Post 2015 changes in GDP calculation

Parameters	Pre 2015	Post 2015
Base Year	2004-05	2011-12
Database	Annual Survey of Industries (around 2 lakh industries)	MCA –21 (around 5 lakh industries)
GDP calculation	GDP at Factor cost	GDP at Market Price

Limitations of GDP as measurement of Economic growth

- Does not reflect economic inequality.
- Not a fair indicator of standard of living, Healthcare facilities, gender disparities etc
- does not take into account the economic value of the environment

Alternatives of GDP

- Human Development Index
- Gender Inequality Index
- Gross National Happiness Index
- Green GDP

Opportunity Cost

Opportunity cost is a concept in Economics that is defined as those values or benefits that are lost by a business, business owners or organisations when they choose one option or an alternative option over another option, in the course of making business decisions.
In simple words, it can be said as the value that is lost when a business is choosing between two or more alternatives. From an investor perspective, opportunity cost will always mean that the investment choices made will be carrying immediate loss or gain in the future.
Opportunity costs can be viewed as a trade off. Trade offs happen in decision making when one option is chosen over another option. Opportunity costs sums up the total cost for that trade off.
For example, a certain kind of bamboo can be used to produce both paper and furniture. If the business takes a decision to consider using bamboo for furniture, then the society has to forego the number of bamboos that could have been used for manufacturing paper.
Here, the opportunity cost of producing furniture is the number of papers that are foregone.

Aspects of Opportunity Cost

The opportunity cost of a product is the best alternative that was foregone. There cannot be any other alternative.

How to Calculate Opportunity Costs

Opportunity costs can be calculated using the following formula
Opportunity Cost = Return on investment for an option not chosen – Return on investment for a chosen option

Limitations of Opportunity Costs

The following are the limitations of opportunity costs:
1. Future returns cannot be predicted accurately using opportunity costs.
2. It is difficult to make quantitative comparison between two available alternatives.

Law Diminishing Returns

Diminishing returns is also known as the law of Diminishing Returns. The law of diminishing marginal productivity states the law of Diminishing Returns. The law of Diminishing Returns occurs when there is a decrease in the marginal output of the production process as a consequence of an increase in the amount of a single factor of production, while the amounts of other parameters of production remain constant. The theories of production describe the law of Diminishing Returns as a fundamental principle of economics.
According to the law of diminishing marginal returns, counting an additional factor of production results in outcomes of small growth. After some ideal level of volume is achieved, the adding of any bigger amounts of a factor of production will only yield reduced per-unit incremental returns.
The law of Diminishing Returns is quickly applicable in the fields of agriculture, mining, forests, fisheries and building industries.

Definition of Law of Diminishing Returns

As per economists, the law of Diminishing Returns is the phenomenon when more and more units of a changing input are to be used. On a given quantity of fixed data, the total output may initially increase at an increasing rate and then at a constant rate. The fact that It will eventually increase at a decreasing rate explains the law of Diminishing Returns.
Various economists have defined the law of Diminishing Returns.
When the total output initially increases with an increase in changing input at a given quantity of fixed data, but it starts decreasing after a point of time, illustrates the law of Diminishing Returns.
The significance of the law of Diminishing Returns can be understood by referring to the theory of production.
To properly illustrate the law of Diminishing Returns, some examples are given in this article

The law of Diminishing Returns owes its origin to the efforts of early economists such as James Steuart, David Ricardo, Jacques Turgot, Adam Smith, Johann Heinrich von and Thomas Robart Malthus. These economists propounded the definition of the law of Diminishing Returns.
An example to further illustrate the law of Diminishing Returns: Let's take an example of a firm that has a set stock of tools and machines, and an uneven supply of labour. As the number of workers increases in the firm, the total output of the firm rises, but at an ever-decreasing rate. It is due to this reason that after a certain point, the firm gets overcrowded and workers start to form lines to use the machines. The permanent solution to this problem is to increase the stock of capital, buy more machinery and build more firms. The above-provided example discusses the law of Diminishing Returns.

Significance of the Law of Diminishing Returns
The law of Diminishing Returns states that the result of adding a factor of production is a smaller increase in output. The addition of any amount of a factor of production, after some best possible level of capacity utilization, will inevitably capitulate decreased per-unit incremental returns. Various factors can be given to illustrate the law of Diminishing Returns.
There are many significant laws of Diminishing Returns. In mathematics, the optimization theory explains the law of diminishing returns as equivalent to a second-order condition. This theory makes perfect sense in economics.
Let us take an example to illustrate the law of diminishing returns. Suppose that the profits of a given company do not decrease with higher levels of production, it could mean that the company would decide to produce an infinite amount of their product for the same Infinitum benefit and returns. Like this, there can be various scenarios for a better understanding of the definition of the law of Diminishing Returns.
The Theory of Production explains the Law of Diminishing Returns
The significance of the law of Diminishing Returns can help in the formulation of various economic policies, to explain the tax difference in the income of different classes
In short, the Law of Diminishing Returns is a perfect phenomenon for the maximization of profit. Failing to prove this second-order condition will mean that the person is minimizing the returns, instead of maximizing them.
The law of Diminishing Returns states that in a production process with which all other factors are fixed except one if the quantity of the variable factor increases by a fixed rate, the level of production will increase by a decreasing rate.

Capitalism vs Socialism
Capitalism is a type of economic system where the means of production are owned by private individuals. Socialism on the other hand is a system where the means of production like money and other forms of capital are owned to some extent by the public. Take a look below to know the difference between capitalism and socialism. Also understand the concept of the two terms that are used so frequently in the Indian Economic System.

Capitalism:
In a capitalist system the economy is substantially run by individuals who own and operate private companies.
All the decisions over the use of resources are made by the individuals who own those companies.
Under capitalism, companies live by the motivation for profit.
The quantity of goods and services produced is based on a system of supply and demand. In the purest form of capitalism free market or laissez-faire capitalism, the individuals are unrestrained in participating in the economy.

Socialism:
Socialism is itself a variety of economic systems in which means of production are owned equally by everyone in society. In various socialist economies, a democratically elected government owns and controls major businesses and industries.
In socialism each person in society gets a share of the economy's collective production based on how much they have contributed to generating it.

Difference between Capitalism and Socialism:
Take a look at the differences below based on the criteria

Criteria	Capitalism	Socialism
Assets Ownership	Means of production is owned by private individuals	Means of production is owned by government or cooperatives
Income	The income is determined by free market forces	Income in such types of economy are equally distributed among all based on needs
Consumer Prices	Prices are determined by demand and supply/ market	Prices are decided and set by the government
Efficiency	Free market competition encourages efficiency and innovation	Government-owned businesses have less incentive for efficiency and innovation
Health Services	Healthcare services are provided by private sector	Healthcare provided free or subsidized by the government
Taxes	Limited taxes based on individual income	High taxes necessary to pay for public services

These were the differences between Capitalism and Socialism based on various categories.

PLANNING

CAPITAL FORMATION AS ECONOMIC FACTOR IN ECONOMIC GROWTH

- **Capital formation** is the process by which a community's savings are channelled into investments in capital goods such as plant, equipment, and machinery, which **increases a country's productive capacity** and worker efficiency, ensuring a greater flow of goods and services in a country.
- The process of capital formation implies that a community does not spend its entire income on goods for current consumption, but **rather saves a portion** of it and uses it to produce or acquire capital goods that significantly increase the nation's productive capacity.
- More goods and services produced can lead to an increase in national income levels. A country must generate savings and investments from household savings or from government policy in order to accumulate additional capital.
- **Countries with high household savings rates can accumulate funds to produce capital goods more quickly**, and a government that runs a surplus can invest the surplus.
- Capital formation refers not only to the creation of physical goods, but also to the **creation of human capital** such as education, health, skill development, etc.
- The process of capital formation occurs in three stages,which are:
    - **Creation of Savings** - It is savings that are converted into capital. Individuals generate savings by deferring their current consumption by reducing their expenditures on consumer goods.
    - **Effective Mobilization of Savings** - It is not enough to simply have more savings. Capital formation cannot occur unless people's savings are actually used (i.e., invested) to produce capital goods. However, in order to achieve this goal, the savings of various households and individuals must be effectively mobilised and made available for investment to businessmen and entrepreneurs.
    - **Investment of Savings** - People's savings must be properly invested in order for a large number of honest and risk-taking entrepreneurs to produce capital goods in various productive systems such as agriculture, industry, trade, public works, transportation, communication, and improved technical know-how.

INDIAN ECONOMY – PRE INDEPENDENCE ERA (BEFORE 1947)

- India had an **independent economy** before the advent of British rule.
- India was particularly well known for its **handicraft industries** in the fields of cotton and silk textiles, metal and precious stone works, etc.
- **Aim of the British colonial rule in India** – To reduce the country to being a feeder economy for Great Britain's own rapidly expanding modern industrial base.
- **British Economic policies** – concerned more with the **protection** and **promotion** of the economic interests of Britain than with the development of the Indian economy.
- **A fundamental change in the structure of the Indian economy** – India was transformed into a net supplier of raw materials and **consumer of finished industrial products** from Britain.
- The colonial government **never made any sincere attempt** to estimate national and per capita income of India.
- **Notable estimators were** – Dadabhai Naoroji (Poverty and Un-British Rule in India), William Digby, Findlay Shirras, V.K.R.V. Rao (considered very significant) and R.C. Desai

AGRICULTURE SECTOR

- **Agrarian Economy** – Indian economy under the British rule was fundamentally **agrarian**e. **about 85 per cent** of the country's population lived **mostly in villages** and **derived livelihood directly or indirectly from** AGRICULTURE.
- **Stagnated agriculture sector** – Reason being **over-crowded** with involvement of maximum population leading to a **very low agricultural productivity,** in absolute terms.

- However, the sector experienced some growth due to the **expansion of the aggregate area under cultivation.**
- Pertaining to systems of land settlement, the profit accruing out of the agriculture sector went to the **zamindars** instead of the cultivators with no zamindars initiating to strive for the development of agriculture.
- **Lack of agricultural inputs** – Low levels of technology, lack of irrigation facilities and negligible use of fertilisers resulted **in a dismal level of agricultural productivity and efficiency.**
- India's agriculture was starved of investment in terracing, flood-control, drainage and desalination of soil.
- **The commercialisation of agriculture** – could hardly help farmers in improving their economic condition as they were producing cash crops which were to be ultimately used by British industries back home.
- **Partition of the country**: A sizeable portion of the undivided country's **highly irrigated and fertile land went to Pakistan** leading to an adverse impact upon India's output from the agriculture sector especially, Jute industry (the whole of the area went away to East Pakistan)

INDUSTRIAL SECTOR

- India **could not develop a sound industrial base** even while carrying the legacy of churning out the best handicraft stuff in the world – it declined rapidly and no corresponding modern industrial base was allowed to take its place.
- **Policy of systematic deindustrialisation** – To reduce India to the **status of a mere exporter of important raw materials** for the upcoming modern industries in Britain.
- To turn India into a **sprawling market for the finished products** of those industries so that their continued expansion could be ensured to the maximum advantage of Britain.
- **Decline of the indigenous handicraft** industries created massive **unemployment** and **rural distress** in india.
- **Cotton and jute textile mills** were mainly concentrated in the **western parts** of the country – Maharashtra and Gujarat (Indians).
- During the second half of the nineteenth century, modern industry began to take root in India but its progress remained very **slow and stagnant.**
- **Iron and steel industries began to rise up** – The Tata Iron and Steel Company (TISCO) was incorporated in **1907**. Other industries like sugar, cement, paper etc. came up after the Second World War.
- **Capital goods industry** – Though necessary to help promote further industrialisation, this industry did not bloom.
- Growth rate of the new industrial sector and its contribution to the Gross Domestic Product (GDP) remained dismal and piecemeal.
- The industrial sector thus, was **left out crying for modernisation, diversification, capacity building** and increased public investment.
- **Limited area of operation of the public sector**—it remained confined only to the railways, power generation, communications, ports and some other departmental undertakings.

Capital goods industry – means industries which can produce machine tools which are, in turn, used for producing articles for current consumption.

FOREIGN TRADE

- India has been an **important trading nation since ancient times.**
- **Restrictive policies** of commodity production, trade and tariff made India an exporter of primary products (raw silk, cotton, wool, sugar, indigo, jute etc.) and an importer of finished consumer goods (cotton, silk and woollen clothes and capital goods like light machinery) produced in the factories of Britain

- Britain maintained a **monopoly** control over India's exports and imports, leading to **more than half of India's foreign trade to be restricted to Britain** while the rest was allowed with a few other countries like China, Ceylon (Sri Lanka) and Persia (Iran).
- The **opening of the Suez Canal** further intensified British control over India's foreign trade (box)
- Several **essential commodities** such as food grains, clothes, kerosene etc. suffered **acute scarcity** in the domestic market.
- The **expenses incurred by an office,** set up by the colonial government in Britain and **expenses on war fought by the British government** were accrued from revenue generated from India.

PRE-INDEPENDENCE PLAN MODELS

1. **Visvesvaraya** published his book **"Planned economy in India" in 1934.** In this book he presented a constructive draft of the development of India in **10 years**. His core idea was to lay out a plan to **shift labour from agriculture to industries** and **double up National income** in ten years. This was the **first concrete scholarly work** towards planning.
2. The economic perspective of India's freedom movement was formulated during the **Karachi session** of INC (1931), **Faizpur session** of INC (1936).
3. **National Planning Committee (1938)** – was the **first attempt** to develop a national plan for India. This committee was set up by Congress president **Subhash Chandra Bose** and was chaired by **Jawaharlal Nehru.** However the reports of the committee could not be prepared and only for the first time in 1948-49 some papers came out.
4. **Bombay Plan** – In 1944, Industrialists of Bombay including Mr. JRD Tata, GD Birla, Purshottamdas Thakurdas, Lala Shriram, Kasturbhai Lalbhai, AD Shroff, Ardeshir Dalal, & John Mathai working together prepared **"A Brief Memorandum Outlining a Plan of Economic Development for India"** which was popularly known as Bombay Plan. This plan envisaged **doubling the per capita income in 15 years** and **tripling the national income** during this period.
5. In August **1944**, The British Indian government set up a **"Planning and Development Department"** under the charge of **Ardeshir Dalal**. But this department was abolished in 1946.
6. **People's Plan** – Plan was based upon Marxist socialism and **drafted by M N Roy**. This plan was **for a ten years period** and gave **greatest priority to Agriculture**. Nationalization of all agriculture and production was the main feature of this plan.
7. **Gandhian Plan (1944**) – Put forward by Sri Shriman Narayan in 1944 who was **principal of Wardha Commercial College**. It was a **modest kind** of plan. Plan emphasized economic **decentralization** with primacy to **rural development** by developing cottage **industries**.
8. **Sarvodaya Plan (1950**) – Plan was drafted by **Jaiprakash Narayan** inspired by Gandhian plan as well as **Sarvodaya Idea of Vinoba Bhave**. It **emphasized on small and cotton industries and agriculture** as well. Plan **also stressed upon land reforms** and **decentralized participatory planning**.

POST-INDEPENDENCE

- **Economic Programme Committee (EPC)** – formed by **All India Congress Committee** (AICC) with **Nehru as its chairman**. The aim of this committee was to make a plan which could **balance private and public partnership and urban and rural economies**. The EPC recommended in 1948 to form a **permanent Planning Commission** in India.
- In **March 1950** in pursuance of declared objectives of the Government, the **Planning Commission was set up by a Resolution**, with **Jawaharlal Nehru as the first Chairman** of the Planning Commission.
- The Planning Commission was charged with the responsibility of **making assessment of all resources** of the country, **augmenting deficient resources,** formulating plans for the most effective and **balanced utilization of resources** and determining priorities.

Democratic Socialism: Nehru was greatly influenced by the achievements of Soviet Planning; The philosophy was to not only check the growth of monopolistic tendencies of the private sector but also provide freedom to the private sector to play for main objective of social gain rather than economic gain.

THE GOALS OF FIVE-YEAR PLANS

GROWTH

- Growth refers to an increase **in the country's capacity** to produce the output of goods and services within the country.
- Good indicator of economic growth is the **steady increase in the country's Gross Domestic Product** (GDP) – the market value of all the goods and services produced in the country during a year.
- The GDP of a country is **derived from the different sectors** (Primary, Secondary and Tertiary) of the economy – the contribution made by each of these sectors makes up the structural composition of the economy.

MODERNIZATION

- Steps taken by a factory to increase output by using a new type of machine and technology is called modernization.
- Modernisation also leads to changes in social outlook such as the recognition that women should have the same rights as men.

SELF RELIANCE

- A nation can promote economic growth and modernisation by using its own resources or by using resources imported from other nations.
- The **first seven five year plans gave importance to self-reliance** which means avoiding imports of those goods which could be produced in India itself, **in order to reduce our dependence** on foreign countries, especially for food.
- There was a fear that dependence on imported food supplies, foreign technology and foreign capital may make **India's sovereignty vulnerable to foreign interference** in our policies.
- Recently, PM stressed for a self-reliant **India (Atma Nirbhar Bharat)** in the backdrop of the Covid-19 outbreak.

EQUITY

- To ensure that **the benefits of economic prosperity reach the poor sections** as well instead of being enjoyed only by the rich – **every Indian should be able to meet his or her basic needs** such as food, a decent house, education and health care; and reducing inequality in the distribution of wealth.

OBJECTIVES OF PLANNING

- **Economic and social planning** and ensuring pattern of the **'welfare state'.**
- Sustainable economic growth.
- Poverty alleviation
- **Employment generation** and self-employment
- **Modernising** the traditional economy was set as a foremost objective of planning especially the agriculture sector
- Accord due place and weightage to all the **aspirations of the Preamble**, the **Fundamental Duties**, the **Fundamental Rights** and the **Directive Principles of the State Policy** – adequate means of livelihood, opportunities for employment and a socio-economic order based on justice and equality.
- **Self-reliance –** an effort to strike against a subordinate position in the world economy.
- Ensuring **economic equality**

FINANCIAL RESOURCES FOR PLANNING

- Central budget and state budgets – revenue and capital receipt side
- Public Sector Enterprises (PSEs)
- Domestic private sector

- **Gross Budgetary Support** – This is an amount from the central budget which goes to fund the planned investment during the plan period.
- **Foreign Direct Investment (FDI)** in India

PRIME MOVING FORCE – AGRICULTURE VS. INDUSTRY

- The government of the time **opted for industry** to be India's prime moving force of the economy.
- Given the available resource base it seems an **illogical decision** as **India lacked all those prerequisites** which could suggest the declaration of industry as its prime mover –
- Almost no presence in the infrastructure sector.
- Lack of robust infrastructure industries, i.e., iron and steel, cement, coal, crude oil, oil refining and electricity.
- Lack of availability of investible capital – either by the government or the private sector.
- Absence of required technology to support the process of industrialisation and lack of research and development.
- Lack of skilled and semi-skilled manpower.
- Lack of entrepreneurship spirit among the people.
- Lack of a market for industrial goods.
- Many other socio-psychological factors which acted as negative forces for the proper industrialisation of the economy.

The obvious choice for India would have been the agriculture sector as the prime moving force of the economy because:

- The country was having the natural resource of fertile land which was fit for cultivation.
- Human capital did not require any kind of higher training.
- Higher population in rural areas with involvement in agriculture
- Just by organising our land ownership, irrigation and other inputs to agriculture, India could have gone for better prospects of development.
- Once the masses were able to achieve a level of purchasing capacity through remunerative income from agriculture, India could have gone for the expansion of industries.

Following developments were in favour of industrialisation –

- By choosing industry as the prime moving force, India opted to industrialise the economy as well as modernise the traditional mode of farming.
- The dominant ideology around the world as well as in the WB (World Bank) and the IMF (International Monetary Fund) was in favour of industrialisation as a means to faster growth and development.
- The Second World War had proved the supremacy of defence power – which needs support not just of science and technology, but also of a robust industrial base.
- India also required a powerful defence base for herself as a deterrent force.
- By the time of independence the might of industrialisation was already proven and there were no doubts regarding its efficacy.
- A major shift took place in the Indian economic landscape, when the government announced in **2002** that from now onwards, in place of industry, **agriculture will be the prime moving force of the economy.**
- According to the Planning Commission such a policy shift will **solve the following major challenges** faced by the economy:
- Economy will be able to **achieve food security** with the increase in agricultural production.
- The agricultural surplus will **generate exports in the globalising world** economy benefiting out of the WTO (World Trade Organisation) regime.
- The challenge of **poverty alleviation** will be solved to a great extent as the emphasis will make agriculture a **remunerative occupation** and induce **growth in the rural economy** by generating more gainful employment.
- The situation of India as an example of 'market failure' will cease.

Reasons for BoP Crisis

India faced the Balance of Payment crisis in 1991 due to huge macroeconomic imbalance. Balance of Payment (BoP) Crisis is also called currency crisis. It occurs when a nation is unable to pay for essential imports or service its external debt payments. This article throws light on the many causes behind the Balance of Payment Crisis India faced in 1991.

What were the Causes of the Balance of Payment Crisis 1991?

There was a huge Macroeconomic imbalance of high current account deficit and high fiscal deficit. The crisis did not develop overnight. It was caused by decades of imprudence. There was reliance on populist measures. The causes of Balance of Payment Crisis are listed below.

1. The Government Expenditure was more than the earnings. Hence the Fiscal Deficit was high. The Gross Fiscal deficit rose from 9 % of GDP in 1980-81 to 12.7 % of GDP in 1990-91.
2. The Internal Debt of the Government rose due to the above reason. It rose from 35 % of GDP in 1985-86 to 53 % of GDP in 1990-91.
3. In addition the country was importing more than exporting. Hence the Current Account Deficit was high.
4. The current account deficit was triggered by the rise in crude oil prices because of the Gulf War. Due to this, the Forex Reserves of India depleted massively. Despite substantial borrowings from the International Monetary Fund (IMF) earlier in the year.
5. By June 1991, India had less than $ 1 billion forex reserves, just sufficient to meet import requirements for a period of 3 weeks.
6. India did not have enough Forex reserves to conduct business with the world.
7. India was on the verge of defaulting on its International Debt Obligations.
8. Investors pulled out their money.
9. Short term credit dried up, as exporters were apprehensive that they would not be paid.
10. There was a massive rise in inflation rates.

The **above crisis** was treated as **Balance of Payment Crisis.**
The effects of the Balance of Payment Crisis are mentioned below.

1. Imports were restricted.
2. The price of fuels were raised.
3. Bank rates were raised.
4. Government had to cut its spending.
5. India had to secure an emergency loan of $ 2.2 billion from the International Monetary Fund by pledging 67 tonnes of Gold as collateral security.
6. In May 1991, India sent 20 tonnes of Gold to Union Bank of Switzerland, Zurich and in July, 47 tonnes of Gold was given to Bank of England to raise a total of $ 600 million.

What did Manmohan Singh do in 1991?

The Government of India led by PV Narasimha Rao, with Manmohan Singh as Finance Minister initiated a 4 pronged strategy to put the economy back on track.

Industrial Policy Reforms

1. License Raj and Inspector Raj were removed.
2. Industrial licensing was abolished.
3. Measures were taken to ease domestic supply constraints.
4. Measures were taken to spur investments.

Trade Policy Reforms

1. To make exports competitive Rupee was devalued by 20%.
2. Licensing controls and regulations on exports were eased.

Public Sector Reforms

1. There was liberalisation of Foreign Direct Investment (FDI).
2. Public Sector companies were given more operational freedom to scale up and make bigger contributions to the economy.

Planning Commission vs NITI Aayog

In March 1950, the Government of India passed a resolution establishing the Planning Commission. It was created to help the government accomplish its stated goals of fostering a quick improvement in the people's quality of life by effective exploitation of the country's resources, greater output, and giving opportunities for everybody to participate in the community's service. The Planning Commission was tasked with assessing all of the country's resources; supplementing those that were insufficient; devising plans for the most efficient and balanced use of resources, and deciding priorities. **In 1951, the country's first five-year plan was implemented. The Indian government replaced the Planning Commission, which was created in 1950, with the NITI Aayog. This action was taken to better fulfill the people's needs and ambitions *with a focus on a "Bottom-Up" approach to envision the goal of Maximum Governance, Minimum Government, mirroring the spirit of "Cooperative Federalism."*.** The Government of India's top policy think tank, NITI Aayog, provides directional and policy suggestions. NITI Aayog offers appropriate technical assistance to the Centre, States, and Union Territories in addition to creating strategic and long-term policies and programs for the Government of India. This action was taken to better fulfill the people's needs and ambitions. NITI Aayog is a significant evolutionary development in that it serves as the Government of India's primary platform for bringing the States together in the national interest, fostering cooperative federalism.

Concepts adopted by NITI Aayog differ from the Planning Commission:

1. *Organization*:
A deputy chairperson, a member secretary, and full-time members make up the Planning Commission. The regular procedure is used to nominate secretaries or member secretaries. **New CEO and Vice-Chairperson positions have been created at NITI Aayog.** There will be five full-time and two part-time members. Ex-officio members will include four cabinet ministers. The Prime Minister appoints the CEO directly. The position of CEO is equivalent to that of a Secretary. Ex-officio members would be four Cabinet members. Two part-time members and five full-time members make up the NITI Aayog.

2. *Planning*:
With public sector resources, the Planning Commission favors top-down planning for government. In a market economy that is connected with the globalized globe, the NITI Aayog develops national development strategies. Recognizing the states' rising autonomy and responsibility, the NITI Aayog recognizes and allows for more engagement by states and other stakeholders (civil society). Furthermore, one of the key pillars of the NITI Aayog is openness and e-governance, which contrasts sharply with the old Planning Commission's planning style.

3. *Finance and States' Role*:
With the introduction of the Planning Commission, the role of the Finance Commission was severely decreased. The Planning Commission was in charge of allocating monies. The NITI Aayog has no responsibility for the allotment of funds. The Finance Ministry will decide on the tax portion that states will get, as well as money distribution and Union support. The Planning Commission had the authority to provide funding to state governments and several central government ministries for a variety of national and state-level programs and projects. **The Planning Commission developed policies first, and subsequently, state governments were consulted on funding allocations for programs and projects.** The ultimate policy will produce fruit at NITI Aayog following adequate discussions with state governments throughout the policy formation stage. **NITI Aayog offers appropriate technical assistance to the Centre, States, and Union Territories in addition to creating strategic and long-term policies and programs for the Government of India.**

4. *Reporting and Constitution*:
The National Development Council, which included State Chief Ministers and Lieutenant Governors, reported to the Planning Commission. The Governing Council of NITI Aayog consists of State Chief Ministers and Lieutenant Governors. The Planning Commission, which is now defunct, was an Executive Body. Because it is not named in the Indian Constitution and was not

constituted by an Act of Parliament, NITI Aayog is likewise an Executive Body. However, it may be turned into a Statutory Body if necessary by passing a statute in Parliament; UIDAI is one example.

5. *Good governance principles include*:

The governance principles adopted by the two planning organizations are perhaps the most important variation between them. **The modern NITI Aayog aspires to foster an open, transparent, responsible, proactive, and purposeful governing approach. In the case of the former Planning Commission, these concepts were there in theory but mostly lacking in practice.** The former Planning Commission was founded as 'a staff agency', but over time it grew into a strong and directive body, deficient in good governance norms.

6. *Key role and objectives*:

Albeit, the former Planning Commission worked as an extra-Constitutional body with broad powers over financial allocation and use, the NITI Aayog (while non-constitutional) has a more consultative role and a lesser executive role. Its **primary function is that of a "think tank**." While the PC has considerable executive powers, the NITI Aayog functions as a policy research organization that assists the government (executive) in devising effective policies for the creation of a "new India."

7. *The number of participants*:

There were eight full-time members on the previous Planning Commission. The number of full-time members on the NITI Aayog board might be lower than those on the Planning Commission.

Conclusion:

With changing conditions, new ideas (such as sustainable development and cooperative federalism) were added to the planning objectives, resulting in the formation of NITI Aayog. However, the Planning Commission's contributions to the nation's progress must not be overlooked. In addition, several flaws in the operation of NITI Aayog must be addressed as soon as possible. The NITI Aayog's replacement of the Planning Commission will help shift the focus away from projects and programs and toward policies and institutions, from spending inputs to real results through stronger governance, and away from political squabbling over incremental appropriations and toward new challenges and possibilities.

Aatmnirbhar Bharat

Atmanirbhar Bharat Abhiyan (Self-reliant India Mission) is a campaign launched by the Central Government of India which included an Rs.20 lakh crore economic stimulus package and a number of reform proposals.

As part of the relief measures in the aftermath of COVID-19, the Prime Minister announced a special economic package and gave a clarion call for "***Atmanirbhar Bharat***" or **"Self-reliant India".**

He noted that this package totals Rs 20 lakh crore, including the government's recent announcements on supporting key sectors and measures by the Reserve Bank of India, which is equivalent to almost ***10% of India's*** GDP.

Meaning of Atmanirbhar Bharat Abhiyan

The meaning of the term '***Atmanirbhar Bharat***' is ***self-reliant India***.

In his speech, the Prime Minister observed that to fulfil the dream of making the 21st century India's, the way forward is through ensuring that the country becomes self-reliant.

Significance of Atmanirbhar Bharat Abhiyan

- Talking about ***turning a crisis into an opportunity***, he gave the example that the production of PPE kits and N-95 masks in India has gone up from almost being negligible to 2 lakh each, daily.
- Remaking that ***self-reliance is the only way out for India***, the PM quoted from our scriptures "**Eshah Panthah**", that is – self-sufficient India.
- ***Self-reliance will make globalization human-centric***. The definition of self-reliance has changed in a globalized world and it is different from being self-centred. India's

fundamental thinking and tradition of "***Vasudhaiva Kutumbakam***" provides a ray of hope to the world. This should be seen in the context of Human-Centric Globalization versus Economy Centralized Globalization.

- Self-reliance does not mean cutting India off from the world. India believes in the welfare of the world and India's progress is linked with the world. The world trusts that India has a lot to contribute to the development of the entire humanity.
- The PM also stressed the need to be vocal about local products and urged people to buy only local products.

Five Pillars of a Self-reliant India

- Bold reforms across sectors will drive the country's push towards self-reliance.
- To spur growth and to build a self-reliant India, Atmanirbhar Bharat Abhiyan rests on 5 important pillars.
    - ***Economy***: contemplates not an Incremental change but a quantum leap so that we can convert the current adversity into an advantage.
    - ***Infrastructure***: that can be an image of modern India or it can be the identity of India.
    - ***Systems***: driven by 21st-century technology, and that is not based on old rules.
    - ***Democracy***: a vibrant democracy that is the source of energy to make India self-reliant.
    - ***Demand***: where the strength of our demand and supply chain is utilized intelligently.

The reforms and stimulus measures under Rs 20 lakh crore package were subsequently elaborated by the Finance Minister in five tranches.

Apart from the above, under Atmanirbhar Bharat Abhiyan decisions are also made to reform labour, agriculture, coal sector etc.

Labour sector reforms

- To avoid regional disparity in minimum wages, **National Floor Wage** to be introduced.
- An appointment letter is to be provided to all workers to promote formalization.
- Occupational Safety & Health (OSH) code to cover all establishments engaged in hazardous work.
- Definition of the inter-state migrant worker to include migrant workers employed directly by the employer.
- ESIC coverage will be extended to all districts and all establishments employing 10 or more employees as against those in notified districts/areas only.
- Mandatory ESIC coverage for employees in hazardous industries with less than 10 employees.
- Introduction of re-skilling funds for retrenched employees.
- Provision for Social Security Fund for unorganized workers.
- Provision of gratuity on completion of one-year service as against 5 years.

Agriculture Marketing Reforms to provide choices to farmers

- Now, farmers are bound to sell agricultural produce only to licensees in APMCs.
- A law will be formulated to provide choices to farmers to sell produce at an attractive price and enable barrier-free inter-state trade.
- The legal framework will be created towards contract farming and enable farmers to engage with processors, aggregators, large retailers, exporters in a fair and transparent manner.
- Risk mitigation for farmers assured returns and quality standardization to be an integral part of the framework.

Coal sector reforms

- Introduction of commercial mining in the coal sector through a revenue-sharing mechanism instead of the regime of fixed Rupee/tonne

- To lower impact on the environment, coal gasification and liquefication will be incentivized through rebate in revenue share
- Coal Bed Methane (CBM) extraction rights to be auctioned from Coal India Limited's (CIL) coal mines.

Self-reliance in defence production

- Ban the import of several weapons and a separate budget provisioning for domestic capital procurement to help reduce the huge defence import bill.
- Corporatize the Ordnance Factory Board to improve autonomy, accountability, and efficiency.
- Increased FDI limit in the defence manufacturing under the automatic route from 49 percent to 74 percent.

Aircraft and airspace sector

- Restrictions on the utilization of the Indian airspace will be eased so that civilian flying becomes more efficient.
- Development of world-class airports through PPP,
- The tax regime for Aircraft Maintenance, Repair, and Overhaul ecosystem is rationalized and the convergence between the defence sector and the civil MROs will be established to create economies of scale.
- Boosting private participation in space activities. The private sector will be allowed to use ISRO facilities and other relevant assets to improve their capacities.

Technology-driven education

- ***PM e-VIDYA*** — a program for multi-mode access to digital/online education — will be launched. The program will comprise one earmarked TV channel per class from 1 to 12. Special e-content will be prepared for the visually and hearing impaired. Top 100 universities will be permitted to automatically start online courses by 30 May 2020.
- ***Manodarpan***, an initiative for psycho-social support of students, teachers, and families for mental health and emotional wellbeing, will also be launched simultaneously.
- ***National Foundational Literacy and Numeracy Mission*** will be launched in December 2020 to ensure that every child attains learning levels and outcomes in grade 5 by 2025.

Ease of doing business related measures

- The minimum threshold to initiate insolvency proceedings raised to Rs 1 crore
- Suspension of fresh initiation of insolvency proceedings up to one year.
- Special insolvency resolution framework for MSMEs to be notified soon.
- Decriminalization of violations under Companies Act
- Allow direct listing of securities by Indian public companies in permissible foreign jurisdictions.
- The government will announce a new, coherent policy where all sectors are open to the private sector while public sector enterprises (PSEs) will play an important role in defined areas.
- A list of strategic sectors requiring the presence of PSEs in the public interest will be notified.
- In strategic sectors, at least one enterprise will remain in the public sector but the private sector will also be allowed.
- In other sectors, PSEs will be privatized.

Parallels with Swadeshi Movement and need for Self-reliance

- The call self-reliance can be compared with the Swadeshi movement and we can find that it is a relatable response to the evolving political and economic currents in a globalized world.
- If Swadeshi was the rejection of the colonial exploitation of India and criticism of the Western model of Capitalism based economic growth, ***Atmanirbhar Bharat is an attempt to find India's legitimate place*** in a rapidly changing world.

- Atmanirbhar Bharat like the Swadeshi movement is a program that is against the unrestricted import of Western thinking and economic models but is not averse to technology. It stands for modernization, but without unbridled Westernisation.
- The clarion call '**Vocal for local**' needs to be seen as a response to the anticipated changes in geopolitical order in the post-COVID world.
- The COVID crisis has shown the ***failings of multilateral and regional institutions*** and also the ineffectiveness of trade barriers and standalone economic models.
- ***Indian entrepreneurship*** must be freed from the shackles by adopting suitable governance models and reforming laws.
- The 'new Swadeshi' must transform local industries to connect the ever-changing global trade structure and lead to '***glocalization***' that serves local and global markets.
- Some early signs of this development were seen during the COVID crisis where India's position as the 'pharmacy of the developing world' was cemented. The importance of self-reliance was also seen in the self-sufficiency for food especially cereals, the lack of which would have exasperated the current crisis.

Criticism of Atmanirbhar Bharat Abhiyan

- ***Inflated figures***
    - Several opposition leaders pointed out that as per the calculations by many economists, the actual government expenditure in the Atmanirbhar package is just 1%.
    - The actions of RBI were included as part of the government's fiscal package whereas government expenditure and RBI's actions cannot be clubbed together.
- ***Need to spend more***
    - The Indian economy is likely to contract and the Gross Value Added across sectors is likely to fall. According to an assessment by Prof N R Bhanumurthy of the National Institute of Public Finance and Policy (NIPFP), India's GVA will contract by 13% this year under the Base case scenario (The Base case scenario refers to a scenario where governments bring down their expenditure in line with their falling revenues to maintain their fiscal deficit target).
    - Several economists suggest that the government needs to spend much more to prevent an economic contraction. Higher public spending will come at the cost of higher levels of fiscal deficits and higher inflation, but a growth contraction will cause even worse outcomes in the form of widespread economic ruin.
- ***Credit easing will not work immediately***
    - Direct expenditure by a government such as direct benefit transfer or by construction will mean that money reaches the people.
    - But credit easing by the RBI is not direct government expenditure and banks will be hesitant to lend the money available with them.
- ***Nothing to stimulate demand*** – many economists have opined that the government stimulus tries to resolve only supply-side issues. There is nothing to generate demand. This could only be done by putting money in the hands of people.
- ***Modest MSME package*** – according to opposition leaders, the MSME package was modest and the measures were skewed in favour of the larger ones. Moreover, the unorganized sector was not catered to.
- ***Insufficient support for the state governments*** – the state governments which are at the forefront of fighting the pandemic have not been supported adequately via fund transfers.
- ***A remodelling of Make in India Campaign*** – The self-reliant India campaign is criticized by many as a re-modelling of the Make in India Campaign – which didn't produce expected results – with some addon-on.
- ***The philosophy of self-reliance:*** India, like most countries, has been following the principles of globalisation since the LPG reforms in 1991. Even though the globalised

world shrank into isolated countries in the COVID19 period, it is yet to be seen if self-reliance can be adopted as a viable economic policy by a country like India, post-COVID.

Problem of Unorganised Sector

Today's Indian economy is hugely based on the existence of the informal or unorganized sector.
The Commission demonstrated a specific block of categories of unorganized labour consisting of the construction workers, a labourer of small-scale industry, casual employment, the power loom workers, employees in shops and commercial establishments, sweepers and scavengers, workers in tanneries, the tribal labourer and the other unprotected labour.

Also, their reports profoundly stated that this sector is full of causal labour, mostly consisting of small jobs at meagre wages. There is no job security and social benefit.
The National Sample Survey Organization (NSSO) conducts thorough surveys of these unorganized sections at a regular interval and has observed that the manufacturing industries which do not come under the Annual Survey of Industries (ASI) are counted in the unorganized sector.
Also, for the service-providing sectors, (except the one who are run by the government) are categorized under the unorganized sector.

Characterization and categorization of the Unorganized sector

The unorganized sector is not independent or exclusive. It is dependent on the organized industry and the economy as a whole. Many factors work as a bridge for these two like capital investment and output requirements, rate of employment, marketing etc.
The unorganized labour is almost disturbing in both stances as of employment rates and wages. The seasonal deficiency of job availability makes it even worse for those people. Many do not yet have stable and secured means of income and thus no plan for an annual fund.
Most of the times, the work areas are not well maintained. Also, migration is a dominating trait of the unorganized sector. The migrant labours face genuine hardships and often shuffle through various geographical locations in search of a job. None of the informal sector businesses has pen and paper contracts. There aren't any formal employer-employee contracts in the unorganized sector. Thus, they often get violated.
The social issues also add to the crisis. The religious and communal issues lead to partiality in fields of job availability and facilities. They often also struggle against debt, which happens to be a prevalent issue on their end.
Sometimes, they are subjected to severe exploitation by the employees. The companies tend to drain the most out of them without thinking about their minimum necessities. History of this unorganized sector proves the seriousness of the situation.
There have been several suicides due to debt, and illiteracy has always been a naturally induced condition to them. Poverty, lack of hygiene and worse health condition summarize the present status of the informal sector employees. The unorganized workers also never received the proper attention from the trade unions. Thus, left stranded and unrepresented, they still reside in the dark.

Who finances the Unorganized sector of India?

The unorganized manufacturing sector of industries is currently void of capital. As they have failed to get access to the organized fundings of finance, they instead borrowed off from the unorganized credit market at high-interest rates. This comparatively big raise in the capital has caused the government to intervene.
Both public and private commercial banks and as well as central and state-level have started offering loans to the unorganized sectors like self-help communities and cooperation groups at really low-interest rates. However, the share of these resources in the total amount of investments for the unorganized manufacturing sector has increased steeply.
The informal financial sources generally include funds available from the family or moneylenders who operate outside the legal and policy framework of banks.
Apart from this, the chit fund is another form of credit source operated by groups of people for mutual benefit; but this approach has its limitations. Credit in the informal system is usually available on tap.
The loans are granted mostly without collateral, and lengthy documentation formalities as the lender depend mainly on the personal knowledge of and contact with, the borrower.

However, over the years, a few NGOs have engaged themselves in activities related to community mobilization for savings and credit-related operations targeted at some groups in the rural sector.

Disadvantages of the Unorganized sector

As we know, the Unorganized sector has almost no support from the government, and that makes it all the more difficult for the entire industry. Less wage is a huge problem. Not helping the matter, their employment is often subjected to insecurity, and the employees can be sacked anytime without any proper reason.

There is no availability of necessary facilities like overtime payment, paid leave, sick leave etc. There is not much adequate job security either, and the working hours are often too long. All these impose a severe threat to the physical condition of the labourers.

Effect of Globalization on the Unorganized sector

Globalization policies in recent years have been adopted in India as an attempt to increase the informal sector. The launch of globalization saw a subtle growth in the employment rates of the unorganized sector.

However, void of the idea of permanent workers, these industries target employees with low wages and long working hours. Some non-government organizations and social movements also invested in such activities for the welfare of the unorganized sector workers. So even though the numbers changed positively, the wage and the work duration affected the informal sector negatively.

How to improve the Unorganized section

There is a lot to be done as the informal section holds a significant share in the graph of the employment. Firstly, the wages need to be taken care of care. There has to be a definite pay scale specified for each category of labour.

The schedule for payment also has to be fixed and secured. Regular payment of wages is an essential factor for uplifting the poverty prevailing.

The duration of labour needs to be rightfully set, and one should get overtime pay for overtime work. Necessary employment facilities should be made available to all, including sick leave and paid leave. Job security should be more strengthened.

Medical and health facilities are also needed to be provided. Often, they work in unhygienic and suffocating conditions leading to severe health conditions. Thus, a better work environment is a must-have.

The government should also try to provide them with retirement benefits if possible.

Conclusion

The national statistics mostly states that approximately 93% of the working population are from the unorganized or informal sector; among which 60% is from agriculture industry alone. This points out how much important it is to develop this sector immediately as we cannot afford to lose our most important industry to the threat it poses. Even worse, the rates are increasing every year.

The discriminated and low waged market has to be uprooted entirely. And even though they are the ones making the most contribution to the GDP, they are the ones getting the most trodden on at the end of the chain.

Even though the government is continually making new efforts to introduce new beneficiary policies for these marginalized people, it's still hard to make a visibly positive impact any time soon.

More job vacancies are needed, and the literacy rate of these informal sector employees need to increase as well. Literacy is the best way out of poverty, and the unorganized sector needs more of that.

That was all about the Unorganized sector in India. Hopefully, this article helped you explore the dynamics of this topic. For any doubt regarding the same, let us know through the comment section below.

Shapes of Economic Recovery

As India is going to come out of the Covid-19 lockdown, experts are debating over the shape of recovery of Indian economy.

Key Points

- The economists are unanimous that in the current financial year 2020-21, India's economy will contract.
    - According to the World Bank's South Asia Economic Focus report, India's growth is likely to remain at 1.5-2.8% in 2020-21 which is the slowest since 1991 economic reforms.
- Many economists are also of the opinion that after hitting the bottom this year, the Indian economy will start its recovery in the next financial year (2021-22).
- However, according to an analysis by Pronab Sen, former Chief Statistician of India, India's economy will contract not just in the financial year 2020-21 but also in 2021-22.
    - This means that India could experience a full-blown depression – the first in India's history as an independent nation.
    - The Table shows India's absolute Gross Domestic Product (GDP) is likely to struggle to even come back to the 2019-20 level by 2023-24.
    - India is likely to end up with an "elongated U-shape" recovery due to the weakness of the economy going into the Covid crisis as well as the inadequate fiscal stimulus measure taken by the government.
    - The Table also provides a snapshot of the likely trend level of GDP had India grown at 6% and 8% respectively over the same period.

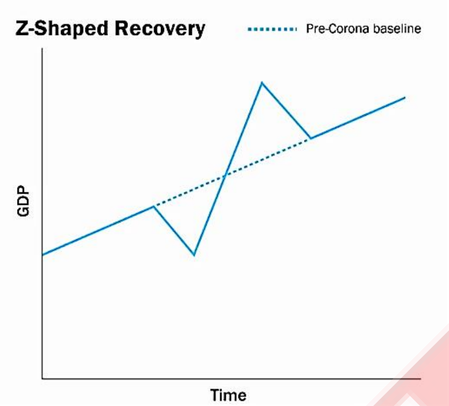
YEAR	Likely growth rate of GDP (in %)	Likely absolute GDP in Rs Trillion*	Absolute GDP at 6% growth (Rs Trillion)	Absolute GDP at 8% growth (Rs Trillion)
2019-20 (pre-Covid)	5	207		
2019-20 (post-Covid)	3	203		
2020-21	—12	178	219	224
2021-22	— 9	163	233	242
2022-23	6	172	247	261
2023-24	6	183	261	282

- Other economists are of the view that it is difficult to predict the shape of economic recovery in India at this juncture as there are too many unknowns.
    - If there is no second wave of Covid-19, India can expect swift normalization from negative growth levels to the pre-covid levels of 5% and a gradual recovery to 7% by the second half of the next fiscal (2021-22).

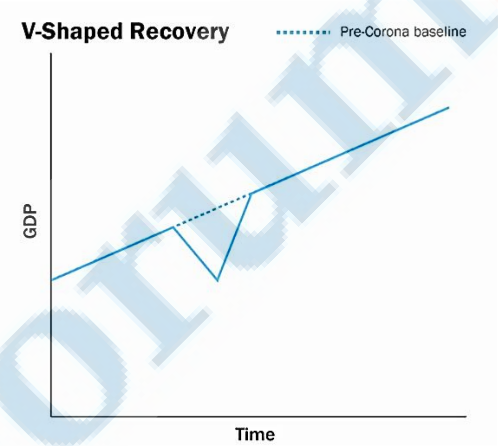
Types of Shape of Economic Recovery

- Economic recovery can take many forms, which is depicted using alphabetic notations. For example, a **Z-shaped recovery, V-shaped recovery, U-shaped recovery, elongated U-shaped recovery, W-shaped recovery** and **L-shaped recovery.**
- The **alphabets generally denote the graph of growth rate,** which resembles the shape of the letter.
- The fundamental difference between the different kinds of recovery is the **time taken for economic activity to normalize.**
    - The time taken is often a factor of multiple things such as the depth of the economic crisis. e.g deeper the recession, longer is the time to get back to normal.
- The other aspect of economic recovery includes the effect of pandemic on jobs and household incomes, and the kind of policy response taken by the government that determines how quickly economic growth will recover.

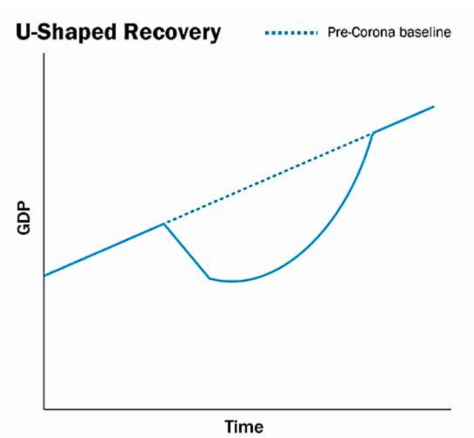
- Z-shaped recovery: It is the most-optimistic scenario in which the economy quickly rises after an economic crash.
    - It makes up more than for lost ground before settling back to the normal trend-line, thus forming a Z-shaped chart.
    - In this economic disruption lasts for a small period wherein more than people's incomes, it is their ability to spend is restricted.



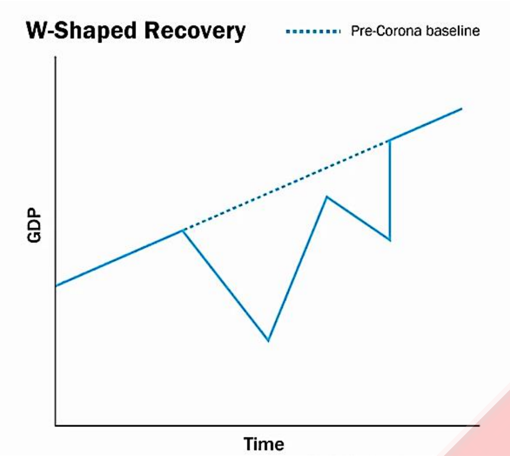
- **V-shaped recovery:** It is the next-best scenario after Z-shaped recovery in which the economy quickly recoups lost ground and gets back to the normal growth trend-line.
    - In this, incomes and jobs are not permanently lost, and the economic growth recovers sharply and returns to the path it was following before the disruption.



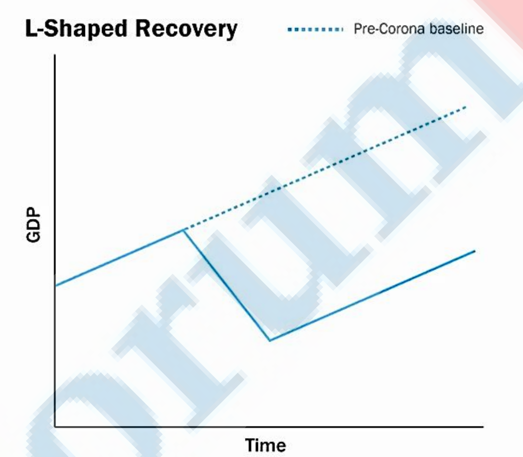
- **U-shaped recovery:** It is a scenario in which the economy, after falling, struggles around a low growth rate for some time, before rising gradually to usual levels.
    - In this case several jobs are lost and people fall upon their savings.
    - If this process is more-long drawn than it throws up the **"elongated U" shape.**



- **W-shaped recovery:** A W-shaped recovery is a dangerous creature. In this, growth falls and rises, but falls again before recovering, thus forming a W-like chart.
    - The double-dip depicted by a W-shaped recovery can be due to the second wave of the pandemic.



- **L-shaped recovery:** In this, the economy fails to regain the level of GDP even after years go by.
    - The shape shows that there is a permanent loss to the economy's ability to produce.



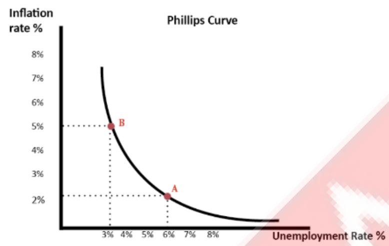
Economics Lecture #5

Inflation

- Sustained/persistent/continuous **rise in the general price level** of goods and services in an economy over a period of time.
- Increase in prices of particular **basket** of goods and services.
- It **reduces savings, pushes up interest rates, dampens investments and reduces purchasing power of money**.

Key Terms

Terms	Description
Deflation	• It is a **decrease** in the general price levels of goods and services. • It is opposite of Inflation. Inflation rate is negative (below 0%). • Considered bad for economy as it may lead to recession.
Disinflation	• It is **decrease in Inflation rate**. • Prices of goods and services do not fall. Their price rises but overall rate is declining • **Inflation is positive**. However, rate of inflation slows down (for example from 3% to 2%)
Stagflation	• Stagflation = High Inflation + High Unemployment + Stagnant Growth.
Skewflation	• When the price rise of one or a small group of commodities is relatively more than the other set of commodities. • e.g. Higher rise in prices of food items (onion, pulses, tomatoes etc) than non-food items.
Reflation	• Deliberate action [fiscal or monetary policy] to increase the rate of inflation to stimulate the economy. • Here the goal is to expand output, stimulate spending and curb the effects of deflation by reducing taxes, changing the money supply and lowering interest rates.
Inflationary Gap	• Separation/gap/difference between actual GDP and potential GDP • Actual GDP is higher than potential GDP. • Demand for goods and services is more than supply. • Occurs when economy is expanding • Policies such as – higher government spending, tax cuts, higher transfer payments, decrease in interest rates may lead to inflationary gap
Deflationary Gap	• Actual GDP is lower than potential GDP. • Demand for goods and services is less than supply. • Policies such as – lower government spending, tax increase, lower transfer payments, increase in interest rates may lead to deflationary gap
Inflationary Spiral (Wage – Price Spiral)	• When Wages press prices up and prices pull wages up • Relationship between rising labour costs and inflation • When inflation rises, workers demand increase in wages. Rising wages increase disposable income for workers. It leads to greater demand for goods and services which causes prices to rise.

	• Rising prices prompt workers to demand higher wages. The higher wages lead to higher production costs and the cycle repeats.
Deflationary Spiral	• When prices fall, profit of firm decreases. Firm may lower production, cut workers' wages, lay off- excess workers. It lowers aggregate demand leading to again decrease in prices and the cycle repeats.
Philips Curve	• There is inverse relationship between inflation and unemployment • Thus, increase in inflation reduces unemployment. 
Base effect	• Impact of price levels of previous year on calculation of current price levels. • Even if price rise is same, rate of inflation may increase or decrease due to choice of base (denominator) • e.g. - The price of a pen is Rs.10, Rs 11 & Rs 12 in year 2019, 2020 & 2021 respectively. Price rise is uniform Rs 1 per year. However, rate of inflation over previous year is 10% (2020) & 9.09% (2021)
Headline Inflation	• It is a measure of total inflation in an economy. • In India, Consumer Price Index Combined (CPI -C) represents Headline Inflation.
Core Inflation	• Core Inflation = Headline Inflation - food and fuel inflation. • It is also known as underlying inflation and measures long term trend in general price levels by factoring out temporary effect

Types of Inflation

Based on causes

1) Demand Pull Inflation
    - Price rise due to Aggregate Demand > Aggregate Supply.
    - Too much money chasing too few goods
    - Aggregate demand may increase due to – increase in government spending (rise in MGNERGA wages, PM KISAN), 7th pay commission, lower interest rates etc.
2) Cost Push Inflation
    - Price rise due to rise in input costs
    - Increase in prices of raw material, wage hike, increased profit margin by firm, costlier imports etc
3) Structural Inflation (bottleneck Inflation)
    - Inflation built into the economic system due to government policies.
    - e.g. Under developed transportation sector will increase logistic cost and will result in overall increase in prices of commodities. Similarly, structural bottlenecks in agricultural sector such as APMCs, involvement of middlemen, imperfect price discovery leads to rise in food prices

Based on rate of increase in price rise

1. Creeping Inflation –

- prices rise by 3% or less per year. It's regarded safe and essential for job creation and economic growth.

2. Trotting Inflation
    - prices rise by 3% - 10% per year. Consumers start to buy more than they need to avoid higher prices in future.
3. Galloping Inflation
    - prices rise by 10% or more per year.
4. Hyperinflation
    - Very high inflation. rapid and unrestrained price increase. Out of control inflation.

Measurement of Inflation

Wholesale Price Index (WPI)

- WPI measures the inflation at wholesale level.
- Base Year – 2011-12
- Compiled and released by - Office of Economic Adviser, Department for Promotion of Industry and Internal Trade, Ministry of Commerce and Industry.
- It is compiled using Geometric Mean
- Components of WPI

Major Components	Weights (Base Year 2011-12)
Primary Articles	22.62
Fuel & Power	13.15
Manufactured Products	64.23

- WPI excludes – services, indirect taxes.
- WPI food index (weight 24.38): - It consists of 'Food Articles' from Primary Articles (15.26) and 'Food Product' from Manufactured Products (9.12).

Consumer Price Index (CPI)

- CPI measures the inflation at retail level.
- It includes services

Index	Released by	Base Year	Food Component
CPI (IW)	Labour Bureau, Ministry of Labour and Employment	2016	39.17
CPI (AL)		1986-87	
CPI (RL)		1986-87	
CPI (R), (U), (C)	NSO, MoSPI	2012	

- CPI (IW) - used for calculating Dearness Allowances
- CPI (AL) - used for indexing MGNREGA wages
- CPI (C) - used as nominal anchor for conduct of monetary policy in India (Inflation Targeting)
- Consumer Food Price Index (CFPI)
    - Rural – 47.25
    - Urban – 29.62
    - Combined – 39.06

GDP Deflator

- GDP Deflator = (GDP at Current Prices/GDP at constant Price) * 100
- It is a measure of general price inflation.

	• GDP deflator is much more broader and comprehensive measure of inflation than CPI and WPI. GDP deflator reflects the prices of all domestically produced goods and services in the economy whereas, other measures like CPI and WPI are based on a limited basket of goods and services, thereby not representing the entire economy. • GDP deflator includes Services, the prices of investment goods, government services and exports, and excludes the price of imports. • Released by MoSPI
Other Indexes	
Producer Purchasing Index (PPI)	• Measures the average change in the price of goods and services which is received by the producers. • It includes Services and excludes indirect taxes. • PPI removes the multiple counting biases inherent in WPI
NHB Residex	• Housing Price Index to measure movement of residential property prices within a geographical boundary. • National Housing Bank publishes NHB RESIDEX for 50 cities on a quarterly basis • Base Year – 2017-18

Impact of Inflation

- Positively impact
    - Businessman and enterpreneurs – Profits may increase due to price rise.
    - Debtors (borrowers) - Inflation redistributes wealth from creditors to debtors
    - Moderate inflation stimulates economic growth
- Negatively Impact
    - Fixed income/salaried/pensioners
    - Lenders - Lenders suffers due to inflation. It is because the money they get paid back has less purchasing power than the money they loaned out.
    - Exporters – Inflation increases cost of production.

Measures to keep inflation under control

- RBI – Adopting Dear Money Policy (increasing interest rates)
- Government reducing taxes (Central Excise Duty) on diesel & petrol
- Essential Commodities Act/ APMC Reform
- Fiscal Consolidation
- Rationalization of subsidies
- Curbing corruption and Black Money

INFLATION

What is Inflation?

Inflation is a general rise in the price level in an economy over a period of time.

OR

Inflation is the decline of purchasing power of a given currency over time.

OR

Inflation is the rate at which the cost of goods and services rises over time.

OR

Inflation indicates how much the average price has changed for the selected basket of goods and services.

Impact of Inflation

- On Creditors and Debtors
- On Savers
- On Investment
- On Lending and Interest Rates
- On Salaried
- On Taxpayers
- On Exchange Rate

Understanding Food Inflation

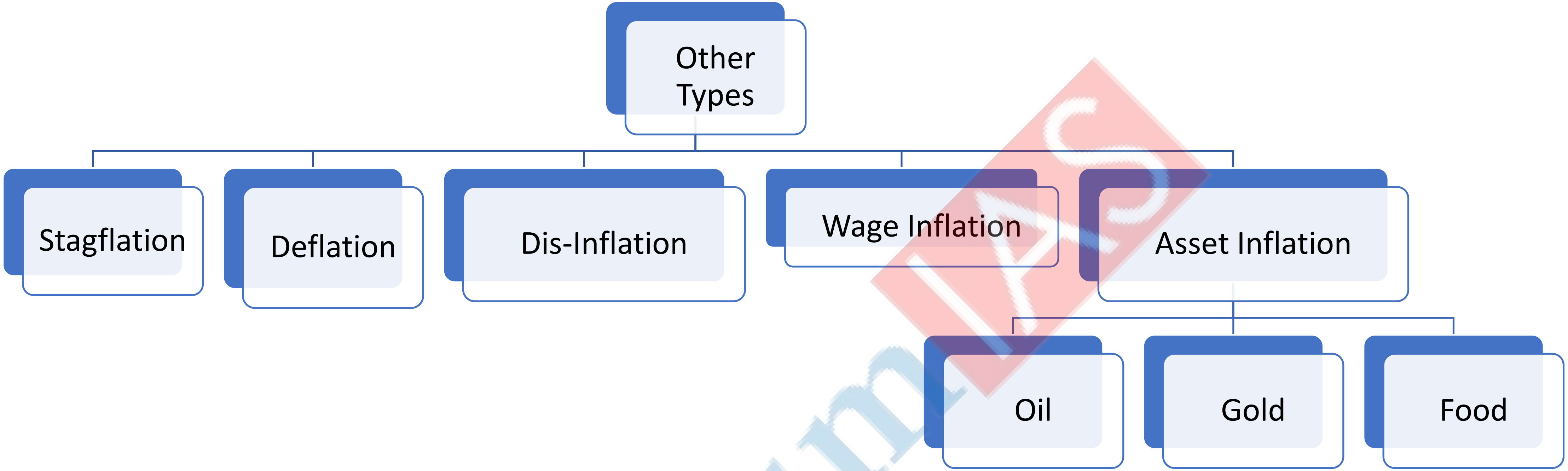
- MSP
- MGNREGA
- Rural Liquidity & Credit
- Labour Shifting to Construction
- Female Participation Rate

Is Food Inflation all bad?

Understanding Philips Curve

Was India under Stagflation in Q3-Q4 of FY20?

- Types of Inflation
  - Based on the reason
    - Demand-Pull Inflation
    - Cost-Push Inflation
    - Built-in Inflation
  - Based on the Speed
    - Creeping Inflation
    - Walking Inflation
    - Galloping Inflation
    - Hyperinflation



Other Types
Stagflation
Deflation
Dis-Inflation
Wage Inflation
Asset Inflation
Oil
Gold
Food

Measuring Inflation

Wholesale Price Index (WPI)

- Published by the **Office of Economic Adviser, Ministry of Commerce and Industry**
- All transactions at the **first point of bulk sale** in the domestic market are included.
- Major criticism for this index is that the general public does not buy products at wholesale price.
- The base year of All-India WPI has been revised from 2004-05 to 2011-12 in 2017.

Consumer Price Index (CPI)

- It measures price changes from the **perspective of a retail buyer.**
- It measures changes over time in the level of retail prices of selected goods and services on which consumers of a defined group spend their incomes.
- Base Year for CPI is 2012.

GDP Deflator or WPI or CPI?

Both Calculated based on Geometric Mean

	WPI	CPI
Published By	DPIIT (Department for Promotion of Industry and Internal Trade)	CSO (Central Statistical Office)
Base-Year	2011-2012	2012
Components	Manufacturing>Primary Articles> Fuel & Power	Food, Beverage> Health-Education>Fuel
Goods & Services	Excludes Services	Includes both Goods and Services

WPI vs CPI vs PPI (Read from link Inflation1&2)

What are Headline Inflation and Core Inflation?

Headline inflation refers to the change in value of all goods in the basket.

Core inflation excludes food and fuel items from headline inflation.

Since the prices of fuel and food items tend to fluctuate and create ‘noise’ in inflation computation, core inflation is less volatile than headline inflation.

In a developed economy, food & fuel account for 10-15% of the household consumption basket and in developing economies it forms 30-40% of the basket.

Headline inflation is more relevant for developing economies than developed economies.

Q1. Which of the following factors can contribute to the supply-side constraints?

1. Higher crude oil prices
2. Infrastructural delays
3. Rupee depreciation
4. Lower agricultural growth

Select the correct answer using the code(s) given below:

(a) Only 1 (b) Only 1 and 2

(c) Only 1, 2 and 3 (d) All of the above

Ans:1)(d)

Match List-I with List-II and select the correct answer using the code(s) given below:

A	Boom	1	Business activity at high level with increasing income, output and employment at macro level
B	Recession	2	Gradual fall of income, output and employment with business activity in a low year.
C	Depression	3	Unprecedented level of under employment and unemployment, drastic fall in income, output and employment
D	Recovery	4	Steady rise in the general level of prices, income, output and employment.

A B C D

(a) 1 2 3 4

(b) 1 2 4 3

(c) 2 1 4 3

(d) 2 1 3 4

Ans:2)(a)

Q3. Which among the following can result in ‘demand pull inflation’?

1. Increase in subsidy on LPG.

2. Increase in fuel prices.

3. Decrease in income tax rates.

Select the correct answer using the code(s) given below.

(a) Only 1 and 2 (b) Only 1 and 3

(c) Only 2 and 3 (d) All of the above

Ans:3)(b)

Q4. Consider the following statements:

1. The Phillips curve shows that higher rates of inflation imply lower rates of unemployment.

2. The Laffer curve suggests that government revenues decline beyond a peak tax rate.

3. Gini Coefficient is derived from the Laffer curve.

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

(a) Only 1 and 2 (b) Only 1 and 3

(c) Only 2 and 3 (d) All of the above

Ans:4)(a)

Q5. A rapid increase in the rate of inflation is sometimes attributed to the "base effect". What is "base effect"?

(a) It is the impact of drastic deficiency in supply due to failure of crops

(b) It is the impact of the surge in demand due to rapid economic growth

(c) It is the impact of the price levels of previous year on the calculation of inflation rate

(d) None of the above

Ans:5)(c)

Q6. With reference to economy, the Marginal Utility Curve depicts:

(a) the relation between the satisfaction generated from the consumption of an additional unit of a good and the quantity of the good consumed.

(b) the inverse relationship between rates of unemployment and corresponding rates of inflation.

(c) the relationship between average tax rates to total tax revenue.

(d) the function relating the quantity purchased of a commodity to the level of money income.

Ans:6)(a)

Q7. Aggregate demand for final goods in an economy is generated though which of the following?

1. Consumption expenditure

2. Investment expenditure

3. Government expenditure

Select the correct answer using the code(s) given below.

(a) Only 1 and 2 (b) Only 2 and 3

(c) Only 1 (d) All of the above

Ans:7)(d)

Q8. Which of the following statements are correct in case of high inflation?

1. Reduction in the real purchasing power per unit of money.
2. Sustained GDP growth.
3. Growing international trade in the currency.
4. Near zero real interest rate situations.

Select the correct answer using the code given below.

(a) Only 1 (b) Only 1 and 4

(c) Only 1, 2 and 3 (d) Only 2, 3 and 4

Ans:8)(b)

Q9. With reference to economy, the term Inflation Tax refers to

(a) Rise in inflation due to lower taxes.

(b) Higher proportion of wages paid as tax.

(c) Decrease in the value of cash due to inflation.

(d) A tax to penalize short-term currency speculation.

Ans:9)(c)

Q10. The effects of inflation on the price competitiveness of a country's products may be offset by:

(a) An appreciation of the currency

(b) A revaluation of the currency

(c) A depreciation of the currency

(d) Lower inflation abroad

Ans:10)(c)

Q11. Scarcity of foreign exchange reserves will be witnessed on which type of inflation?

(a) Demand-Pull Inflation

(b) Structural Inflation

(c) Cost-Push Inflation

(d) None of the above

Ans:11)(b)

Characteristics of Structural Inflation includes:

● Food shortage

● Scarcity of resources

● Scarcity of foreign exchange reserves

Characteristics of Cost-Push Inflation includes:

● Increase in wages

● Increase in taxes

● Increase in prices of raw materials

● Supply shocks

Characteristics of Demand-Pull Inflation includes:

● Increasing government expenditure

● Increasing money supply (liberal monetary/ fiscal policy)

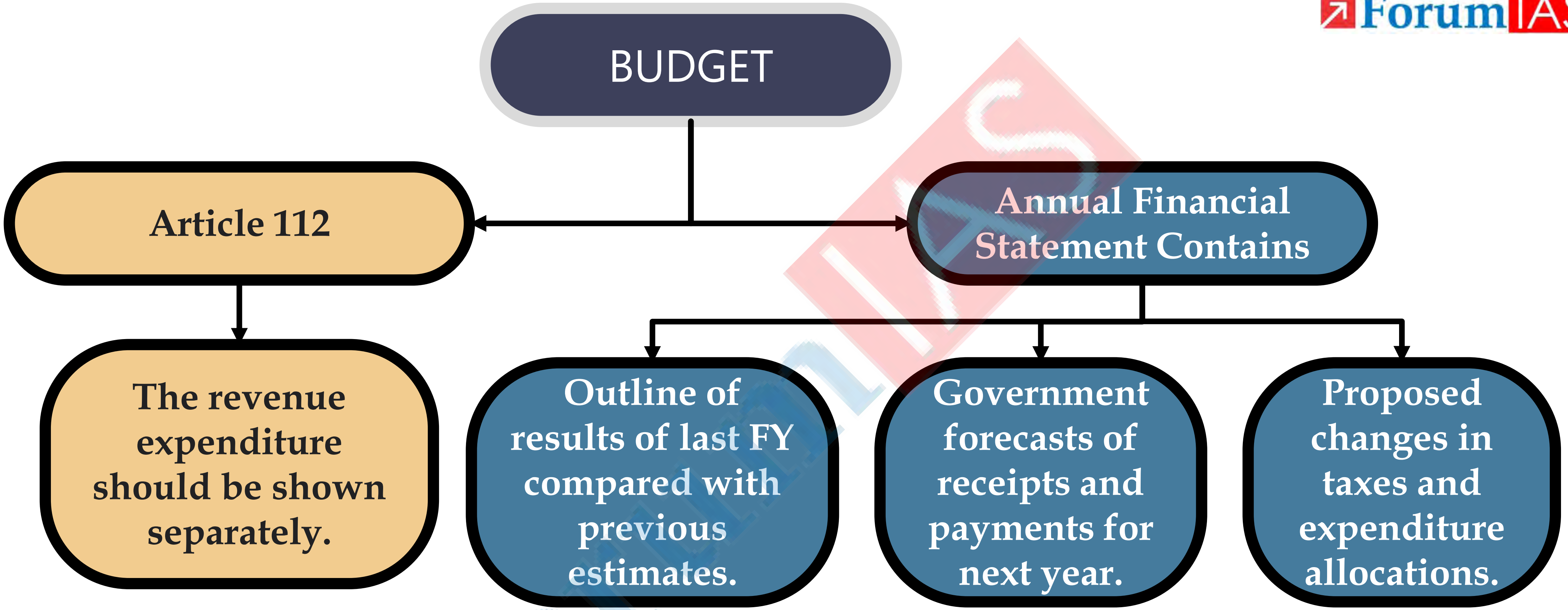
● Parallel economy/ black economy

● Increasing forex reserves

PUBLIC FINANCE

Public Finance is the investigation into nature and principles of state revenue and expenditure.

- Adam Smith


BUDGET
Article 112
The revenue expenditure should be shown separately.
Annual Financial Statement Contains
Outline of results of last FY compared with previous estimates.
Government forecasts of receipts and payments for next year.
Proposed changes in taxes and expenditure allocations.

Budget shows receipts and payments under three heads:

- **Consolidated Fund of India (Article 266)**
  - Shows revenue and capital receipts
- **Contingency Fund Of India (Article 267)**
  - Comprises the sum placed at the disposal of President to meet the unforeseen expenditure.
- **Public Accounts of India (Article 266(1))**
  - All receipts and payments in nature of a deposit account like National small savings Funds (NSSF), PF etc.

Centre tweaks spending norms for Contingency Fund of India

Now, 40 per cent of the total corpus will be placed at the disposal of the expenditure secretary

The government had raised the size of the fund to Rs 30,000 crore from Rs 500 crore in the last budget.

The government had raised the size of the fund to Rs 30,000 crore from Rs 500 crore in the last budget.

Contingency Fund of India

The government had raised the size of the fund to Rs 30,000 crore from Rs 500 crore in Budget 2021-2022.

It is dealt under Contingency Fund of India Act, 1950.

New Norms for Spending

40%

60%

At Disposal Of Expenditure Secretary

Requires Approval Of Expenditure Secretary And Economic Affairs Secretary

M17. Budget is more a political tool than a socio-economic document. Comment.

Budget Process

Types of Budgeting and their Evolution

M18. What do you understand by Outcome budget? How is it different from performance budget? Explain.

M19. Women empowerment in India needs gender budgeting. What are the requirements and status of gender budgeting in the Indian context? ***(UPSC 2016)***

The two major parts of Budget

- Capital Budget
- Revenue Budget

Dividends and Profits from PSUs
Interest Receipts from States & UTs
RBI Surplus Transfer
External Grants

Q20. Which of following is not a component of 'Capital Receipts'? (IEnggS-2018)

(a) Market borrowings including special bonds

(b) External loans raised by the Central Government from abroad

(c) Receipts from taxes on property and capital transactions

(d) Provident Funds (State Provident Funds and Public Provident Fund)

Ans: 20 (c)

M17. Distinguish between Capital Budget and Revenue Budget. Explain the components of both these Budgets. ***(UPSC 2021)***

M18. The public expenditure management is a challenge to the Government of India in the context of budget-making during the post-liberalization period. Clarify it. ***(UPSC 2019)***

Which type of income and expenditure is better?

Q21. Find correct statement(s): ***(UPSC-2015)***

1. The Rajya Sabha has no power either to reject or to amend a Money Bill.
2. The Rajya Sabha cannot vote on the Demands for Grants.
3. The Rajya Sabha cannot discuss the Annual Financial Statement.

Codes:

(a) 1 only
(b) 1 and 2 only
(c) 2 and 3 only
(d) 1, 2 and3

Ans: 21(b)

Recent Changes in Budget

- Date Advancement (Vote on Account and Interim Budget)
- Plan and Non Plan Expenditure distinction removed.
- Railway budget merged with the general budget.

What is Public Debt?

Internal > Public Accounts>External

Few Basics Regarding Government Borrowings

Borrowing is a loan taken by the government and falls under **capital receipts** in the Budget document.

91 Days

365 Days

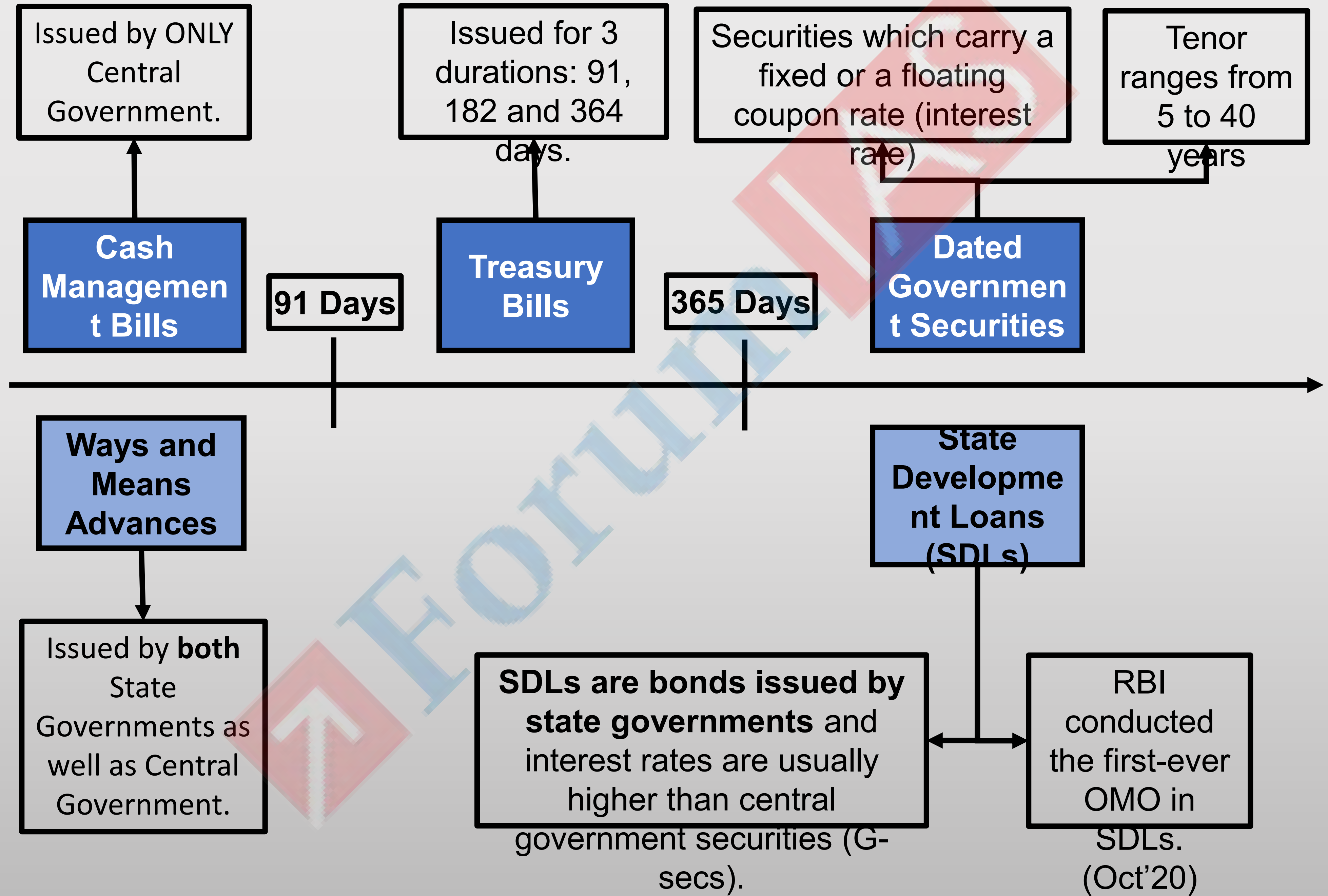
Cash Management Bills (CMBs)

The bills are issued by the RBI on behalf of the government.

CMBs are issued at a discount and redeemed at face value at maturity. For example, if the face value of a CMB is Rs 100, we can get the bill at Rs 97 and at the end of the maturity date, say 60 after days, we can get Rs 100.

Here, there is no interest payment as the maturity period is so small. But the return for buying CMB is obtained in the form of a discount.

Zero-Coupon Bonds issued at discount.



Issued by ONLY Central Government.
Issued for 3 durations: 91, 182 and 364 days.
Securities which carry a fixed or a floating coupon rate (interest rate)
Tenor ranges from 5 to 40 years
Cash Management Bills
91 Days
Treasury Bills
365 Days
Dated Government Securities
Ways and Means Advances
State Development Loans (SDLs)
Issued by **both** State Governments as well as Central Government.
SDLs are bonds issued by state governments and interest rates are usually higher than central government securities (G-secs).
RBI conducted the first-ever OMO in SDLs. (Oct’20)

Government's Medium-Term Debt Management Strategy (2019-2022)

Low cost of borrowing

Elongating maturity profile of the debt portfolio.

+

Rationalization of interest rates on small savings schemes and other instruments like PF, special securities, etc.

+

Advising other Divisions of Department of Economic Affairs to help them arrive at the best terms for external loans.

Risk mitigation

Setting benchmarks for certain indicators such as external debt, to ensure minimal risk in terms of Roll-over Risk.

Market development

Maintaining transparency

Calibrated opening of the Government securities market to foreign investors.

India's performance on indicators of debt sustainability

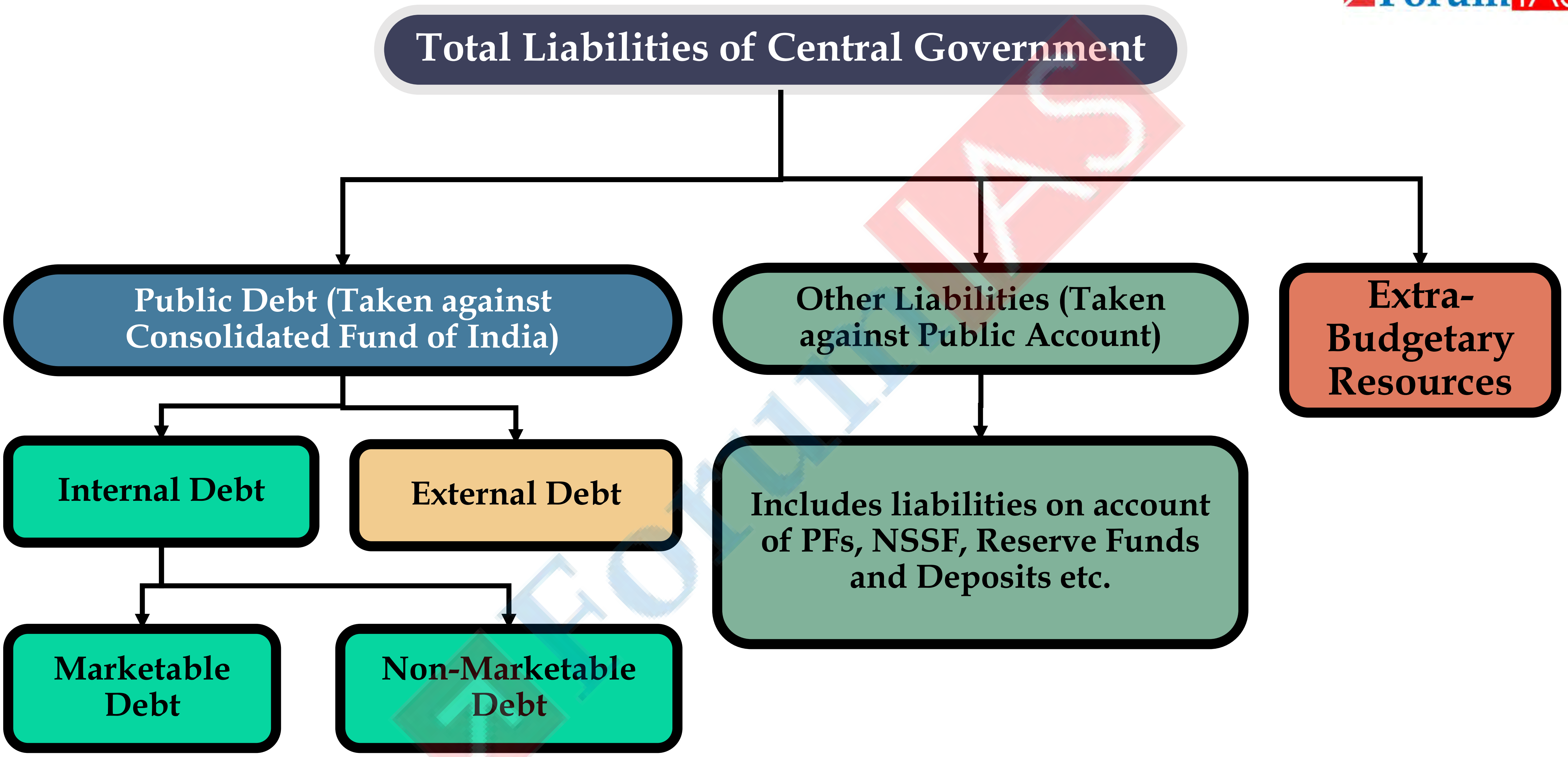
Gross Fiscal Deficit (GFD) as a percentage of GDP has been on a declining trend since 2012-13.

The share of short-term debt is within safe limits.

The Government has adopted a conscious strategy of elongating maturity to reduce roll-over risk.

Most of the Government debt is at fixed interest rates, with floating internal debt constituting only 0.9 per cent of GDP in 2019, which minimizes the impact of interest rate volatility on the budget.

Low share of external debt implies that currency risk and the susceptibility of debt portfolio to volatile international capital markets is not substantial.


Total Liabilities of Central Government
Public Debt (Taken against Consolidated Fund of India)
Other Liabilities (Taken against Public Account)
Extra-Budgetary Resources
Internal Debt
External Debt
Includes liabilities on account of PFs, NSSF, Reserve Funds and Deposits etc.
Marketable Debt
Non-Marketable Debt

Is Public Debt good or bad?

- Why it is taken?
- Its Trend
- From where is it taken? (and how paid back?)
- Debt Sustainability

EXTRA BUDGETARY RESOURCES

Interest and Principal paid from the Budget

But still called "OFF BUDGET LIABILITIES"

How borrowings outside the budget hide the real defi numbers

REMYA NAIR 5 February, 2019 7:44 pm IST

Most Popular

Sub-African India: M richer than us, has be while we diminish
Shekhar Gupta - 5 Jun

PM has no individual NDMA. Notice to Ala Bandyopadhyay ques
Gopal Sankaranarayan

7,000 cases/day to 2,6 IAS officer turned it a Chennai in a fortnigh
Soniya Agrawal - 4 Jun

With off-budget borrowings, FY22 fiscal deficit rises to 6.9%: Report

The states' gross borrowings have been revised upwards to ₹8.7 lakh cr and net borrowings to ₹7.2 lakh cr in FY21

2 min read . Updated: 02 Feb 2021, 04:38 PM IST

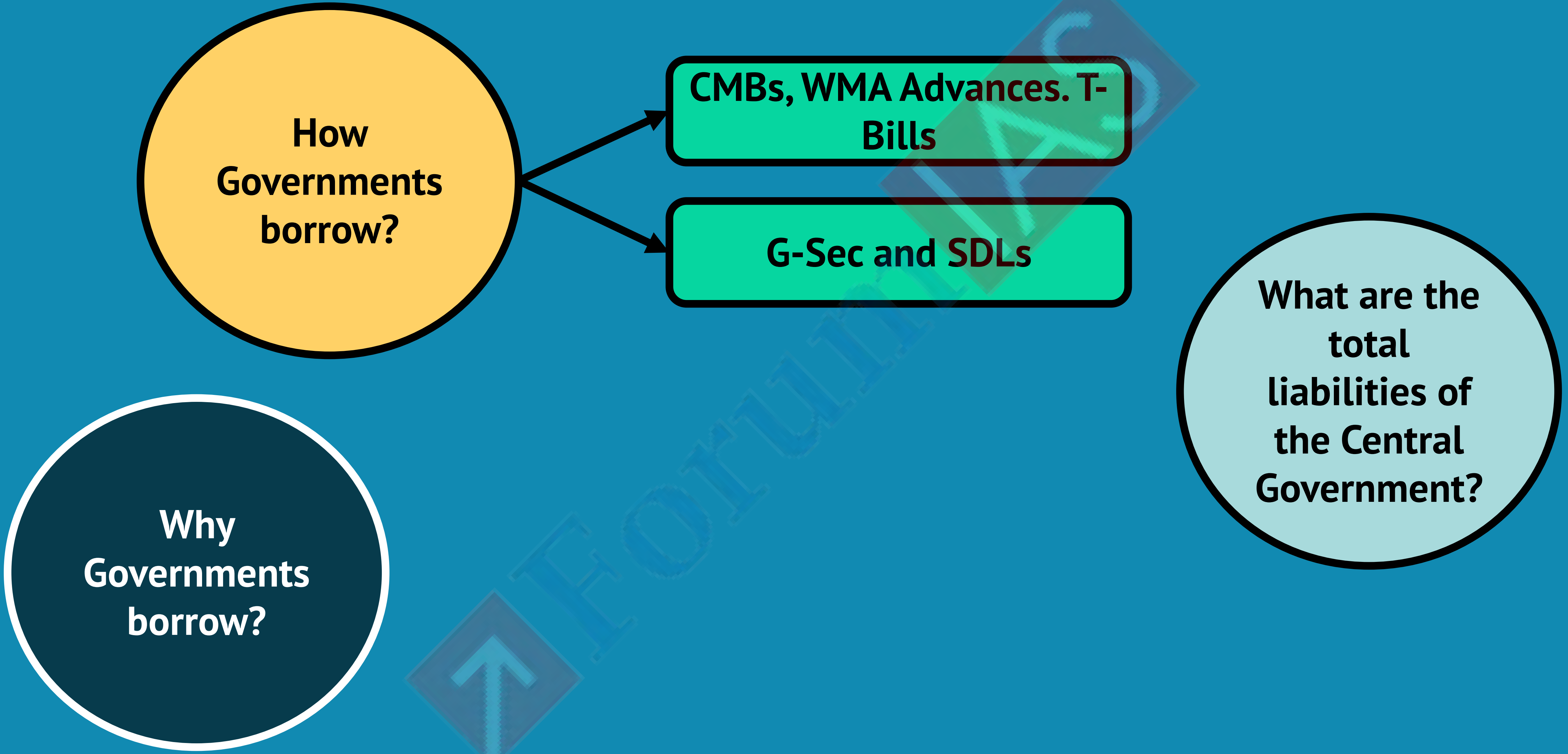
Governments in Developing countries have to pull the "growth cart".

- Gross Public Investment
- Government Final Consumption Expenditure

Why Governments borrow?

How Governments borrow?

What are the total liabilities of the Central Government?


How Governments borrow?
CMBs, WMA Advances. T-Bills
G-Sec and SDLs
Why Governments borrow?
What are the total liabilities of the Central Government?

Extra-Budgetary Resources

Extra budgetary resources (EBRs) are those financial liabilities that are raised by PSUs for which repayment of entire principal and interest is done from Government budget.

Markets

Will provide Rs 100 loans to farmers.

But don't have funds.

NABARD

Lends further and ultimately reaches the farmers through various channels

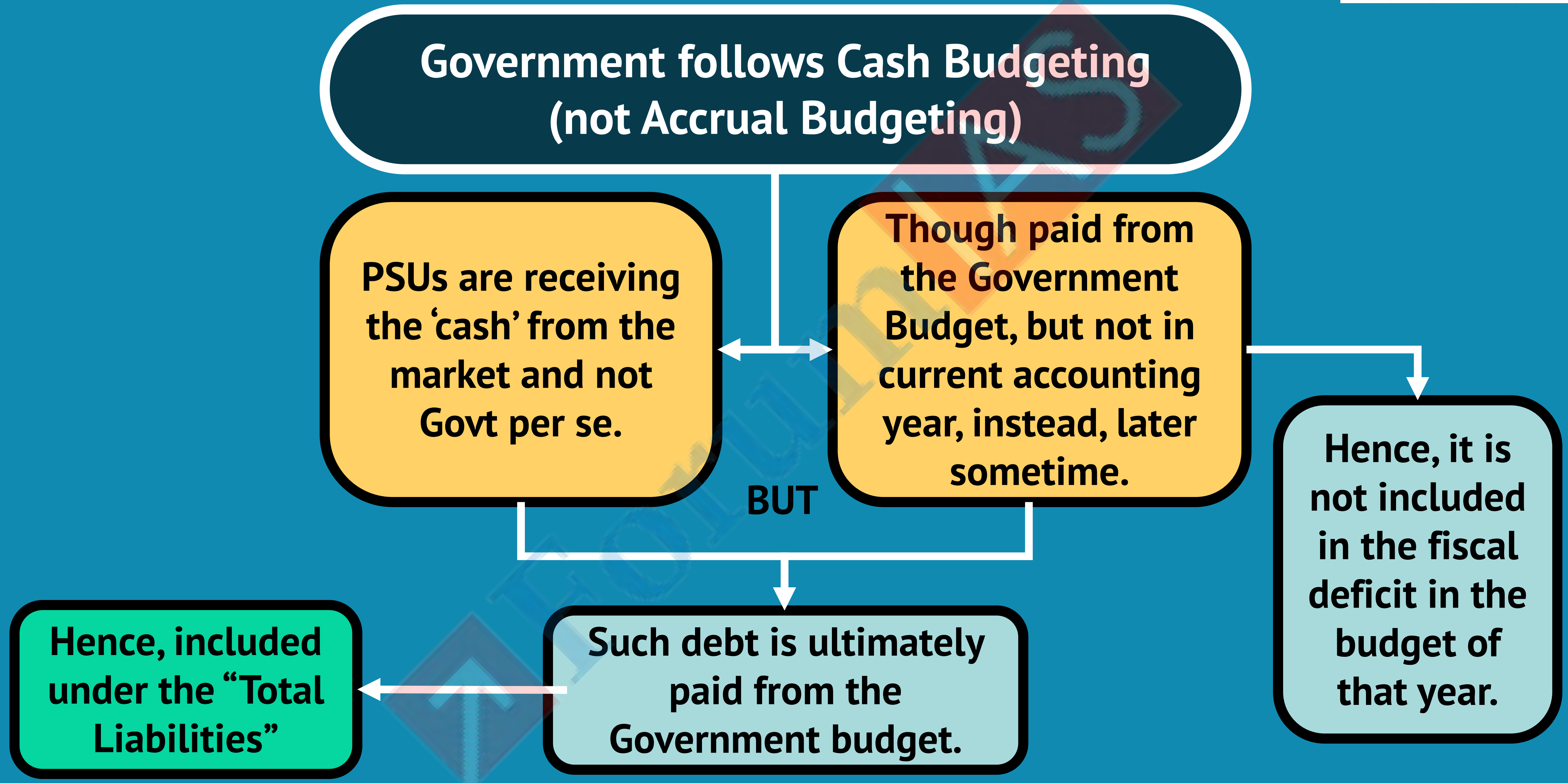
This solves the problem of funds for the government to meet their expenditure.

Such debt is paid from the Government budget.

But it is not included in the fiscal deficit in the budget of that year.

How?

Accounting Gymnastics


Government follows Cash Budgeting
(not Accrual Budgeting)
PSUs are receiving the 'cash' from the market and not Govt per se.
Though paid from the Government Budget, but not in current accounting year, instead, later sometime.
BUT
Hence, it is not included in the fiscal deficit in the budget of that year.
Such debt is ultimately paid from the Government budget.
Hence, included under the "Total Liabilities"

Since, they are kept "off" the budget for current year, they are also called:

Off-Budget Liabilities

The Fifteenth Finance Commission in its initial report advised both the centre and the states to eliminate extra budget borrowings.

Outstanding extra-budgetary liabilities need to be clearly identified and eliminated in a time-bound manner as per the amended FRBM Act of 2018.

Why is this Transparency even important?

Government's Steps to Transparency

Government Started publishing Extra-Budgetary Liabilities in the Budget Document from 2019.

Business Standa

OME | MARKETS | COMPANIES | OPINION | TECH | SPECIALS | PF | PORTFOLIO | MULTIMEDI

Today's Paper | Latest News | Economy | Finance | Current Affairs | International | Management | Strategist

JUST IN Delhi govt presents Rs 69,000-cr budget themed on patriotism for FY 2021-22

You are here: Home » Budget » News

Going easy on loans: FM brings transparency in off-budget borrowings

Does away with loans from National Small Savings Fund to Food Corporation of India

Topics
Budget 2021 | national borrowing

Dhasmana | New Delhi
dated at February 2, 2021 01:10 IST

Doing away with loans from the National Small Savings Fund (NSSF) to the Food Corporation of India (FCI) from FY22.

Trends in Sovereign Debt/National Debt

Central Government Debt: Steadily increasing or decreasing?

Central government debt is characterized by low currency risk and interest rate risk?

Gradual elongation of maturity profile of central government debt leading to lower rollover risks?

It has crossed 100 lakh crore rupees .

Total Liabilities of Central Government has declined steadily immediately after enactment of FRBM Act and has sustained at a level during last decade?

The proportion of dated securities maturing in less than 5 years has seen consistent decline in recent years?

Article 293 (3)

Figure 15: Maturity Profile of Outstanding Dated Central Government Securities (as per cent of Total)

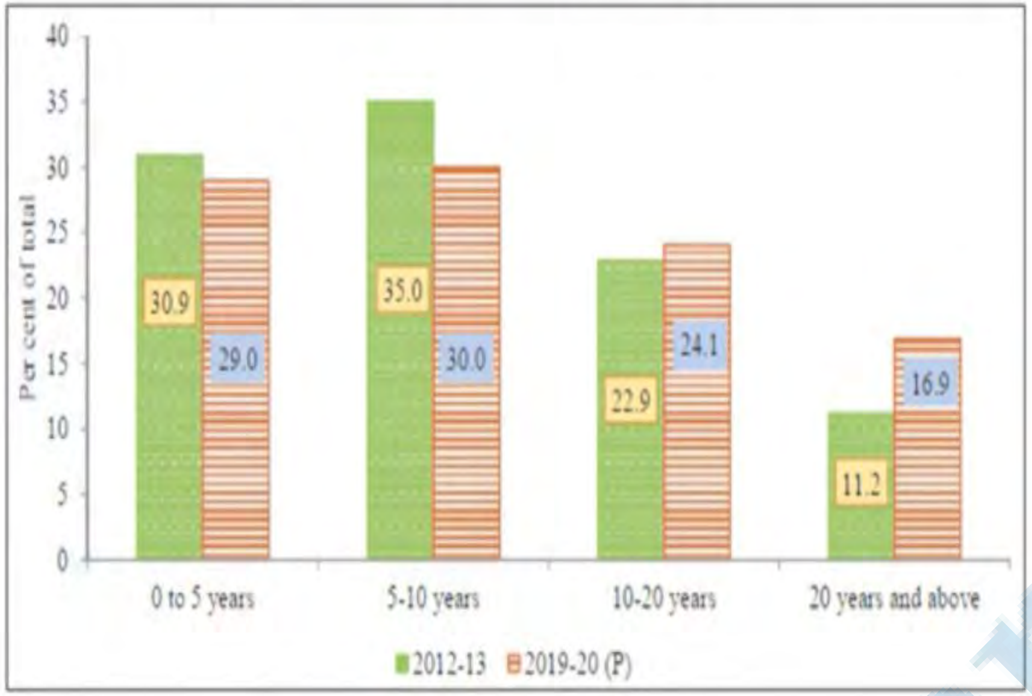
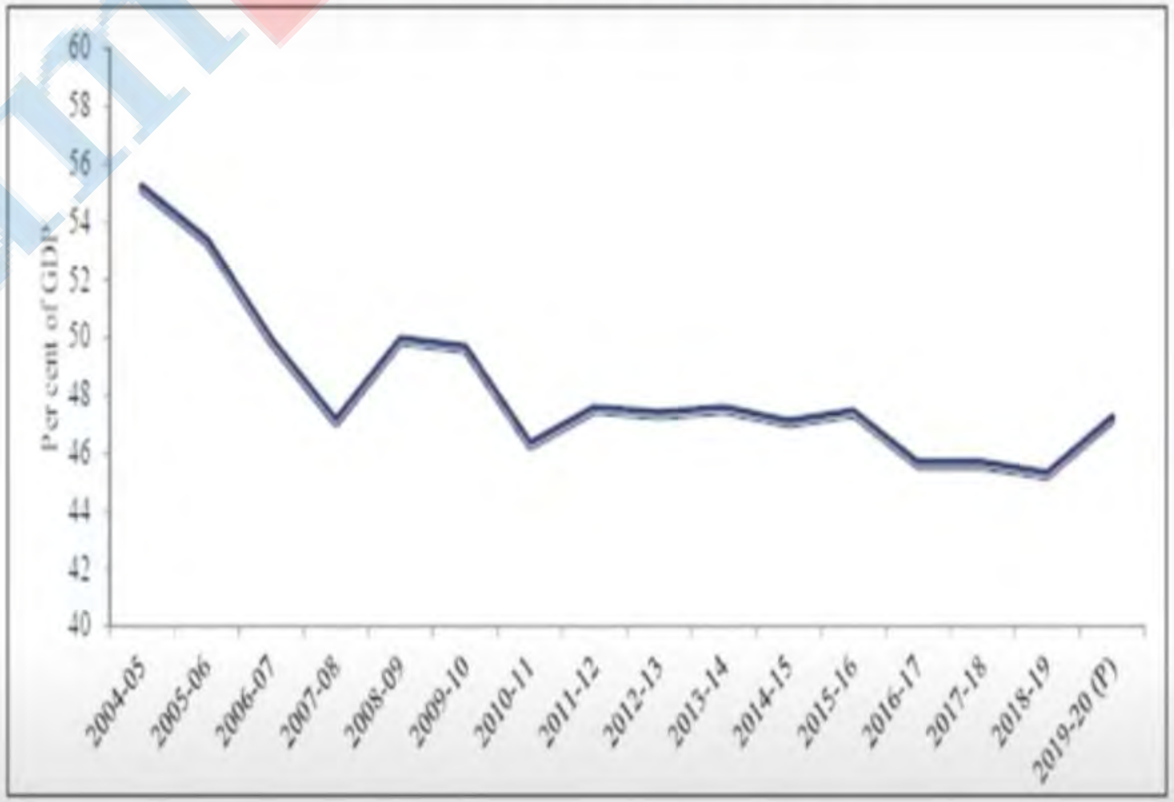


Figure 14: Trend in Centre's Debt-GDP ratio



State's Borrowings

Centre increased borrowing limit of states to 5% of GSDP from 3%.

Total net borrowing by states for 2020-21 stood at Rs 6.41 lakh crore, based on 3% of GSDP

0.5%

Untied

1%

0.25%

Urban Local Bodies Empowering

0.25%

Power Distribution Reforms

0.25%

Improvements in EoDB

0.25%

Universalization of One Nation, One Ration

0.5%

If 3 of 4 is done.

How does the enhanced borrowing limit help States?

Helps plug the shortfall in Centre's Devolution	Availability of Additional Capital	Addresses Revenue Shortfall	Avoid Cut in Capital Expenditure
The budgeted Rs 7.8 lakh crore of devolution for FY21 could end up closer to Rs 5 lakh crore, since the Centre's Rs 24.2 lakh crore target will not be met.	This move that will make an additional Rs 4.28 lakh crore available to States.	Enhancement of borrowing limit will help to absorb the expected plunge in States' revenue receipts.	Due to fixed expenditure on salaries & pensions and on politically sensitive issues like subsidies, a reduction in revenue will eventually lead to cut in infrastructure creation that is not good in long term.

Type of Deficits

In 1950-51, GoI recognized only two types of deficits:

- Revenue Deficit
- Budget Deficit

Q22. There has been a persistent deficit budget year after year. What can be done by the government to reduce the deficit? ***(UPSC-2015)***

1) Reducing revenue expenditure
2) Introducing new welfare schemes
3) Rationalizing subsidies
4) Expanding industries

Select the correct option:

(a) 1 and 3 only
(b) 2 and 3 only
(c) 1 only
(d) 1, 2, 3 and 4

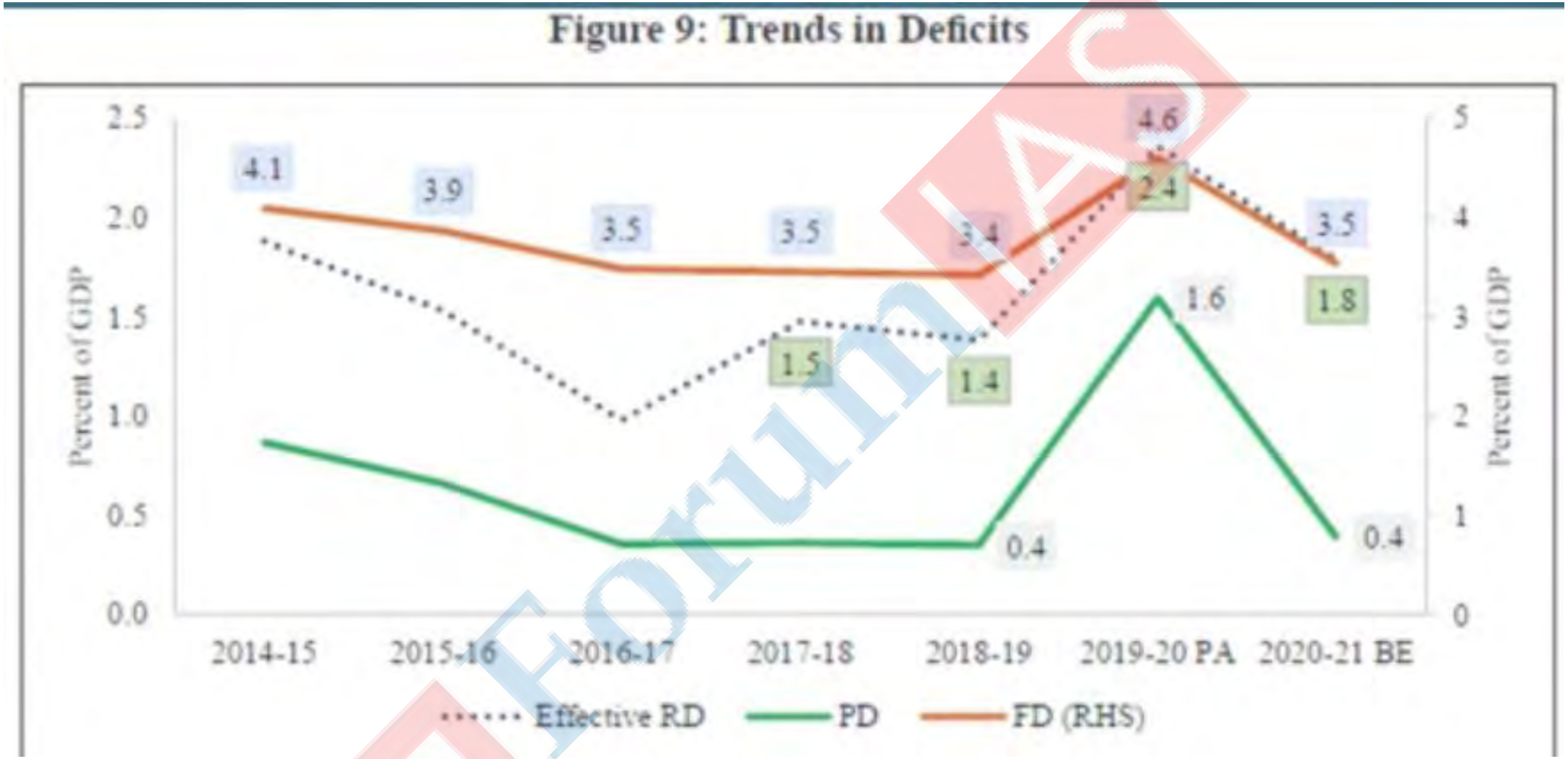
Ans: 22 (a)

Q23. Which one of the following statements appropriately describes the “fiscal stimulus”? ***(UPSC-2011)***

a) It is a massive investment by the Government in manufacturing sector to ensure the supply of goods to meet the demand surge caused by rapid economic growth.
b) It is an intense affirmative action of the Government to boost economic activity in the country.
c) It is Government’s intensive action on financial institutions to ensure disbursement of loans to agriculture and allied sectors to promote greater food production and contain food inflation.
d) It is an extreme affirmative action by the Government to pursue its policy of financial inclusion

Ans: 23 (b)

	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20 PA	2020-21 BE
	(in ₹ Lakh crore; Figures in parenthesis are as a per cent of GDP)						
Revenue Receipts	11.01	11.95	13.74	14.35	15.53	16.82	20.21
	(8.8)	(8.7)	(8.9)	(8.4)	(8.2)	(8.3)	(9)
Gross Tax Revenue	12.45	14.56	17.16	19.19	20.80	20.10	24.23
	(10)	(10.6)	(11.2)	(11.2)	(11)	(9.9)	(10.8)
Net tax revenue	9.04	9.44	11.01	12.42	13.17	13.56	16.36
	(7.2)	(6.9)	(7.2)	(7.3)	(6.9)	(6.7)	(7.3)
Non-tax revenue	1.98	2.51	2.73	1.93	2.36	3.26	3.85
	(1.6)	(1.8)	(1.8)	(1.1)	(1.2)	(1.6)	(1.7)
Non-debt capital receipts*	0.51	0.63	0.65	1.16	1.13	0.69	2.25
	(0.4)	(0.5)	(0.4)	(0.7)	(0.6)	(0.3)	(1)
Non-debt receipts	11.53	12.58	14.4	15.51	16.66	17.51	22.46
	(9.2)	(9.1)	(9.4)	(9.1)	(8.8)	(8.6)	(10)
Total Expenditure	16.64	17.91	19.75	21.42	23.15	26.86	30.42
	(13.3)	(13.0)	(12.9)	(12.5)	(12.2)	(13.2)	(13.5)
Revenue Expenditure	14.67	15.38	16.91	18.79	20.07	23.50	26.30
	(11.8)	(11.2)	(11.0)	(11.0)	(10.6)	(11.6)	(11.7)
Capital Expenditure	1.97	2.53	2.85	2.63	3.08	3.37	4.12
	(1.6)	(1.8)	(1.9)	(1.5)	(1.6)	(1.7)	(1.8)
Fiscal Deficit	5.11	5.33	5.36	5.91	6.49	9.36	7.96
	(4.1)	(3.9)	(3.5)	(3.5)	(3.4)	(4.6)	(3.5)
Revenue Deficit	3.66	3.43	3.16	4.44	4.54	6.68	6.09
	(2.9)	(2.5)	(2.1)	(2.6)	(2.4)	(3.3)	(2.7)
Primary Deficit	1.08	0.91	0.55	0.62	0.67	3.25	0.88
	(0.9)	(0.7)	(0.4)	(0.4)	(0.4)	(1.6)	(0.4)
Memo Item							
GDP at Market Price	124.68	137.72	153.62	170.95	189.71	203.40	224.89



In FY21, all deficits are above 5%.

Fiscal Policy

It involves the use of taxation, public expenditure and the management of public debt in order to achieve certain specified objectives.

Major themes of Fiscal Policy:

- Tax structure simplification
- Efforts to strengthen methods of controlling expenditure
- Greater recognition of resource allocation being equitable.

Fiscal Deficit

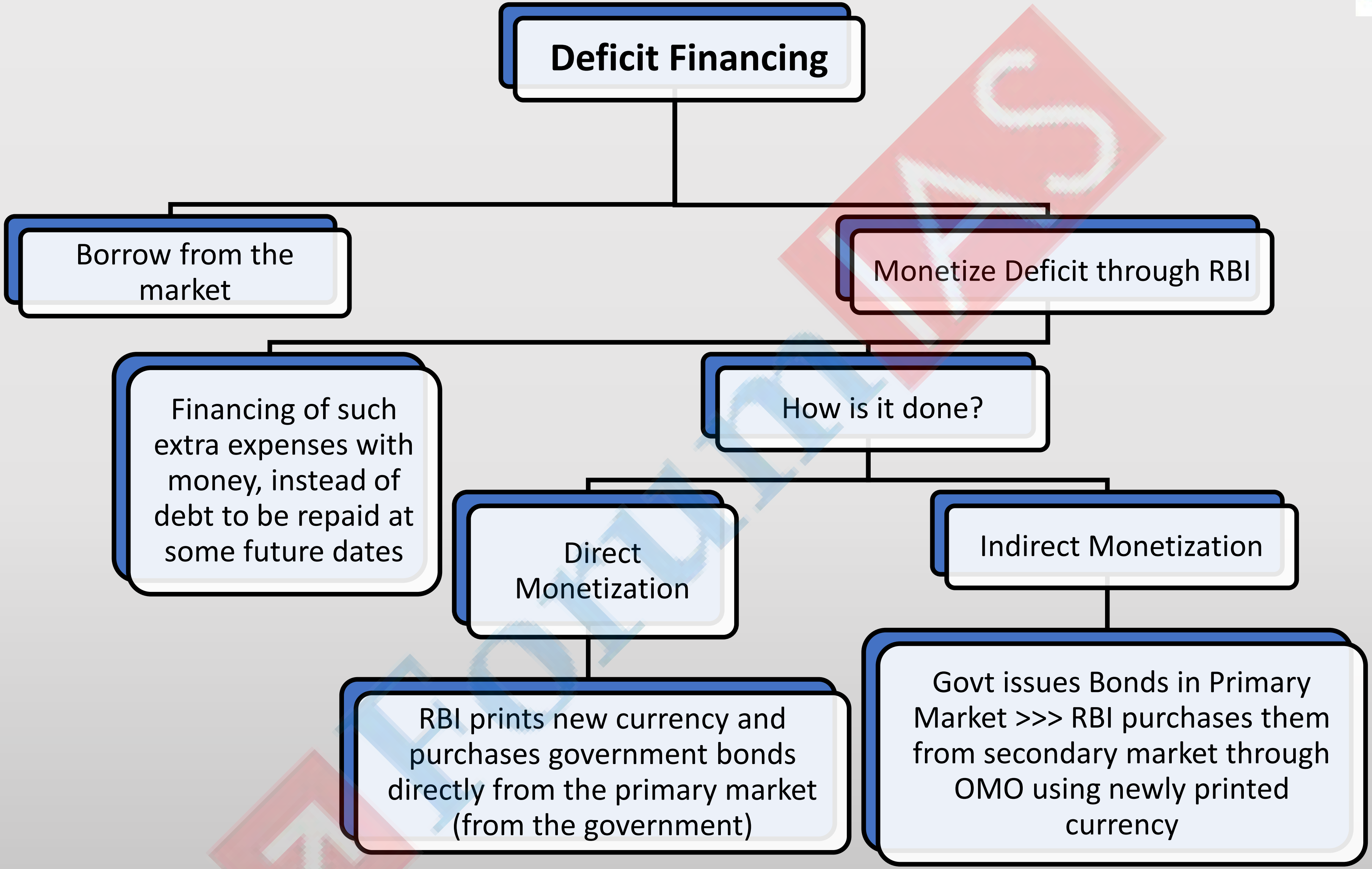
- Crowd Out Private Borrowing
- Lead to Higher taxes or Higher inflation or both.
- Decrease Net Exports
  - However, sometimes, trade deficit helps in debt financing for eg US-China
    <u>(To be explained in International Trade)</u>

MONETIZATION OF DEFICIT

Some economists including former RBI governor C Rangarajan have suggested that the government should **monetize the deficit.**

It is a form of "**non-debt financing**“. As a result, under monetization, there is *no increase in net (not gross)* public debt.

The **FRBM Act as amended in 2017** contained an **escape clause which permits monetization** of the deficit under special circumstances.


Deficit Financing
Borrow from the market
Monetize Deficit through RBI
Financing of such extra expenses with money, instead of debt to be repaid at some future dates
How is it done?
Direct Monetization
Indirect Monetization
RBI prints new currency and purchases government bonds directly from the primary market (from the government)
Govt issues Bonds in Primary Market >>> RBI purchases them from secondary market through OMO using newly printed currency

Q24. Which one of the following is likely to be the most inflationary in its effect? (2013)

(a) Repayment of public debt

(b) Borrowing from the public to finance a budget deficit

(c) Borrowing from banks to finance a budget deficit

(d) Creating new money to finance a budget deficit

Ans: 24 (d)

FRBM Act,2003

The Fiscal Responsibility and Budget Management (FRBM) Bill was introduced in the parliament of India in the year 2000 by Atal Bihari Vajpayee Government for providing legal backing to the fiscal discipline to be institutionalized in the country. Subsequently, the FRBM Act was passed in the year 2003.

It is an act of the parliament that set targets for the Government of India to establish financial discipline, improve the management of public funds, strengthen fiscal prudence, and reduce its fiscal deficits.

In 2021-22, the government has not provided a target for the next three years and will amend the FRBM Act to accommodate the higher fiscal deficit. The fiscal deficit is targeted at 6.8% of GDP in 2021-22, down from the revised estimate of 9.5% in 2020-21 (4.6% in 2019-20). In the Union Budget 2021 speech, the Finance Minister has announced the government's aim to steadily reduce fiscal deficit to 4.5% of GDP by 2025-26.

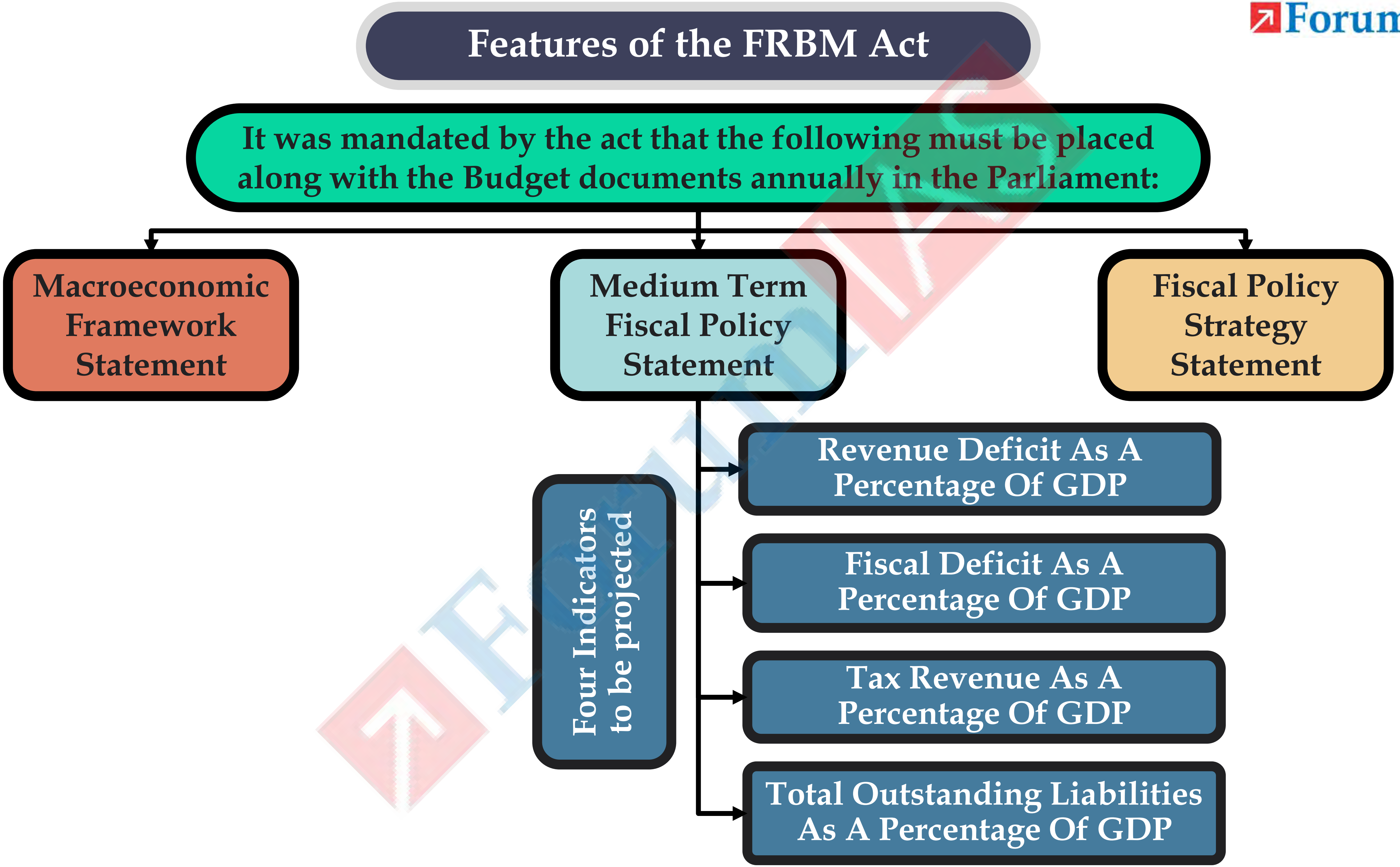
Why was the FRBM Act passed?

The primary objective was the elimination of revenue deficit and bringing down the fiscal deficit.

The other objectives included:

- Ensuring fiscal stability in the long run
- Ensuring equitable distribution of debt over the years
- Introduction of a transparent system of fiscal management within the country

The act also intended to give the required flexibility to the Central Bank for managing inflation in India.


Features of the FRBM Act
It was mandated by the act that the following must be placed along with the Budget documents annually in the Parliament:
Macroeconomic Framework Statement
Medium Term Fiscal Policy Statement
Fiscal Policy Strategy Statement
Four Indicators to be projected
Revenue Deficit As A Percentage Of GDP
Fiscal Deficit As A Percentage Of GDP
Tax Revenue As A Percentage Of GDP
Total Outstanding Liabilities As A Percentage Of GDP

N K Singh Committee (2017)-FRBM ACT

It proposed to replace the FRBM Act, 2003 with a Debt Management and Fiscal Responsibility Bill, 2017.

Debt to GDP Ratio

The debt to GDP ratio should be 40% for the central government, 20% for the state governments together by the FY 2022 – 23.

Recommended a Fiscal Council

- To prepare multi-year fiscal forecasts.
- To improve fiscal data quality.
- To suggest changes to the fiscal strategy.
- To advise the government on fiscal matters.

Public Debt Management Agency?
(to be discussed in Money & Banking)

Deviations from targets allowed:

- National calamity, war, in considerations of national security, agricultural collapse affecting incomes and outputs.
- Structural reforms in the economy having fiscal implications.
- A decline in real output growth of at least 3% below the average of the previous four quarters.

Q25. According FRBM Act, the Government is under obligation to present three statements before the parliament along with the Annual Budget. Which one of the following is not one of them? ***[UPSC-CDS-2008]***

(a) Macroeconomic Framework Statement
(b) Fiscal Policy Strategy Statement
(c) Medium-term Fiscal Policy Statement
(d) Statement showing Short term Fiscal Policy

Ans: 25 (d)

M21. What were the reasons for the introduction of Fiscal Responsibility and Budget Management (FRBM) Act, 2013? Discuss critically its salient features and their effectiveness. ***(UPSC 2013)***

Public Finance (an important diagram)

DISINVESTMENT

DISINVESTMENT TARGETS, RARELY ACHIEVED

YEAR	DISINVESTMENT TARGET (BE, Rs CRORE)	ACTUAL DISINVESTMENT RECEIPTS (Rs CRORE)	ACTUALS AS A PROPORTION OF BE (%)
2006-2007	3840	0	0.00
2007-2008	41651	3392	8.14
2008-2009	1165	2	0.17
2009-2010	1120	4306	384.46
2010-2011	40000	22275	55.69
2011-2012	40000	1145	2.86
2012-2013	30000	2193	7.31
2013-2014	40000	1589	3.97
2014-2015	43425	222	0.51
2015-2016	41000	12853	31.35
2016-2017	36000	21433	59.54
2017-2018	100000	100195	100.20
2018-2019	80000	85045	106.31
2019-2020	105000	50304	47.91
2020-2021*	210000	17957.7	

Data for all years except 2020-21 from the website of the Controller General of Accounts (CGA). Data for the current year from the Ministry of Finance

Reasons for low Disinvestment proceeds

The proceeds realized through disinvestment were not paid to the enterprise concerned for its expansion and improving efficiency but the government has been using such disinvestment proceeds to bridge the budget deficit.

The offers made by the Government for disinvestment of PSUs are not attractive and stringent bureaucratic procedures causing discouragement to the private sector investors.

Undervaluation of assets leading to 'under-pricing' of public sector enterprises shares resulting in considerable loss to the Government.

The Government does not have a comprehensive policy on disinvestment of its PSU's. The procedures adopted for disinvestment suffered from adhocism. It narrowly focused only on disinvestment of shareholdings.

Disinvestment Policy- Budget 2021

Union Minister for Finance while presenting the Union Budget FY 2021-22 announced that government has approved a policy of strategic disinvestment of public sector enterprises that will provide a clear roadmap for disinvestment in all non-strategic and strategic sectors.

Non- Strategic Sector

In this sector, CPSEs will be privatized, otherwise shall be closed.

Strategic Sector

- Atomic Energy, Space and Defence
- Transport and Telecommunications
- Power, Petroleum, Coal and other minerals
- Banking, Insurance and financial services

Singapore's Model of Temasek Holdings

Temasek Holdings was incorporated by Singapore government as a private commercial entity, to hold and manage its investments in its government-linked companies.

Economic Survey 2019-20 suggests this model to lend professionalism and autonomy to disinvestment programme of the Government.

Government can transfer its stake in the listed CPSEs to a separate corporate entity. This entity would be managed by an independent board and would be mandated to divest the government stake in these CPSEs over a period of time.

Methods of Disinvestment

- IPO
- FPO
- IPP
- Offer for Sale
- ETF
  - CPSE-ETF
  - Bharat-22 ETF
  - Bharat Bond ETF

To be discussed in Capital Market Chapter

Q26. Why is the Government of India disinvesting its equity in the Central Public Sector Enterprises (CPSEs)? ***(UPSC-2011)***

1. The Government intends to use the revenue earned from the disinvestment mainly to pay back the external debt.
2. The Government no longer intends to retain the management control of the CPSEs.

(a) 1 only
(b) 2 only
(c) Both 1 and 2
(d) Neither 1 nor 2

Ans: 19 (d)

Taxation

Taxation Policy

What is an ideal Tax Policy?

- Principles that should be followed
  - Equity
  - Adam Smith's 4 Cannons
- Should Tax rates be high or low?

Difference between Indirect and Direct Taxes.

Laffer Curve

Trends in Tax and Non-Tax Revenue

- Tax Revenue:
  - Indirect Tax >Direct Tax
  - GST>Income Tax> Corporation Tax> Union Excise> Customs Duty (2021 RE)
  - Income Tax> Corporation Tax> Central GST> Union Excise > Customs Duty (2021 RE)

प्राप्तियां Receipts

(₹ करोड़) (In ₹ crore)

	2019-20 वास्तविक Actuals	2020-2021 बजट अनुमान Budget Estimates	2020-2021 संशोधित अनुमान Revised Estimates	2021-22 बजट अनुमान Budget Estimates
REVENUE RECEIPTS				
1. Tax Revenue				
Gross Tax Revenue	**2010059**	**2423020**	**1900280**	**2217059**
a. Corporation Tax	556876	681000	446000	547000
b. Taxes on Income	492654	638000	459000	561000
c. Wealth Tax	20	...	...	...
d. Customs	109283	138000	112000	136000
e. Union Excise Duties	240615	267000	361000	335000
f. Service Tax	6029	1020	1400	1000
g. GST	598750	690500	515100	630000
- CGST	494072	580000	431000	530000
- IGST	9125	...	...	...
- GST Compensation Cess	95553	110500	84100	100000
h. Taxes of Union Territories	5835	7500	5780	7059
Less - NCCD transferred to the NCCF/NDRF	**2480**	**2930**	**5820**	**6100**
Less - State's share	**650678**	**784181**	**549959**	**665563**
1a Centre's Net Tax Revenue	**1356902**	**1635909**	**1344501**	**1545397**
2. Non-Tax Revenue	**327157**	**385017**	**210653**	**243028**
Interest receipts	12349	11042	14005	11541
Dividends and Profits	186132	155396	96544	103538
External Grants	373	812	1422	747
Other Non Tax Revenue	126540	215465	96602	124671
Receipts of Union Territories	1762	2303	2081	2531
Total- Revenue Receipts (1a + 2)	**1684059**	**2020926**	**1555153**	**1788424**
3. CAPITAL RECEIPTS				
A. Non-debt Receipts	**68620**	**224967**	**46497**	**188000**
(i) Recoveries of loans and advances@	18316	14967	14497	13000
(ii) Disinvestment Receipts	50304	210000	32000	175000
B. Debt Receipts*	**928680**	**849340**	**1866013**	**1435428**
Total Capital Receipts (A+B)	**997301**	**1074306**	**1912510**	**1623428**
4. Draw-Down of Cash Balance	**4970**	**-53003**	**-17358**	**71383**
Total Receipts (1a+2+3)	**2681360**	**3095233**	**3467663**	**3411853**

Non Tax Revenue Trend:

- Dividends & Profits from PSUs>Interest Receipts from State and UTs>External Grants

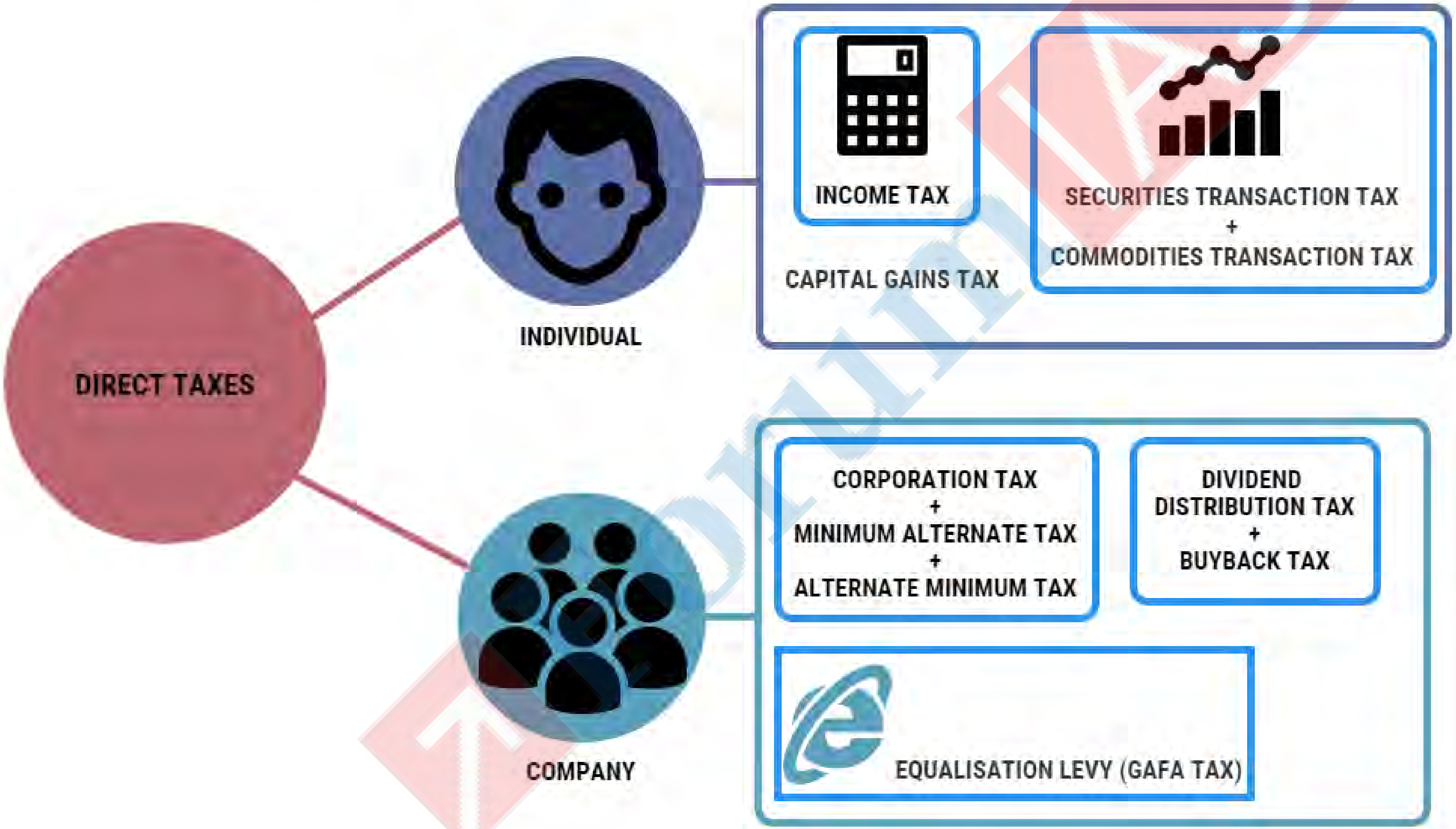
Table 7: Trends in Non-tax Revenue of Central Government

	2015-16	2016-17	2017-18	2018-19	2019-20 PA	2020-21 BE
	(in ₹ Lakh crore)					
Interest receipts	0.25	0.16	0.14	0.12	0.12	0.11
Dividends & Profits	1.12	1.23	0.91	1.13	1.86	1.55
External Grants	0.02	0.01	0.04	0.01	0.00	0.01
Others	1.12	1.32	0.84	1.07	1.28	2.15
Non-tax Revenue	2.51	2.73	1.93	2.36	3.26	3.85

DIRECT TAX

- On Income
  - Union
    - Corporation Tax, MAT, *DDT*
    - Capital Gains Tax
  - States
    - Agriculture Income
    - Professional Tax (Constitutional ceiling of Rs 250)
- On Assets
  - Union
    - STT, CTT, *Wealth Tax*
  - States
    - Land Revenue, Stamp Duty, Registration Duty
- On Expenditure
  - *Fringe Benefit Tax, Gift Tax*

Understanding Direct Tax



- Corporation Tax
  - Companies
    - Existing (25.17%)
    - New (17.01%) (Registered from 1st Oct 2019)
    - Foreign Companies (Same: 40% plus cess and surcharge)
    - Zero Profit Companies (15% MAT)
  - Cooperative Societies (25.17%)
  - Start-Ups
    - Angel Tax *(To be read in Capital Markets)*

Direct Tax Reforms

Need

- **Rationalization and simplification of Income Tax Structure** by revisiting tax slabs.
- **Simplify corporate tax rate structure and phase out exemptions** as there is loss of revenue due to large number of exemptions.
- **Widen tax base** by revising tax rates and decreasing the complexity in Direct Tax systems.
- **Reducing tax litigations** by addressing the tendency of tax officials to initiate an action without the necessary justification or assessment.
- **Need of Technology infusion** in the tax administration to improve efficiency of tax collection as well as to aid the taxpayer.
- **Creating better sync with global economy** by gradually phasing out the differential treatment of foreign and domestic companies in the country.

Steps Taken

Personal Income Tax: Finance Act, 2020 has provided an option to individuals and co-operatives for paying income tax at concessional rates if they do not avail specified exemption and incentive.

- **Abolition of Dividend Distribution Tax (DDT):** In order to increase the attractiveness of the Indian Equity Market and to provide relief to a large class of investors companies who are not required to pay DDT.
- **Vivad se Vishwas:** To provide for resolution of pending tax disputes which will not only benefit the Government by generating timely revenue but also the taxpayers as it will bring down mounting litigation costs.
- **Simplification of compliance norms for Start-ups:** Start-ups have been provided hassle-free tax environment which includes simplification of assessment procedure, **exemptions from Angel-tax**, constitution of dedicated start-up cell etc.
- **Raising of monetary limit for filing of appeal:** To effectively reduce taxpayer grievances/ litigation monetary thresholds for filing appeals have been raised from:
    - **Rs. 20 lakh to Rs. 50 lakh** for appeal before **Income Tax Appellate Tribunal**
    - **Rs. 50 lakh to Rs. 1 crore** for appeal before the **High Court**
    - **Rs. 1 crore to Rs. 2 crore** for appeal before the **Supreme Court.**

Recent Direct Tax Changes

- TRANSPARENT TAXATION – *'HONOURING THE HONEST' PLATFORM'*
  - Faceless appeals
  - Taxpayer charter
- Equalisation Levy (Digital Service Tax)
- Buyback Tax
  - <u>Impact:</u>

    These many shares are extinguished from company's liability side.
  - <u>Benefit to company:</u>

    No need to pay dividend on these shares in future.
  - Applicable to both unlisted and listed companies (from 2019).
- Abolition of DDT
- Bringing back LTCGT

Direct Tax Code (Read from the link shared Public Finance-1
Corporation Tax: Public Finance-2)
LTCGT (Read from Link Public Finance-5)

M19. Comment on the important changes introduced in respect of the Long-term Capital Gains Tax (LCGT) and Dividend Distribution Tax (DDT) in the Union Budget for 2018-2019. ***(UPSC 2018)***

EQUALIZATION LEVY 2.0


ThePrint

Quickly fill up online business details, upload documents, pay gst registration fees.

POLITICS GOVERNANCE ECONOMY DEFENCE INDIA FEATURES OPINION EVENTS VIDEO MORE

Home › Diplomacy › US temporarily suspends additional tariffs on India, 5 other countries over digital...

Diplomacy

US temporarily suspends additional tariffs on India, 5 other countries over digital tax issue

US had last March proposed retaliatory trade actions against India and other countries that imposed or were considering equalisation levy/digital services tax on e-commerce firms.

PTI 3 June, 2021 10:10 am IST

Most Popular

EQUALIZATION LEVY 2.0

- Why the need?
- Similar Global Efforts?
- India's Steps!
- Issues in the Step
- Way Forward

Why the need?

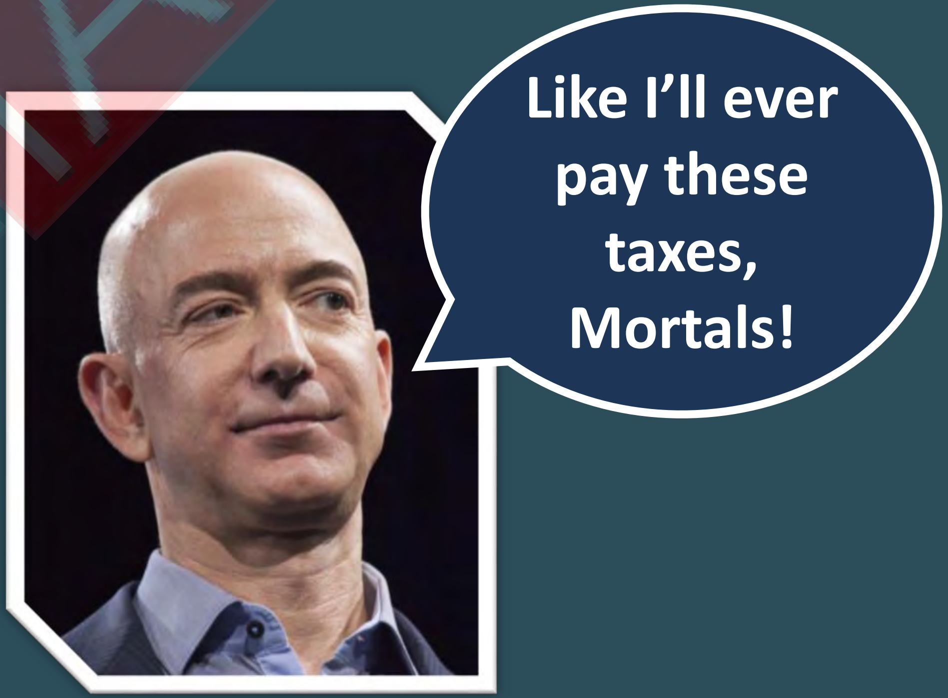
Why the need?

Digital Revolution (IR4.0) has virtually transformed the way in which businesses are carried out, across the globe.

In India, it is estimated to be about $200bn big soon. (India's Trillion Dollar Digital Opportunity, Feb 2019)

Changes in Businesses

This has resulted in many transactions completely escaping the tax net. Hence, the need was felt to address the challenges posed by the digital economy.



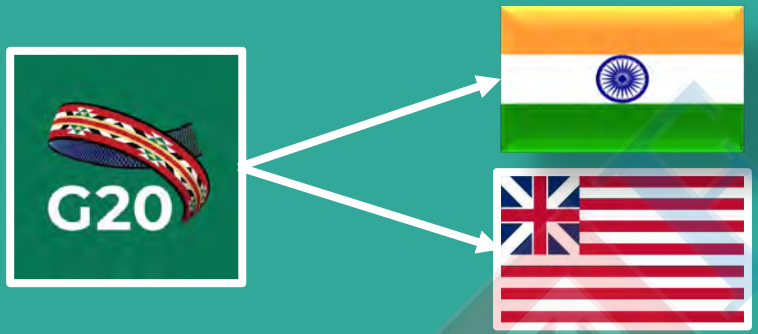
EQUALIZATION LEVY 2.0

- Why the need?
- Similar Global Efforts?
- India's Steps!
- Issues in the Step
- Way Forward

Similar Global Efforts?

Similar Global Efforts

The OECD and the G-20 group initiated talks to address the taxation issues of digital economy.



The outcome was Project Base Erosion Profit Sharing (BEPS) in 2015.

BEPS Proposed 15 Action Plans

Action Plan 1
Action Plan 2
Action Plan 3
Action Plan 4
Action Plan 5
Action Plan 6
Action Plan 7
Action Plan 8
Action Plan 9
Action Plan 10
Action Plan 11
Action Plan 12
Action Plan 13
Action Plan 14
Action Plan 15

Tax Challenges Arising from Digitalisation

The problem was with the term “Permanent Establishment”.

- Whether the corporation has a fixed place of business within the target country.
- But in the Digital Economy, no need for a brick and mortal offices as everything happens online.

It proposed three interim options to tackle the issues emerging from digital transactions:

- Significant Economic Presence
- Withholding tax on digital transactions
- Equalization Levy

Significant Economic Presence

If a transaction amount by a non-resident with any person in India, including provision of download of data or software in India, exceeds a certain amount.

Withholding tax on digital transactions

Taxing the income at source.

Equalization Levy

A non resident with no PE in that country providing advertisement services will have to pay a "levy" to that government.

You will!

India was the first country to implement Equalization Levy in 2016.

Like I'll ever pay these taxes, Mortals!

Q1. The term 'Base Erosion and Profit Shifting' is sometimes seen in the news in the context of (UPSC 2016)

(a) mining operation by multinational companies in resource-rich but backward areas
<u>**(b) curbing of the tax evasion by multinational companies**</u>
(c) exploitation of genetic resources of a country by multinational companies
(d) lack of consideration of environmental costs in the planning and implementation of developmental projects

EQUALIZATION LEVY 2.0

Why the need?

Similar Global Efforts?

India's Steps!

Issues in the Step

Way Forward

India's Steps

India's Steps

Equalization levy

Significant Economic Presence

Equalization levy

2016

2020

Introduced with the intention of taxing the digital transactions i.e. the income accruing to “non-residents” e-commerce companies from India.

It is aimed at taxing business to business (B2B) transactions on online advertising.

Not introduced under ITA (hence can’t claim exemptions under DTAA).

amazon

PATANJALI

Q8. With reference to India's decision to levy an equalization tax of 6% on online advertisement services offered by non-resident entities, which of the following statements is/are correct? **(UPSC 2018)**

1.It is introduced as a part of the Income Tax Act.
2.Non-resident entities that offer advertisement services in India can claim a tax credit in their home country under the "Double Taxation Avoidance Agreements".

Select the correct answer using the code given below:

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

2016

amazon — PATANJALI

6%

2020

2%

amazon

PATANJALI

adidas

FOUR IMPORTANT POINTS

- Other activities also included.
- Now B2C also covered.
- Compliance burden had shifted to E-commerce operator.
- Non Resident to Non Resident Services also included.

India's Steps

Equalization levy

Significant Economic Presence

Why Amazon has to pay Equalization Levy despite having offices in India?

It's revenue generating activities still happen outside India.

Critical data is stored on offshore servers.

Significant Economic Presence

Significant Economic Presence was introduced as an amendment Income Tax Act, 1961 vide the Finance Act, 2018.

Since introduced under ITA, 1961; DTAA will override this provision if it exists with the host country.

EQUALIZATION LEVY 2.0

Why the need?

Similar Global Efforts?

India's Steps!

Way Forward

Issues in the Step

Issues in the Step

Issues in the Step

Lack of clarity.

Since benefits of DTAA is not available, these US giants making huge earning from India will repatriate lesser income to US, hence lesser tax to US Govt.

Lack of clarity

What constitutes a digital platform? Is advisory service/consultancy rendered through E-mail be covered?

Will EL be applicable where services are booked online but provided through physical delivery/ physical provision of service (eg: hotel booking).

Will the credit of EL paid be available for paying taxes in overseas jurisdiction.

The additional levy of tax will eventually be shifted to buyers .

EQUALIZATION LEVY 2.0

Why the need?

Similar Global Efforts?

India's Steps!

Issues in the Step

Way Forward

Way Forward

Way Forward

Greater clarity from the Indian Government on the wide applicability of EL.

US itself has been calling for a Global Minimum Corporate Tax for such companies and hence shouldn't act selectively.

Q27. : With reference to India's decision to levy an equalization tax of 6% on online advertisement services offered by non-resident entities, which of the following statements is/are correct? ***(UPSC 2018)***

1. It is introduced as a part of the Income Tax Act.
2. Non-resident entities that offer advertisement services in India can claim a tax credit in their home country under the "Double Taxation Avoidance Agreements".

a) 1 only
b) 2 only
c) Both 1 and 2
d) Neither 1 nor 2

Ans: 27 (d)

Q28. In which of the following circumstances may 'capital gains' arise? ***(UPSC- 2012)***

1. When there is an increase in the sales of a product.
2. When there is a natural increase in the value of the property owned.
3. When you purchase a painting and there is a growth in its value due to increase in its popularity.

(a) 1 only
(b) 2 and 3 only
(c) 2 only
(d) 1, 2 and 3

Ans: 28 (b)

Direct Tax Code

Akhilesh Ranjan Committee Recommendations (2019):

1) Personal Income Tax: simplification of personal income tax structure.
2) Uniform corporate tax for domestic and foreign companies
3) Abolition of Dividend Distribution Tax (DDT)
4) Mediation between CBDT and the taxpayer
5) Litigation Management Unit
6) Assessing unit instead of assessment officer
7) **Public Ruling Option for Taxpayers**
   A concept of *"public ruling"* has been recommended by the taskforce. Here, taxpayers will have the option of approaching the Central Board for Direct Taxes (CBDT) for clarification on any important point of law that is not case or fact specific.
8) **Branch Profit tax**
   Foreign companies have to pay a repatriation tax in the form of *branch profit tax* on the earnings they repatriate to their overseas parent company. This branch profit tax will be in addition to the corporate tax they pay to the government.

G7: Rich nations back deal to tax multinationals

3 days ago

G7 global tax 'levels the playing field'

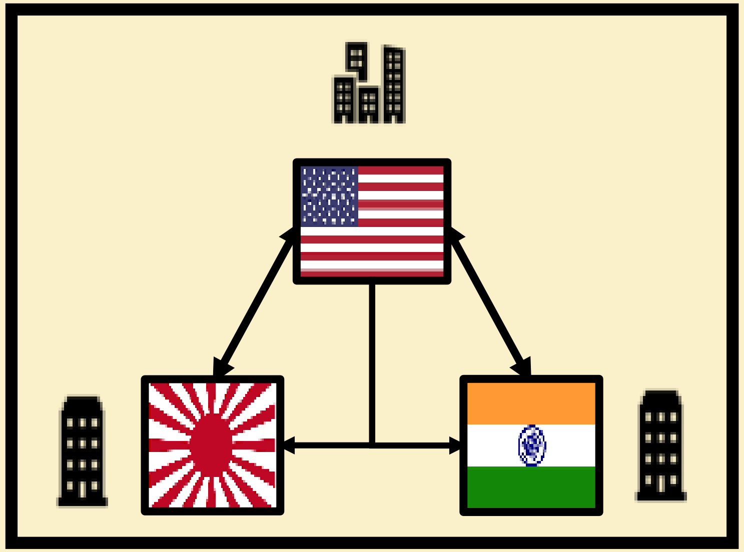
The G7 group of advanced economies has reached a "historic" deal to make multinational companies pay more tax.

Taxation in Inter-Connected World

Taxation in Inter-Connected World

Globalisation

Companies of one country entering into another's . These were called MNCs.



Companies were paying taxes in every jurisdiction on the <u>same income</u>. (Double Taxation)

This had to be avoided.

Hence, countries sign DTAAs (Double Taxation Avoidance Agreements) amongst themselves to facilitate trade, commerce & investments.

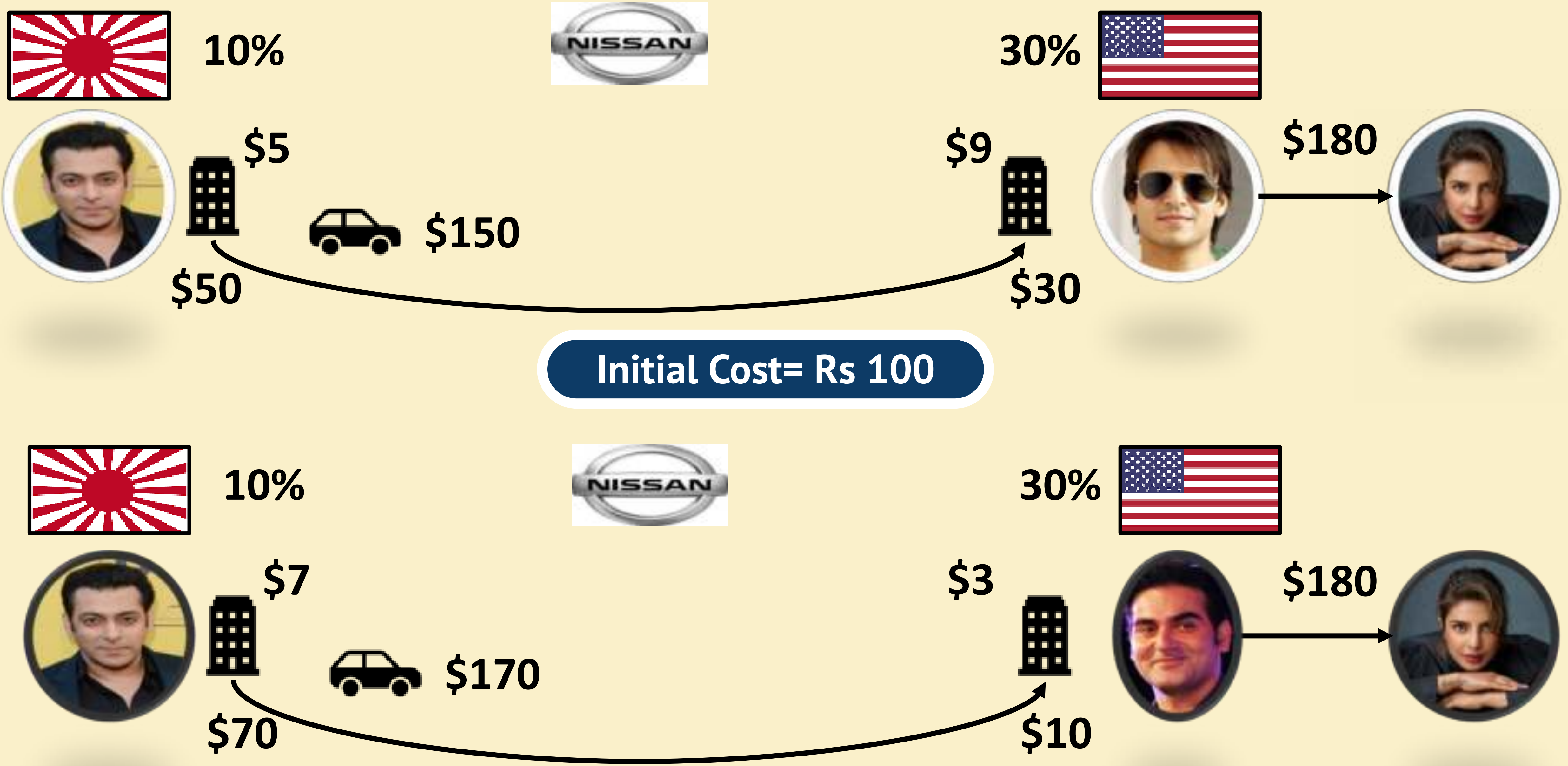
But gradually companies started exploiting taxation loopholes through:

- Treaty Shopping and Transfer Pricing
- Special Purpose Entities
- Hybrid Mismatches

Transfer Pricing

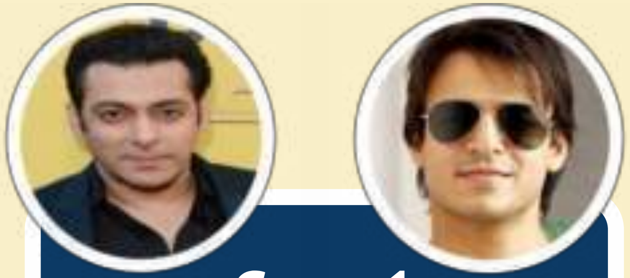
Transfer price is the price at which related parties transact with each other.

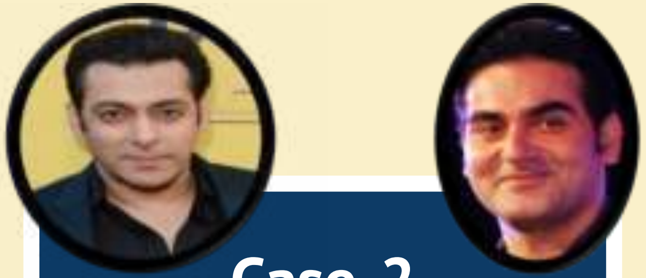
ForumIAS



10%
NISSAN
30%
$5
$9
$180
$150
$50
$30
Initial Cost= Rs 100
10%
NISSAN
30%
$7
$3
$180
$170
$70
$10

NISSAN





	Case-1	Case-2
Profit	$50	$70 + $10 = $80
Total Tax Liability	$5	$7 + $3 = $10
Profit After Tax	$45	$70

NOT ILLEGAL

Transfer Pricing

Transfer price is the price at which related parties transact with each other.

Special Purpose Entities

Its an entity which is established only for tax purposes.

It often has few or no employees and little or no physical presence in the host economy.

Transfer Profits to a company in other jurisdiction (with low tax rates) and receive dividends or investments (which will not be taxed due to DTAAs).

→ **Shell Companies**

Transfer Patents or other assets to another company and pay royalty (thus artificially, but legally, inflate expenditure)

→ **Double Irish Dutch Sandwich Method**

Shell Companies

Letterbox Companies.

Also used for money laundering. (The erstwhile infamous “Mauritius route”)

Double Irish Dutch Sandwich Method

Used by companies like Google, Amazon etc.

Round Tripping

Money makes a round trip across various countries and comes back while evading taxes.

Treaty Shopping

Misusing DTAAs.

Base Erosion and Profit Shifting (BEPS)

Such practices of shifting profit erodes the tax base and causes revenue loss for the host country.

Companies exploit taxation loopholes through:

- Treaty Shopping and Transfer Pricing
- Special Purpose Entities
- Hybrid Mismatches

Securities

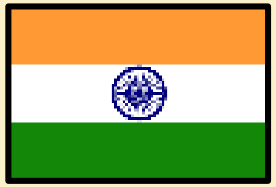
Capital market is a market where buyers and sellers engage in trade of financial securities like bonds, stocks, etc.

What are it's types?

- **EQUITY**
  - It represents ownership interest held by shareholders in an entity.
  - No regular payment, though dividend according to profits of company.
- **DEBT**
  - It represents borrowed money that must be repaid.
- **HYBRID**
  - They combine some of the characteristics of both debt and equity securities. Eg. *Convertible Bonds.*
- **DERIVATIVES**

Hybrid Mismatches

Some convertible bonds are **hybrid** instruments and are **treated differently** in different countries.

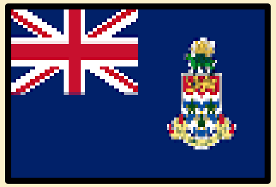


Would have offered lowered interest rate.

Issues a Convertible Bond

Pays Interest to the bond holder

Pays Money to purchase that bond (Investment)

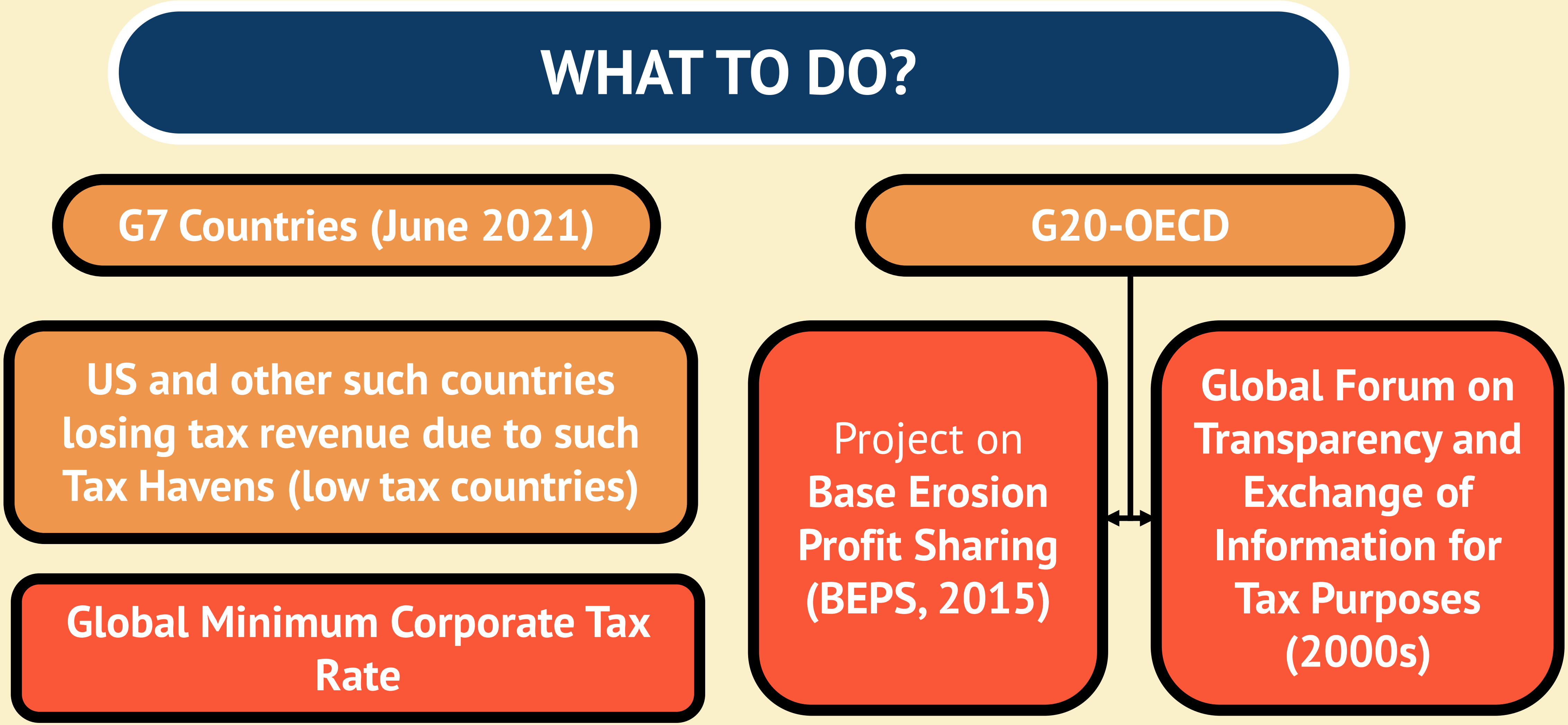


Tax rebate on interest paid

Such interest earned is not taxable

NOT ILLEGAL

- Treaty Shopping and Transfer Pricing
- Special Purpose Entities
- Hybrid Mismatches


WHAT TO DO?
G7 Countries (June 2021)
US and other such countries losing tax revenue due to such Tax Havens (low tax countries)
Global Minimum Corporate Tax Rate
G20-OECD
Project on Base Erosion Profit Sharing (BEPS, 2015)
Global Forum on Transparency and Exchange of Information for Tax Purposes (2000s)

Global Forum on Transparency and Exchange of Information for Tax Purposes (2000s)

Tax Information Exchange Agreement

For eg, now India can ask Switzerland about the information on all Indians with Swiss Accounts.

TIEAs are not binding instruments and can be terminated as stipulated in the agreements.

WHAT TO DO?

US and other such countries losing tax revenue due to such Tax Havens (low tax countries)

Global Minimum Corporate Tax Rate

Multilateral Steps: G20-OECD

Project on **Base Erosion Profit Sharing (BEPS, 2015)**

Global Forum on Transparency and Exchange of Information for Tax Purposes (2000s)

AP1

Address the tax challenges of the digital economy

- Equalization Levy

AP2

Neutralize the effects of hybrid mismatch arrangements

AP6

Prevent treaty abuse

- Principle Purpose Test
- Amend DTAA
- GAAR & SAAR

AP 13

Country-by-Country Reporting

AP 15

Develop a multilateral instrument

- Multilateral Instrument (MLI, 2018)

Multilateral Instrument (MLI, 2018)

Simultaneous modification of all Bilateral Treaties amongst it's signatories.

It also implements agreed minimum standards while providing flexibility to accommodate specific tax treaty policies.

What about those DTAAs in which one party is not a signatory to MLI?

Amend DTAA

India is a signatory but China and Sri Lanka aren't a signatory to MLI.

What was amended?

Amongst other provisions, Principle Purpose Test (PPT) and Limitation of Benefit Clause (LoB) were added.

Principle Purpose Test

International practice mentioned under Action Plan 6 of BEPS Project.

What about domestic?

GAAR & SAAR

GAAR & SAAR

Anti-Avoidance Rules are generally existing in many countries in two categories:

- General — GAAR
- Specific — SAAR

In India, GAAR overrides SAAR.

ForumIAS

General Anti Avoidance Rule (GAAR) in India

What if DTAA and GAAR are in conflict?

→ **CBDT has clarified that GAAR will override DTAA only if:**

- **LoB Clause in DTAA is insufficient to handle tax evasion.**
  - A provision is to limit the ability of third country residents to obtain benefits under the said treaty.
- **There is an Impermissible Avoidance Agreement (IAA)**
  - If the transaction has been entered into with the main purpose of obtaining a tax benefit and it lacks commercial substance.

Other provisions of GAAR

Applicable for Rs3cr or above.

If any part declared IAA, only that part will be scrutinized.

The investments made before 1st April 2017 will be grandfathered.

GAAR not to apply to Foreign Institutional Investors ("FII") subject to satisfaction of certain conditions.

Grandfathering clause: old rule continues to apply to some existing situations, while a new rule applies to all future situations.

ForumIAS

Next Video Lectures on:

Global Minimum Corporate Tax

Part-2

Equalisation Levy

Part-3

Indirect Taxes

- Types
  - Ad-Valorem
  - Specific Tax per unit
  - Pigouvian

Is it Regressive of Progressive?

Understanding:

1. Tax-on-Tax
2. Cascading Effect of Taxes
3. Input Tax Credit

Indirect Tax Reforms Timeline

- 1944
  - Central Excise Duty
- 1956
  - Central Sales Tax
- 1962
  - Customs Act
- 1986
  - MODVAT
- 1994
  - Service Tax
- 2004
  - CENVAT
- 2005
  - VAT
- 2017
  - GST

GST Regime

- GST is a **destination-based indirect tax** and is **levied at the final consumption point.**
- Under GST, a gamut of **17 indirect taxes** like excise duty, VAT, service tax, luxury tax etc are subsumed.
- **Taxes NOT subsumed under GST**: Basic Custom Duty, Anti-Dumping Duty, Central Excise on Petroleum Products, VAT on alcohol for human consumption, Stamp Duty, Property Tax (levied by local bodies), Professional Tax etc.
- GST is currently levied on every product [except **petroleum products, alcohol, real estate & electricity**] in four slabs of **5, 12, 18 and 28%.** o Most of the daily use articles have zero GST as per the latest revision of the tax rates last year.
- In addition, a Compensation cess is levied on automobiles, luxury, and demerit and sin goods.

GST: 101st CAA, 2016

- Article 246-A
  - Both Union and States now have "concurrent powers" to make laws w.r.t. G&S
  - Intra-State: Both U & S

    Inter-State: Only U
- Article 268-A
  - Repealed
- Article 269-A
  - IGST as per GST Council
  - Such proceeds not part of CFI
- Article 270
  - CGST (which replaced Service Tax and Excise Duty) to be shared with States according to FC' formula
- Article 279-A
  - GST Council (Chairman: FM)

GST Council Voting pattern and decision making.

Important Features in GST

- Reverse Charge Mechanism
- Composition Scheme
- Input Tax Credit (Cross-Utilisation?)
- E-Way Bill
  - FASTags
- Tax Administration
- Compensation Cess
  - Why Compensate?
  - How to Compensate?

Important Organisations Under GST Regime

- **National Anti-Profiteering Authority**
  - Statutory (set up under CGST Act)
  - Initially for 2 years, but extended for 2 more years in 2019.
- **Authority for Advance Ruling**
  - CGSTA,2017 provides for it.
  - Seek clarification in advance about applicable GST rate.
- **GSTN Network**
  - “Not for Profit” Pvt LTD, set up under Companies Act
  - Now fully owned by the Government (50:U; 50: States)

Key Developments in GST in recent times:

1. **Taxpayers with turnover more than Rs 5 crores** will have to provide **Harmonised System Nomenclature (HSN)** Code from April 2021.

o HSN code, developed by World Customs Organization, is an **international nomenclature for the classification** of traded goods for customs purposes.

2. Ministry of Finance indicated that **issuers and beneficiaries of fake GST invoices can be detained under the COFEPOSA** (Conservation of Foreign Exchange and Prevention of Smuggling Activities Act), 1974.

o At present, **actions are being initiated under the GST law, income tax law and the Prevention of Money Laundering Act.**

o COFEPOSA Act, 1974 provides for preventive detention in certain cases for the purposes of **conservation and augmentation of foreign exchange and prevention of smuggling activities** and for matters connected.

3. **Supreme Court Upheld Levy of GST on Lottery, Betting and Gambling**

o SC observed that **definition of goods under Article 366(12) of the Constitution was inclusive** and there was no intention to give any restrictive meaning to goods.

Assessment of GST

ForumIAS

BEFORE GST	AFTER GST
In-House Sourcing	Ancilliarisation + MSME Growth (Subcontracting and outsourcing)
“Rate Arbitrage” due to different VATs.	No more there.
Inverted Duty Structure	“Zero Rated Exports”

Q29. What is/are the most likely advantages of implementing 'Goods and Services Tax (GST)'? ***(UPSC-2017)***

1. It will replace multiple taxes collected by multiple authorities and will thus create a single market in India.
2. It will drastically reduce the 'Current Account Deficit' of India and will enable it to increase its foreign exchange reserves.
3. It will enormously increase the growth and size of economy of India and will enable it to overtake China in the near future.

Select the correct answer using the code given below:

(a) 1 only
(b) 2 and 3 only
(c) 1 and 3 only
(d) 1, 2 and 3

Ans: 29 (a)

M20. Explain the rationale behind the Goods and Services Tax (Compensation to States) Act of 2017. How has COVID-19 impacted the GST compensation fund and created new federal tensions? ***(UPSC 2020)***

M21. Enumerate the indirect taxes which have been subsumed in the Goods and Services Tax (GST) in India. Also, comment on the revenue implications of the GST introduced in India since July 2017. ***(UPSC 2019)***

Cess and Surcharge

A common feature of both surcharge and cess is that the centre need not share it with states.

Following are the difference between the usual taxes, surcharge and cess.

1. The usual taxes goes to the consolidated fund of India and can be spend for any purposes.
2. Surcharge also goes to the consolidated fund of India and can be spent for any purposes.
3. Cess goes to Consolidated Fund of India but can be spend only for the specific purposes.

The main difference between surcharge and cess is that despite they are not shareable with state governments, surcharge can be kept with the CFI and spent like any other taxes, the cess should be kept as a separate fund after allocating to CFI and can be spent only for a specific purpose. This means cess can be spent only for the specific purpose for which it is created. If the purpose for which the cess is created is fulfilled, it should be eliminated.

India's Tax-GDP Ratio

- Does India Tax Low?
  - Yes
  - May be, not

Read from link (Public Finance-6,7&8)

- How to Increase Tax-GDP Ratio
  - Tax Reforms
    - Direct Tax Reforms
    - Indirect Tax Reforms
  - Non-Tax Revenue

M22. What is the meaning of the term ‘tax expenditure’? Taking the housing sector as an example, discuss how it influences the budgetary policies of the government. ***(UPSC 2013)***

Q30. Find Correct Statement(s) ***(UPSC-2017)***

1. Tax revenue as a percent of GDP of India has steadily increased in the last decade.
2. Fiscal deficit as a percent of GDP of India has steadily increased in the last decade.

Codes:

(a) 1 only

(b) 2 only

(c) Both 1 and 2

(d) Neither 1 nor 2

Ans: 30 (a)

Fiscal Federalism

M23. How have the recommendations of the 14th Finance Commission of India enabled the states to improve their fiscal position? ***(UPSC 2021_Paper-2)***

15th FC Terms of Reference

President of India has ordered them to study and recommend following:

1. Union Taxes' vertical devolution to the states, and its horizontal distribution amongthe states. (except cess, surcharge and IGST).

2. Union's grant-in-aids to the states.

3. How to augment State Govts' Consolidated funds to help their PRI/ULBs

4. Any other matters referred by the President of India such as:

✓ Use Census-2011 for your calculation.

✓ Keep in mind Union's responsibilities for New India 2022 vision.

✓ Recommend measures for Fiscal discipline, Fiscal consolidation for the Union and State governments. Whether union government should continue to provide revenue deficit grants to States?

✓ How to finance the disaster management initiatives?

✓ Performance based incentives to the state governments?

✓ **(2019-Jul)** suggest ways for allocation of non-lapsable funds for defence and internal security.

✓ **(2019-Oct)** Award for the UT of J&K. *(This terms of reference required under JAMMU AND KASHMIR REORGANISATION ACT, 2019)*

15th FC's TOR Issues

- New India Vision 2022 to be kept in mind.
- Performance Based Incentives
- Census 2011
- Debt and Grants
  - Will Revenue Deficit grants be given?

ES 2016-2017: 'aid curse' in context of Redistributive Resource Transfer (RRT)

M24. How is the Finance Commission of India constituted? What do you know about the terms of reference of the recently constituted Finance Commission? Discuss. ***(UPSC 2018)***

Important Points:

1. Maintaining vertical devolution at 41 per cent

2. On GST:

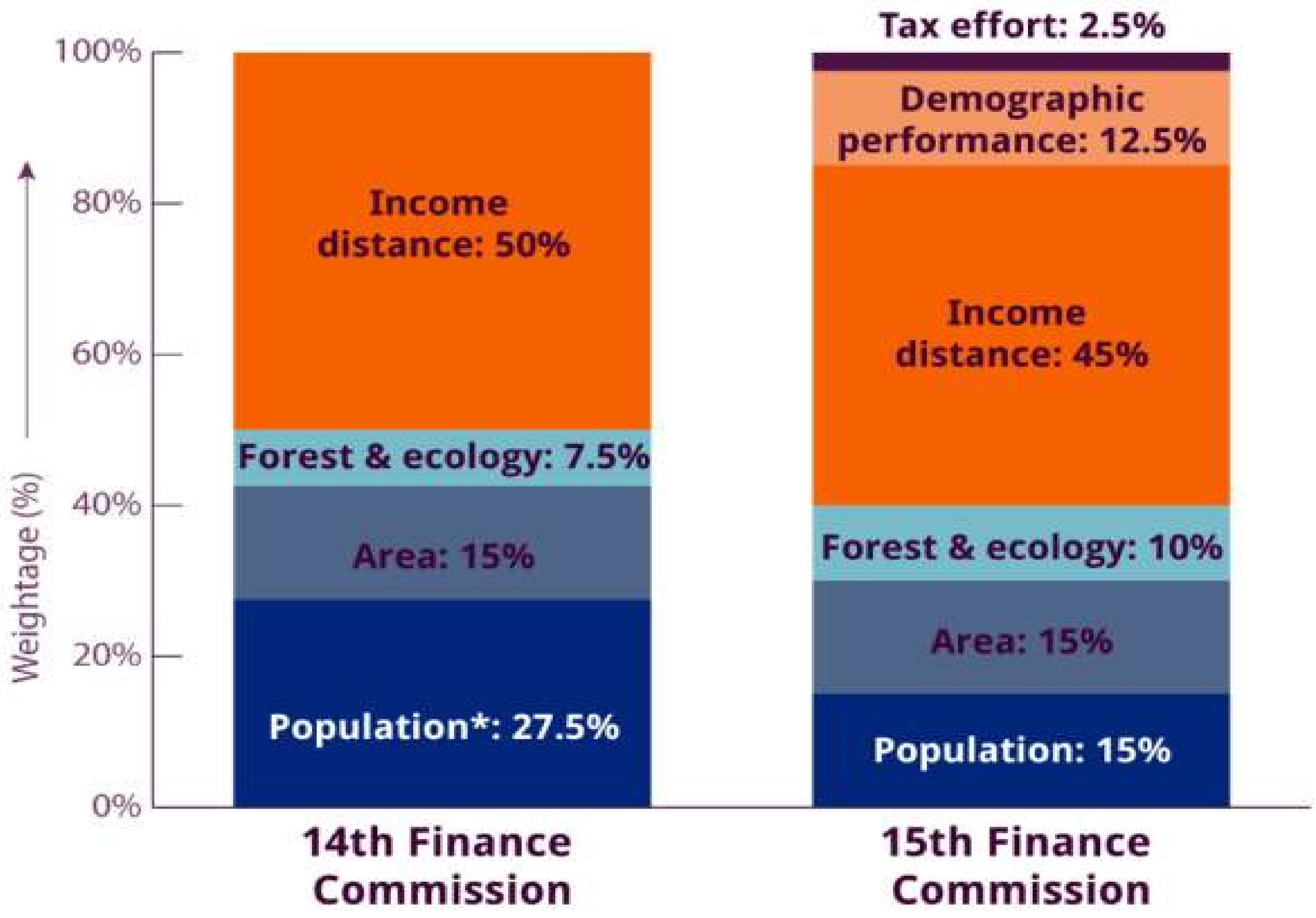
1. GST accounts for 35 per cent of the gross tax revenue of the Union.
2. GST accounts for around 44 per cent of own tax revenue of the States.

3. On Revenue Deficit Grants (RDG): It has recommended total revenue deficit grants of around Rs 2.94 crore over the award period for seventeen States

4. On Gross Tax Revenue: There is a drop of 1.7 percentage points in the gross tax revenue after excluding GST cess collection in comparison to 2016-17 figures. The impact of this drop could be seen in the tax devolution to states.

5. Gross Tax Revenue Assessment 2021-26: It is expected to be 135.2 lakh crore, out of which the divisible pool is estimated to be 103 lakh crore

Revenue-sharing formulas in the 14th and 15th Finance Commissions



6. On Health:

- The commission has suggested increasing the state expenditure on health by 8 percent by 2022.
- The commission suggested prioritizing the creation of **All India Health Services/All India Medical Services** on the pattern of the UPSC Civil Services.
- National Medical Council is suggested to develop small courses on wellness clinic, basic surgical procedures, anaesthesia, obstetrics and gynaecology, eye, ENT etc. for MBBS doctors.
- AYUSH to be encouraged as an elective subject for medicine undergraduates.
- The Allied and Healthcare Professions Bill should be passed at the earliest.

7. On Defense: Recommendation to create a **non-lapsable pool** for the defence and internal security sector under the Public Accounts of India.

8. On Disaster Risk Management:

- The fifteenth finance commission recommended maintaining the contribution of states to the State Disaster Risk Fund (SDRF) to be 25 percent except by the NE States (10 percent.) It has seen no changes since 13th Finance Commission recommended the same arrangement.
- Creation of Mitigation Funds both at central and state levels.

9. On Higher Education: The XV finance commission has recommended two subtypes of higher education grants:

- Promotion of online education – Rs. 5,078 crore is a total sum of grant for the promotion of online education.
- Development of professional courses in regional languages: The commission's recommendation is in line with the New Education Policy 2020. Rs. 1,065 crore has been allocated for the development of these courses from 2021-26.
  - Two colleges in each state should convert their learning material and pedagogy into the recognized regional language

Understanding 15th FC Recommendations

- Vertical Devolution
- Horizontal Devolution
- Grants
  - Revenue Deficit Grants
  - Performance Linked Grants
    - Social Sector (Health and Education)
    - Rural Economy (Agriculture and Rural Roads)
    - Governance Reforms (Judiciary, Statistics and Aspirational Districts)
    - Power Sector Reforms (not linked to grants but for additional borrowing)
  - Grants to Local Bodies
    - Basic Grants for Urban cities less than 1 million population.
    - For Million Plus Cities, 100% Performance Linked grants through Million Plus Cities Challenge Fund
- Fiscal Space to Centre

Major Issues after 15th FC Report

- **Horizontal Devolution**
- **Conditional grants increased from 17% to 57%**
  - Setting up of State Finance Commission (SFC) and applicability of SFC's recommendations for 5 years
  - Availability of online accounts
  - Notiflying floor rate for property tax
- **Changes in limit on net borrowings of State Governments**
  - The commission has recommended that the normal limit for net borrowings of state governments be fixed at **4 per cent of GSDP in 2021-22.**
  - This will ease to 3.5 per cent by 2022-23, thereafter reverting to the erstwhile 3 per cent limit till 2025-26.
  - The additional borrowing space of 0.5 per cent of GSDP for states is **conditional on the completion of power sector reforms.**
- **Prospect of huge gaps in states' revenue in the future**
  - The states' fiscal arithmetic will alter in 2022-23 with the **GST compensation set to cease at the end of June 2022** as things stand today.

Subsidies

Pension Reforms

Money and Banking

Evolution of System of Exchanging Goods and Services

Evolution of Money

- **Commodity Money**
- **Metallic Money**
  - Full Bodied Coins
  - Token Coins
- **Paper Money**
  - Must Fulfil Two Conditions:
    - It MUST BE in the form of coin / currency Notes / (or sometimes virtual crypto coin like Marshall Island's SOV).
    - It MUST BE issued by the order of a King / Queen / Government / Central Bank.
  - Who issues what?
    - Government issues all coins upto ₹ 1,000, using powers of powers of Coinage Act 2011.
    - RBI issues: Currency notes other than ₹ 1 Note using the powers of RBI Act 1934.
  - What is a Legal Tender?
    - It must be a FIAT MONEY.
    - It must be legally valid for all debts & transactions throughout the country.
    - Its Types:
      - Limited legal tenders.
      - Unlimited legal tenders.
- **Bank Money, Deposit Money**
- **Crypto Currency**

Q1. Which one of the following correctly describes the meaning of legal tender money? ***(UPSC-2018)***

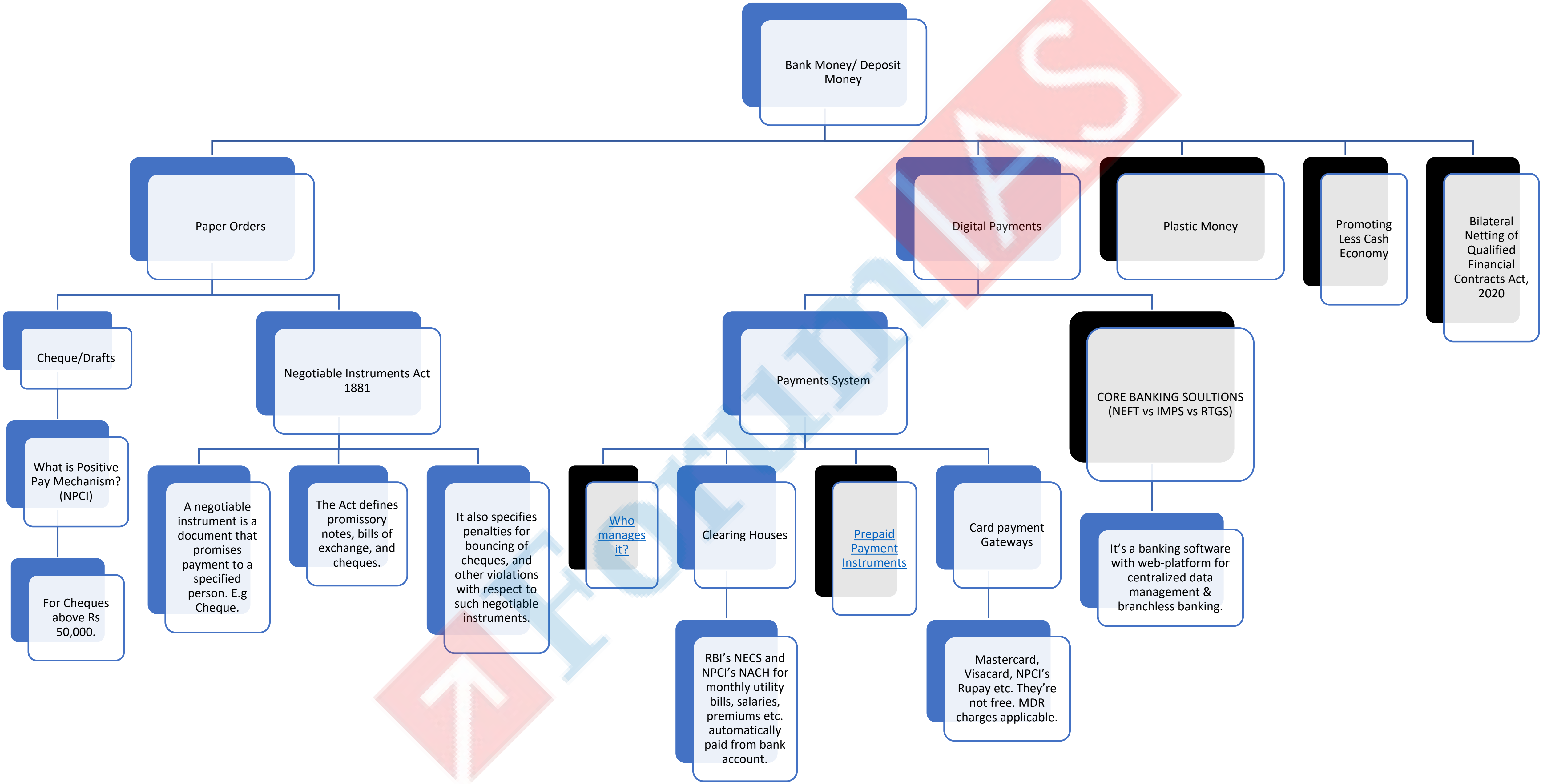
(a) The money which is tendered in courts of law to defray the fee of legal cases

(b) The money which a creditor is under compulsion to accept in settlement of his claims

(c) The bank money in the form of cheques, drafts, bills of exchange, etc.

(d) The metallic money in circulation in a country

Answer: b



Bank Money/ Deposit Money
Paper Orders
Digital Payments
Plastic Money
Promoting Less Cash Economy
Bilateral Netting of Qualified Financial Contracts Act, 2020
Cheque/Drafts
Negotiable Instruments Act 1881
Payments System
CORE BANKING SOULTIONS (NEFT vs IMPS vs RTGS)
What is Positive Pay Mechanism? (NPCI)
For Cheques above Rs 50,000.
A negotiable instrument is a document that promises payment to a specified person. E.g Cheque.
The Act defines promissory notes, bills of exchange, and cheques.
It also specifies penalties for bouncing of cheques, and other violations with respect to such negotiable instruments.
Who manages it?
Clearing Houses
Prepaid Payment Instruments
Card payment Gateways
It's a banking software with web-platform for centralized data management & branchless banking.
RBI's NECS and NPCI's NACH for monthly utility bills, salaries, premiums etc. automatically paid from bank account.
Mastercard, Visacard, NPCI's Rupay etc. They're not free. MDR charges applicable.

Payments System: Who Manages it?

- According to the PSSA, 2007 a **payment system** is a system that enables payment to be effected between a payer and a beneficiary, involving clearing, payment or settlement service or all of them, but does not include a stock exchange.
  - It includes both, **paper-based** such as cheque, demand draft and **digital** such as NEFT, BHIM app, settlement systems.

- The **RBI is authorised under the Payment and Settlement System Act (PSSA), 2007 to regulate payment and settlement system** in India.
  - NPCI (National Payment Corporation of India) (2008)
    - It is a "Not for Profit Company" 10 promoter banks with ₹ 100 crore capital to provide cost-effective payment solutions for banks (in 2008).
    - Its UPI-BHIM app & other mechanisms also help in financial inclusion of villagers & poor by expanding the reach of banking network.
  - New Umbrella Entity (NUE) for Retail Payments System (Feb 2020)
    - Why?
      - **Limitations of NPCI:** Players in the payments space have indicated the various pitfalls of NPCI being the only entity managing all of retail payments systems in India
      - **To Increase Competitiveness:** Players planning to establish these NUE aim to get an even bigger share in the digital payments sector.

- Payment Regulatory Board (Proposed)

More about NPCI from link: Money and Banking-1

Are foreign entities allowed to operate a payment system in India? Yes

Payment Regulatory Board (Proposed)

Why needed?

- It is important to distinguish the role of the central bank (RBI) as an infrastructure institution providing settlement function from its role as a regulator of the payment sector.
- The committee had recommended that the chairperson of the payments regulator should be appointed by the government in consultation with the RBI.

Why RBI opposes it?

- According to the RBI, the PRB must remain with the central bank and should be headed by the RBI governor. The RBI and the government may nominate three members each to the board, with a casting vote for the governor.
- The payment system is bank-dominated in India. Regulation of the banking systems and payment system by the same regulator **provides synergy and inspires public confidence** in the payment instruments.
- Regulation of the payment system by the central bank is the dominant **international model for stability consideration.**
- Thus, having the regulation and supervision over Payment and Settlement systems with the central bank will ensure holistic benefits. Also, it will not result in increased compliance costs.

❖ Payment systems are a sub-set of currency which is regulated by the RBI. The overarching impact of Monetary policy on payment and settlement systems and vice versa provides support for the regulation of payment systems to be with the monetary authority. There is an underlying bank account for payment systems which is under the purview of banking system regulation which is vested with the RBI.

❖ The RBI cited the report of the **Ratan Watal Committee** on digital payments as recommending the establishment of the PRB within the overall structure of the RBI, arguing therefore that there is no need for any deviation.

❖ There has been no evidence of any inefficiency in payment systems of India. Hence, there need not be any change in a well-functioning system.

Q2. Find Correct Statement(s)

1. National Payments Corporation of India (NPCI) helps in promoting the financial inclusion in the country.

2. NPCI has launched RuPay, a card payment scheme.

Answer codes:

(a) 1 only (b) 2 only

(c) Both 1 and 2 (d) Neither 1 nor 2

Answer : C

Criteria	RBI's NEFT	RBI's RTGS	NPCI's IMPS
Transfer Amount	Re1 to 10 Lakh (SBI)	2 lakh to 2000 cr (SBI)	Rs 1 to 2 lakh
Settlement	Net Amount settled every half hour	Real Time	Real Time
Timings	Restricted	24*7	24*7
Who can provide this facility	Banks + Mobile Wallets	Banks + Mobile Wallets	Banks + Mobile Wallets

Q3. The term ‘Core Banking Solutions’ correct term? (UPSC-2016)

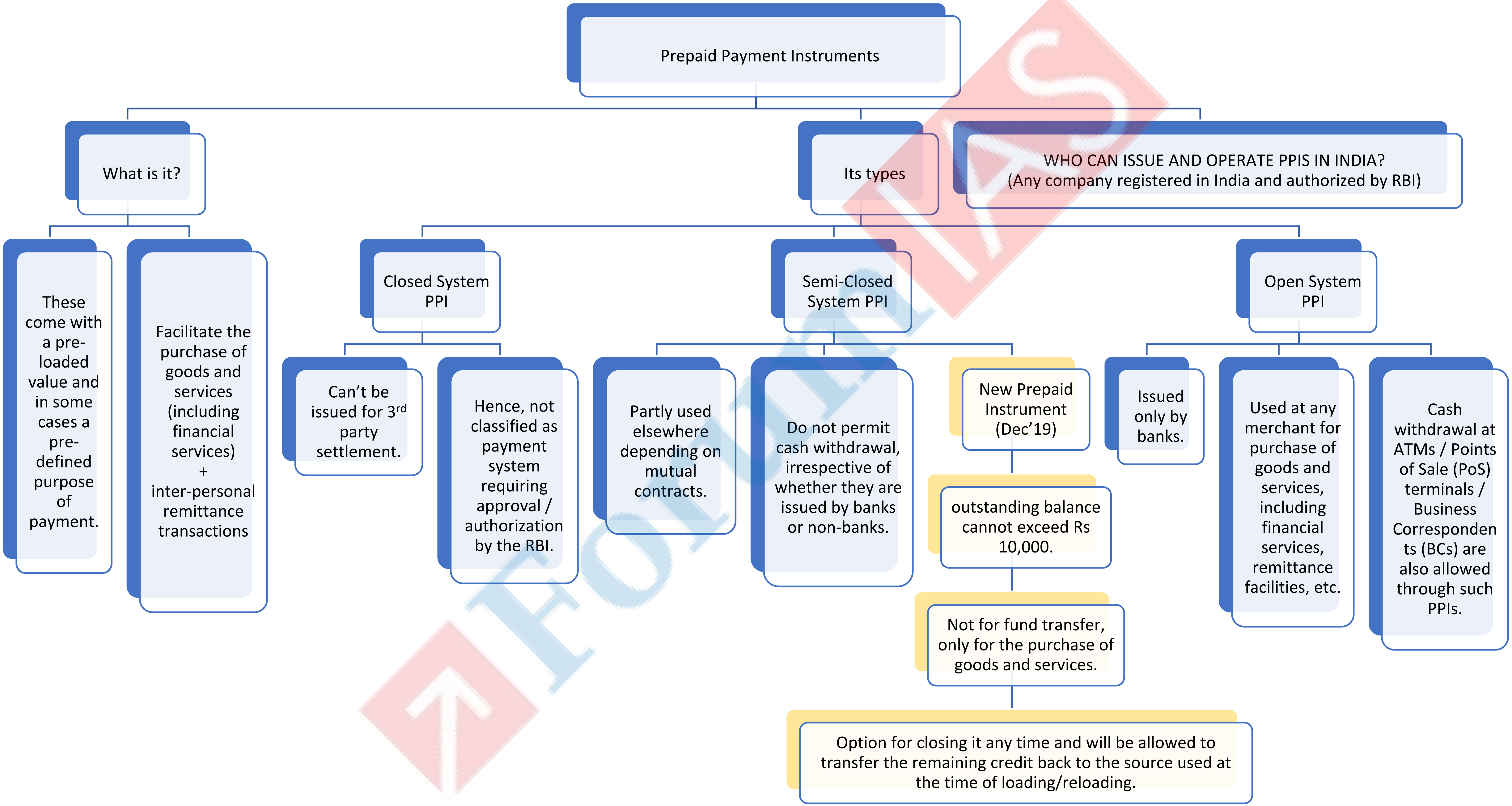
1. It is a networking of a bank’s branches which enables customers to operate their accounts regardless of here they open their accounts.

2. It is an effort to increase RBI’s control over commercial banks through computerization.

3. It is a detailed procedure by which a bank with huge non-performing assets is taken over by another bank.

(a)1 only (b) 2 and 3 only (c) 1 and 3 only (d) 1, 2 and 3

Answer : A


Prepaid Payment Instruments
What is it?
These come with a pre-loaded value and in some cases a pre-defined purpose of payment.
Facilitate the purchase of goods and services (including financial services) + inter-personal remittance transactions
Its types
Closed System PPI
Can't be issued for 3rd party settlement.
Hence, not classified as payment system requiring approval / authorization by the RBI.
Semi-Closed System PPI
Partly used elsewhere depending on mutual contracts.
Do not permit cash withdrawal, irrespective of whether they are issued by banks or non-banks.
New Prepaid Instrument (Dec'19)
outstanding balance cannot exceed Rs 10,000.
Not for fund transfer, only for the purchase of goods and services.
Option for closing it any time and will be allowed to transfer the remaining credit back to the source used at the time of loading/reloading.
Open System PPI
Issued only by banks.
Used at any merchant for purchase of goods and services, including financial services, remittance facilities, etc.
Cash withdrawal at ATMs / Points of Sale (PoS) terminals / Business Correspondents (BCs) are also allowed through such PPIs.
WHO CAN ISSUE AND OPERATE PPIS IN INDIA?
(Any company registered in India and authorized by RBI)

Q4. Consider the following statements regarding Prepaid Payment Instruments (PPIs):

1. A company incorporated in India and registered under the Companies Act, 1956/ Companies Act, 2013 can issue and operate PPIs after receiving authorization from RBI.
2. These instruments also facilitate purchase of financial services.

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

(a) Only 1 (b) Only 2

(c) Both 1 and 2 (d) None of the above

Answer : C

Plastic Money

ATM

- Bank Label (Bank itself owns and operates the ATM network.)
- Brown Label (BANK owns but works OUTSOURCED)
- White Label (NON-BANK owns & operate)
- Micro-ATM (Bankmitra manually makes entries of deposit and withdrawal for customer. He uses handheld device for using card & Aadhar biometrics. NPCi's AEPS technology gives backend technological support.)

Card Tokenization

- RBI released guidelines in 2019-Jan.
- Token number is generated for a given credit/debit card.

National Common Mobility Card (NCMC)

- NCMC is **an automatic fare collection system.**
- Dubbed as **'One Nation One Card'**
- **Ministry of Housing & Urban Affairs** brought to the
  +
  To enable seamless travel by different metros and other transport systems across the country
  +
  Retail shopping and purchases.
- Idea was floated by **the Nandan Nilekani committee set up by the Reserve Bank of India.**

FASTags (already discussed in Public Finance)

MDR Controversy

White label ATM	Brown Label ATM
When ATMs are owned and operated by non-bank entities but they are not doing 'outsourcing-contract' from a particular bank.	When banks outsourced the ATM operations to a third party.
The private company owns & operates the ATM machine, pays office rent. They negotiate with the landlord, electricity company, telecom company and so on.	Same
Sponsor bank provides the cash.	The bank (which has outsourced this work) provides cash for that ATM.
No. White label ATM doesn't have such logo. Not even of the sponsor bank.	ATM has logo of that bank (which has outsourced this work).
They've to compulsory open a few ATMs in (tier 3 to tier 6) areas.	No such compulsion.
RBI directly involved because these white label Companies have to separately get license/permission from RBI to run business.	RBI not involved directly. These outsourcing companies have contractual obligation with their respective banks.

Q5. Which one of the following best describes the term “Merchant Discount Rate” sometimes seen in news? (UPSC 2018)

(a) The incentive given by a bank to a merchant for accepting payments through debit cards pertaining to that bank.

(b) The amount paid back by banks to their customers when they use debit cards for financial transactions for purchasing goods or services.

(c) The charge to a merchant by a bank for accepting payments from his customers through the bank’s debit cards.

(d) The incentive given by the Government to merchants for promoting digital payments by their customers through Point of Sale (PoS) machines and debit cards.

Answer : C

Promoting Less Cash Economy

How far have we come?

- Currency in Circulation as a percentage of GDP increased from 8.7% in 2016-17 to 11.2% in 2018-19. This is less than the pre-demonetisation level of 12.1% in 2015-16.
- Demand for high value denominated currency has outpaced low value denominated currency = Cash is increasingly used as a store of value and less for making payments.
- Estimates of Cash Payments: 72% of India's consumer transactions take place in cash.
- Merchants, especially in rural areas, remain unable or unwilling to accept digital transactions due to network connectivity issues and a reluctance to pay charges for low-value transactions.
- Digital payments witnessed a Compounded Annual Growth Rate of 61% and 19% in terms of volume and value, respectively over the past 5 years. This demonstrates a steep shift towards digital payments.

How did we get here?

- Political Will
- Proactive Central Bank
- Technology
  - Aadhar, the "identity rail"
  - UPI, the "payments rail"

Points of Sale (PoS) machines

- Under the facility of cash withdrawal at PoS terminals, cardholders can withdraw cash using their **debit cards and open system prepaid cards issued by banks in India.**
- However, **credit cards cannot be used under this facility**.
- Cash can also be withdrawn at PoS terminals through **Unified Payments Interface (UPI) as well as through use of electronic cards** that are linked with overdraft facility provided along with Pradhan Mantri Jan Dhan Yojana (PMJDY) accounts.

Mobile Aided Note Identifier (MANI)

- It is a mobile application, launched by RBI, **for aiding visually impaired persons to identify denomination of Indian banknotes.**

Read Money and Banking Link-2

RBI's Nandan Nilekani Panel Suggestions:

- **For Government**
  - For effective DBT utility, generate awareness about BHIM-UPI
  - Tax incentives for digital payments.
  - Govt. Offices shouldn't charge convenience fee from citizens for accepting digital payment.
  - **NCMC**
  - Set up **FIN-CERT**
- **For RBI**
  - Prepare a Digital Financial Inclusion Index for better monitoring.
  - Setup an **Acceptance Development Fund** to develop digital payment infrastructure in poorly served areas e.g. subsidy on PoS devices. (Tier 3 to Tier 6 cities)
    - **Payments Infrastructure Development Fund (PIDF) Scheme**: aimed at encouraging deployment of more digital payments infrastructure across tier-3 to tier-6 centres with special focus on North Eastern States.
  - Reduce the MDR / card payment fees.
- **For NPCI**
  - NPCI should offer RuPay and BHIM UPI in other countries to facilitate remittance to India.
  - Encourage local language apps/ software for digital payments.

Netting:

Netting refers to offsetting of all claims arising from dealings between two parties, to determine a net amount payable or receivable from one party to other.

- **Bilateral contracts (40%)** Recently permitted.
  - It enables two counterparties in a financial contract to offset claims against each other to determine a single net payment obligation due from one counterparty to the other.
  - **<u>Bilateral Netting of Qualified Financial Contracts Act, 2020</u>**
    - It seeks to provide a legal framework for bilateral netting of qualified financial contracts (QFC) which are over the counter derivatives (OTC) contracts.
    - Imposes certain limitations on powers of administration.
- **Multilateral Netting (60%)** Already was allowed in India
  - The agreement allows counterparties to offset claims against each other through a Central Counterparty (CCP) in a clearing house under the Payment and Settlement Systems (Amendment) Act (2015).

Over the Counter (OTC) derivatives: They are contracts traded between two parties (bilateral negotiation) without going through an exchange or any other intermediaries.

CRYPTO CURRENCY

Ban on Cryptocurrency Bill 2021: Read the link Money and Banking-3

Q6. Find correct statement(s) about Bitcoin? [UPSC-CDS-2017-I]

1. It is a decentralized virtual currency.

2. It is generated through complex computer software systems.

3. The Reserve Bank of India recognized it as a legal tender in January 2016.

(a)1 only (b) 1 and 2 only

(c) 2 and 3 only (d) 1, 2 and 3

Answer : B

Measuring Money Supply in the Economy

The money supply tells us that how much currency and how much physical assets that they are pretty close to acting as currency are there in the economy.

Money Multiplier

It is the relationship between monetary base and money supply in economy. The amount money that banks generates with each unit (Rs in case of India) of money. It is the ratio of deposits to the reserves in the banking system.

Money Multiplier = 1/ Reserve Ratio

For example let's say total deposit in banking system is Rs100 and reserve ratio requirement is 10%.
The banks can lend 90% of deposit i.e. Rs90. This Rs90 that banks will lend to its customers will ultimately be deposited in another bank which can further lend 90% of that i.e. Rs81 and cycle continues.

1. Reserve Money (M0): It is also known as High-Powered Money, monetary base, base money etc.

M0 = Currency in Circulation + Bankers' Deposits with RBI + Other deposits with RBI

It is the monetary base of economy.

2. Narrow Money (M1):

M1 = Currency with public + Demand deposits with the Banking system (current account, saving account) + Other deposits with RBI

3. *M2 = M1 + Savings deposits of post office savings banks*

4. Broad Money (M3)/ Aggregate Money Supply

M3 = M1 + Time deposits with the banking system

5. M4 = M3 + All deposits with post office savings banks (excluding National Savings Certificates)

Money Aggregates: Standard Measures of Money Supply

In short, there are two types of money.

1. **Central bank money (M0**) – obligations of a central bank, including currency and central bank depository accounts.
2. **Commercial bank money (M1 and M3)** – obligations of commercial banks, including current accounts and savings accounts.

M0 = Net RBI credit to the Government + RBI credit to the commercial sector + RBI's claims on banks + RBI's net foreign assets + Government's currency liabilities to the public – RBI's net non-monetary liabilities.

(Just another way to look at it)

Q8 : If you withdraw 1,00,000 in cash from your Demand Deposit Account at your bank, the immediate effect on aggregate money supply in the economy will be: (UPSC 2020)

(a) to reduce it by 1,00,000

(b) to increase it by 1,00,000

(c) to increase it by more than 1,00,000

(d) to leave it unchanged

Q9: Consider the following liquid assets: (2013)

1.Demand deposits with the banks

2.Time deposits with the banks

3.Savings deposits with the banks

4.Currency

The correct sequence of these decreasing order of Liquidity is

(a) 1-4-3-2

(b) 4-3-2-1

(c) 2-3-1-4

(d) 4-1-3-2

Solution (d)

Functions of Reserve Bank Of India

Established on 1st April 1935, after Hilton Young Commission under RBI Act 1934.

Initially privately owned, it was nationalised in 1949 (i.e. before 1st FYP)

Main Functions of RBI

- Monetary Authority
  - Monitors the Monetary Policy
    - Inflation Targeting by MPC (POLICY RATE)
    - Liquidity Management for effective Monetary Transmission (TARGET RATE)
- Issuer of Currency
  - Does it issue all types of currency?
- Regulator and Supervisor of Payment and Settlement System
  - What is then Payment Regulatory Board?
- Manager of Forex
- Regulator and Supervisor of the Financial System
  - Banker to Banks as a final resort
- Performs Debt Management of the Government
  - Have we read something about Public Debt Management Agency somewhere?

Article 371-F of Constitution gives special status to Sikkim, as a result, their State Bank of Sikkim is outside RBI's regulatory powers.

Monetary Policy of India

Monetary policy refers to the policy of the central bank – ie Reserve Bank of India – in matters of interest rates, money supply and availability of credit.

It is through the monetary policy, RBI controls inflation in the country.

Monetary policy refers to the use of monetary instruments under the control of the central bank to regulate magnitudes such as interest rates, money supply and availability of credit with a view to achieving the ultimate objective of economic policy.

The monetary policy can be expansionary or contractionary.

An expansionary monetary policy is focused on expanding (increasing) the money supply in an economy. An expansionary monetary policy is implemented by lowering key interest rates thus increasing market liquidity.

A contractionary monetary policy is focused on contracting (decreasing) the money supply in an economy. A contractionary monetary policy is implemented by increasing key interest rates thus reducing market liquidity.

The Reserve Bank of India (RBI) is vested with the responsibility of conducting monetary policy. This responsibility is explicitly mandated under the Reserve Bank of India Act, 1934.

- What is the main goal of Monetary Policy?
  - Maintain price stability.
    - To maintain price stability, inflation needs to be controlled.
    - **Flexible Inflation Targeting Framework (FITF)**
      - Who sets the target?
      - When will the target be deemed to have failed?

- **Monetary Policy Committee (MPC)**
  - Members/Composition
  - How many times to meet?

Is Inflation targeting a good policy?

Inflation targeting as a good policy

- It increases the transparency and credibility of the central bank consequently allowing it to carry out its monetary policy more effectively.
- It helps to stabilize inflationary expectations in an uncertain future.
- Increases the focus on domestic considerations and enables quick response to domestic economy shocks.

Limitations of Inflation targeting policy

- The policy doesn't address the sudden shocks in the economy and inefficient transmission mechanisms.
- Too much weight to inflation stabilization might prove detrimental to the stability of real economy and other growth objectives.
- Requirement of Number of preconditions like well-developed technical infrastructure for forecasting, modelling and data availability etc.
- India lacks suitable conditions for successful implementation of inflation targeting. For example, lack of adequately developed financial markets, confidence of global capital markets is low, independence of the RBI etc.
- Policy of inflation targeting will lead to highly unstable and inappropriate exchange rate.

Monetary Policy Transmission

Monetary transmission refers to the process by which a central bank's monetary policy signals (like repo rate) are passed on, through financial system to influence the businesses and households.

In an economy, both consumption and investment are often financed by borrowings from banks.

Interest rate is the main channel of monetary policy transmission.

In the Indian scenario, the momentary policy transmission is heavily depending upon the repo rate.

Monetary Policy Transmission

- ***Informal Indian Economy***
  - The monetary policy affects only around 60% of loans/credit in the Indian economy which are sourced from formal channels
- ***Supply chain disruptions***
  - CPI doesn't factor the rise in inflation driven by supply-chain dislocations.
- ***Limitation of Inflation targeting***
- ***Triangular balance-sheet***
- ***Gold Economy***

RBI- Economic Capital Framework *(After Bimal Jalan Committee)*

RBI transfers the surplus – that is, the excess of income over expenditure – to the government, in accordance with **Section 47** of the **RBI Act, 1934.**

Earlier, the RBI used keep a major chunk of this surplus for its contingency and asset development.

In view of the RBI's function as a lender of last resort, it needs to maintain some **Contingent Risk Buffer (CRB)** to insure the economy against any tail risk of financial stability crisis.

- **Revaluation reserves** comprise of periodic marked-to-market unrealized/notional gains/losses in values of foreign currencies and gold, foreign securities and rupee securities, and a contingency fund.
- **Realized equity,** which is a form of a contingency fund for meeting all risks/losses primarily built up from retained earnings. It is also called the **Contingent Risk Buffer (CBR).**

Bimal Jalan set up to review the provisions under the **Economic Capital Framework.**

The committee has **defined economic capital-** as a combination of **realized equity** and **revaluation**

The Jalan Committee recommended that the CRB needs to be maintained at a range of **5.5% to 6.5% of the RBI's balance sheet**.

By and large, with a few exceptions, the quantum of surplus transfer averages around **0.5% of the GDP.**

RBI BALANCE SHEET
(As Of June 2018)

Liabilities (Rs Cr)			Assets (Rs Cr)	
Capital & other reserves	6,733		Foreign Currency Assets	26,35,074
Contingency Fund	2,54,919		Gold	1,44,023
Currency & Gold Revaluation	6,91,641		INR assets - RBI lending to government	6,29,745
Bond & derivative revaluation gains	16,547		Other INR assets	2,08,752
Subtotal of above 4	9,69,840			
Other Provisions	33,197			
Surplus transferable to government	50,000			
Total capital, reserves & provisions		10,53,037		
Deposits		6,52,597		
Notes issued - currency in circulation		19,11,960		
Total		36,17,594	Total	36,17,594

C.

A. What the conservative focus on (7% of assets)

B. Total capital buffers (27% of assets)

Source: RBI Annual report

Bloomberg | Quint

RBI's Income

Management commission on handling the borrowings of state governments and the central government.

Interest on its holdings of local rupee-denominated G-Sec, and while lending to banks for very short tenures, such as overnight.

Returns earned on its foreign currency assets

RBI's Expenses

Printing of currency notes and on staff

The commission it gives to banks for undertaking transactions on behalf of the government across the country

How to achieve the perfect or near perfect balance?

Control Inflation

Make sure Lending rates are low too.

Low Inflation would mean banks can offer lower savings rate.

If RBI can keep Bank's cost of funds lower, then lesser lending rates.

Inflation Targeting
To maintain price stability in economy by controlling inflation.
Policy Rate (Repo Rate)

Success depends on

Monetary Policy Transmission

Success depends on

Liquidity Management
RBI Tries to keep the **Target rate** closer to Call rate (the rate at which inter-bank lending happens)

Managed by Monetary Policy Committee

MPC is responsible for Liquidity Management in Indian Economy.

Liquidity Management is done by RBI.

EXTERNAL BENCHMARKING OF LOANS (For better MONETARY POLICY TRANSMISSION)

Monetary policy transmission refers to the process through which changes in the policy rates (such as Repo) by the RBI leads to commensurate changes in the rates of Interest of the Banks.

Why poor Monetary Policy Transmission?

- Over-dependence on Deposits
- Deposits with higher maturity period
- Small savings Schemes
- Higher NPAs
- Opaqueness in calculation of MCLR

Before 2016 — BASE RATE REGIME

It **did not consider the Repo rate** for the calculation of the minimum rate of interest on the loans offered by the Banks. Hence, changes in the Repo rate did not have much impact on the rate of interest on loans.

From 2016 — MARGINAL COST OF LENDING RATE

It included Repo Rate, amongst other parameters. However, even this had problem

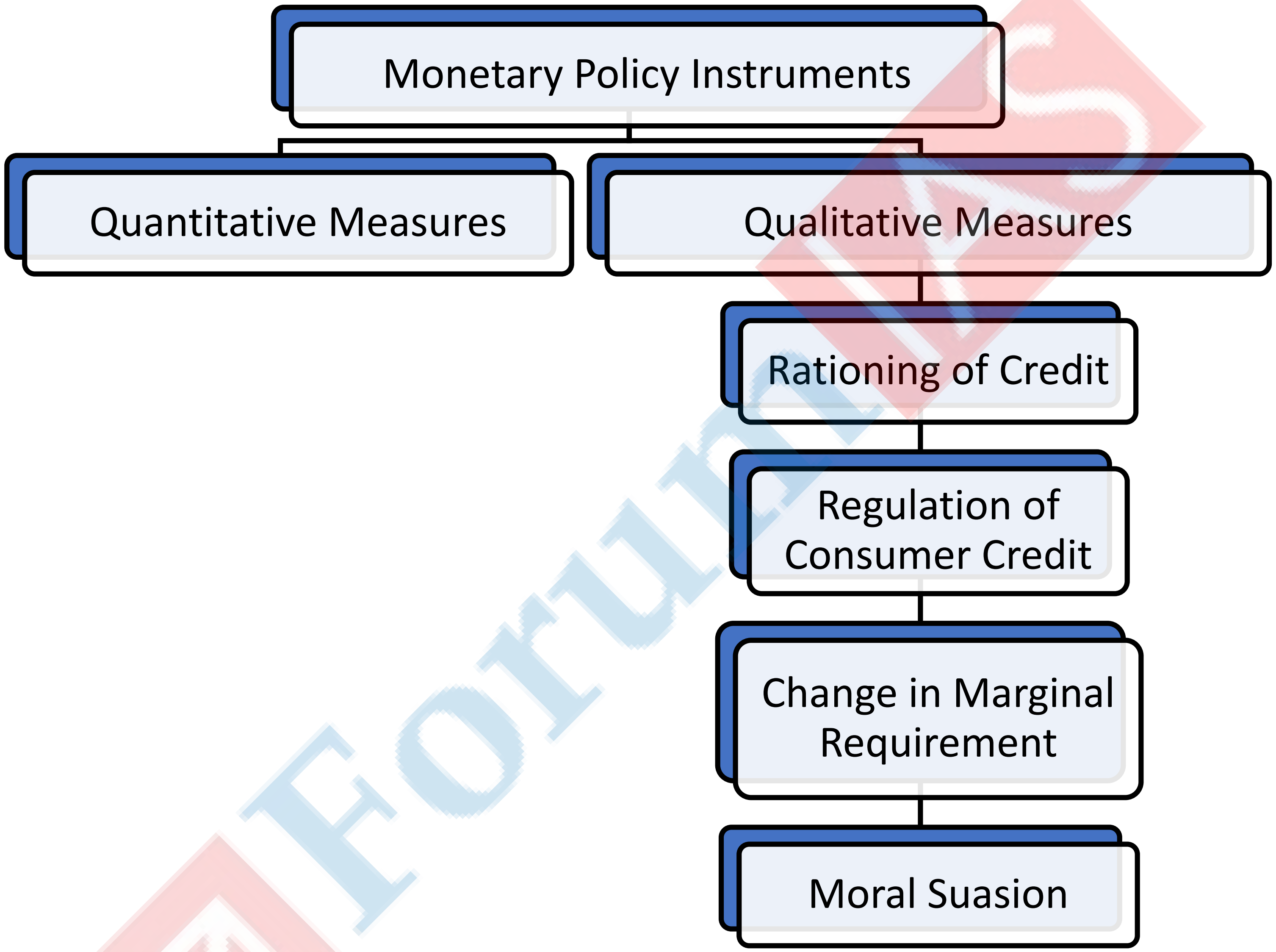
Considered to be flawed on account of two reasons- Opaqueness and not being solely dependent on Repo rate.

NOW — EXTERNAL BENCHMARK

4 Options to link interest rate: Repo Rate, T-91, T-182 or Benchmark published by **FIBIL**

INFLUENCED SOLELY BY THE POLICY RATES LEADING TO HIGHER EFFICIENCY.

- Greater transparency.
- Borrowers know the profit margin fixed by various banks and hence can choose accordingly


Monetary Policy Instruments
Quantitative Measures
Qualitative Measures
Rationing of Credit
Regulation of Consumer Credit
Change in Marginal Requirement
Moral Suasion

Quantitative Measures

CRR
The average daily balance that a bank is required to maintain **with the Reserve Bank** as a share of such per cent of its Net demand and time liabilities (NDTL)

SLR
The share of NDTL that a bank is required to maintain in safe and liquid assets, such as, unencumbered **government securities, cash and gold**.

REPO
The (fixed) interest rate at which the Reserve Bank provides overnight liquidity to banks against the collateral of government and other approved securities under the liquidity adjustment facility (LAF).

Reverse REPO
The (fixed) interest rate at which the Reserve Bank absorbs liquidity, on an overnight basis, from banks against the collateral of eligible government securities under the LAF.

LAF
The LAF consists of overnight as well as term repo auctions.
The aim of term repo is to help develop the inter-bank term money market, hence improve transmission of monetary policy.

LTRO?

MSF
Marginal Standing Facility: A facility under which scheduled commercial banks can borrow additional amount of overnight money from the Reserve Bank by dipping into their Statutory Liquidity Ratio (SLR) portfolio up to a limit at a penal rate of interest.

SDF?

Bank Rate
It is the rate at which the Reserve Bank is ready to buy or rediscount bills of exchange or other commercial papers. The Bank Rate is published under **Section 49 of the Reserve Bank of India Act, 1934.** This rate has been **aligned to the MSF rate** and, therefore, changes automatically as and when the MSF rate changes alongside policy repo rate changes.

OMO
These include both, outright purchase and sale of government securities, for injection and absorption of durable liquidity, respectively.

Operation Twist?

MSS
Market Stabilisation Scheme (MSS): This instrument for monetary management was introduced in 2004. Surplus liquidity of a more enduring nature arising from large capital inflows is absorbed through sale of short-dated government securities and treasury bills. The cash so mobilised is held in a separate government account with the Reserve Bank.

CORRIDOR
The MSF rate and Reverse Repo Rate determine the corridor for daily movements in the weighted average call money rate.

Q10 : If the RBI decides to adopt an expansionist monetary policy, which of the following would it not do? (UPSC 2020)

1.Cut and optimize the Statutory Liquidity Ratio

2.Increase the Marginal Standing Facility Rate

3.Cut the Bank Rate and Repo Rate

Select the correct answer using the code given below:

(a) 1 and 2 only

(b) 2 only

(c) 1 and 3 only

(d) 1, 2 and 3

Long term repo operation (LTRO)

RBI conducted **targeted long-term repo operations (TLTRO)** for an amount of Rs 1 lakh crore to ensure comfortable liquidity conditions in the system. (Oct 2020)

As banks get long-term funds at lower rates, their cost of funds falls.

In turn, they reduce interest rates for borrowers.

LTRO helped RBI ensure that banks reduce their marginal cost of funds-based lending rate, **without reducing policy rates.**

LTRO also showed the market that RBI will not only rely on revising repo rates and conducting open market operations for its monetary policy, but also use new tools to achieve its intended objectives.

Why LTRO when already LAF and MSF?

LAF and MSF: 1-28 days; LTRO :1- to 3-year needs. LTRO operations are intended to prevent short-term interest rates in the market from drifting a long way away from the policy rate, which is the repo rate.

STANDING DEPOSIT FACILITY

During post demonetization, RBI ran out of government securities to offer as collateral and had to temporarily hike its CRR.

The SDF will allow the RBI to suck out liquidity without offering government securities as collateral.

Within the existing liquidity management framework, liquidity absorption through reverse repos, open market operations and the cash reserve ratio (CRR) are at the **discretion of the Reserve Bank**. On the other hand, **the use of standing facilities (MSF, SDF) would be at the discretion of banks.**

As a standing facility, the SDF supplements Marginal Standing Facility or the MSF (**SDF for liquidity absorption whereas MSF for liquidity injection**).

What is Operation Twist?

In 2019 and 2020, the Reserve Bank of India conducted its version of ‘Operation Twist’ through simultaneous purchase and sale of government securities under OMOs.

Originally done by US Fed.

With simultaneous **buying** of long-term bonds and **selling** of short-term securities, RBI can bring down the interest rates of long-term government securities.

$$\boldsymbol{Bond\ Price\ \alpha\ \frac{1}{Bond\ Yield}}$$

Yield is the return an investor gets on his (bond) holding/investment.

The bond yield comes down with an increase in prices.

The interest rate in an economy is determined by yield. Thus, lower long-term interest rates mean people can avail long-term loans (such as buying houses, cars or financing projects) at lower rates.

Unconventional Monetary Policy Tools

Zero Interest Rate Policy (ZIRP)

This policy was followed in USA from 2008 in the wake of financial crisis in order to inject money into the economy to promote economic growth.

This was also known as **Quantitative Easing**. *(The Opposite of Quantitative Easing is Fed Tapering)*

Negative Interest Rate Policy (NIRP)

This policy was followed in developed economies such as Japan, Denmark, Sweden, Switzerland etc.

The banks would be required to pay interest to the central bank if they park their surplus reserves.
Done to provide loans to the borrowers at cheaper rates

Helicopter Money

Hypothetical Concept. Print money and distribute amongst people free of cost.

Introduction to Economics for UPSC

Importance in UPSC/CSE

Weightage in Marks

Booklist

Prelims

Mains

Flow of Topics

- National Income
- Planning
- Public Finance
- Inflation
- Money and Banking
- Capital Markets
- International Trade
- Agriculture
- Industry
- Infrastructure
- Poverty and Unemployment

Evolution through Phases

P1. With reference to opportunity cost of a decision 'X', consider the following statements:

1. The opportunity cost of 'X' is only the next-best alternative foregone and not any other alternative.
2. Opportunity cost of 'X' is different for each individual and nation".

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

(a) Only 1 (b) Only 2

(c) Both 1 and 2 (d) None of the above

Ans:1)(c)

P2. With reference to economy, the Marginal Utility Curve depicts:

(a) The relation between the satisfaction generated from the consumption of an additional unit of a good and the quantity of the good consumed.
(b) The inverse relationship between rates of unemployment and corresponding rates of inflation.
(c) The relationship between average tax rates to total tax revenue.
(d) The function relating the quantity purchased of a commodity to the level of money income

Ans:2)(a)

P3. Which one of the following factors is responsible for negative relationship between price and demand?

(a) Increasing Marginal Utility
(b) Decreasing Marginal Utility
(c) Constant Marginal Utility
(d) None of the above

Ans:3)(b)

P4. Keynesian theory of pump priming aimed at:

(a) To take the economy out of the recession through enhanced government spending
(b) To allow the market reach equilibrium on its own without any government intervention
(c) To globalise the economy
(d) To trade on the basis of comparative advantage enjoyed by a country

Ans:4)(a)

Why do we need the government today?

Capitalism vis-à-vis Socialism: A Perspective

Two types of Social Organizations

Capitalism

Socialism

Value Emphasis

Who decides what people want?

Distribution of Wealth or Wealth Creator?

Capitalism

Socialism

Who has claim over your labour?

Psychology of Entities

Moral Problem

THANK YOU