APPOLO STUDY CENTRE CHENNAI

APPOLO STUDY CENTRE

FISCAL POLICY – MONETARY POLICY

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Unit 1- Money, Savings and Investment

Introduction

Money is a fascinating subject and full of curiosities. It is important to capture this element for the students. The history of money and how various forms were used at different times is an interesting story. Modern forms of money are linked to the banking system.

Money is a fundamental discovery, which has eased the day to day transactions, valuing goods and services and has allowed us to store the wealth and trade in future. "Money is anything which is widely accepted in payment for goods or in discharge of other business obligations" Robertson. Money in some form, has been part of human history for atleast the last 3000 years. Before that time, it is assumed that a system of bartering was likely used.

Evolution of Money

The word Money is derived from Roman word "Moneta Juno". It is the roman goddesses and the republic money of roman empire. The Indian rupee is derived from Sanskrit word 'Rupya' which means silver coin.Today we use paper notes, coins as money. But the evolution of this stage has not happened overnight. It took thousands of years to reach such a stage. There are many stages of evolution of money. The earliest and primitive stage is Barter system.

Barter system

Barter system is exchanging goods for goods without the use of money in the primitive stage. A barter system is an old method of exchange. This system has been used for centuries and long before money was invented. People exchanged services and goods for other services and goods in return. The value of bartering items can be negotiated with the other party. Bartering doesn't involve money which is one of the advantages.Hence Barter system had many deficiencies like,

1. Lack of double coincidence of wants,
2. Common measure of value
3. Indivisibility of commodities
4. Difficulties of storing wealth

Some of the major stages through which money has evolved are as followsCommodity Money, Metallic Money, Paper Money, Credit Money, Near Money and recent forms of Money. Money has evolved through different stages according to the time, place and circumstances.

Commodity Money

In the earliest period of human civilization, any commodity that was generally demanded and chosen by common consent was used as money. Goods like furs, skins, salt, rice, wheat, utensils, weapons etc. were commonly used as money. Such exchange of goods for goods was known as 'Barter Exchange'.

Metallic Money

With progress of human civilization, commodity money changed into metallic money. Metals like gold, silver, copper, etc. were used as they could be easily handled and their quantity can be easily ascertained. It was the main form of money throughout the major portion of recorded history.

History of Metallic Money

The precious metals especially gold, silver, bronze were used for metallic money. The standard weight and fineness of metal particularly gold and silver with a seal on it became medium of exchange. They were of different denomination easily divisible, portable and were convenient in making payment.King Midas of Lydia innovated metal coin in the 8th century BC (BCE) by the ancient historian Herodotus. But gold coins were in use in india many centuries than in Lydia.The earliest issuers of coins in the world are the ancient Indians along with Chinese and Lydian's from the middle east. The first time Indian coins were minted in the 6th century BC (BCE) by the Mahajanpadas known as Puranas, Karshapanas or Panas.

The Mauryas came up with the Punch Marked Coins minting of silver, gold copper or lead and Indo-Greek Kushan kings introduced the Greek custom of engraving portraits on the coins. Turkish sultans of Delhi has replaced the royal designs of Indian kings with Islamic Calligraphy by the 12th century AD (CE). The currency was made up of gold, silver and copper known as Tanka and lower valued coin known as Jittals.The Mugual Empire from 1526 AD consolidate the monetary system for the entire empire.

In this era evolution of rupee occurred with Sher Shah Suri defeated Humayun and issued a silver coin of 178 gms known as rupiya and was divided into 40 copper pieces or paisa and during the whole Mugual period silver coin remained in use. During the British East India company i.e. 1600, the mughal currency remained popular but in 1717 AD, Farrukhsiyar the Mughal Emperor gave permission to the Britishes to coin Mughal Money at the Bombay mint. The British gold coins were termed as Carolina, the silver coins as Angelina, the copper coins as cupperoon and the tin coins as tinny.

Paper Money

It was found inconvenient as well as dangerous to carry gold and silver coins from place to place. So, invention of paper money marked a very important stage in the development of money. The development of paper money started on the basis of storage of gold and the receipts were issued by the goldsmiths for these storages. This receipt of goldsmiths were a substitute for money and became paper money. Paper money is regulated and controlled by Central bank of the country (Reserve Bank of India). At present, a very large part of money consists mainly of currency notes or paper money issued by the central bank.

Credit Money or Bank Money

Emergence of credit money took place almost side by side with that of paper money. People keep a part of their cash as deposits with banks, which they can withdraw at their convenience through cheques. The cheque (known as credit money or bank money), itself, is not money, but it performs the same as functions of money.

Near Money: The final stage in the evolution of money has been the use of bills of exchange, treasury bills, bonds, debentures, savings certificate etc.
Recent forms of Money

Plastic Money: The latest type of money is plastic money in the form of Credit cards and Debit cards. They aim for cashless transactions.

E-Money: Electronic Money is money which exists in banking computer systems and is available for transactions through electronic system.

Online Banking (Net Banking)

Online Banking, also known as internet banking is an electronic payment system that enables customers of a bank or other financial institutions to conduct a range of financial transactions through website.

E-Banking

Electronic banking, also known as National Electronic Funds Transfer (NEFT), is simply the use of electronic means to transfer funds directly from one account to another rather than by cheque or cash.

Value of Money

Value of money is meant the purchasing power of money over goods and services in a country. Thus it is related to the price level of goods and services. But the relation between the value of money and price level is an inverse one.

The value of money is of two types

1. Internal value of money
2. External value of money

The Internal value of money refers to the purchasing power of money overdomestic goods and services. The External value of money refers to the purchasing power of money over foreign goods and services.

Nature of Money

There has been lot of controversy and confusion over the meaning and nature of money(Scitovsky). "Money is a difficult concept to define, partly because it fulfils not one but three functions, each of them providing a criterion of moneyness those of a unit of account, a medium of exchange, and a store of value". Sir John Hicks, say that "Money is defined by its functions, anything is money which is used as money, "Money is what money does".

These are the functional definitions of money because they define money in terms of the functions it performs.Some economists define money in legal terms saying that "anything which state declares as money is money". Such money possesses general acceptability and has the legal power to discharge debts. But people may not accept legal money by refusing to sell goods and services against the payments of legal tender money.On the otherhand, they may accept some other things as money winch are not legally defined as money in discharge of debts. This may circulate freely.

Functions of Money: Functions of money are classified into Primary or Main function, Secondary function and Contingent function.

Primary or main functions: The important functions of money performed in very economy are classified under main functions:-

i. **Medium of exchange or means of payment:** Money is used to buy the goods and services.
ii. **Measure of value:** All the values are expressed in terms of money it is easier to determine the rate of exchange between various type of goods and services.

Secondary functions

The three important of secondary functions are

i. **Standard of deferred payment:** Money helps the future payments too. A borrower borrowing today places himself under an obligation to pay a specified sum of money on some specified future date.

ii. **Store of value or store of purchasing power:** Savings were discouraged under barter system as some commodities are perishable. The introduction of money has helped to save it for future as it is not perishable.

iii. **Transfer of value or transfer of purchasing power:** Money makes the exchange of goods to distant places as well as abroad possible. It was therefore felt necessary to transfer purchasing power from one place to another.

Contingent functions

1. Basis of credit
2. Increase productivity of capital
3. Measurement and Distribution of National Income

Savings in Banks and Investments Savings

Savings are defined as the part of consumer's disposable income which is not used for current consumption, rather kept aside for future use. There are several ways through which a person can save money.

The banking facilitates saving money through various forms of accounts.

1. **Student Savings Account:** There are savings accounts some banks offer specifically for young people enrolled in high school or college, and they main feature more flexible terms such as lower minimum balance requirements.

2. **Savings Deposits:** Savings deposits are opened by customers to save the part of their current income. The customers can withdraw their money from their accounts when they require it. The bank also gives a small amount of interest to the money in the saving deposits.

3. **Current Account Deposit:** Current accounts are generally opened by business firms, traders and public authorities. The current accounts help in frequent banking transactions as they are repayable on demand.

4. **Fixed Deposits:** Fixed deposits accounts are meant for investors who want their principle to be safe and yield them fixed yields. The fixed deposits are also called as Term deposit as, normally, they are fixed for specified period.

Benefits of Savings

You will be financially independent sooner.
You would not have to worry any unforeseen expenses.
In future, you will have financial backup in place if you lose your job.
You will be prepared if your circumstances change.
You will be more comfortable in retirement.
Save today for better tomorrow

Intensity to save among the students

Teach them about taxes and accounting.
Involve them in grown-up money decisions.
Encourage them to apply for scholarship.
Help them budget and apply for student loans.
Teach them personal savings.

Encourage them to open a student Sanchayeka Scheme.

Investments

The process of investing something is known as an investment. It could be anything, i.e. money, time efforts or other resources that you exchange to earn returns in future. Investment can be made in different investment vehicles like,

1. Stock
2. Bonds
3. Mutual funds
4. Commodity futures
5. Insurance
6. Annuities
7. Deposit account or any other securities or assets

An investment always comes with risks of losing money, but it is also true that you can reap more money with the same investment vehicle. It has a productive nature that helps in the economic growth of the country.

Comparison of Savings and Investments		
Basis for comparison	**Savings**	**Investments**
Meaning	Savings represents that part of the person's income which is not used for consumption	Investment refers to the process of investing funds in capital asset, with a view to generate returns
Purpose	Savings are made a fulfil short term or urgent requirements	Investment is made to provide returns and help in capital formation
Risk	Low or negligible	Very high
Returns	No or Less	Comparatively high
Liquity	Highly liquid	Less liquid

Black Money

Black Money is any money on which it is not paid to the government. Black Money is money earned through any illegal activity controlled by country

regulations. Black money proceeds are usually received in cash from underground economic activity and, as such, are not taxed.

The black money is accumulated by the criminals, smugglers, hoarders, tax-evaders and other anti-social elements of the society.In India, black money is funds earned in the black market, on which income and other taxes have not been paid.The total amount of black money deposited in foreign banks by Indians is unknown. The root cause for the increasing rate of black money in the country is the lack of strict punishments for the offenders.

Effects of Black Money on economy

1. Dual economy
2. Tax evasion, thereby loss of revenue to government.
3. Undermining equity
4. Widening gap between the rich and poor
5. Lavish consumption spending
6. Distortion of production pattern
7. Distribution of scarce resource
8. Effects on production.

Recent steps against Black Money

1. Under pressure from India and other countries, Switzerland has made key changes in its local laws governing assist foreign allegedly stashed in Swiss Banks.
2. Special Investigation Team appointed by government on the directions of Supreme Court on black money.
3. Demonetization

Some Legislative Framework in India against to Black Money

1. Prevention of money laundering act 2002
2. Lokpal and Lokayukta act
3. Prevention of corruption act- 1988
4. The undisclosed foreign Income and Asset Bill(Imposition of Tax) 2015
5. Benami transactions prohibition act 1988 amended in 2016
6. The Real Estate (Regulation and Development) Act, 2016

9th book

3. Money and Credit

Almost all things used by man have a monetary value. In addition to that, the pay given for labour, wages and services are all fixed on the basis of money. The taxes and duties are also paid in the form of money. We would have seen our parents planning the expenses at our home every month. The monthly income, pending expenditure, savings, payment of interest etc., are all measured in terms of money. Not only at homes, but also the budgets of a country or states are also framed on the basis of money. The Government, as well as, private institutions and industries calculate their financial status through money. Thus, money plays a predominant and inseparable role in all our lives.

Barter System

If there arises a question, "Has man always used money?", the answer would be 'no'. How? When did money enter into the lives of men? In this lesson, let us learn about the evolution of money over the years. Ancient man hunted and gathered food. He lived in caves and forests. In later stages, he invented weapons for hunting and gathering food. Later, he invented fire and learnt to practise agriculture. He used mud to build houses and settle down in a place and also to make earthenware.

When the agricultural yield was high, they made handicrafts. When there was surplus in agricultural produce and other articles like earthenware, they exchanged it with people who needed them. For example, if a community had excess food stuff, they would exchange that with those who had excess pots. Likewise, when a particular grain grew in abundance in a region, it was exchanged for a different crop in another region. These articles which were exchanged through barter system can be termed as the first form of trade.

Coins

The barter system flourished wherever civilizations thrived. This system was active not only within a civilization, but also among civilizations. This was the initial form of international trade. During archaeological excavations in Egypt and Iraq (Mesopotamia), articles used during the Indus valley civilization were excavated. As years went by, there were issues found in barter system. For example there were problems in the exchanging needed goods. A person who had paddy was in need of earthenware for instance. But, the person who had pots and other utensils was not in need of paddy.

Thus, the needs of many people were not fulfilled. Measuring the quantity and value of the goods exchanged were found very difficult. To solve these issues, they fixed a common item with a standard value, for the effective exchange of goods. It was usually in the form of some metal. Metals were rare to find and could be

maintained for a long time and never lost their value. Hence, the metals can be termed as the first form of money.

These may be the reasons why metals were chosen. Gold, silver and copper were the metals used first. They were called ancient currency. Leather, beads, shells, tobacco, salt, corn and even slaves were exchanged as barter, say economists. The later Cholas allowed the traders to have their own army. Historical evidences state that during this period, small traders and producers gave credit to the Tamil traders to support their export needs.

Natural Money

The metals such as silver and gold gained importance gradually all over the world. So, these metals were used as standard value in the exchange of goods. There is called as natural money.

Paper Money

Asdays went by, issues arose because while trade prospered, there were insufficient reserves of gold and silver. Mines also had a limited reserve of these metals. An alternative was found and coins were made using metals with lesser value. These were used to buy and sell goods of lesser value. It was used as the money of the poor people. Hence these coins were printed in large numbers. Paper money came into being as the next stage. This money was without form and people started saving in banks. The Great Economic Depression was also prompted the saving habit of the people. Money has become an inseparable part of everyone's life today. It has changed its form in the economic front. Money transactions are done through many ways in the electronic world.

History of Money

1. **Barter System 9000 B.C (B.C.E):** During this period, exchange of goods was done through barter system. Man exchanged the surplus goods for other goods that he needed.

2. **Coins 1100 B.C (B.C.E):** The Chinese have used small coins during this period. These coins were made in bronze. Countries bordering the Indian Ocean used shells as a medium of exchange.

3. **Currency 600 B.C (B.C.E):** King Alyattes of Lydia announced publically that official currency will be used for trade. Lydia is a part of Turkey today. This Transaction of money spread throughout the Mediterranean region.

4. **Gold Coin 1250 A.D (C.E):** The florin, a gold plated coin was introduced in Europe

5. **Marco Polo 1290 A.D (C.E):** Paper money spread to Europe through the travels of Marco Polo

6. **Printing of Currency 1661 A.D (C.E):** When new paper money was printed in Sweden, it was not much welcome.

7. **Electronic Transfer 1860 A.D (C.E):** Through telegramme an effort was under taken to transfer money electronically.

8. **Credit Card 1946 A.D (C.E):** John Biggins invented the credit card

9. **Mobile Banking 1999 A.D (C.E):** European banks introduced mobile banking

10. **NFC 2008 A.D (C. E)**Near field communication (NFC) was introduced in Britain. In 2016, it came to India> It takes only about 7 to 8 seconds to transact money through NFC.

Electronic Transactions

One has to visit the bank and fill in a challan or produce a cheque to withdraw money from his account. Now this practice is gradually vanishing. Instead, one can easily withdraw the necessary amount from an Automated Teller Machine (ATM), with the help of an ATM debit card. One can easily withdraw the money needed at any time at ATMs located everywhere. A person can deposit money in their account without visiting the branch.

Similarly, credit cards are also available, through which things are bought on credit and the amount can be paid later.
Nowadays, instead of using cheques or Demand Drafts (DDs), online transactions through net banking are carried out. Through this, money is transacted to anyone who lives anywhere across the globe.
Technology has advanced so much that even mobile banking is widely used nowadays.

Role of the Reserve Bank of India

A government has the responsibility to regulate money supply and oversee the monetary policy. Hoarding of money must be avoided at all costs in a country's economy. Only then money can be saved in banks. A major portion of the savings in banks are used for the development of industries, economic growth and various development schemes for the welfare of the poor. All the major and important banks were nationalised (1969) in India. The Reserve Bank of India (RBI) regulates the circulation of currency in India.

The Reserve Bank of India started its operations on 1st April 1935. It was permanently moved to Mumbai from the year 1937. RBI was natinolised in 1949. 85% of the printed currency is let for circulation. According to the statistics available as on August 2018, currency worth of 19 lakh crore are in circulation. **(source - Reserve Bank of India)**

Educational Loans

Educational loan attempts to meet the educational aspirations of the society.
A student is the main borrower.
A parent, spouse or sibling can be the co-applicant.
It is offered to students who want to pursue higher education in India or overseas.
It can be taken for a full time, part – time or vocational course and Graduation or Post Graduation.
There is no security required for the loan amount up to ` 4 lakhs
The loan is repaid by the student generally after the employment.
Students can apply through "Vidya Lakshmi Portal Education Loan Scheme".

Relationship between Money and Prices

There is a close relationship between volume of circulation money and the price of things. 90% of the products are manufactured with the main aim of sales or meant for services. Growing crops and production are done on a commercial basis, rather than on a subsistence level. This phenomenon also increased the importance of the market and money.

The relationship between money and price is connected with the Monetary policy. There is a close relationship between the growth of money supply and inflation. Price controls play a very important role in a country's economic stability. This role is played by the Central Bank of our country, RBI in India. Currency is the medium of exchange in a country. The Indian currency is called the Indian Rupee (INR). In a country the foreign currency is called foreign exchange. Purchasing capacity of all currencies in the world are compared using the US dollar as the standard currency. This value differs from country to country. Most of the international trade transactions are carried out in US dollar.

How is currency printed in India?

One rupee and two rupee notes were first printed in India in the year 1917. The Reserve Bank of India is empowered to issue the Government of India notes since1935. 500 rupee note currency was introduced later. In 1940, one Rupee notes were issued again. Till 1947, the currency notes with the image of King George VI were in circulation. After Independence, the Government of India issued currency notes.

In 1925, the British government established a government press at Nasik in Maharashtra. Currencies were printed three years later. In 1974, a press was started in Dewas, Madhya Pradesh. (Security Printing and Minting Corporation of India Ltd.)In the 1990s.two more presses were started in Mysuru, Karnataka and Salboni in West Bengal to print bank notes.

The Reserve Bank of India has the authority to decide the value of currency to be printed and how the amount should reach its destination safely. Around ten thousand workers are employed here. Countries like Sri Lanka, Bhutan, Iraq and Africa have drawn contracts for printing their currencies and sent to the respective countries. Though the RBI has the power to print up to ten thousand rupee notes, at present a maximum of up to rupees two thousand is printed.

Foreign exchange rate equivalent to US Dollars

Country	**Currency**	**Equivalent Value for 1 US Dollar (July 2018)**
India	Rupee	68.72 rupees
England	Pound	0.76 pound
European Union	Euro	1.14 euro
Canada	Dollar	1.31 dollar
Japan	Yen	111.15 yen
China	Yuan	6.76 yuan
Saudi Arabia	Riyal	3.75 riyal
Australia	Dollar	1.35 dollar
Malaysia	Ringgit	4.05 ringgit
Pakistan	Rupee	124.2 rupees
SriLanka	Rupee	159.8 rupees

Functions of Money: When money replaced the barter system, a lot of practical issues were solved. Money acts a medium of exchange, a unit of measurement, a store of value and a standard of deferred payments. It plays an important role in transactions.

Medium of Exchange: Money should be accepted liberally in exchange of goods and services in a country.

Unit of Account: Money should be the common, standard unit of calculating a country's total consumer goods, products, services etc. For example, if a book costs ` 50, it means that the price of the book is equale to 50 units of money. Money is used to measure and record financial transactions in a country.

A Store of Value: Money is used as a store of purchasing power. It can be used to finance future payments.

Credit

Farmers avail credit during monsoons for buying seeds, agricultural input and other expenses. Traders and small entrepreneurs need credit for their needs. Even large industries receive credit to take up their new projects.

Credit is available from:

Formal financial institutions like nationalised and private banks and co-operative banks
Informal financial institutions
Micro credit is received through Self Help Groups (SHG)

As far as nationalised banks and co-operative banks are concerned the interest to credit is comparatively lesser and there is gurantee for the pledged, goods.

Money supply is divided into four:

M1 = Currency held with the public + cash Reserves in commercial and Co-operative banks + cash reserves in the RBI.
M2 = M1 + Money saved in Post office and bank savings Accounts
M3 = M1 + Time Deposits in Commercial and co-operative banks
M4 = M3 + Post office savings Money

Informal Financial Institutions

Informal financial institutions are easily approachable to the customers with flexible procedures. But there are issues like the safety of items pledged high rates of interest and modes of recovery. People who live in a particular place or those who are involved in a certain work join together as a group and start saving. These are called as Self Help Groups. The nationalised banks provide help to these groups through micro-credit. . Credit given though Self Help Groups for street vendors, fishermen, especially women and the poor really make a difference in their life.

In Tamil Nadu, all the banks have 10,612 branches; across the state. They carry on a total transaction of around 15 lakh crore rupees during the financial year (2017-2018). A few salient features of the Tamil Nadu Bank transactions are given in the table below

Tamil Nadu – Banking Statistics	
Banking Activates (April 2017 – March 2018)	Rupees (approximately)
Deposits Received	7.17 Lakh crore
Loans sanctioned	7.84 lakh crore
Loans to micro & small enterprises	1.40 lakh crore
Priority sector Loans including	3.56 lakh crore

Agriculture	
Loans to weaker section	1.04 lakh crore
Education Loan	1.67 lakh crore
Credit Deposit Ratio	**109.34%**

NOTE

- During his rule(1540-1546) Sher Shah Suri set up a new civic and military administration and issued a coin of silver weighing 178 grams, which was termed the Rupiya. The silver coin remained in use during the Mughal period, the Maratha era and in Biritish India as well.
- Dr. B.R. Ambedkar'sPh.D.thesis on 'The Problem of the Rupee - Its origin and solution' was the reference tool and provided guidelines for the Reserve Bank of India Act of 1934.

10th Full Book

Unit 1 – GDP and its Growth: an Introduction

Economists call such tangible items "goods". These goods are not free but have to paid for.

Though you don't realise it in addition to these tangible things called goods, something else is being produced : the work done by the cooks and the people who serve the food. The activity of cooking and serving is not something you can feel and touch. Such activities are not tangible but are nevertheless crucial for you to enjoy the food. Economists call such activity "services". As in the case of goods, these and other services are not free but have to be paid for.

What happens everyday in a hotel happens nation wide: goods and services are produced and paid for and this what the GDP measures.

The GDP is defined follows:

The GDP is the market value of all the final goods and services produced in the country during a time period.

Every part of the definition is important.

Goods and services: as you know by now, goods are tangible items while services are activities which are intangible .

Market value: This is the price at which goods and services are sold in the market.

The GDP measures all the goods and services produced in the country. For this, we have to add all the goods and services produced. However a nation produces a wide range of goods like rice, shoes , trains, milk, clocks, books and bicycles. If only the quantities are taken into account, there is no meaningful way to add these up. For example, how do you add 1000 litres of milk with 500 clocks?! Likewise there is no meaningful way to add the quantities of services since a wide range of services are produced , such as the work done by doctors, police, fire brigade, teachers, bus drivers and district collectors.

The GDP solves this problem by measuring the goods and services in the currency of the country, which is the rupee in the case of India. The rupee values are derived from the prices at which the goods and services are sold in the market. Only those goods and services with a market value are included in the GDP.

This implies that unless a good or service is sold in the market, it is not included in the GDP. For example if you pay ` 50 to get a manuscript typed in a computer centre, the service is included in the GDP since it is sold in the market. If you type the manuscript yourself , the service typing a manuscript is not included in the GDP since you did not purchase it for a price in the market.

Final goods and services: Economists Tyler Cowen and Alex Tabarrok say that "final goods and services" are the goods and services which will be used or consumed and will not form a part of other goods and services. The goods and services which will be used for producing other goods and services and will form a part of the goods and services produced are called "intermediate goods".

Only the final goods are included in the GDP. Intermediate goods are not counted in calculating the GDP because their value is included in the final goods. So if the intermediate goods are included in the GDP it will result in what is called "double counting".

For example, a cup of tea bought in a hotel is a final good because it is consumed and does not form a part of producing something else. So the market value of the cup of tea, being a final good, is included in the GDP. Sugar which is mixed in the tea is an intermediate good because it is used in making tea and forms a part of the tea served. Suppose the tea is priced ` 10 a cup, of which the value of sugar used is ` 2. So the price of the cup of tea includes the ` 2 price of the spoon of sugar. If this value of sugar is included in the GDP , it will be counted twice: as a spoon of sugar and again as a part of the cup of tea. This is "double counting" and to avoid it the intermediate goods like sugar are excluded from GDP.

National Income

'National Income is a measure of the total value of goods and services produced by an economy over a period of time, normally a year'. Commonly National Income is called as Gross National Product(GNP) or National Dividend.

Various terms associated with measuring of National Income

Gross National Product (GNP)

Gross National Product is the total value of (goods and services) produced and income received in a year by domestic residents of a country. It includes profits earned from capital invested abroad.

GNP = C + I + G + (X–M) + NFIA)
C = Consumption
I = Investment
G = Government Expenditure
X-M = Export – Import

NFIA = Net Factor Income from Abroad)

Gross Domestic Product (GDP)

Gross Domestic Product (GDP) is the total value of output of goods and services produced by the factors of production within the geographical boundaries of the country.

Net National Product (NNP)

Net National Product(NNP) is arrived by making some adjustment with regard to depreciation that is we arrive the Net National Product (NNP) by deducting the value of depreciation from Gross National Product. (NNP = GNP − Depreciation)

Net Domestic Product (NDP)

Net Domestic Product (NDP) is a part of Gross Domestic Product, Net Domestic Product is obtained from the Gross Domestic Product by deducting the Quantum of tear and wear expenses (depreciation)
NDP = GDP – Depreciation

Per Capita Income (PCI)

Per capita Income or output per person is an indicator to show the living standard of people in a country. It is obtained by dividing the National Income by the population of a country.
Per capita Income = National Income / Population

In 1867-68 for the first time DadabhaiNavroji had ascertained the Per Capital Income in his book "Poverty and Un- British Rule of India".

Personal Income (PI)

Personal income is the total money income received by individuals and households of a country from all possible sources before direct taxes, therefore, personal income can be expressed as follows (PI = NI corporate Income Taxes − Undistributed corporate profits − social security contribution + Transfer payment).

Disposable Income (DI)

Disposable income means actual income which can be spent on consumption by individuals and families, thus, it can be expressed as
DPI = PI − Direct Taxes
(From consumption approach DI = Consumption Expenditures + Savings)

Gross Domestic Product (GDP)

Produced in the country: GDP of India includes only the market value of goods and services produced in India. For example the market value of apples produced in Kashmir are included in our GDP since Kashmir is in India. The market value of apples produced in California, even ifthey are sold in Indian markets, are not included in our GDP because California is in the U.S.

Produced during a time period: The GDP of a country measures the market value of goods and services produced only during the specified time period. The goods and services produced in earlier periods are not included. If an year is the specified time period, the GDP of 2018 will include the market value of goods and services produced only during 2018. So a bicycle produced in 2017 will not be included in the GDP measure for 2018.

In India the GDP is measured both annually and quarterly. The annual GDP is for a financial year which is from April1 of say 2017 to March 31, 2018. This is written as 2017-18. The quarterly GDP estimates are for each of the four quarters into which India's financial year is divided:

First quarter, denoted Q1: April, May and June
Second quarter, or Q2: July, August, September
Third Quarter or Q3: October, November, December
Fourth Quarter, or Q4: January, February, March.

The annual GDP for financial year 2017 - 18 will include only the goods and services produced during this financial year and will exclude the goods and services produced in the previous years. Likewise GDP for Q2 will include only the goods and services produced in Q2 and will not include the goods and services produced in Q1.

Gross Domestic Product (GDP) definition

Gross Domestic Product (GDP) represents the economic health of a country. It represents a sum of a country's production which consists of all purchases of goods and services used by individuals, firms, foreigners and the governing bodies. The monetary value of all the finished goods and services produced within a country's border in a specific time period.

GDP = C + I + G + (X − M)
C = Consumption I = Investment
G = Government Expenditure
(X − M) = X = Exports − M = Imports

The modern concept of GDP was first developed by Simon Kuznets for a US Congress report in 1934.

Methods of GDP Calculating

Expenditure Approach: In this method, the GDP is measured by adding the expenditure on all the final goods and services produced in the country during a specified period. The different types of expenditure are shown in this equation: $Y = C + I + G + (X - M)$

The Income Approach: This method looks at GDP from the perspective of the earnings of the men and women who are involved in producing the goods and services. The income approach to measuring GDP (Y) is Y = wages + rent + interest + profit

Value-Added Approach: A cup of tea served to you in a hotel is a "final good". The goods used to produce it, tea powder, milk, and sugar, are "intermediate goods" since they form a part of the final good, the cup of tea. One way to measure the market value of the cup of tea is to add the value produced by each intermediate good used to produce it. Each intermediate good, the tea powder , milk and sugar, adds value to the final output, the cup of tea. In the value-added approach the value added by each intermediate good is summed to estimate the value of the final good. The sum of the value added by all the intermediate goods used in production gives us the total value of the final goods produced in the economy.

Importance of GDP

Study of Economic Growth.
Unequal distribution of wealth
Problems of inflation and deflation.
Comparison with developed countries of the world.
Estimate the purchasing power.
Public Sector.
Guide to economic planning.

Limitations of GDP

The GDP is the most widely used measure of the state of the economy. While appreciating its usefulness, we should be aware of some of its limitations.

Several important goods and services are left out of the GDP: The GDP includes only the goods and services sold in the market. The services provided by parents to their children is very important but it is not included in the GDP because it is not sold in the market. Likewise clean air, which is vital for a healthy life, has no market value and is left out of the GDP.

GDP measures only quantity but not quality: In the 1970s schools and banks did not permit the use of ballpoint pens. This is because the ones available in India were of very poor quality. Since then, not only has there been a substantial increase in the quantity of ballpoint pens produced in India but their quality has also improved a lot. The improvement in quality of goods is very important but it is not captured by the GDP.

GDP does not tell us about the way income is distributed in the country: The GDP of a country may be growing rapidly but income may be distributed so unequally that only a small percentage of people may be benefitting from it.

The GDP does not tell us about the kind of life people are living: A high level of per capita real GDP can go hand-in-hand with very low health condition of people, an undemocratic political system, high pollution and high suicide rate.

Estimation of GDP

The Central Statistical Organisation (CSO), under the Ministry of Statistical department keeps the records. It's processes involves conducting an annual survey of industries and compilation of various indexes like the Index of Industrial Production (IIP) Consumer Price Index (CPI) etc.

Composition of Gross Domestic Product (GDP)

Indian economy is broadly divided into three sectors which contribute to the GDP namely Agriculture and allied activity, Industry and Services.

Primary Sector: (Agricultural Sector)

Agricultural sector is known as primary sector, in which agricultural operations are undertake. Agriculture based allied activities, production of raw materials such as cattle farm, fishing, mining, forestry, corn, coal etc. are also undertaken.

Secondary Sector: (Industrial Sector)

Industrial sector is secondary sectors in which the goods and commodities are produced by transforming the raw materials. Important industries are Iron and Steel industry, cotton textile, Jute, Sugar, Cement, Paper, Petrochemical, automobile and other small scale industries.

Tertiary: (Service Sector)

Tertiary sector is known as service sector it includes Government, scientific research, transport communication, trade, postal and telegraph, Banking, Education, Entertainment, Healthcare and Information Technology etc.. In the 20th century,economists began to suggest that, traditional tertiary services could be further distinguished from “quaternary” and “quinary” service sectors.

Contribution of different sectors in GDP of India

Services sector is the largest sector of India. Gross Value Added (GVA) at current prices for Services sector is estimated at 92.26 lakh crore in 2018-19. Services sector accounts for 54.40% of total India's GVA of 169.61 lakh crore Indian rupees. With GVA of ` 50.43 lakh crore, Industry sector contributes 29.73%. While, Agriculture and allied sector shares 15.87%.

India is 2nd larger producer of agriculture product. India accounts for 7.39 percent of total global agricultural output. In Industrial sector, India world rank is 6 and in Service sector, India world rank is 8. Contribution of Agriculture sector in Indian economy is much higher than world's average (6.4%). Contribution of Industry and Services sector is lower than world's average 30% for Industry sector and 63% for Services sector.

Gross value added (GVA) is the measure of the value of goods and services produced in an area, industry or sector of an economy. In national accounts GVA is output minus intermediate consumption; it is a balancing item of the national accounts' production account.

GVA is linked as a measurement to Gross Domestic Product (GDP), as both are measures of output. The relationship is defined as GVA + taxes on products - subsidies on products = GDP
GVA = GDP + subsidies - (direct, sales) taxes.

Year	**Agriculture(%)**	**Industry(%)**	**Service(%)**
1950-51	51.81	14.16	33.25
1960-61	42.56	19.30	38.25
1970-71	41.95	20.48	37.22
1980-81	35.39	24.29	39.92
1990-91	29.02	26.49	44.18
2000-01	23.02	26.00	50.98
2010-11	18.21	27.16	54.64
2011-12	17.86	27.22	54.91
2012-13	17.52	26.21	56.27
2013-2014	18.20	24.77	57.03
2015-2016	17.07	29.08	52.05
2016-17	17.09	29.03	52.08

2017-18	17.01	29.01	53.09

Economic Growth and Development

As per the economist AmartyaSen, economic growth is one aspect of economic development. Also, united nation see it like this "Economic development focuses not only on man's materialistic need but it focuses on overall development or rise in its living standards.

Economic Growth

It is the quantitative measure which considers the rise in the output produced in an economy or nation in a particular period in its monetary value. The key parameters of economic growth in any economy are its Gross Domestic Product (GDP) and gross national product which helps in measuring the actual size of an economy.

For example, we say GDP of India is 2.8 trillion USD and ranked 6th in globe whereasGDP of the United States of America is 19.3 trillion USD and ranked one.It shows how much the production of goods and services has increased compared from last year in a quantitative manner. It has many parameters to measure and few of them are human Resources. They are Natural Resource, Advancement in technology, Capital formation, Political and social economic factors.

Economic Development

Economic development projects a broader picture of an economy which takes into account an increase in production level or output of an economy along with an improvement in the living standard of its citizens. It focuses more on socioeconomic factors rather than the just quantitative increase in production. Economic development is a qualitative measure which measures improvement in technology, labour reforms, rising living standards, broader institutional changes in an economy.

Human development Index (HDI) is apt tool to measure the real development in an economy.

Differences between Economic Growth and Economic Development

Comparison between Economic Growth and Economic Development	Economic Growth	Economic Development
Definition / Meaning	It is the positive quantitative change in the output of an economy in a particular time period	It considers the rise in the output in an economy along with the advancement of HDI index which considers a rise in living standards,

		advancement in technology and overall happiness index of a nation.
Concept	Economic growth is the "Narrower" concept	Economic development is the "Broader" concept
Nature of Approach	Quantitative in nature	Qualitative in nature
Scope	Rise in parameters like GDP, GNP, FDI,FII etc.	Rise in life expectancy rate, infant, improvement in literacy rate, infant mortality rate and poverty rate etc.
Term / Tenure	Short term in nature	Long-term in nature
Applicability	Developed nation	Developing economies
Measurement Techniques	Increase in national income	Increase in real national income i.e. per capita income
Frequency of Occurrence	In a certain period of time	Continuous process
Government Aid	It is an automatic process so may not require government support/aid or intervention	Highly dependent on government intervention as it includes widespread policies changes so without government intervention it is not possible
Wealth Distribution	Economic growth does not emphasize on the fair and equal distribution of wealth/income among all its people.	It focuses on a balanced and equitable distribution of wealth among all individual and tries to uplift the downgrade societies

Human Development Index

In 1990 MahbubulHaq, a Pakistani Economist at the United Nations, introduced the Human Development Index (HDI). The HDI is a composite index of life expectancy at birth, adult literacy rate and standard of living measured as a logarithmic function of GDP, adjusted to purchasing power parity.

India climbed one spot to 130 out of 189 countries in the latest human development rankings released today by the United Nations Development Programme (UNDP). India's HDI value for 2017 is 0.640, which put the country in the medium human development category. Between 1990 and 2017, India's HDI value incased from 0.427 to 0.640, an increase of nearly 50 percent – and an indicator of the country's remarkable achievement in lifting millions of people out of poverty.

Between 1990 and 2017, India's life expectancy at birth too increased by nearly 11 years, with even more significant gains in expected years of schooling. Today's Indian school-age children can expect to stay in school for 4.7 years longer than in 1990. Whereas, India's GNI per capita increased by a staggering 266.6 % between

1990 and 2017.

Developmental Path based on GDP and Employment

In the development path of India, it first undertook the policy of closed trade. This was to give a thrust to domestic industries and reduce dependence on foreign products and companies.Trade and interaction with the outside world remained limited. This outlook continued till 1991 when India finally decided to open its borders to free trade and liberalized its economy by allowing foreign companies to enter the Indian economy.

A thrust was given to employment generation under the Five Year plans. This was to make up for a rising population and lacking jobs to absorb the increased workforce size. Rural development was also given importance in India, for the important constituent it was of the Indian landscape.

Poverty alleviation came as a corollary of rural development and a part of the development path of India. India inherited a poverty-stricken economy from the British rule, which had destroyed its resource base completely.

The public sector was given significant importance, Private companies and industries were subject to strict regulations and standards. It was believed that the government was the soleprotector of the people and would work towards social welfare.

India has sustained rapid growth of GDP for most of the last two decades leading to rising per capita incomes and a reduction in absolute poverty. Per capita incomes have doubled in 12 years. In Per capita income, placing India just inside the Middle Income Country category.

Life expectancy at birth is 65 years and 44% of children under 5 are malnourished. The literacy rate for the population aged 15 years and above is only 63% compared to a 71% figure for lower middle income countries.

India has followed a different path of development from many other countries. India went more quickly from agriculture to services that tend to be less tightly regulated than heavy industry. There are some emerging manufacturing giants in the Indian economy.

Gross National Happiness (GNH)

Gross National Happiness (GNH) is a philosophy that guides the government of Bhutan. It includes an index which is used to measure the collective happiness and well-being of a population. Gross National Happiness is instituted as the goal of the government of Bhutan in the Constitution of Bhutan, enacted on 18 July 2008.

The term Gross National Happiness was coined in 1972 during an interview by a British journalist for the Financial Times at Bombay airport when the then king of Bhutan, JigmeSingyeWangchuck, said "Gross National Happiness is more important than Gross National Product.

In 2011, The UN General Assembly passed Resolution "Happiness: towards a holistic approach to development" urging member nations to follow the example of Bhutan and measure happiness and well-being and calling happiness a "fundamental human goal."

GNH is distinguishable from Gross Domestic Product by valuing collective happiness as the goal of governance, by emphasizing harmony with nature and traditional values as expressed in the 9 domains of happiness and 4 pillars of GNH. The four pillars of GNH's are 1) sustainable and equitable socio-economic development; 2) environmental conservation; 3) preservation and promotion of culture; and 4) good governance.

The nine domains of GNH are psychological well-being, health, time use, education, cultural diversity and resilience, good governance, community vitality, ecological diversity and resilience, and living standards. Each domain is composed of subjective (survey-based) and objective indicators. The domains weigh equally but the indicators within each domain differ by weight.

Factors supporting Indian development

A fast-growing population of working age. There are 700 million Indians under the age of 35 and the demographics look good for Indian growth in the next twenty years at least. India is experiencing demographic transition that has increased the share of the working-age population from 58 percent to 64 percent over the last two decades.

India has a strong legal system and many English-language speakers. This has been a key to attracting inward investment from companies such as those specialising in Information Technology.

Wage costs are low in India and India has made strides in recent years in closing some of the productivity gap between her and other countries at later stages of development.

India's economy has successfully developed highly advanced and attractive clusters of businesses in the technology space. For example witness the rapid emergence of Bangalore as a hub for global software businesses. External economies of scale have deepened their competitive advantages in many related industries.

Growth of GDP and Economic Policies

Many Economic Policies have been framed by the Government of India since independence for increasing rate of economic growth and economic development. The important economic policies are

Agriculture policy

Agricultural policy is the set of government decisions and actions relating to domestic agriculture and imports of foreign agricultural products. Governments usually implement agricultural policies with the goal of achieving a specific outcome in the domestic agricultural product markets. Some overarching themes include risk management and adjustment, economic stability, natural resources and environmental sustainability research and development, and market access for domestic commodities.
Some Agricultural policies are Price policy, land reform policy, Green Revolution, Irrigation policy, Food policy, Agricultural Labour Policy and Co-operative policy.

Industrial Policy

Industrial development is a very important aspect of any economy. It creates employment,promotes research and development, leads to modernization and ultimately makes the economy self-sufficient. In fact, industrial development even boosts other sectors of the economy like the agricultural sector (new farming technology) and the service sector. It is also closely related to the development of trade.
Several industrial policies since 1948, Industrial policy on large scale industries Eg.Textile Industry policy, Sugar Industry policy, Price policy of industrial growth, Small scale industrial policy and Industrial Labour policy.

New Economic Policy
The economy of India had undergone significant policy shifts in the beginning of the 1990s. This new model of economic reforms is commonly known as the LPG or Liberalisation, Privatisation and Globalisation model. The primary objective of this model was to make the economy of India the fastest developing economy in the globe with capabilities that help it match up with the biggest economies of the world. These economic reforms had influenced the overall economic growth of the country in a significant manner.

Some other policies in India

Trade Policy - Import and Export policy (International Trade Policy), Domestic Trade Policy.
Employment policy
Currency and Banking Policy
Fiscal and Monetary Policy
Wage Policy

Population Policy

GDP Growth of India

India's economic growth story since the 1990s has been steady, stable, diversified, resilent and reflect strong macro economics fundamentals. Despite fluctuations in recent quarters due to disruptions caused by two major structural reforms - demonetisation and the Goods andServices Tax (GST). The world Bank projected a growth rate of 7.3% in the year 2018-19 and 7.5% 2019-2020. India's average economic growth between 1970 and 1980 has been 4.4% which rise by 1% point to 5.4% between the 1990 and 2000.

According to IMF World Economic Outlook (October-2018), GDP growth rate of India in 2018 is projected at 7.3% and India is 5th fastest growing nation of the world just behind Bangladesh.

Unit – 4 Government and Taxes

Introduction

Tax is levied by government for thedevelopment of the state's economy. Therevenue of the government depends upondirect and indirect taxes. Direct taxes arelevied on income of the persons and theindirect taxes are levied on goods andservices by which the government mobilisesits "financial resources".

Role of Government in Development Policies

The role of government and development policies

In India, the three levels of governments,namely, union, state and local, have beencarrying out various functions for thebenefit of people and society at large. Theseroles are into divided into seven categoriesfor easy understanding.

1. Defence: This is an essential securityfunction to protect our nation from ourenemies. We know that we have threeservices, namely, army, navy and air force.The Union government is responsible forcreating and maintaining defence forces.

2. Foreign policy: In today's world, we needto maintain friendly relationships with allthe other countries in the world. India iscommitted to world peace. We should alsomaintain cordial economic relationshipsthrough exports and imports, sending andreceiving investments and labour. This serviceis also provided by the Union government.

3. Conduct of periodic elections: Indiais a democratic country. We elect ourrepresentatives to Parliament and stateassemblies. The Union governmentcreates laws and administrative systemand conducts elections to these twolegislature institutions. Similarly the stategovernments conduct elections to localbodies within the state.

4. Law and order: Both the Union andstate governments enact numerous lawsto protect our rights, properties and toregulate our economy and society. Tosettle disputes, the Union governmenthas a vibrant judicial system consistingof courts at the national, state and lowerlevels and state governments take theresponsibility for administering the policeforce in respective states.

5. Public administration and provision of public goods: The governmentgenerally administers the economy andsociety through various departments, forexample, revenue department, schools,hospitals, rural development and urbandevelopment. The list of departmentswith the Union and state governments areavailable in the

public domain. The localgovernments provide public goods likelocal roads, drainage, drinking water andwaste collection and disposal.

6. Redistribution of income and poverty alleviation: Governments collectvarious taxes to finance the variousactivities mentioned earlier. The taxes arecollected in a way that the high-incomepeople can bring in more tax revenueto the government than the poor. Thegovernments also spend money such thatthe poor are given some basic necessities oflife like food, shelter, clothing education,health care and monthly income to thevery poor persons. Thus collecting taxesand spending for the poor is how thegovernment redistributes income andintroduces measures to reduce poverty.

7. Regulate the economy: The Uniongovernment, through the Reserve Bankof India, controls money supply andcontrols the interest rate, inflation andforeign exchange rate. The main objectiveis to remove too much of fluctuation inthese rates. The Union also controls theeconomy through various other agenciessuch as Securities Exchange Board of Indiaand Competition Commission of India.All the governments in India run publicsector enterprises to provide importantgoods and services at affordable rates tothe people.

Tax

The origin of theword "tax" is from"taxation," whichmeans an estimate.

Taxation is ameans by whichgovernments financetheir expenditure by imposing charges oncitizens and corporate entities. The mainpurpose of taxation is to accumulate funds for thefunctioning of the government machinery. Taxhas come into forefront on account of the newconcept of "welfare state". Modern governmentsdo not confine themselves to law and order only.The importance of public finance (tax) has vastlyincreased in recent years.

Taxes are compulsory payments togovernment without expectation of directreturn (or) benefit to the tax payer. Prof.Seligman also defined a tax as "a compulsorycontribution from a person to the governmentto defray the expenses incurred in thecommon interest of all, without reference tospecial benefits conferred."

Why Taxes?

The levying of taxes aims to raise revenueto fund governance or to alter prices in orderto affect demand. States and their functionalequivalents throughout history have usedmoney provided by taxation to carry out manyfunctions. Some of these include expendituresson economic infrastructure (transportation,sanitation, public safety, education, healthcaresystems, to name a few), military, scientificresearch, culture and the arts, public worksand public insurance and the operation ofgovernment itself. A government's ability toraise taxes is called its fiscal capacity.

Taxation in India has its roots from the period of ManuSmriti and Arthasastra. Thepresent Indian tax system isbased on this ancient tax system.

Tax system

Every type of tax has some advantages and some disadvantages. So we have a tax system, thatis, a collection of variety of taxes. All countries use a variety of taxes. There are some characteristicsof tax system that economists think should be followed while designing a tax system. Thesecharacteristics are called as canons of taxation. From Adam Smith, many economists have givenlists of canons of taxation. It is important to recall those common among them for discussion here.

Canon of equity – Since tax is a compulsory payment, all economists agree that equity is thecardinal principle in designing the tax system. The equity principal says that the rich should paymore tax revenue to government than the poor, because rich has more ability than the poor to paythe tax. Moreover, after payment of tax, you will find the economic difference is reduced betweenthe rich and the poor. You can do an exercise to find out which of the taxes adhere to the canon ofequity.

Canon of Certainty – Government should announce in advance the tax system so that everytax payer will be able to calculate how much tax amount one may have to pay during a year to thegovernment. In other words, government should not change the tax system frequently and shouldnot announce sudden changes in the tax system.

Canons of Economy and Convenience – These two canons are related. As tax payers we incura cost to process our accounts and pay the tax, for example, salary paid to accountants and auditors.Similarly government also pays salary to its taxmen and run huge institutions. If the tax is simple,then the cost of collecting taxes (tax payer cost + tax collector cost) will be very low. Further, taxshould be collected from a person at the time he gets enough money to pay the tax. This is calledcanon of convenience. A convenient tax reduces the cost of collecting tax.

Canons of Productivity and Elasticity – Government should choose the taxes that can getenough tax revenue to it. In other words, it should choose a few taxes that can fetch more taxrevenue, instead of lots of taxes and each one of them getting a little tax revenue. This is canonof productivity. Tax is paid by the people out their incomes. Therefore the tax system should bedesigned in such a way that the people automatically pay more tax revenue if their incomes grow.This is called canon of elasticity. In a broader sense, as the economy is growing the people will getmore income and consequently they will also pay more tax revenue to government if the tax systemis elastic.

In India, Income Tax wasintroduced for the first timein 1860 by Sir James Wilsonin order to meet the lossessustained by the Governmenton account of the Mutiny of 1857.

When expenditures exceed tax revenue, agovernment accumulates debt. A portion of taxesmay be used to service past debts. Governmentsalso use taxes to fund welfare and public services.
These services can include education systems,pensions for the elderly, unemployment benefitsand public transportation. Energy, water andwaste management systems are also commonpublic utilities.

According to the proponents of the theoryof money creation, taxes are not needed forgovernment revenue, as long as the government inquestion is able to issue fiat money. The purpose oftaxation is to maintain the stability of the currency, express public policy regarding the distributionof wealth, subsidising certain industries orpopulation groups or isolating the costs of certainbenefits such as highways or social security.

Types of Taxes

Direct Taxes

A tax imposed on an individual ororganisation, which is paid directly, is a directtax. The burden of a direct tax cannot be shiftedto others. J.S. Mill defines a direct tax as "onewhich is demanded from the very persons whoit is intended or desired should pay it." Somedirect taxes are income tax, wealth tax andcorporation tax.

Income tax

Income tax is the most common and mostimportant tax levied on an individual in India.It is charged directly based on the income of aperson. The rate at which it is charged varies,depending on the level of income.

Corporate tax

This tax is levied on companies that existas separate entities from their shareholders.It is charged on royalties, interest gains fromsale of capital assets located in India and feesfor a technical services and dividends.

Foreign companies are taxed on incomethat arises or is deemed to arise in India.

Income	For Indian Companies	For Foreign Companies
Less than ` 50crore	25%	40%
More than ` 50crore	30%	40%

Wealth tax

Wealth tax is charged on the benefitsderived from property ownership. The sameproperty will be taxed every year on itscurrent market value. The tax is levied on theindividuals and companies alike.

In India taxes are collected by all thethree tiers of government. There are taxesthat can be easily collected by the Uniongovernment. In India almost all the directtaxes are collected by the Union governments.Taxes on goods and services are collectedby both Union and state governments. Thetaxes on properties are collected by localgovernments.

In India we collect more tax revenuethrough indirect taxes than through directtaxes. The major indirect taxes in India arecustoms duty and GST. Both these taxes havedifferent tax rates for different goods andservices. The governments try to design insuch a way that the rich consumers pay moretax than the poor. However, poor still paymore through these taxes. Therefore, manyargue we should reduce the indirect taxes andincrease the collection through direct taxes.

Indian tax system adheres to all thecanons of taxation. But there are argumentsthat often the equity principle is compromisedand productivity is lost when we tinker withtax system to the advantage of a few. Weannounce the tax system once in a year in theannual budget. It is very rarely breached byannouncing mid-year tax changes. Therefore,Indian tax system adheres to canon ofcertainty more than anything else.

Indirect Taxes

If the burden of the tax can be shifted toothers, it is an indirect tax. The impact is on oneperson while the incidence is on the anotherperson. Therefore, in the case of indirect taxes,the tax payer is not the tax bearer. Some indirect taxes are stamp duty,entertainment tax, excise duty and goods andservice tax (GST).

Stamp duty

Stamp duty is a tax that is paid on officialdocuments like marriage registration ordocuments related to a property and in somecontractual agreements.

Entertainment tax

Entertainment tax is a duty that ischarged by the government on any sourceof entertainment provided. This tax can becharged on movie tickets, tickets to amusementparks, exhibitions and even sports events.

Excise duty

An excise tax is any duty on manufacturedgoods levied at the movement of manufacture,rather than at sale. Excise is typically imposedin addition to an indirect tax such as a salestax.

Goods and service tax (GST)

The goods and service tax (GST) is oneof the indirect taxes. The GST was passed inParliament on 29 March 2017. The act cameinto effect on 1 July 2017. The motto is onenation, one market, one tax.

Goods and service tax is defined as thetax levied when a consumer buys a good orservice. That aims to replace all indirecttaxes levied on goods and services by theCentral and state governments. GST wouldeliminative the cascading effect of taxes on the production and distribution of goodsand services. It is also a "one-point tax"unlike value-added tax (VAT), which was amultipoint tax.

France was the firstcountry to implement GST in1954 and many other Europeancountries introduced GST in1970-80.

How Taxes Are Levied?

Tax is levied by the government progressively,proportionately as well as regressively.

Structure of Goods and Service Tax (GST)

State Goods and Service Tax (SGST): Intra state (within the state)

VAT/sales tax, purchase tax, entertainment tax, luxury tax, lottery tax and state surcharge andcesses

Central Goods and Service Tax (CGST): Intra state (within the state)

Central Excise Duty , service tax, countervailing duty, additional duty of customs, surcharge,education and secondary/higher secondary cess

Integrated Goods and Service Tax (IGST): Inter state (integrated GST)

There are four major GST rates: 5%, 12%, 18% and 28%. Almost all the necessities of lifelike vegetables and food grains are excempted from this tax.

Progressive tax

Progressive tax rate is one in which the rateof taxation increases (multiplier) as the tax baseincreases (multiplicand). The amount of taxpayable is calculated by multiplying the tax basewith the tax rate. In the case of a progressivetax, the multiplicand (income) increases. Whenincome increases, the tax rate also increases.This is known as a progressive tax.

Example:

Tax Base	Tax Rate	Amount of Tax
10,000	10%	1000
20,000	15%	3000

30,000	25%	7500
40,000	40%	16000

Proportionate taxes

Tax levied on goods and service in a fixedportion is known as proportionate taxes. Alltax payers contribute the same proportionof their incomes. In this method, the rate oftaxation is the same regardless of the size ofincome. The tax amount realised varies in thesame proportions that of income.

Example:

Tax Base	**Tax Rate**	**Amount of Tax**
10,000	10%	1000
20,000	10%	2000
30,000	10%	3000
40,000	10%	4000

Regressive Taxes

It implies that higher the rate of taxlower the income groups than in the case ofhigher income groups. It is a very opposite ofprogressive taxation.

Progressive Tax	**Income increase**	**Tax also Increase**	**E.g. Income Tax**
Proportional Tax	Income Increase	Tax Decrease	E.g. Corporate Tax
Regressive Tax	Income change	Same tax always	E.g. Sales Tax

Black Money

Black money is funds earned on the blackmarket on which income and other taxes havenot been paid. The unaccounted money thatis concealed from the tax administrator iscalled black money.

Recent Legislative Initiatives to curb Black Money in India

1. Constitution of the Special Investigation Team (SIT) on Black Money under Chairmanshipand Vice-Chairmanship of two former Judges of Hon'ble Supreme Court.
2. Enactment of a comprehensive law – The Black Money (Undisclosed Foreign Income andAssets) and Imposition of Tax Act, 2015 .
3. Constitution of Multi-Agency Group (MAG) consisting of officers of Central Board ofDirect Taxes (CBDT), Reserve Bank of India (RBI),

Enforcement Directorate (ED) andFinancial Intelligence Unit (FIU) for the investigation of recent revelations in Panama paperleaks.

4. Double Taxation Avoidance Agreements (DTAAs)/Tax Information Exchange Agreements(TIEAs)/Multilateral Conventions.
5. Foreign Account Tax Compliance Act (FATCA).
6. Money-laundering Act, 2002 through the Finance Act, 2015.
7. Enactment of the Benami Transactions (Prohibition) Amendment Act, 2016 .
8. Launching of ‘Operation Clean Money’ on 31 January 2017.
9. Lokpal and Lokayukta act.
10. The Real Estate (Regulation and Development) Act, 2016.

Causes of Black Money

Several sources of blackmoney are identified ascauses.

1. Shortage of goods: Shortage of goods,whether natural orartificial, is the root cause of black money.Controls are often introduced to checkblack money.

2. Licensing proceeding: It is firmly believedthat the system of controls permits, quotes andlicences are associated with maldistributionof commodities in short supply, which resultsin the generation of black money.

3. Contribution of the industrial sector:Industrial sector has been the majorcontributor to black money. For example,the Controller of Public LimitedCompanies tries to buy commodities at lowprices and get them billed at high amountsand pockets the difference personally.

4. Smuggling: Smuggling is one of themajor sources of black money. WhenIndia had rigid system of exchangecontrols, precious metals like gold andsilver, textiles and electronics goodswere levied a heavy excise duty. Bringingthese goods by evading the authorities issmuggling.

5. Tax structure: When the tax rate is high,more black money is generated.

Tax Evasion

Tax evasion is the illegal evasion of taxesby individuals, corporations and trusts. Taxevasion often entails taxpayers deliberatelymisrepresenting the true state of their affairs tothe tax authorities to reduce their tax liabilityand includes dishonest tax reporting, such asdeclaring less income, profits or gains thanthe amounts actually earned, or overstatingdeductions.

Tax evasion is an activity commonlyassociated with the informal economy. Onemeasure of the extent of tax evasion is theamount of unreported income, which is thedifference between the amount of income thatshould be reported to the tax authorities and theactual amount reported.

Tax evasion activities included

- Underreporting income
- Inflating deductions or expenses
- Hiding money
- Hiding interest in offshore accounts

Causes of tax evasion

1 Tax evasion resulting in black moneyprevents the resource mobilisation effortsof the Union government. Shortageof funds distorts implementation ofdevelopmental plans and forces thegovernment to resort to deficit financingin case public expenditure is inelastic.

2 Tax evasion interferes with the declaredeconomic policies of the government bydistorting saving and investment patternsand availability of resources for varioussectors of the economy.

3 Tax evasion undermines the equity attribute ofthe tax system. Honest taxpayers willingly beardisproportionate tax burden, feel demoralisedand lured to join the tax evaders' camp.

4 Tax evasion and black money encouragethe concentration of economic power inthe hands of undeserving groups in thecountry, which, in turn, is a threateningto the economy in its way.

5. Evasion of tax consumes time and energyof tax administration to disentangle theintricate manipulations of tax dodgers.

Tax evasion penalties

1. If a person wilfully commits the act of taxevasion, he may face felony charges. Taxevasion penalties include imprisonment ofup to five years and high amount as fines.

2 The defendant may also be ordered to payfor the costs of prosecution.

3 Other tax evasion penalties includecommunity service, probation andrestitution depending on the circumstancesof the case.

4 Tax evasion penalties can be harsh,depending on the severity of the crime.

Tax and other Payments

Taxes are compulsory payments togovernment without expectation of directreturn (or) benefit to the tax payer.

Payment includes income received fromproduction and supply of goods and servicesof public enterprises and revenue fromadministrative activities. Payments from nontaxsources other than tax income is known aspayments.

Some payments are fees, fines andpenalties, and forfeitures.

S. No	Tax	Payments
1	Tax is compulsory to thegovernment withoutgetting any direct benefits	Fee is the payment for getting any service
2	If the element of revenue for general purposeof the state predominates, the levy becomesa tax	While a fee is a payment for a specific benefitprivilege although the special to the primarypurpose of regulation in public interest.
3	Tax is a compulsory payment	Fee is a voluntary payment.
4	If tax is imposed on a person, he has to pay it;otherwise he has to be penalised	On the other hand fee is not paid if the persondo not want to get the service
5	In this case, tax payer does not expect anydirect benefit. Example: Income tax, gift box, wealth tax, VAT etc.	Fee payer can get direct benefit for paying fee. Examples: stamp fee, driving license fee, government registration fee

Taxes and Development

The role of taxation in developingeconomics is as follows.

1. Resource mobilisation: Taxation enablesthe government to mobilise a substantialamount of revenue. The tax revenue isgenerated by imposing direct taxes such aspersonal income tax and corporate tax andindirect taxes such as customs duty, exciseduty, etc.

2. Reduction in equalities of income: Taxationfollows the principle of equity. The directtaxes are progressive in nature. Also certain indirect taxes, such as taxes on luxury goods,is also progressive in nature.

3. Social welfare: Taxation generates social welfare.Social welfare is generated due to higher taxeson certain undesirable products like alcoholicproducts.

4. Foreign exchange: Taxation encouragesexports and restricts imports, Generallydeveloping countries and even the developedcountries do not impose taxes on export items.

5. Regional development: Taxation plays animportant role in regional development,Tax incentives such as tax holidays forsetting up industries in backward regions,which induces business firms to set upindustries in such regions.

6. Control of inflation: Taxation can be used as aninstrument for controlling inflation. Throughtaxation the government can control inflationby reducing the tax on the commodities.

12th Economics

Unit 2 – National Income

" The concept of national income is an indispensable preparation for tackling the great issues of unemployment, inflation and growth". - Samuelson

Introduction

National Income provides a comprehensive measure of the economic activities of a nation. It denotes the country's purchasing power. The growth of an economy is measured by the rate at which its real national income grows over time. National income thus serves as an instrument of economic planning. Further, national income is one of the most significant macroeconomic variables. Thus, a clear understanding of the meaning, concepts, measurement and uses of national income is essential.

Nobel laureate Simon Kuznets first introduced the concept of national income.

Meaning of National Income

In common parlance, National Income means the total money value of all final goods and services produced in a country during a particular period of time (one year).

Definitions
"The labour and capital of a country acting on its natural resources produce annually a certain net aggregate of commodities, material and immaterial including services of all kinds. This is the true net annual income or revenue of the country or national dividend". -Alfred Marsh

GDP and its detractors. The welfare of anation can scarcelybe inferred froma measurement ofnational income as defined by theGDP... goals formore growth shouldspecify of what andfor what.

"The net output of the commodities and services flowing during the year from the country's productive system into the hands of the ultimate consumers or into net addition to the country's stock of capital goods". - Simon Kuznets.

Basic concepts of national income.

The following are some of the concepts used in measuring national income.

- GDP
- GNP
- NNP
- NNP at factor cost
- Personal Income
- Disposable Income
- Per capita Income
- Real Income
- GDP deflator

Gross Domestic Product (GDP)

GDP is the total market value of final goods and services produced within the country during a year. This is calculated at market prices and is known as GDP at market prices.

GDP by expenditure method at market prices = C + I + G + (X – M)

Where
C – consumption goods;
I – Investment goods;
G – Government purchases;
X – Exports; M – Imports (X – M) is net export which can be positive or negative.

a) Net Domestic Product (NDP)

NDP is the value of net output of the economy during the year. Some of the country's capital equipment wears out or becomes out dated each year during the production process. Thus

Net Domestic Product = GDP - Depreciation.

Gross National Product (GNP)

GNP is the total measure of the flow of final goods and services at market value resulting from current production in a country during a year, including net income from abroad. GNP includes five types of final goods and services:

1. value of final consumer goods and services produced in a year to satisfy the immediate wants of the people which is referred to as consumption (C);
2. gross private domestic investment in capital goods consisting of fixed capital formation, residential construction and inventories of finished and unfinished goods which is called as gross investment (I) ;

3. goods and services produced or purchased by the government which is denoted by (G) ; and
4. net exports of goods and services, i.e., the difference between value of exports and imports of goods and services, known as (X-M) ; Net factor incomes from abroad which refers to the difference between factor incomes (wage, interest, profits) received from abroad by normal residents of India and factor incomes paid to the foreign residents for factor services rendered by them in the domestic territory in India (R-P);
5. GNP at market prices means the gross value of final goods and services produced annually in a country plus net factor income from abroad (C + I + G + (X-M) + (R-P)).

GNP at Market Prices = GDP at Market Prices + Net Factor income from Abroad.

Net National Product (NNP) (at Market price)

Net National Product refers to the value of the net output of the economy during the year. NNP is obtained by deducting the value of depreciation, or replacement allowance of the capital assets from the GNP. It is expressed as,

NNP + GNP – depreciation allowance

(depreciation is also called as Capital Consumption Allowance)

NNP at Factor cost

NNP refers to the market value of output. Whereas NNP at factor cost is the total of income payment made to factors of production. Thus from the money value of NNP at market price, we deduct the amount of indirect taxes and add subsidies to arrive at the net national income at factor cost.

NNP at factor cost = NNP at Market prices – Indirect taxes + Subsidies

Personal Income

Personal income is the total income received by the individuals of a country from all sources before payment of direct taxes in a year. Personal income is never equal to the national income, because the former includes the transfer payments whereas they are not included in national income. Personal income is derived from national income by deducting undistributed corporate profit and employees' contributions to social security schemes and adding transfer payment.

Personal Income = National Income– (Social Security Contribution and undistributed corporate profits) +Transfer payments

Disposable Income

Disposable Income is also known as Disposable personal income. It is the individuals income after the payment of income tax. This is the amount available for households for consumption.

Disposable Income = Personal income – Direct Tax. As the entire disposable income is not spent on consumption,
Disposal income = consumption + saving

Per Capita Income

The average income of a person of a country in a particular year is called Per Capita Income. Per capita income is obtained by dividing national income by population.

$$\text{Per Capita income} = \frac{National\ Income}{Population}$$

Real Income

Nominal income is national income expressed in terms of a general price level of a particular year in other words, real income is the buying power of nominal income. National income is the final value of goods and services produced and expressed in terms of money at current prices. But it does not indicate the real state of the economy. The real income is derived as follows:

P1 – Price index during current year;
P0 – Price index during base year

GDP deflator

GDP deflator is an index of price changes of goods and services included in GDP. It is a price index which is calculated by dividing the nominal GDP in a given year by the real GDP for the same year and multiplying it by 100.

$$\text{GDP deflator} = \frac{Nominal\ GDP}{Real\ GDP} \times 100$$

Methods of Measuring National Income

All goods and services produced in the country must be counted and converted against money value during a year. Thus, whatever is produced is either used for consumption or for saving. Thus, national output can be computed at any of three levels, viz., production, income and expenditure. Accordingly, there are three methods that are used to measure national income.

1. Production or value added method
2. Income method or factor earning method
3. Expenditure method

And if these methods are done correctly, the following equation must hold

Output = Income = Expenditure

GDP – By Sum of Spending, Factor Incomes or Output		
GDP (Expenditure)	**GDP (Factor Incomes)**	**GDP (Value of Output)**
Consumption Government spending Investment spending	Income from people in jobs and in self employment (e.g. wages and salaries)	Value added from each of the main economic sectors
Change in value of stocks	Profits of private sector business	These sectors are • Primary • Secondary • Manufacturing • Quaternary
Exports	Rent income from the ownership of land	
-Imports		
= GDP (known as aggregate demand)		

This is because the three methods are circular in nature. It begins as production, through recruitments of factors of production, generating income and going as incomes to factors of production.

Product Method

Product method measures the output of the country. It is also called inventory method. Under this method, the gross value of output from different sectors like agriculture, industry, trade and commerce, etc., is obtained for the entire economy during a year. The value obtained is actually the GNP at market prices. Care must be taken to avoid double counting.

The value of the final product is derived by the summation of all the values added in the productive process. To avoid double counting, either the value of the final output should be taken into the estimate of GNP or the sum of values added should be taken.

In India, the gross value of the farm output is obtained as follows :

i. Total production of 64 agriculture commodities is estimated. The output of each crop is measured by multiplying the area sown by the average yield per hectare.
ii. The total output of each commodity is valued at market prices.
iii. The aggregate value of total output of these 64 commodities is taken to measure the gross value of agricultural output.
iv. The net value of the agricultural output is measured by making deductions for the cost of seed, manures and fertilisers, market charges, repairs and depreciation from the gross value.

Similarly, the gross values of the output of animal husbandry, forestry, fishery, mining and factory establishments are obtained by multiplying their estimatesof total production with market prices. Net value of the output in these sectors is derived by making deductions for cost of materials used in the process of production and depreciation allowances, etc. from gross value of output.

Net value of each sector measured in this way indicates the net contribution of the sector to the national income.

Precautions

The product method is followed in the underdeveloped countries, but it is less reliable because the margin of error in this method is large. In India, this method is applied to agriculture, mining and manufacturing, including handicrafts.

1. Double counting is to be avoided under value added method. Any commodity which is either raw material or intermediate good for the final production should not be included. For example, value of cotton enters value of yarn as cost, and value of yarn in cloth and that of cloth in garments. At every stage value added only should be calculated.
2. The value of output used for self consumption should be counted while measuring national income.
3. In the case of durable goods, sale and purchase of second hand goods (for example pre owned cars) should not be included.

Income Method (Factor Earning Method)

This method approaches national income from the distribution side. Under this method, national income is calculated by adding up all the incomes generated in the course of producing national product.

Steps involved

1. The enterprises are classified into various industrial groups.
2. Factor incomes are grouped under labour income, capital income and mixed income.

i. Labour income - Wages and salaries, fringe benefits, employer's contribution to social security.
ii. Capital income – Profit, interest, dividend and royalty
iii. Mixed income – Farming, sole proprietorship and other professions.

3. National income is calculated as domestic factor income plus net factor incomes from abroad. In short,

$$Y = w + r + i + \pi + (R-P)$$

w = wages, r = rent, i = interest, π = profits, R = Exports and P = Imports

This method is adopted for estimating the contributions of the remaining sectors, viz., small enterprises, banking and insurance, commerce and transport, professions, liberal arts and domestic service, public authorities, house property and foreign sector transaction.

Data on income from abroad (the rest of the world sector or foreign sector) are obtained from the account of the balance of payments of the country.

Precautions

While estimating national income through income method, the following precautions should be taken.

Items not to be included

1. Transfer payments are not to be included in estimation of national income as these payments are not received for any services provided in the current year such as pension, social insurance etc.
2. The receipts from the sale of second hand goods should not be treated as part of national income as they do not create new flow of goods or services in the current year.
3. Windfall gains such as lotteries are also not to be included as they do not represent receipts from any current productive activity.
4. Corporate profit tax should not be separately included as it has been already included as a part of company profit.

Items to be included

1. Imputed value of rent for self occupied houses or offices is to be included.
2. Imputed value of services provided by owners of production units (family labour) is to be included.

The Expenditure Method (Outlay method)

Under this method, the total expenditure incurred by the society in a particular year is added together. To calculate the expenditure of a society, it includes personal consumption expenditure, net domestic investment, government expenditure on consumption as well as capital goods and net exports. Symbolically,

$$GNP = C + I + G + (X-M)$$

C - Private consumption expenditure
I - Private Investment Expenditure
G - Government expenditure

X-M = Net exports

Precautions

1. Second hand goods: The expenditure made on second hand goods should not be included.

2. Purchase of shares and bonds: Expenditures on purchase of old shares and bonds in the secondary market should not be included.

3. Transfer payments: Expenditures towards payment incurred by the government like old age pension should not be included.

4. Expenditure on intermediate goods: Expenditure on seeds and fertilizers by farmers, cotton and yarn by textile industries are not to be included to avoid double counting. That is only expenditure on final products are to be included.

Factor cost (FC)
There are a number of inputs that are included into a production process when producing goods and services. These inputs are commonly known as factors of production and include things such as land, labour, capital and entrepreneurship.
Producers of goods and services incur a cost for using these factors of production. These costs are ultimately added onto the price of the product.
The factor cost refer to the cost of production that is incurred by a firm when producinggoods and services.
Examples of such production costs include the cost of renting machines, purchasing machinery and land, paying salaries and wages, cost of obtaining capital, and the profit margins that are added by the entrepreneur.
The factor cost does not include the taxes that are paid to the government since taxes are not directly involved in the production process and, therefore, are not part of the direct production cost.
However, subsidies received are included in the factor cost as subsidies are direct inputs into the production.

Market price (MP)
Once goods and services are produced they are sold in a market place at a set marketprice.
The market price is the price that consumers will pay for the product when they purchaseit from the sellers.
Taxes charged by the government will be added onto the factor price while subsidesprovided will be reduced from the factor price to arrive at the market price.
Taxes are added on because taxes are costs that increase the price, and subsidies arereduced because subsidies are already included in the factor cost, and cannot be doublecounted when market price is calculated.
Thus, MP = FC + Indirect Taxes - Subsidies ...... Equation (1)
Or, FC = MP - Indirect Taxes + Subsidies .... Equation (2)

National Income (NNP_{FC}) = Gross Value Added by all the production Enterprises within the Domestic territory of the Country – Depreciation – Net Indirect Taxes + Net Factor Income from Abroad

[Where, Net Indirect Taxes = Indirect tax – Subsidies]
[Gross Value Added = Value of Output – Intermediate Consumption]
Value of Output = Sales = Change in Stock
Where, Change in Stock = Closing Stock – Opening Stock

Note: If entire out put is sold within the year, then value of output will be equal to salesitself.

or

Value of Output = Price x Quantity Sold

GDP_{MP} = Private Final Consumption + Government Final Consumption Expenditure+ Gross Domestic Capital Formation + Net Exports (Exports – Imports)

Importance of National Income Analysis

National income is of great importance for the economy of a country. Nowadays the national income is regarded as accounts of the economy, which are known as social accounts. It enables us

1. To know the relative importance of the various sectors of the economy and their contribution towards national income; from the calculation of national income, we could find how income is produced, how it is distributed, how much is spent, saved or taxed.

2. To formulate the national policies such as monetary policy, fiscal policy and other policies; the proper measures can be adopted to bring the economy to the right path with the help of collecting national income data.
3. To formulate planning and evaluate plan progress; it is essential that the datapertaining to a country's gross income, output, saving and consumption from different sources should be available for economic planning.
4. To build economic models both in short - run and long - run.
5. To make international comparison, inter - regional comparison and inter - temporal comparison of growth of the economy during different periods.
6. To know a country's per capita income which reflects the economic welfare of the country (Provided income is equally distributed)
7. To know the distribution of income for various factors of production in the country.
8. To arrive at many macro economic variables namely, Tax – GDP ratio, Current Account Deficit - GDP ratio, Fiscal Deficit - GDP ratio, Debt - GDP ratio etc.

Difficulties in Measuring National Income

In India, a special conceptual problem is posed by the existence of a large, unorganised and non-monetised subsistence sector where the barter system still prevails for transacting goods and services. Here, a proper valuation of output is very difficult.

Transfer payments

Government makes payments in the form of pensions, unemployment allowance, subsidies, etc. These are government expenditure. But they are not included in the national income. Because they are paid without adding anything to the production processes.

During a year, Interest on national debt is also considered transfer payments because it is paid by the government to individuals and firms on their past savings without any productive work.

Difficulties in assessing depreciation allowance

The deduction of depreciation allowances, accidental damages, repair and replacement charges from the national income is not an easy task. It requires high degree of judgment to assess the depreciation allowance and other charges.

Unpaid services

A housewife renders a number of useful services like preparation of meals, serving, tailoring, mending, washing, cleaning, bringing up children, etc. She is not paid for them and her services are not directly included in national income. Such services performed by paid servants are included in national income. The reason for the exclusion of her services from national income is that the love and affection of a

housewife in performing her domestic work cannot be measured in monetary terms. Similarly, there are a number of goods and services which are difficult to be assessed in money terms for the reason stated above, such as rendering services to their friends, painting, singing, dancing, etc.

Income from illegal activities

Income earned through illegal activities like gambling, smuggling, illicit extraction of liquor, etc., is not included in national income. Such activities have value and satisfy the wants of the people but they are not considered as productive from the point of view of society.

Production for self-consumption and changing price

Farmers keep a large portion of food and other goods produced on the farm for self consumption. The problem is whether that part of the produce which is not sold in the market can be included in national income or not.

National income by product method is measured by the value of final goods and services at current market prices. But prices do not remain stable. They rise or fall. To solve this problem, economists calculate the real national income at a constant price level by the consumer price index.

Capital Gains

The problem also arises with regard to capital gains. Capital gains arise when a capital asset such as a house, other property, stocks or shares, etc. is sold at higher price than was paid for it at the time of purchase. Capital gains are excluded from national income.

Statistical problems

There are statistical problems, too. Great care is required to avoid double counting. Statistical data may not be perfectly reliable, when they are compiled from numerous sources. Skill and efficiency of the statistical staff and cooperation of people at large are also equally important in estimating national income.

The following are the some of the statistical problems:

1. Accurate and reliable data are not adequate, as farm output in the subsistence sector is not completely informed. In animal husbandry, there are no authentic production data available.
2. Different languages, customs, etc., also create problems in computing estimates.
3. People in India are indifferent to the official inquiries. They are in most cases non-cooperative also.

4. Most of the statistical staff are untrained and inefficient.

Therefore, national income estimates in our country are not very accurate or adequate. There is at least 10 per cent margin of error, i.e., national income is overestimated or underestimated by at least 10 per cent. That is why the GDP estimates for India varies from 2 trillion US dollar to 5 trillion US dollar.

National Income and Social Accounting

National income is also being measured by the social accounting method. Under this method, the transactions among various sectors such as firms, households, government, etc., are recorded and their interrelationships traced. The social accounting framework is useful for economists as well as policy makers, because it represents the major economic flows and statistical relationships among various sectors of the economic system. It becomes possible to forecast the trends of economy more accurately.

Social Accounting and Sector

Under this method, the economy is divided into several sectors. A sector is a group of individuals or institutions having common interrelated economic transactions. The economy is divided into the following sectors

i. Firms,
ii. Households,
iii. Government,
iv. Rest of the world and
v. Capital sector.

§ Firms" undertake productive activities. Thus, they are all organizations which employ the factors of production to produce goods and services.

§ Households" are consuming entities and represent the factors of production, who receive payment for services rendered by them to firms. Households consume the goods and services that are produced by the firms.

Thus, firms make payment to households for their services. Households spend money incomes they received on the goods and services produced by the firms. This is a circular flow of money between these two groups.

§ The Government sector" refers to the economic transactions of public bodies at all levels, centre, state and local. In their work concerning social accounting, Edey and Peacock have defined government as a collective 'person' that purchases goods and services from firms. These purchases may be financed through taxation, public borrowings, or any other fiscal means. The main function of the government is to provide social goods like defence, public

health, education, etc. This means satisfying the collective wants of society. However, public enterprises like Post Offices and railways are separated from the Government sector and included as "Firms".

§ Rest of the world sector" relates to international economic transactions of the country. It contains income, export and import transactions, external loan transaction, and allied overseas investment income and payments.

§ Capital sector" refers to saving and investment activities. It includes the transactions of banks, insurance corporations, financial houses, and other agencies of the money market. These are not included under "Firms". These agencies merely provide financial assistance to the firms' activities.

While assessing sectoral contribution to GDP, the economy is divided into three namely Primary, Secondary and Tertiary sectors.

National Income and Welfare

National Income is considered as an indicator of the economic wellbeing of a country. The economic progress of countries is measured in terms of their GDP per capita and their annual growth rate. A country with a higher per capita income is supposed to enjoy greater economic welfare with a higher standard of living.

But the rise in GDP or per capita income need not always promote economic welfare. The per capita income as an index of economic welfare suffers from limitations which are stated below:

1. The economic welfare depends upon the composition of goods and services provided. The greater the proportion of capital goods over consumer goods, the improvement in economic welfare will be lesser. Similarly the production of luxuries is meant for rich classes only.
2. Higher GDP with greater environmental hazards such as air, water and soil pollution will be little economic welfare.
3. The production of war goods will show the increase in national output but not welfare.
4. An increase in per capita income may be due to employment of women and children or forcing workers to work for long hours. But it will not promote economic welfare.

Therefore the Physical Quality of Life Index (PQLI) is considered a better indicator of economic welfare. It includes standard of living, life expectancy at birth and literacy.

National Income & Erosion of national Wealth

For achieving higher GDP, larger natural resources are being depleted or damaged. This means reduction of potential for future growth. Hence, it is

suggested that while assessing national income, loss of natural resources should be subtracted from national income.

National income in terms of US$

When Indian national income is expressed in terms of US$, the former looks very low. If Purchasing Power Parity (PPP) method is adopted India looks better.

Social and Environmental Cost

While producing economic goods, many environmental and social bads are also generated. Hence, they also must be considered while enumerating National income.

Chapter 4

Consumption and Investment Functions

The theory of multiplier and the theory of accelerator are the two sides of the theory of fluctuations just as the theory of demand and the theory of supply are the two sides of the theory of value. The full theory must be that which shows both sides in operation.

- J.R.Hicks.

Introduction

The primary macroeconomic objective is acceleration of growth of national income. We have already seen that national income comprises of consumption goods (C) and investment (I) goods. There is close correlation between investment and national income.

The multiplier refers to the change in national income resulting from change in investment. The value of multiplier itself depends on consumption function or marginal propensity to consume. The consumption function is the relationship between consumption expenditure and the national income. The unspent portion of national income is called saving which becomes investment and thereby capital. The relationship between consumption expenditure and the capital expenditure is explained by the principle of accelerator. All these variables are closely interconnected.

In this chapter one can learn the consumption function, psychological law of consumption, investment function, multiplier, accelerator and super multiplier.

Consumption Function

Meaning of Consumption Function

The consumption function or propensity to consume refers to income consumption relationship. It is a "functional relationship between two aggregates viz., total consumption and gross national income." Symbolically, the relationship is represented as

$$C = f(Y)$$

Where,

C = Consumption
Y = Income

f = Function

Thus the consumption function indicates a functional relationship between C and Y, where C is the dependent variable and Y is the independent variable, i.e., C is determined by Y. This relationship is based on the ceteris paribus (other things being same) assumption, as only income consumption relationship is considered and all possible influences on consumption are held constant.

In fact, consumption function is a schedule of the various amounts of consumption expenditure corresponding to different levels of income. A hypothetical consumption schedule is given in Table 1.

Table : 1 Income - Consumption Schedule (₹Crores)

Income Y	**Consumption C**	**Savings S**
0	20	-20
60	70	-10
120	120	0
180	170	10
240	220	20
300	270	30
360	320	40

If we take C = 100 + 0.8y, then MPC = 0.8 Here, if Y = 0, C = 100; if Y = 100, C = 180;

if Y = 200, C = 260;
if Y = 300, C = 340 (MPC = $\Delta c / \Delta y = 0.8$)

In mathematical terms
C= a + b Y or C = 20 + 0.8Y

Where a>0 and b<1
C= Consumption
a= constant or intercept = 20

Y= income
b= MPC (Marginal prosperity to consume) = 0.8 = $\Delta c / \Delta y$

The above table shows that consumption is an increasing function of income because consumption expenditure increases with increase in income. Here it is shown that when income is zero, people spend out of their past savings on consumption because they must eat in order to live (Autonomous Consumption).

Here, when y = 120, C = 120 (Point B is the diagram)

When y = 180, C = 170, S = 10 (Point S is the diagram)

If Y increases to 360, C = 320, S = 40

In the diagram, income is measured horizontally and consumption is measured vertically. In 45 line at all levels, income and consumption are equal. It is a linear consumption function based on the assumption that consumption changes by the same amount as does income.

Thus the consumption function measures not only the amount spent on consumption but also the amount saved. This is because the propensity to save is merely the propensity not to consume. The 45° line may therefore be regarded as a zero-saving line, and the shape and position of the C curve indicate the division of income between consumption and saving.

(i) The Average Propensity to Consume= c/ y
(ii) The Marginal Propensity to Consume = Δc / Δy
(iii) The Average Propensity to Save= s / y
(iv) The Marginal Propensity to Save = Δs / Δy

(1) The Average Propensity to Consume:

The average propensity to consume is the ratio of consumption expenditure to any particular level of income." Algebraically it may be expressed as under:

APC = C/Y

Where,
C= Consumption
Y = Income

(2) The Marginal Propensity to Consume:

The marginal propensity to consume may be defined as the ratio of the change in the consumption to the change in income. Algebraically it may be expressed as under:

MPC = ΔC / ΔY

Where,
ΔC= Change in Consumption
ΔY = Change in Income
MPC is positive but less than unity

0 ‹ ΔC / ΔC ‹ I

(3) The Average Propensity to Save (APS):

The average propensity to save is the ratio of saving to income.

APS is the quotient obtained by dividing the total saving by the total income. In other words, it is the ratio of total savings to total income. It can be expressed algebraically in the form of equation as under

$$APS = S / Y$$

Where,
S= Saving
Y=Income

(4) The Marginal Propensity to Save (MPS):

Marginal Propensity to Save is the ratio of change in saving to a change in income.

MPS is obtained by dividing change in savings by change in income. It can be expressed algebraically as

$$APS = \Delta S / \Delta Y$$

ΔS = Change in Saving
ΔY= Change in Income
Since MPC+MPS=1
MPS=1-MPC and MPC = 1 - MPS

Generally the average ie APC is expressed in percentage and the MPC in fraction.

Income Y	**Consumption C**	**APC % C/Y**	**APS % S/Y**	**MPC ΔC / ΔY**	**MPC ΔS / ΔY**
120	120	(120/120) 100 = 100	(0/120) 0	-	-
180	170	(170 / 180) 100 = 94	(10 / 180) 100	50 / 60 = 0.83	0.17

Keyne's Psychological Law of Consumption:

Keynes propounded the fundamental Psychological Law of Consumption which forms the basis of the consumption function. He stated that "The fundamental psychological law upon which we are entitled to depend with great confidence both prior from our knowledge of human nature and from the detailed facts of experience, is that men are disposed as a rule and on the average to increase their

consumption as their income increases but not by as much as the increase in their income." The law implies that there is a tendency on the part of the people to spend on consumption less than the full increment of income.

Assumptions:
Keynes's Law is based on the following assumptions:

1. Ceteris paribus (constant extraneous variables):

   The other variables such as income distribution, tastes, habits, social customs, price movements, population growth, etc. do not change and consumption depends on income alone.

2. Existence of Normal Conditions:

   The law holds good under normal conditions. If, however, the economy is faced with abnormal and extraordinary circumstances like war, revolution or hyperinflation, the law will not operate. People may spend the whole of increased income on consumption.

3. Existence of a Laissez-faire Capitalist Economy:
   The law operates in a rich capitalist economy where there is no government intervention. People should be free to spend increased income. In the case of regulation of private enterprise and consumption expenditures by the State, the law breaks down.

Propositions of the Law:

This law has three propositions:

(1) **When income increases, consumption expenditure also increases but by a smaller amount.** The reason is that as income increases, our wants are satisfied side by side, so that the need to spend more on consumer goods diminishes. So, the consumption expenditure increases with increase in income but less than proportionately.

(2) **The increased income will be divided in some proportion between consumption expenditure and saving.** This follows from the first proposition because when the whole of increased income is not spent on consumption, the remaining is saved. In this way, consumption and saving move together.

(3) **Increase in income always leads to an increase in both consumption and saving.** This means that increased income is unlikely to lead to fall in either consumption or saving. Thus with increased income both consumption and saving increase.

APPOLO STUDY CENTRE CHENNAI

The three propositions of the law

Income Y	Consumption C	Saving S=Y-C
120	120	0
180	170	10
240	220	20

Proposition (1):

Income increases by ₹ 60 crores and the increase in consumption is by ₹ 50 crores.

Proposition (2):

The increased income of ₹ 60 crores in each case is divided in some proportion between consumption and saving respectively. (i.e., ₹ 50crores and ₹ 10 crores).

Proposition (3):

As income increases consumption as well as saving increase. Neither consumption nor saving has fallen.

Diagrammatically, the three propositions are explained in Figure 4.2. Here, income is measured horizontally and consumption and saving are measured on the vertical axis. C is the consumption function curve and 45° line represents income consumption equality.

Proposition (1):

When income increases from 120 to 180 consumption also increases from 120 to 170 but the increase in consumption is less than the increase in income, 10 is saved.

Proposition (2):

When income increases to 180 and 240, it is divided in some proportion between consumption by 170 and 220 and saving by 10 and 20 respectively.

Proposition (3):

Increases in income to 180 and 240 lead to increased consumption 170 and 220 and increased saving 20 and 10 than before. It is clear from the widening area below the C curve and the saving gap between 45° line and C curve.

Determinants of Consumptionfunction: Subjective and ObjectiveFactors

J.M Keynes has divided factors influencing the consumption function into two namely: Subjective factors and Objective factors

A) Subjective Factors

Subjective factors are the internal factors related to psychological feelings. Major subjective factors influencing consumption function are given below.

Keynes lists eight motives which lead individuals to refrain from spending, they are:

1. The motive of precaution: To build up a reserve against unforeseen contingencies. Eg. Accidents, sickness
2. The motive of foresight: The desire to provide for anticipated future needs. Eg. Old age
3. The motive of calculation: The desire to enjoy interest and appreciation.
4. The motive of improvement: The desire to enjoy for improving standard of living.
5. The motive of financial independence.
6. The motive of enterprise (desire to do forward trading).
7. The motive of pride.(desire to bequeath a fortune)
8. **The motive of avarice.** (purely miserly instinct)

Keynes sums up the motives as Precaution, Foresight, Calculation, Improvement, Independence, Enterprise, Pride and Avarice.

The Government, institutions and business corporations and firms may also consume mainly because of the following four motives:

1. The motive of enterprise: The desire to obtain resources to carry out further capital investment without incurring debt.

2. The motive of liquidity: The desire to secure liquid resources to meet emergencies, and difficulties.

3. The motive of improvement: The desire to secure a rising income and to demonstrate successful management.

4. The motive of financial prudence: The desire to ensure adequate financialprovision against depreciation and obsolescence and to discharge debt.

According to Keynes, the subjective factors do not change in the short run and hence consumption function remains stable in the short period.

B) Objective Factors

Objective factors are the external factors which are real and measurable. These factors can be easily changed in the long run. Major objective factors influencing consumption function are:

1) Income Distribution

If there is large disparity between rich and poor, the consumption is low because the rich people have low propensity to consume and high propensity to save. The community with more equal distribution of income tends to have high propensity to consume. This view has been corroborated by V.K.R.V. Rao.

2) Price level

Price level plays an important role in determining the consumption function. When the price falls, real income goes up; people will consume more and propensity to save of the society increases.

3) Wage level

Wage level plays an important role in determining the consumption function and there is positive relationship between wage and consumption. Consumption expenditure increases with the rise in wages. Similar is the effect with regard to windfall gains.

4) Interest rate

Rate of interest plays an important role in determining the consumption function. Higher rate of interest will encourage people to save more money and reduces consumption.

5) Fiscal Policy

When government reduces the tax the disposable income rises and the propensity to consume of community increases. The progressive tax system increases the propensity to consume of the people by altering the income distribution in favour of poor.

6) Consumer credit

The availability of consumer credit at easy installments will encourage households to buy consumer durableslike automobiles, fridge, computer. This pushes up consumption.

7) Demographic factors

Ceteris paribus, the larger the size ofthe family, the grater is the consumption.Besides size of family, stage in family lifecycle, place of residence and occupationaffect the consumption function. Familieswith children of college education stagespend more than those of primaryeducation and urban families spend morethan rural families.

8) Duesenberry hypothesis

Duesenberry has made twoobservations regarding the factorsaffecting consumption.

a) The consumption expenditure depends not only on his current income but also past income and standard of living. As the individuals are accustomed to a particular standard of living, they continue to spend the same amount on consumption even though the current income is reduced.

b) Consumption is influenced by demonstration effect. The consumption standards of low income groups are influenced by the consumption standardsof high income groups. In other words, the poor people want to imitate the consumption pattern of rich. This results in spending beyond their income level.

9) Windfall Gains or losses

Unexpected changes in the stock market leading to gains or losses tend to shift the consumption function upward or downward.

Investment Function

The investment function refers toinvestment -interest rate relationship.There is a functional and inverserelationship between rate of interest andinvestment. The investment functionslopes downward.

I = f (r)
I= Investment (Dependent variable)
r = Rate of interest (Independent variable)

Meaning of investment

The term investment means purchase of stocks and shares, debentures, government bonds and equities. According to Keynes, it is only financial investment and not real investment. This type of investment does result in an addition to the stock of real capital of the nation.

In the views of Keynes, Investment includes expenditure on capital investment.

Types of investment
Autonomous Investment and Induced Investment

Autonomous Investment

- Investment that is not dependent
- on the national income
- Mainly done with the welfare
- motive and not for making profits
- Examples : Construction of road,
- bridges, School, Charitable houses
- Not affected by rise in raw materials
- or wages of workers
- Essential to development of nation
- and out of depression

i) Autonomous investment: Autonomous investment is the expenditure on capital formation, which is independent of the change in income, rate of interest or rate of profit.

This investment is independent of economic activity. Autonomous investment is income-inelastic, the volume of autonomous investment is the same at all levels.

The autonomous investment curve is horizontal, parallel to X axis.

In the times of economic depression, the governments try to boost the autonomous investment. Thus, autonomous investment is one of the key concepts in welfare economics.

Generally, Government makes autonomous investment because of the welfare consideration.

ii) Induced investment: Induced investment is the expenditure on fixed assets and stocks which are required when level of income and demand in an economy goes up.

Induced investment is profit motivated. It is related to the changes of national income. The relationship between the national income and induced investment is positive; decreases in national income leads to decrease in induced investment and vice versa. Induced investment is income elastic. It is positively sloped as shown here.

SI. No	Autonomous Investment	Induced Investment
1.	Independent	planned
2.	Income inelastic	Income elastic
3.	Welfare motive	Profit motive

Determinants of Investment Function

The classical economists believed that investment depended exclusively on rate of interest. In reality investment decision depends on a number of factors. They are as follows:

1. Rate of interest
2. Level of uncertainty
3. Political environment
4. Rate of growth of population
5. Stock of capital goods
6. Necessity of new products
7. Level of income of investors
8. Inventions and innovations
9. Consumer demand
10. Policy of the state
11. Availability of capital
12. Liquid assets of the investors

However, Keynes contended that business expectations and profits are more important in deciding investment. He also pointed out that investment depends on MEC (Marginal Efficiency of Capital) and rate of interest.

i. Private investment is an increase in the capital stock such as buying a factory or machine.

ii. The marginal efficiency of capital (MEC) states the rate of return on an investment project. Specifically, it refers to the annual percentage yield (output) earned by the last additional unit of capital.

iii. If the marginal efficiency of capital is 5% and interest rates is 4%, then it is worth borrowing at 4% to get an expected increase in output of 5%.

Relationship between rateof interest andInvestment:

An explanation of how the rate of interest influences the level of investment in the economy. Typically, higher interest rates reduce investment, because higher

rates increase the cost of borrowing and require investment to have a higher rate of return to be profitable.

Interest rates and investment

As the real cost of borrowing rises, fewer investment projects are profitable.

If interest rates rise from 5% to 8 %, then we get a fall in the amount of investment from ₹ 100 cr to ₹ 80 cr.

If interest rates are increased then it will tend to discourage investment because investment has a higher opportunity cost.

1. With higher rates, it is more expensive to borrow money from a bank.

2. Saving money in a bank gives a higher rate of return. Therefore, using savings to finance investment has an opportunity cost of lower interest payments.

If interest rates rise, firms will need to gain a better rate of return to justify the cost of borrowing using savings.

Marginal Efficiency of Capital.

MEC was first introduced by J.M Keynes in 1936 as an important determinant of autonomous investment. The MEC is the expected profitability of an additional capital asset. It may be defined as the highest rate of return over cost expected from the additional unit of capital asset.

Meaning of Marginal Efficiency of Capital (MEC) is the rate of discount which makes the discounted present value of expected income stream equal to the cost of capital.

MEC depends on two factors:

1. The prospective yield from a capital asset.
2. The supply price of a capital asset.

Factors Affecting MEC:

Three factors that are taken into consideration while making any investment decision

- l The cost of the capital asset
- l The expected rate of return
- from during its lifetime
- l The market rate of interest

The marginal efficiency of capital is influenced by short - run as well as ongrun factors. These factors are discussed in brief:

a) Short - Run Factors

i. **Demand for the product:** If the market for a particular good is expected to grow and its costs are likely to fall, the rate of return from investment will be high. If entrepreneurs expect a fall in demand for goods and a rise in cost, the investment will decline.

ii. **Liquid assets:** If the entrepreneurs are holding large volume of working capital, they can take advantage of the investment opportunities that come in their way. The MEC will be high.

iii. **Sudden changes in income:** The MEC is also influenced by sudden changes in income of the entrepreneurs. If the business community gets windfall profits, or tax concession the MEC will be high and hence investment in the country will go up. On the other hand, MEC falls with the decrease in income.

iv. **Current rate of investment:** Another factor which influences MEC is the current rate of investment in a particular industry. If in a particular industry, much investment has already taken place and the rate of investment currently going on in that industry is also very large, then the marginal efficiency of capital will be low.

v. **Waves of optimism and pessimism:** The marginal efficiency of capital is also affected by waves of optimism and pessimism in the business cycle. If businessmen are optimistic about future, the MEC will be likely to be high. During periods of pessimism the MEC is under estimated and so will be low.

b) Long - Run Factors

The long run factors which influence the marginal efficiency of capital are as follows:

i. **Rate of growth of population:**Marginal efficiency of capital is also influenced by the rate of growth of population. If population is growing at a rapid speed, it is usually believed that the demand of various types of goods will increase. So a rapid rise in the growth of population will increase the marginal efficiency of capital and a slowing down in its rate of growth will discourage investment and thus reduce marginal efficiency of capital.

ii. **Technological progress:** If investment and technological development take place in the industry, the prospects of increase in the net yield brightens up. For example, the development of automobiles in the 20th century has greatly

stimulated the rubber industry, the steel and oil industry etc. So we can say that inventions and technological improvements encourage investment in various projects and increase marginal efficiency of capital.

iii. **Monetary and Fiscal policies:** Cheap money policy and liberal tax policy pave the way for greater profit margin and so MEC is likely to be high.

iv. **Political environment:** Political stability, smooth administration, maintenance of law and order help to improve MEC.

v. **Resource availability:** Cheap and abundant supply of natural resources, efficient labour and stock of capital enhance the MEC.

Marginal Efficiency of Investment

MEI is the expected rate of return on investment as additional units of investment are made under specified conditions and over a period of time. When cost of borrowing is high, businesses are less motivated to borrow money and make investment on different projects because high cost of borrowing reduces profit margin of the business firms;

Marginal Efficiency of Capital(MEC)	MarginalEfficiencyof Investment(MEI)
1) It is based on a given supply price for capital.	1) It is based on the induced change in the price due to change in the demand for capital.
2) It represents the rate of return on all successive units of capital without regard to existing capital.	2) It shows the rate of return on just those units of capital over and above the existing capital stock.
3) The capital stock is taken on the X axis of diagram.	3) The amount of investment is taken on the X - axis of diagram
4) It is a "stock" concept.	4) It is a "flow" concept.
5) It determines the optimum capital stock in an economy at each level of interest rate.	5) It determines the net investment of the economy at each interest rate given the capital stock.

Multiplier

The concept of multiplier was first developed by R.F. Khan in terms of employment. J.M Keynes redefined it as investment multiplier.

The multiplier is defined as the ratio of the change in national income to change in investment. If ΔI stands for increase in investment and ΔY stands for resultant increase in income, the multiplier K =ΔY/ΔI. Since ΔY results from ΔI, the multiplier is called investment multiplier.

Assumptions of Multiplier:

Keynes's theory of the multiplier works under certain assumptions which limit the operation of the multiplier. They are as follows:

1. There is change in autonomous investment.
2. There is no induced investment
3. The marginal propensity to consume is constant.
4. Consumption is a function of current income.
5. There are no time lags in the multiplier process.
6. Consumer goods are available in response to effective demand for them.
7. There is a closed economy unaffected by foreign influences.
8. There are no changes in prices.
9. There is less than full employment level in the economy.

Marginal propensityto consume andmultiplier.

The propensity to consume refers to the portion of income spent on consumption. The MPC refers to the relation between change in consumption (C) and change in income(Y).

Symbolically

$$MPC = \Delta C/\Delta Y$$

The value of multiplier depends on MPC

Multiplier

$$(K) = 1/1\text{-}MPC$$

The multiplier is the reciprocal of one minus marginal propensity to consume. Since marginal propensity to save is 1 - MPC. (MPC+MPS =1). Multiplier is 1/ MPS. The multiplier is therefore defined as reciprocal of MPS. Multiplier is inversely related to MPS and directly with MPC.

Numerically if MPC is 0.75, MPS is 0.25 and k is 4.

Using formula k = 1/1- MPC
1/1-0.75 =1/0.25 =4

Table 4.

Taking the following values, we can explain the functioning of multiplier

MPC	MPS	K
0.00	1.00	1

0.10	0.90	1.11
0.50	0.50	2.00
0.75	0.25	4.00
0.90	0.10	10.00
1.00	0.00	a

C =100 + 0.8 y; I =100 I = 10

Y = C + I

= 100 + 0.8y + 100
0.2y = 200
Y = 1000

Here, C = 100 + 0.8y = 100 + (1000) = 900;

S = 100 = I
After I is raised by 10, now I = 110,
Y = 100 + 0.8y + 110
0.2y = 210

Y = 210/0.2 = 1050

Here C = 100=0.8(1050) = 940; S = 110 = I

Diagrammatic Explanation.

At 45° line y = C+ S
It implies the variables in axis and axis are equal.
The MPC is assumed to be at 0.8 (C = 100 + 0.8y)
The aggregate demand (C+I) curve intersects 45° line at point E.
The original national income is 500.

(C = 100 + 0.8y = 100 + 0.8(500) = 500)

When I is 100, y = 1000, C = 900;
S = 100 = I

The new aggregate demand curve is C+I' = 100 + 0.8y + 100 +10

Y = 210/0.2= 1050

C = 940; S = 110 = I

Working of Multiplier

Suppose the Government undertakes investment expenditure equal to Rs. 100 crore on some public works, by way of wages, price of materials etc. Thus income of labourers and suppliers of materials increases by Rs. 100 crore. Suppose the MPC is 0.8 that is 80 %. A sum of Rs. 80 crores is spent on consumption (A sum of Rs. 20 Crores is saved). As a result, suppliers of goods get an income of Rs. 80 crores. They inturn spend Rs. 64 crores (80% of Rs. 80 cr). In this manner consumption expenditure and increase in income act in a chain like manner.

Positive Multiplier and Negative Multiplier Effects	
Positive Multiplier	Negative Multiplier
When an intial increases in an injection (or a decrease in a leakage) leads to a greater final increase in real GDP.	When an intial increases in an injection (or an increase in a leakage) leads to a greater final decrease in real GDP.

The final result is$\Delta Y = 100+100\times4/5+100 \times[4/5]^2+100\times[4/5]^3$ or,

$\Delta Y = 100 + 100 \times 0.8 + 100 \times (0.8)^2 + 100 \times (0.8)^3$

$= 100 + 80 + 64 + 51.2...$
$= 500$
that is $100\times1/1\text{-}4/5$
$100\times1/1/5$
100×5 = Rs. 500 crores

For instance if C = 100 + 0.8Y, I = 100,

Then Y = 100 + 0.8Y + 100
0.2Y = 200
Y = 200/0.2 = 1000→Point B

If I is increased to 110, then
0.2Y =210
Y = 210/0.2 = 1050→Point D

For Rs. 10 increase in I, Y has increased by Rs. 50.

This is due to multiplier effect.

At point A, Y = C = 500

C = 100 + 0.8 (500) = 500; S=0

At point B, Y = 1000
C = 100 + 0.8 (1000) = 900; S = 100 = I

At point D, Y = 1050

C = 100 + 0.8 (1050) = 940; S = 110 = I

When I is increased by 10, Y increases by 50.

This is multiplier effect (K = 5)

K = 1/0.25 = 5

Classification of Multiplier:

1. Static and dynamic multiplier

i. Static multiplier is otherwise known as simultaneous multiplier, timeless multiplier, and logical multiplierUnder static multiplier the change in investment and the resulting change in income are simultaneous.There is no time lag. There is also no change in MPC as the economy moves from one equilibrium position to another.

ii. Dynamic multiplier is also known as 'sequence multiplier'. In real life, income level does not increase instantly with investment. In fact, there is a time lag between increase in income and consumption expenditure.

Leakages of multiplier

The multiplier assumes that those who earn income are likely to spend a proportion of their additional income on consumption. But in practice, people tend to spend their additional income on other items. Such expenses are known as leakages.

Payment towards past debts.

If a portion of the additional income is used for repayment of old loan, the MPC is reduced and as a result the value of multiplier is cut.

Purchase of existing wealth

If income is used in purchase of existing wealth such as land, building and shares money is circulated among people and never enters into the consumption stream. As a result the value of multiplier is affected.

Import of goods and services

Income spent on imports of goods or services flows out of the country and has little chance to return to income stream in the country. Thus imports reduce the value of multiplier.

Non availability of consumer goods

The multiplier theory assumes instantaneous supply of consumer goods following demand. But there is often a time lag. During this gap (D>S) inflation is likely to rise. This reduces the consumption expenditure and thereby multiplier value.

Full employment situation

Under conditions of full employment, resources are almost fully employed. So, additional investment will lead to inflation only, rather than generation of additional real income.

Uses of multiplier

1. Multiplier highlights the importance of investment in income and employment theory.
2. The process throws light on the different stages of trade cycle.
3. It also helps in bringing the equality between S and I.
4. It helps in formulating Government policies.
5. It helps to reduce unemployment and achieve full employment.

KINDS OF MULTIPLIER

1. Tax multiplier
2. Employment multiplier
3. Foreign Trade multiplier
4. Investment Multiplier

The Accelerator Principle

The origin of accelerator principlecan be traced back in the writingsof Aftalion (1909), Hawtrey (1913)and Bickerdike(1914). However, thesystematic development of the simpleaccelerator model was made by J.M.Clark,in 1917. It was further developed by Hicks,Samuelson and Harrod in relation to thebusiness cycles.

Meaning

A given increase in the demand forconsumption goods in the economygenerally leads to an accelerated demandfor machineries (investment goods).Accelerator is the numerical value of therelation between an increase inconsumption and the resulting increase ininvestment.

Accelaration Effects		
Increase in consumer demand	Films get chose to fill capacity	Films Invest in meet rising demand

$$\text{Accelerator } (\beta) = \Delta I / \Delta C$$

ΔI = Change in investment outlays (Say 100)

ΔC = Change in consumption demand (Say 50)

The accelerator expresses the ratio of the net change in investment to change in consumption

Definition

"The accelerator coefficient is the ratio between induced investment and an initial change in consumption."

Assuming the expenditure of ₹50crores on consumption goods, if industries lead to an investment of ₹ 100 crores in investment goods industries, we can say that the accelerator is 2.

Accelerator = 100/50 = 2

Assumptions

1. Absence of excess capacity in consumer goods industries.
2. Constant capital - output ratio
3. Increase in demand is assumed to be permanent
4. Supply of funds and other inputs is quite elastic
5. Capital goods are perfectly divisible in any required size.

Operation of theAcceleration Principle

Let us consider a simple example. The operation of the accelerator may be illustrated as follows.

Let us suppose that in order to produce 1000 consumer goods, 100 machines are required. Also suppose that working life of a machine is 10 years. This means

that every year 10 machines have to be replaced in order to maintain theconstant flow of 1000 consumer goods. This might be called replacement demand.

Suppose that demand for consumer goods rises by 10 percent (ie from 1000 to 1100). This results in increase in demand for 10 more machines. So that total demand for machines is 20. (10 for replacement and 10 for meeting increased demand). It may be noted here a 10 percent increase in demand for consumer goods causes a 100 percent increase in demand for machines (from 10 to 20). So we can conclude even a mild change in demand for consumer goods will lead to wide change in investment.

Diagrammatic illustration:
Operation of Accelerator.

SS is the saving curve. II is the investment curve. At point E1, the economy is in equilibrium with OY1 income. Saving and investment are equal at OI2. Now, investment is increased from OI2 to OI4. This increases income from OY1 to OY3, the equilibrium point being E3. If the increase in investment by I2 I4 is purely exogenous, then the increase inincome by Y1 Y3 would have been due to the multiplier effect. But in this diagram it is assumed that exogenous investment is only by I2 I3 and induced investment is by I3 I4. Therefore, increase in income by Y1 Y2 is due to the multiplier effect and the increase in income by Y2 Y3 is due to the accelerator effect.

Limitations

1. The assumption of constant capitaloutput ratio is unrealistic.
2. Resources are available only before full employment.
3. Excess capacity in capital goods industries is assumed.
4. Accelerator will work only if the increased demand is permanent.
5. Accelerator will work only when credit is available easily.
6. If there is unused or excess capacity in the consumer goods industry, the accelerator principle would not work.

Super Multiplier:(k and β interaction)

The super multiplier is greater than simple multiplier which includes only autonomous investment and no induced investment, while super multiplierincludes induced investment.

In order to measure the total effect of initial investment on income, Hicks has combined the k and β mathematically and given it the name of the Super Multiplier. The super multiplier is worked out by combining both induced consumption and induced investment.

Leverage Effect

The combined effect of the multiplier and the accelerator is also called the leverage effect which may lead the economy to very high or low level of income propagation.

Symbolically

$$Y = C + I_A + I_P$$

Y = Aggregate income.
C = Consumption expenditure
IA= autonomous investment
IP= induced private investment

Unit 5 – Monetary Economics

Introduction

Monetary Economics is a branch of economics that provides a framework for analyzing money and its functions as a medium of exchange, store of value and unit of account. It examines the effects of monetary systems including regulation of money and associated financial institutions.

Money

Meaning

Money is anything that is generally accepted as payment for goods and services and repayment of debts and that serves as a medium of exchange. A medium of exchange is anything that is widely accepted as a means of payments. In recent years, the importance of credit has increased in all the countries of the world. Credit instruments are used on an extensive scale. The use of cheques, bills of exchange, etc. has gone up. It should however, be remembered that money is the basis of credit.

Definitions

Many economists developed definition for money. Among these, definitions of Walker and Crowther are given below:

“ Money is, what money does”
- Walker.

“Money can be anything that is generally acceptable as a means of exchange and at the same time acts as a measure and a store of value”.
–Crowther

The history of Barter system starts way back in 6000 BC

- Barter system was introduced by Mesopotamia tribes.
- Phoenicians adopted bartering of goods with various other cities across oceans.
- Babyloninan’s also developed an improved barter system, where goods were exchanged for goods.

Evolution of Money

Barter System

The introduction of money as a medium of exchange was one of the greatest inventions of mankind. Before money was invented, exchange took place by Barter, that is, commodities and services were directly exchanged for other commodities and services. Under the barter system, buyers and sellers of commodities had to face

a number of difficulties. Surplus goods were exchanged for money which in turn was exchanged for other needed goods. Goods like furs, skins, salt, rice, wheat, utensils, weapons, etc. were commonly used as money. Such exchange of goods for goods was known as "Barter Exchange" or "Barter System".

Metallic Standard

After the barter system and commodity money system, modern money systems evolved. Among these, metallic standard is the premier one. Under metallic standard, some kind of metal either gold or silver is used to determine the standard value of the money and currency. Standard coins made out of the metal are the principal coins used under the metallic standard. These standard coins are full bodied or full weighted legal tender. Their face value is equal to their intrinsic metal value.

Gold Standard

Gold Standard is a system in which the value of the monetary unit or the standard currency is directly linked with gold. The monetary unit is defined in terms of a certain weight of gold. The purchasing power of a unit of money is maintained equal to the value of a fixed weight of gold.

Silver Standard

The silver standard is a monetary system in which the standard economic unit of account is a fixed weight of silver. The silver standard is a monetary arrangement in which a country's Government allows conversion of its currency into fixed amount of silver.

Paper Currency Standard

The paper currency standard refers to the monetary system in which the paper currency notes issued by the Treasury or the Central Bank or both circulate as unlimited legal tender. Paper currency is not convertible into any metal. Its value is determined independent of the value of gold or any other commodity. The paper standard is also known as managed currency standard. The quantity of money in circulation is controlled by the monetary authority to maintain price stability.

Plastic Money

The latest type of money is plastic money. Plastic money is one of the most evolved forms of financial products. Plastic money is an alternative to the cash or the standard "money". Plastic money is a term that is used predominantly in reference to the hard plastic cards used every day in place of actual bank notes. Plastic money can come in many different forms such as Cash cards, Credit cards, Debit cards, Pre-

paid Cash cards, Store cards, Forex cards and Smart cards. They aim at removing the need for carrying cash to make transactions.

Crypto Currency

A digital currency in which encryption techniques are used to regulate the generation of units of currency and verify the transfer of funds, operating independently of a Central Bank.

Decentralised crypto currencies such as Bitcoin now provide an outlet for Personal Wealth that is beyond restriction and confiscation.

Functions of Money

The main functions of money can be classified into four categories:

1.Primary Functions:

i) Money as a medium of exchange:

This is considered as the basic function of money. Money has the quality of general acceptability, and all exchanges take place in terms of money. On account of the use of money, the transaction has now come to be divided into two parts. First, money is obtained through sale of goods or services. This is known as sale. Later, money is obtained to buy goods and services. This is known as purchase. Thus, in the modern exchange system money acts as the intermediary in sales and purchases.

ii) Money as a measure of value:

The second important function of money is that it measures the value of goods and services. In other words, the prices of all goods and services are expressed in terms of money. Money is thus looked upon as a collective measure of value. Since all the values are expressed in terms of money, it is easier to determine the rate of exchange between various types of goods in the community.

2.Secondary Functions

i) Money as a Store of value: Savings done in terms of commodities were not permanent. But, with the invention of money, this difficulty has now disappeared and savings are now done in terms of money. Money also serves as an excellent store of wealth, as it can be easily converted into other marketable assets, such as, land, machinery, plant etc.

ii) Money as a Standard of Deferred Payments: Borrowing and lending were difficult problems under the barter system. In the absence of money, theonly in terms of goods and services. But the modern money-economy has greatly facilitated

the borrowing and lending processes. In other words, money now acts as the standard of deferred payments.

iii) Money as a Means of Transferring Purchasing Power: The field of exchange also went on extending with growing economic development. The exchange of goods is now extended to distant lands. It is therefore, felt necessary to transfer purchasing power from one place to another.

3.Contingent Functions

i) Basis of the Credit System: Money is the basis of the Credit System. Business transactions are either in cash or on credit. For example, a depositor can make use of cheques only when there are sufficient funds in his account. The commercial bankscreate credit on the basis of adequate cash reserves. But, money is at the back of all credit.

ii) Money facilitates distribution of National Income: The task of distribution of national income was exceedingly complex under the barter system. But the invention of money has now facilitated the distribution of income as rent, wage, interest and profit.

iii) Money helps to Equalize Marginal Utilities and Marginal Productivities: Consumer can obtain maximum utility only if he incurs expenditure on various commodities in such a manner as to equalize marginal utilities accruing from them. Now in equalizing these marginal utilities, money plays an important role, because the prices of all commodities are expressed in money. Money also helps to equalize marginal productivities of various factors of production.

iv) Money Increases Productivity ofCapital: Money is the most liquid form of capital. In other words, capital in the form of money can be put to any use. It is on account of this liquidity of money that capital can be transferred from the less productive to the more productive uses.

4.Other Functions

i) Money helps to maintain Repayment Capacity: Money possesses the quality of general acceptability. To maintain its repayment capacity, every firm has to keep assets in the form of liquid cash. The firm ensures its repayment capacity with money. Likewise, banks, insurance companies and even governments have to keep some liquid money (i.e., cash)to maintain their repayment capacity.

ii) Money represents Generalized Purchasing Power: Purchasing power kept in terms of money can be put to any use. It is not necessary that money should be used only for the purpose for which it has been served.

iii) Money gives liquidity to Capital: Money is the most liquid form of capital. It can be put to any use.

Supply of Money

Money supply means the total amount of money in an economy. It refers to the amount of money which is in circulation in an economy at any given time. Money supply plays a crucial role in the determination of price level and interest rates. Money supply viewed at a given point of time is a stock and over a period of time it is a flow.

Meaning of Money Supply

In India, currency notes are issued by the Reserve Bank of India (RBI) and coins are issued by the Ministry of Finance, Government of India (GOI). Besides these, the balance is savings, or current account deposits, held by the public in commercial banks is also considered money. The currency notes are also called fiat money and legal tenders.

Money supply is a stock variable. RBI publishes information for four alternative measures of Money supply, namely M_1,M_2,M_3 and M_4.

M_1 = Currency, coins and demand deposits
M_2 = M_1 + Savings deposits with post office savings banks
M_3 = M_2 + Time deposits of all commercial and cooperative banks
M_4 = M_3 + Total deposits with Post offices.
M_1 and M_2 are known as narrow money
M_3 and M_4 are known as broad money

The gradations are in decreasing order of liquidity.

Currency Symbol
The new symbol designed by D.Udaya Kumar, a post graduate of IIT Bombay was finally selected by the Union cabinet on 15th July, 2010. The new symbol, is an amalgamation of Devanagri 'Ra' and the Roman 'R' without the stem. The symbol of India rupee came into use on 15thJuly,2010. After America, Britain, Japan, Europe Union. India is the 5th country to accept a unique currency symbol.

Determinants of Money Supply

1. Currency Deposit Ratio (CDR); It is the ratio of money held by the public in currency to that they hold in bank deposits.

2. Reserve deposit Ratio (RDR); Reserve Money consists of two things (a) vault
3. cash in banks and (b) deposits of commercial banks with RBI.

4. Cash Reserve Ratio (CRR); It is the fraction of the deposits the banks must keep with RBI.

5. Statutory Liquidity Ratio (SLR); It is the fraction of the total demand and time
6. deposits of the commercial banks in the form of specified liquid assests.

Quantity Theories of Money

Quantity theories of money explain the relationship between quantity of money and value of money. Here, we are given two approaches of Quantity Theory of Money, viz. Fisher's Transaction Approach and Cambridge Cash Balance Approach.

(a) Fisher's Quantity Theory of Money:

The quantity theory of money is a very old theory. It was first propounded in 1588 by an Italian economist, Davanzatti. But, the credit for popularizing this theory in recent years rightly belongs to the well-known American economist, Irving Fisher who published his book, 'The Purchasing Power of Money" in 1911.He gave it a quantitative form in terms of his famous "Equation of Exchange".

The general form of equation given by Fisher is

$$MV = PT$$

Where M = Money Supply/quantity of Money

V = Velocity of Money
P = Price level
T = Volume of Transaction.

Fisher points out that in a country during any given period of time, the total quantity of money (MV) will be equal to the total value of all goods and services bought and sold (PT).

$$MV = PT$$

Supply of Money = Demand for Money

This equation is referred to as "Cash Transaction Equation".

It is expressed as $P = MV / T$ which implies that the quantity of money determines the price level and the price level in its turn varies directly with the quantity of money, provided 'V' and 'T' remain constant.

The above equation considers only currency money. But, in a modern economy, bank's demand deposits or credit money and its velocity play a vital part in business. Therefore, Fisher extended his original equation of exchange to include bank deposits M1 and its velocity V1. The revised equation was:

$$PT = MV + M_1V_1$$
$$P = MV + M_1 V_1 / T$$

From the revised equation, it is evident, that the price level is determined by

(a) the quantity of money in circulation 'M'
(b) the velocity of circulation of money 'V'
(c) the volume of bank credit money M1
(d) the velocity of circulation of credit money V1 and the volume of trade (T)

Diagrammatic Illustration

Figure (A) shows the effect of changes in the quantity of money on the price level. When the quantity of money is OM, the price level is OP. When the quantity of money is doubled to OM_2, the price level is also doubled to OP2 . Further, when the quantity of money is increased four-fold to OM_4 , the price level also increases by four times to OP4 . This relationship is expressed by the curve OP = f (M) from the origin at 450.

Figure (B), shows the inverse relation between the quantity of money and the value of money, where the value of money is taken on the vertical axis. When the quantity of money is OM, the value ofmoney is OI / P. But with the doubling of the quantity of money to OM2 , the value of money becomes one-half of what it was before, (OI / P_2). But, with the quantity of money increasing by four-fold to OM_4, the value of money is reduced by OI / P4. This inverse relationship between the quantity of money and the value of money is shown by downward sloping curve IO / P = f(M).

b) Cambridge Approach (Cash Balances Approach)

i) Marshall's Equation

The Marshall equation is expressed as:

M = KPY

Where

M is the quantity of money

Y is the aggregate real income of the community

P is Purchasing Power of money

K represents the fraction of the real income which the public desires to hold in the form of money.

Thus, the price level P = M/KY or the value of money (The reciprocal of price level) is 1/P = KY/M

The value of money in terms of this equation can be found out by dividing the total quantity of goods which the public desires to holdout of the total income by the total supply of money.

According to Marshall's equation, the value of money is influenced not only by changes in M, but also by changes in K

ii) Keynes' Equation

Keynes equation is expressed as:

$n = pk$ (or) $p = n / k$

Where

n is the total supply of money

p is the general price level of consumption goods

k is the total quantity of consumption units the people decide to keep in the form of cash,

Keynes indicates that K is a real balance, because it is measured in terms of consumer goods.

According to Keynes, peoples' desire to hold money is unaltered by monetary authority. So, price level and value of money can be stabilized through regulating quantity of money (n) by the monetary authority.

Later, Keynes extended his equation in the following form:

$n = p (k + rk')$ or $p = n/(k + rk')$

Where,

n = total money supply

p = price level of consumer goods

k = peoples' desire to hold money in hand (in terms of consumer goods) in the total income of them

r = cash reserve ratio

k' = community's total money deposit in banks, in terms of consumers goods.

In this extended equation also, Keynes assumes that, k, k' and r are constant. In this situation, price level (P) is changed directly and proportionately changing in money volume (n).

Inflation

Both inflation and deflations are evils of economy. So, understanding of these is essential.

Meaning of Inflation

Inflation is a consistent and appreciable rise in the general price level. In other words, inflation is the rate at which the general level of prices for goods and services is rising and consequently the purchasing power of currency is falling.

Definition

" Too much of Money chasing too few goods"

- Coulbourn

"A state of abnormal decrease in the quantity of purchasing power" Gregorye

Types of Inflation
On the basis of speed

(i) Creeping inflation (ii) Walking inflation (iii) Running inflation and (iv) Galloping inflation or Hyper inflation.

i. **Creeping Inflation:** Creeping inflation is slow-moving and very mild. The rise in prices will not be perceptible but spread over a long period. This type of inflation is in no way dangerous to the economy. This is also known as mild inflation or moderate inflation.

ii. **Walking Inflation:** When prices rise moderately and the annual inflation rate is a single digit (3% - 9%), it is called walking or trolling inflation.

iii. **Running Inflation:** When prices rise rapidly like the running of a horse at a rate of speed of 10% - 20% per annum, it is called running inflation.

iv. **Galloping inflation:** Galloping inflation or hyper inflation points out to unmanageably high inflation rates that run into two or three digits. By high inflation the percentage of the same is almost 20% to 100% from an overall perspective.

The first hyper inflation of the 21st century Zimbabwe's annual inflation rate surged to an unprecendented 3714 percent at the end of April 2007.

Demand-Pull Vs Cost-Push inflation

i. **Demand-Pull Inflation:** Demand and supply play a crucial role in deciding the inflation levels in the society at all points of time. For instance, if the demand is high for a product and supply is low, the price of the products increases.

ii. **Cost-Push Inflation:** When the cost of raw materials and other inputs rises inflation results. Increase in wages paid to labour also leads to inflation.

Wage-Price Spiral

Wage-price spiral is used to explain the cause and effect relationship between rising wages and rising prices or inflation.

Other types of inflation (on the basis of inducement)

i. **Currency inflation:** The excess supply of money in circulation causes rise in price level.

ii. **Credit inflation:** When banks are liberal in lending credit, the money supply increases and thereby rising prices.

iii. **Deficit induced inflation:** The deficit budget is generally financed through printing of currency by the Central Bank. As a result, prices rise.

iv. **Profit induced inflation:** When the firms aim at higher profit, they fix the price with higher margin. So prices go up.

v. **Scarcity induced inflation:** Scarcity of goods happens either due to fall in production (eg. farm goods) or due to hoarding and black marketing. This also pushes up the price. (This has happened is Venezula in the year 2018)

vi. **Tax induced inflation:** Increase in indirect taxes like excise duty, custom duty and sales tax may lead to rise in price (eg. petrol and diesel). This is also called taxflation.

Causes of Inflation

The main causes of inflation in India are as follows:

i. **Increase in Money Supply:** Inflation is caused by an increase in the supply of money which leads to increase in aggregate demand. The higher the growth rate of the nominal money supply, the higher is the rate of inflation.

ii. **Increase in Disposable Income:** When the disposable income of the people increases, it raises their demand for goods and services. Disposable income may increase with the rise in national income or reduction in taxes or reduction in the saving of the people.

iii. **Increase in Public Expenditure:**Government activities have been expanding due to developmental activities and social welfare programmes. This is also a cause for price rise.

iv. **Increase in Consumer Spending:** The demand for goods and services increases when they are given credit to buy goods on hire-purchase and installment basis.

v. **Cheap Money Policy:** Cheap money policy or the policy of credit expansion also leads to increase in the money supply which raises the demand for goods and services in the economy.

vi. **Deficit Financing:** In order to meet its mounting expenses, the government resorts to deficit financing by borrowing from the public and even by printing more notes. This raises aggregate demand in relation to aggregate supply, thereby leading to inflationary rise in prices.

vii. **Black Assests, Activities and Money:** The existence of black money and black assests due to corruption, tax evasion etc., increase the aggregate demand. People spend such money, lavishly. Black marketing and hoarding reduces the supply of goods. These trends tend to raise the price level further.

viii. **Repayment of Public Debt:**Whenever the government repays its past internal debt tothe public, it leads to increase in the money supply with the public. This tends to raise the aggregate demand for goods and services.

ix. **Increase in Exports:** When exports are encouraged, domestic supply of goods decline. So prices rise.

Effects of Inflation

The effects of inflation can be classified into two heads:
(1) Effects on Production and
(2) Effects on Distribution.

1. Effects on Production:

When the inflation is very moderate, it acts as an incentive to traders and producers. This is particularly prior to full employment when resources are not fully utilized. The profit due to rising prices encourages and induces business class to increase their investments in production, leading to generation of employment and income.

i. However, hyper-inflation results in a serious depreciation of the value of money and it discourages savings on the part of the public.

ii. When the value of money undergoes considerable depreciation, this may even drain out the foreign capital already invested in the country.

iii. With reduced capital accumulation, the investment will suffer a serious set-back which may have an adverse effect on the volume of production in the country. This may discourage entrepreneurs and business men from taking business risk.

iv. Inflation also leads to hoarding of essential goods both by the traders as well as the consumers and thus leading to still higher inflation rate.

v. Inflation encourages investment in speculative activities rather than productive purposes.

2. Effects on Distribution

i. **Debtors and Creditors:** During inflation, debtors are the gainers while the creditors are losers. The reason is that the debtors had borrowed when the purchasing power of money was high and now repay the loans when the purchasing power of money is low due to rising prices.

ii. **Fixed-income Groups:** The fixed income groups are the worst hit during inflation because their incomes being fixed do not bear any relationship with the rising cost of living. Examples are wage, salary, pension, interest, rent etc.

iii. **Entrepreneurs:** Inflation is the boon to the entrepreneurs whether they are manufacturers, traders, merchants or businessmen, because it serves as a tonic for business enterprise. They experience windfall gains as the prices of their inventories (stocks) suddenly go up.

iv. **Investors:** The investors, who generally invest in fixed interest yielding bonds and securities have much to lose during inflation. On the contrary those who invest in shares stand to gain by rich dividends and appreciation in value of shares.

Measures to Control Inflation

Keynes and Milton Friedman together suggested three measures to prevent and control of inflation.

1. Monetary measures,
2. Fiscal measures (J.M. Keynes) and
3. Other measures.

1. **Monetary Measures:** These measures are adopted by the Central Bank of the country. They are (i) Increase in Bankrate (ii) Sale of Government Securities in the Open Market (iii) Higher Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) (iv) Consumer Credit Control and (v) Higher margin requirements (vi) Higher Repo Rate and Reverse Repo Rate.

2. **Fiscal Measures:** Fiscal policy is now recognized as an important instrument to tackle an inflationary situation. The major anti-inflationary fiscal measures are the following: Reduction of Government Expenditure, Public Borrowing and Enhancing taxation.

3. **Other Measures:** These measures can be divided broadly into short-term and long-term measures.

   i. Short-term measures can be in regard to public distribution of scarce essential commodities through fair price shops (Rationing). In India whenever shortage of basic goods has been felt, the government has resorted to import so that inflation may not get triggered.

   ii. Long-term measures will require accelerating economic growth especially of the wage goods which have a direct bearing on the general price and the cost of living. Some restrictions on present consumption may help in improving saving and investment which may be necessary for accelerating the rate of economic growth in the long run.

Meaning of Deflation, Disinflation and Stagflation

Deflation: The essential feature of deflation is falling prices, reduced money supply and unemployment. Though falling prices are desirable at the time of inflation, such a fall should not lead to the fall in the level of production and employment. But if prices fall from the level of full employment both income and employment will be adversely affected.

Disinflation: Disinflation is the slowing down the rate of inflation by controlling the amount of credit (bank loan, hire purchase) available to consumers without causing more unemployment. Disinflation may be defined as the process of reversing inflation without creating unemployment or reducing output in the economy.

Stagflation: Stagflation is a combination of stagnant economic growth, high unemployment and high inflation.

Trade Cycle

The economic activity in a capitalist economy will have its periodic ups and downs. The study of these ups and downs is called the study of Business cycle or Trade cycle or Industrial Fluctuation.

Meaning of Trade Cycle

A Trade cycle refers to oscillations in aggregate economic activity particularly in employment, output, income, etc. It is due to the inherent contraction and expansion of the elements which energize the economic activities of the nation. The fluctuations are periodical, differing in intensity and changing in its coverage.

Definition

"A trade cycle is composed of periods of good trade characterised by rising prices and low unemployment percentages altering with periods of bad trade characterised by falling prices and high unemployment percentages".
- J.M. Keynes

Phases of Trade Cycle

The four different phases of trade cycle is referred to as (i) Boom (ii) Recession (iii) Depression and (iv) Recovery..

Phases of Trade Cycle

i. **Boom or Prosperity Phase:** The full employment and the movement of the economy beyond full employment is characterized as boom period. During this period, there is hectic activity in economy. Money wages rise, profits increase and interest rates go up. The demand for bank credit increases and there is all-round optimism.

ii. **Recession:** The turning point from boom condition is called recession. This happens at higher rate, than what was earlier. Generally, the failure of a company or bank bursts the boom and brings a phase of recession. Investments are drastically reduced, production comes down and income and profits decline. There is panic in the stock market and business activities show signs of dullness. Liquidity preference of the people rises and money market becomes tight.

iii. **Depression:** During depression the level of economic activity becomes extremely low. Firms incur losses and closure of business becomes a common feature and the ultimate result is unemployment. Interest prices, profits and wages are low. The agricultural class and wage earners would be worst hit. Banking institutions will be reluctant to advance loans to businessmen. Depression is the worst phase of the business cycle. Extreme point of depression is called as "trough", because it is a deep point in business cycle. Any person fell down in deeps could not come out from that without other's help. Similarly, an economy fell down in trough could not come out from this

without external help. Keynes advocated that autonomous investment of the government alone can help the economy to come out from the depression.

iv. **Recovery:** After a period of depression, recovery sets in. This is the turning point from depression to revival towards upswing. It begins with the revival of demand for capital goods. Autonomous investments boost the activity. The demand slowly picks up and in due course the activity is directed towards the upswing with more production, profit, income, wages and employment. Recovery may be initiated by innovation or investment or by government expenditure (autonomous investment).

Unit – 6

Banking

"Commercial Banks are the institutions that make short term loans to business and in the process create Money'.'
- Culbertson

Introduction

Finance is the life blood of all economic activities such as trade, commerce, agriculture and industry. A bank is generally understood as an institution which provides fundamental financial services such as accepting deposits and lending loans. Banking sector acts as the backbone of modern business world. The banking system significantly contributes for the development of any country. Due to the importance in the financial stability of a country, banks are highly regulated in most countries.

Historical Development

The Ricks Banks of Sweden, which had sprung from a private bank established in 1656 is the oldest central bank in the world. It acquired the sole right of note issue in 1897. But the fundamentals of the art of banking have been developed by the Bank of England (1864) as the first bank of issues.

A large number of central banks were established between 1921 and 1954 in compliance with the resolution passed by the International Finance Conference held at Brussels in 1920. The South African Reserve Bank (1921), the Central Bank of China (1928), The Reserve Bank of New Zealand (1934), The Reserve Bank of India (1935), the Central Bank of Ceylon (1950) and the Bank of Israel (1954) were established.

Commercial banks

Commercial bank refers to a bank, or a division of a large bank, which more specifically deals with deposit and loan services provided to corporations or large/ middle-sized business - as opposed to individual members of the public/small business. They do not provide, long-term credit, as liquidity of assets is to be maintained.

Functions of Commercial Banks:

Commercial banks are institutions that conduct business with profit motive by accepting public deposits and lending loans for various investment purposes.

The functions of commercial banks are broadly classified into primary functions and secondary functions, which are shown in the picture

Functions of Commercial Banks

(a) Primary Functions:

1. Accepting Deposits

It implies that commercial banks are mainly dependent on public deposits. There are two types of deposits, which are discussed as follows

i. **Demand Deposits**

It refers to deposits that can be withdrawn by individuals without any prior notice to the bank. In other words, the owners of these deposits are allowed to withdraw money anytime by writing a withdrawal slip or a cheque at the bank counter or from ATM centres using debit card.

ii. **Time Deposits**

It refers to deposits that are made for certain committed period of time. Banks pay higher interest on time deposits. These deposits can be withdrawn only after a specific time period by providing a written notice to the bank.

2. Advancing Loans

It refers to granting loans to individuals and businesses. Commercial banks grant loans in the form of overdraft, cash credit, and discounting bills of exchange.

(b) Secondary Functions

The secondary functions can be classified under three heads, namely, agency functions, general utility functions, and other functions.

1. Agency Functions: It implies that commercial banks act as agents of customers by performing various functions.

(i) Collecting Cheques

Banks collect cheques and bills of exchange on the behalf of their customers through clearing house facilities provided by the central bank.

(ii) Collecting Income

Commercial banks collect dividends, pension, salaries, rents, and interests on investments on behalf of their customers. A credit voucher is sent to customers for information when any income is collected by the bank.

(iii) Paying Expenses

Commercial banks make the payments of various obligations of customers, such as telephone bills, insurance premium, school fees, and rents. Similar to credit voucher, a debit voucher is sent to customers for information when expenses are paid by the bank.

(2) General Utility Functions: It implies that commercial banks provide some utility services to customers by performing various functions.

(i) Providing Locker Facilities

Commercial banks provide locker facilities to its customers for safe custody of jewellery, shares, debentures, and other valuable items. This minimizes the risk of loss due to theft at homes. Banks are not responsible for the items in the lockers.

(ii) Issuing Traveler's Cheques

Banks issue traveler's cheques to individuals for traveling outside the country. Traveler's cheques are the safe and easy way to protect money while traveling.

(iii) Dealing in Foreign Exchange

Commercial banks help in providing foreign exchange to businessmen dealing in exports and imports. However, commercial banks need to take the permission of the Central Bank for dealing in foreign exchange.

3. Transferring Funds

It refers to transferring of funds from one bank to another. Funds are transferred by means of draft, telephonic transfer, and electronic transfer.

4. Letter of Credit

Commercial banks issue letters of credit to their customers to certify their creditworthiness.

(i) Underwriting Securities

Commercial banks also undertake the task of underwriting securities. As public has full faith in the creditworthiness of banks, public do not hesitate in buying the securities underwritten by banks.

(ii) Electronic Banking

It includes services, such as debit cards, credit cards, and Internet banking.

(C) Other Functions:

(i) Money Supply

It refers to one of the important functions of commercial banks that help in increasing money supply. For instance, a bank lends ₹5 lakh to an individual and opens a demand deposit in the name of that individual. Bank makes a credit entry of Rs.5 lakh in that account. This leads to creation of demand deposits in that account. The point to be noted here is that there is no payment in cash. Thus, without printing additional money, the supply of money is increased.

(ii) Credit Creation

Credit Creation means the multiplication of loans and advances.Commercial banks receive deposits from the public and use these deposits to give loans. However, loans offered are many times more than the deposits received by banks. This function of banks is known as 'Credit Creation'.

(iii) Collection of Statistics:

Banks collect and publish statistics relating to trade, commerce and industry. Hence, they advice customers and the public authorities on financial matters.

Mechanism / Technique of Credit Creation by Commercial Banks

Bank credit refers to bank loans and advances. Money is said to be created when the banks, through their lending activities, make a net addition to the total supply of money in the economy. Likewise, money is said to be destroyed when the loans are repaid by the borrowers to the banks and consequently the credit already created by the banks is wiped out in the process.

Banks have the power to expand or contract demand deposits and they exercise this power through granting more or less loans and advances and acquiring other assets. This power of commercial bank to create deposits through expanding their loans and advances is known as credit creation.

Primary / Passive Deposit and Derived / Active Deposit

The modern banks create deposits in two ways. They are primary deposit and derived deposit. When a customer gives cash to the bank and the bank creates a book debt in his name called a deposit, it is known as a "primary deposit'. But when such a deposit is created, without there being any prior payment of equivalent cash to the bank, it is called a 'derived deposit'.

Primary Deposits
• It is out of these primary deposits that the bank makes loans and advances to its customers. • The initiative is taken by the customers themselves. In this case, the role of the bank is passive. • So these deposits are also called "Passive deposits".

Credit Creation literally means the multiplication of loans and advances. Every loan creates its own deposits. Central Bank insists the banks to maintain a ratio between the total deposits they create and the cash in their possession.

For the purpose of understanding, it is assumed that all banks are obliged to keep the ratio between cash and its deposits at a minimum of 20 percent.

1. The banks do not keep any excess reserves, in other words, it would exhaust possible avenues of income earning activities like giving loans etc. up to the maximum extent after attaining the minimum cash reserves.

2. There are no drains in the supply of money i,e., the public do not suddenly want to hold more ideal currency or withdraw from the time deposits.

Under the above assumptions, when a customer deposits a sum of Rs.1000 in a bank, the bank creates a deposit of Rs. 1000 in his favor. Bank deposits (Bank Money) have increased by Rs.1000. But, at this stage, there is no increase in the total supply of money with the public, because the above extra bank money of Rs.1000 is offset by the cash of Rs.1000 deposited in the bank.

The bank has now additional cash of Rs.1000 in its custody. Since it is required to keep only a cash reserve of 20 per cent, this means that Rs. 800 is excess cash reserve with it. According to the above assumption, the bank should lend out this Rs. 800 to the public. Suppose, it does so, and the debtor deposits the money in his own account with another bank B, Bank is creating a deposit of Rs. 800. Bank B then has also excess cash reserve of Rs. 640(800-160). It could, in its turn, lend out Rs. 640. This Rs. 640 will, in its turn find its way with, say Bank C; it will create a deposit of Rs. 640and so on.

The total deposits will now grow into Rs. 1000+800+640+…….till ultimately the excess cash reserve peters out. It can be shown that when that stage is reached the total of the above will be Rs. 5000.

Money Multiplier = 1/20% =1/20/100=1/20x100=5
Credit creation is 1000x5 = Rs. 5000.

Role of Commercial Banks in Economic Development of a Country

1. **Capital Formation**

Banks play an important role in capital formation, which is essential for the economic development of a country. They mobilize the small savings of the people scattered over a wide area through their network of branches all over the country and make it available for productive purposes.

Now-a-days, banks offer very attractive schemes to induce the people to save their money with them and bring the savings mobilized to the organized money market. If the banks do not perform this function, savings either remains idle or used in creating other assets,(eg.gold) which are low in scale of plan priorities.

2. **Creation of Credit**

Banks create credit for the purpose of providing more funds for development projects. Credit creation leads to increased production, employment, sales and prices and thereby they bring about faster economic development.

3. **Channelizing the Funds towards Productive Investment**

Banks invest the savings mobilized by them for productive purposes. Capital formation is not the only function of commercial banks. Pooled savings should be allocated to various sectors of the economy with a view to increase the productivity. Then only it can be said to have performed an important role in the economic development.

4. **Encouraging Right Type of Industries**

Many banks help in the development of the right type of industries by extending loan to right type of persons. In this way, they help not only for industrialization of the country but also for the economic development of the country. They grant loans and advances to manufacturers whose products are in great demand. The manufacturers in turn increase their products by introducing new methods of production and assist in raising the national

income of the country. Sometimes, sub-prime lending is also clone. That is how there was an economic crisis in the year 2007-08 in the US.

5. **Banks Monetize Debt**

Commercial banks transform the loan to be repaid after a certain period into cash, which can be immediately used for business activities. Manufacturers and wholesale traders cannot increase their sales without selling goods on credit basis. But credit sales may lead to locking up of capital. As a result, production may also be reduced. As banks are lending money by discounting bills of exchange, business concerns are able to carryout the economic activities without any interruption.

6. **Finance to Government**

Government is acting as the promoter of industries in underdeveloped countries for which finance is needed for it. Banks provide long-term credit to Government by investing their funds in Government securities and short-term finance by purchasing Treasury Bills. RBI has given Rs. 68,000 crores to the government of India in the year 2018-19, this is 99% the RBI's surplus.

7. **Employment Generation**

After the nationalization of big banks, banking industry has grown to a great extent. Bank's branches are opened frequently, which leads to the creation of new employment opportunities.

8. **Banks Promote Entrepreneurship**

In recent days, banks have assumed the role of developing entrepreneurship particularly in developing countries like India by inducing new entrepreneurs to take up the well-formulated projects and provision of counseling services like technical and managerial guidance. Banks provide 100% credit for worthwhile projects, which is also technically feasible and economically viable. Thus commercial banks help for the development of entrepreneurship in the country.

Non-Banking Financial Institution (NBFI)

A non-banking financial institution (NBFI) or non-bank financial company (NBFC) is a financial institution that does not have a full banking license or is not supervised by the central bank.

The NBFIs do not carry on pure banking business, but they will carry on other financial transactions. They receive deposits and give loans. They mobilize people's savings and use the funds to finance expenditure on investment activities. In short,

they are institutions which undertake borrowing and lending. They operate in both the money and the capital markets.

NBFIs can be broadly classified into two categories. Viz.., (1) Stock Exchange; and (2) Other Financial institutions. Under the latter category comes Finance Companies, Finance Corporations, ChitFunds, Building Societies, Issue Houses, Investment Trusts and Unit Trusts and Insurance Companies.

Central Bank

A central bank, reserve bank, or monetary authority is an institution that manages a state's currency, money supply, and interest rates. Central banks also usually oversee the commercial banking system of their respective countries.

Functions of Central Bank (Reserve Bank of India)

The Reserve Bank of India (RBI) is India's central banking institution, which controls the monetary policy of the Indian rupee. It commenced its operations on 1 April 1935 in accordance with the Reserve Bank of India Act, 1934. The original share capital was divided into shares of Rs.100 each fully paid, which were initially owned entirely by private shareholders. Following India's independence on 15 August 1947, the RBI was nationalised on 1 January 1949.

1. **Monetary Authority:** It controls the supply of money in the economy to stabilize exchange rate, maintain healthy balance of payment, attain financial stability, control inflation, strengthen banking system.

2. **The issuer of currency:** The objective is to maintain the currency and credit system of the country. It is the sole authority to issue currency. It also takes action to control the circulation of fake currency.

3. **The issuer of Banking License:** As per Sec 22 of Banking Regulation Act, every bank has to obtain a banking license from RBI to conduct banking business in India.

RESERVE BANK OF INDIA		
History	**Administration**	**Functions**
• Formed on April 1, 1935 in accordance with the RBI Act, 1934 • Nationalized on January 1, 1949 (Fully owned by GOI) • Headquarter moved from Calcutta to Mumbai in 1937	• It is the Central Bank/ Regulator for all bank in India • Also called "Lender of Last Resort" • Governors and 4 Deputy Governors along with a central board of directors	• Issues currency • Banker to the government {It collects receipts of funds and makes payments on behalf of the government} • Regulator of Indian Banking system

• Osborne Smith was the first Governor of RBI	appointed by the GOI.	• Custodian of Forex • Controller of credit

The process of issuing paper currency was started in the 18th century. Private Banks such as the bank of Bengal the bank of Bombay and the Bank of Madras – first printed paper money.

The first rupee was introduced by Sher Shah Suri based on a ratio of 40 copper pieces (paisa) per rupee. The name was derived from the Sanskrit word Raupya, meaning silver. Each banknote has its amount written in 17languages (English and Hindi on the front and 15 other on the back) illustrating the diversity of the country.

4. **Banker to the Government:** It acts as banker both to the central and the state governments. It provides short-term credit. It manages all new issues of government loans, servicing the government debt outstanding and nurturing the market for government securities. It advises the government on banking and financial subjects.

5. **Banker's Bank:** RBI is the bank of all banks in India as it provides loan to banks, accept the deposit of banks, and rediscount the bills of banks.

6. **Lender of last resort:** The banks can borrow from the RBI by keeping eligible securities as collateral at the time of need or crisis, when there is no other source.

7. **Act as clearing house:** For settlement of banking transactions, RBI manages 14 clearing houses. It facilitates the exchange of instruments and processing of payment instructions.

8. **Custodian of foreign exchange reserves:** It acts as a custodian of FOREX. It administers and enforces the provision of Foreign Exchange Management Act (FEMA), 1999. RBI buys and sells foreign currency to maintain the exchange rate of Indian rupee v/s foreign currencies.

9. **Regulator of Economy:** It controls the money supply in the system, monitors different key indicators like GDP, Inflation, etc.

10. **Managing Government securities:** RBI administers investments in institutions when they invest specified minimum proportions of their total assets/liabilities in government securities.

11. **Regulator and Supervisor of Payment and Settlement Systems:** The Payment and Settlement Systems Act of 2007 (PSS Act) gives RBI oversight authority for the payment and settlement systems in the country. RBI focuses on the development and functioning of safe, secure and efficient payment and settlement mechanisms.

12. **Developmental Role:** This role includes the development of the quality banking system in India and ensuring that credit is available to the productive sectors of the economy. It provides a wide range of promotional functions to support national objectives. It also includes establishing institutions designed to build the country's financial infrastructure. It also helps in expanding access to affordable financial services and promoting financial education and literacy.

13. **Publisher of monetary data and other data:** RBI maintains and provides all essential banking and other economic data, formulating and critically evaluating the economic policies in India. RBI collects, collates and publishes data regularly.

14. **Exchange manager and controller:** RBI represents India as a member of the International Monetary Fund [IMF]. Most of the commercial banks are authorized dealers of RBI.

15. **Banking Ombudsman Scheme:** RBI introduced the Banking Ombudsman Scheme in 1995. Under this scheme, the complainants can file their complaints in any form, including online and can also appeal to the Ombudsman against the awards and the other decisions of the Banks.

16. **Banking Codes and Standards Board of India:** To measure the performance of banks against Codes and standards based on established global practices, the RBI has set up the Banking Codes and Standards Board of India (BCSBI).

Credit Control Measures

Credit control is the primary mechanism available to the Central banks to realize the objectives of monetary management. The RBI is much better placed than many of credit control. The statutory basis for the control of the credit system by the Reserve Bank is embodied in the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949.

Credit Control Measures	
General (Quantitative)	**Selective (Quantitative)**
1. Bank Rate 2. Open Market Operations 3. Variable Cash Reserve Ratio	1. Rationing of Credit 2. Direct Action 3. Moral suasion 4. Publicity 5. Regulation of Consumer' Credit

	6. Marginal Requirements

Methods of Credit Control

I. Quantitative or General Methods:

1. Bank Rate Policy:

The bank rate is the rate at which the Central Bank of a country is prepared to re-discount the first class securities. It means the bank is prepared to advance loans on approved securities to its member banks. As the Central Bank is only the lender of the last resort the bank rate is normally higher than the market rate. For example: If the Central Bank wants to control credit, it will raise the bank rate. As a result, the deposit rate and other lending rates in the money-market will go up. Borrowing will be discouraged, and will lead to contraction of credit and vice versa.

2. Open Market Operations:

In narrow sense, the Central Bank starts the purchase and sale of Government securities in the money market.

In Broad Sense, the Central Bank purchases and sells not only Government securities but also other proper eligible securities like bills and securities of private concerns. When the banks and the private individuals purchase these securities they have to make payments for these securities to the Central Bank.

3. Variable Reserve Ratio:

a) Cash Reserves Ratio:

Under this system the Central Bank controls credit by changing the Cash Reserves Ratio. For example, if the Commercial Banks have excessive cash reserves on the basis of which they are creating too much of credit, this will be harmful for the larger interest of the economy. So it will raise the cash reserve ratio which the Commercial Banks are required to maintain with the Central Bank.

Similarly, when the Central Bank desires that the Commercial Banks should increase the volume of credit in order to bring about an economic revival in the economy. The central Bank will lower down the Cash Reserve Ratio with a view to expand the lending capacity of the Commercial Banks.

Variable Cash Reserve Ratio as an objective of monetary policy was first suggested by J.M. Keynes. It was first followed by Federal Reserve System in United States of America. The commercial banks as per the statute has to maintain reserves based on their demand deposit and fixed deposit with central bank is called as Cash Reserve Ratio.

If the CRR is high, the commercial bank's capacity to create credit will be less and if the CRR is low, the commercial bank's capacity to create credit will be high.

b) Statutory Liquidity Ratio:

Statutory Liquidity Ratio (SLR) is the amount which a bank has to maintain in the form of cash, gold or approved securities. The quantum is specified as some percentage of the total demand and time liabilities (i.e., the liabilities of the bank which are payable on demand anytime, and those liabilities which are accruing in one month's time due to maturity) of a bank.

II. Qualitative or Selective Method of Credit Control:

The qualitative or the selective methods are directed towards the diversion of credit into particular uses or channels in the economy. Their objective is mainly to control and regulate the flow of credit into particular industries or businesses. The following are the frequent methods of credit control under selective method:

1. Rationing of Credit
2. Direct Action
3. Moral Persuasion
4. Method of Publicity
5. Regulation of Consumer's Credit
6. Regulating the Marginal Requirements on Security Loans

1. Rationing of Credit

This is the oldest method of credit control. Rationing of credit as an instrument of credit control was first used by the Bank of England by the end of the 18th Century. It aims to control and regulate the purposes for which credit is granted by commercial banks. It is generally of two types.

a) The variable portfolio ceiling: It refers to the system by which the central bank fixes ceiling or maximum amount of loans and advances for every commercial bank.

b) The variable capital asset ratio: It refers to the system by which the central bank fixes the ratio which the capital of the commercial bank should have to the total assets of the bank.

2. Direct Action

Direct action against the erring banks can take the following forms.

a) The central bank may refuse to altogether grant discounting facilities to such banks.

b) The central bank may refuse to sanction further financial accommodation to a bank whose existing borrowing are found to be in excess of its capital and reserves.

c) The central bank may start charging penal rate of interest on money borrowed by a bank beyond the prescribed limit.

3. Moral Suasion

This method is frequently adopted by the Central Bank to exercise control over the Commercial Banks. Under this method Central Bank gives advice, then requests. and persuades the Commercial Banks to co-operate with the Central Bank in implementing its credit policies.

4. Publicity

Central Bank in order to make their policies successful, take the course of the medium of publicity. A policy can be effectively successful only when an effective public opinion is created in its favour.

5. Regulation of Consumer's Credit:

The down payment is raised and the number of installments reduced for the credit sale.

6. Changes in the Marginal Requirements on Security Loans:

This system is mostly followed inU.S.A. Under this system, the Board of Governors of the Federal Reserve System has been given the power to prescribe margin requirements for the purpose of preventing an excessive use of credit for stock exchange speculation.

This system is specially intended to help the Central Bank in controlling the volume of credit used for speculation in securities under the Securities Exchange Act, 1934.

The Repo Rate and the Reverse Repo Rate are the frequently used tools with which the RBI can control the availability and the supply of money in the economy. RR is always greater than RRR in India	
Repo Rate: (RR)	Reverse Repo Rate (RRR)
The rate at which the RBI is willing to lend to commercial banks is called Repo Rate. Whenever banks have any shortage of funds they can borrow from the RBI, against securities. If the RBI increases the Repo Rate, it makes borrowing expensive for banks and vice versa. As a tool to control inflation, RBI increases the Repo Rate, making it more expensive for the banks to borrow from the RBI. Similarly,	The rate at which the RBI is willing to borrow from the commercial banks is called reverse repo rate. If the RBI increases the reverse repo rate, it means that the RBI is willing to offer lucrative interest rate to banks to park their money with the RBI. This results in a decrease in the amount of money available for banks customers as banks prefer to park their money with the RBI as it involves higher

the RBI will do the exact opposite in a deflationary environment.	safety. This naturally leads to a higher rate of interest which the banks will demand from their customers for lending money to them.

Reserve Bank of India and Rural Credit

In a developing economy like India, the Central bank of the country cannot confine itself to the monetary regulation only, and it is expected that it should take part in development function in all sectors especially in the agriculture and industry.

Role of RBI in agricultural credit

RBI has been playing a very vital role in the provision of agricultural finance in the country. The Bank's responsibility in this field had been increased due to the predominance of agriculture in the Indian economy and the inadequacy of the formal agencies to cater to the huge requirements of the sector. In order to fulfill this important role effectively, the RBI set up a separate Agriculture Credit Department. However, the volume of informal loans has not declined sufficiently.

Functions of Agriculture Credit Department:

a. To maintain an expert staff to study all questions on agricultural credit;
b. To provide expert advice to Central and State Government, State Co-operative Banks and other banking activities.
c. To finance the rural sector through eligible institutions engaged in the business of agricultural credit and to co-ordinate their activities.

The duties of the RBI in agricultural credit were much restricted as it had to function only in an ex-officio capacity being the Central Bank of the country. It could not lend directly to the farmers, but the supply of rural credit was done through the mechanism of refinance with institutions specializing in rural credit. Primary societies may borrow from Central Co-operative Bank, and the latter may borrow from the apex or the State Co-operative Bank, which in its turn might get accommodation facilities from the RBI.

The RBI was providing medium-term loans also for a period exceeding 15 months to 5 years for reclamation of land, construction of irrigation works, purchase of machinery, etc.

The Reserve Bank of India was also providing long-term loans to fiancé permanent changes in land and also for the redemption of old debts.

With the establishment of National Bank for Agriculture and Rural Development (NABARD), all the functions of the RBIrelating to agricultural credit

had been taken over and looked after by NABARD since 1982. Since then, all activities relating to rural credit are entirely looked after by NABARD.

The Agricultural Refinance Development Corporation (ARDC)

Farmers in India require mainly medium term and long term loans and they face a lot of difficulties in getting them. The only organization providing long term credit is Land Development Banks which have lagged behind and recorded only limited success. The credit requirements of the agricultural sector are increasing year after year. With the aim of bridging the gap in agricultural finance and to extend credit for projects involving agricultural development, an organization called the Agricultural Refinance Development Corporation (ARDC) was established by an Act of Parliament and it started functioning from July 1, 1963.

Objectives of the ARDC:

i. To provide necessary funds by way of refinance to eligible institutions such as the Central Land Development Banks, State Co-operative Banks, and Scheduled banks.
ii. To subscribe to the debentures floated by the Central Land Development banks, State Co-operative Banks, and Scheduled banks, provided they were approved by the RBI.

Regional Rural Banks (RRBs)

One of the important points of the 20 points economic programme of Mrs. Indira Gandhi during emergency was the liquidation of rural indebtedness by stages and provide institutional credit to farmers and artisans in rural areas. It was in pursuance of this aspect of the New Economic programme that the Government of India setup Regional Rural Banks (RRBs) on 1975. The share capital of RRB is subscribed by the Central Government (50%), the State Government concerned (15%), and the sponsoring commercial bank (35%).

The main objective of the RRBs is to provide credit and other facilities particularly to the small and marginal farmers, agricultural labourers, artisans and small entrepreneurs so as to develop agriculture, trade, commerce, industry and other productive activities in the rural areas.

Concessions to RRBs

From the beginning, the sponsor banks have continued to provide managerial and financial assistance to RRBs and also other concessions such as lower rate of interest (8.5 per cent) on the latter's borrowings from sponsor banks. Further, the cost of staff deputed to RRBs and training expenses of RRB staff are borne by the sponsor banks.

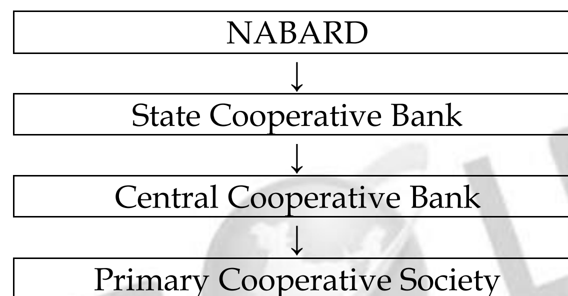
The RBI has been granting many concessions to RRBs:

a. They are allowed to maintain cash reserve ratio at 3 per cent and statutory liquidity ratio at 25 per cent; and

b. They also provide refinance facilities through NABARD.

NABARD and its role in Agricultural credit

Since its inception, RBI has shown keen interest in agricultural credit and maintained a separate department for this purpose. RBI extended short-term seasonal credit as well as medium-term and long-term credit to agriculture through State level co-operative banks and Land Development banks.



Three Tier Cooperative Credit Structure

At the same time, RBI has also set up the Agricultural Refinance Development Corporation (ARDC) to provide refinance support to the banks to promote programmes of agricultural development, particularly those requiring term credit. With the widening of the role of bank credit from “agricultural development” to “rural development” the Government proposed to have a more broad-based organization at the apex level to extend support and give guidance to credit institutions in matters relating to the formulation and implementation of rural development programmes.

A National Bank for Agriculture and Rural Development (NABARD), was therefore, set up in July 1982 by an Act of parliament to take over the functions of ARDC and the refinancing functions of RBI in relation to co-operative banks and RRBs. NABARD is linked organically with the RBI by the latter contributing half of its share capital the other half being contributed by the Government of India(GOI). GOI nominates three of its Central Board Directors on the board of NABARD.A Deputy Governor of RBI is appointed as Chairman of NABARD.

Functions of NABARD

NABARD has inherited its apex role from RBIi.e, it is performing all the functions performed by RBI with regard to agricultural credit.

i. NABARD acts as a refinancing institution for all kinds of production and investment credit to agriculture, small-scale industries, cottage and village industries, handicrafts and rural crafts and real artisans and other allied economic activities with a view to promoting integrated rural development.

ii. It provides short-term, medium-term and long-term credits to state co-operative Banks (SCBs), RRBs, LDBs and other financial institutions approved by RBI.

iii. NABARD gives long-term loans (upto 20 Years) to State Government to enable them to subscribe to the share capital of co-operative credit societies.

iv. NABARD gives long-term loans to any institution approved by the Central Government or contribute to the share capital or invests in securities of any institution concerned with agriculture and rural development.

v. NABARD has the responsibility of co-ordinating the activities of Central and State Governments, the Planning Commission (now NITI Aayog) and other all India and State level institutions entrusted with the development of small scale industries, village and cottage industries, rural crafts, industries in the tiny and decentralized sectors, etc.

vi. It has the responsibility to inspect RRBs and co-operative banks, other than primary co-operative societies.

vii. It maintains a Research and Development Fund to promote research in agriculture and rural development

Reserve bank of India and industrial finance

Though industries get finance from commercial banks, the quantum and the term will be very much limited generally. Commercial banks lend for short term only, as they get only short-term deposits from the public. Further lending to industries is only a fragment of the total lending by the banks.

Hence, there is a need and urgency of establishing long-term credit facilities to industries. The institutional set-up in India for financing in India for financing and promoting industries are as follows

All-India Level Institutions:

1. Industrial Finance Corporation of India (IFCI)

This was first in the chain of establishment of financial corporations to provide financial assistance for industrial development. This was established on July

1, 1948 under the Act of the Parliament. IFCI provides assistance to the industrial concerns in the following ways:

i) Long-term loans; both in rupees and foreign currencies.
ii) Underwriting of equity, preference and debenture issues.
iii) Subscribing to equity, preference and debenture issues.
iv) Guaranteeing the deferred payments in respect of machinery imported from abroad or purchased in India; and
v) Guaranteeing of loans raised in foreign currency from foreign financial institutions.

Financial assistance of IFCI can be availed by any Limited Company in the public, private or joint sector, or by a co-operative society incorporated in India, which is engaged or proposes to be engaged in the specified industrial activities. Such financial assistance will be available for the setting up of new industrial projects and also for the expansion diversification, renovation or modernisation of existing ones.The IFCI also provides financial assistance on concessional terms for setting up industrial projects in industrially less developed districts in the States or Union Territories notified by the Central Government,

The IFCI raises its resources by way of (a) issue of bonds in the market; (b) borrowing from Industrial Development Bank of India and the Central Government; (c) foreign credit secured from foreign financial institutions and borrowings in the international capital markets.

3. Industrial Credit and Investment Corporation of India (ICICI)

Functions of ICICI

- Assistance to industries
- Provision of foreign currency loans
- Merchant banking
- Letter of credit
- Project promotion
- Housing loans
- Leasing operations

This was set up on 5th January 1955 as a joint-stock company on the advice given by a three-man mission sponsored by the World Bank and The Government of USA to the Government of India. The principal purpose of this institution is to channelize the World Bank funds to industry in India and also to help build up a capital market. Initially the capitalof ICICI was held by private companies, institutions and individuals. But now, a very large part of its equity capital is held by public sector institutions, such as banks, LIC, GIC and its subsidiaries, as ‘this private institution was nationalized.

The significant feature of the operations of ICICI is the foreign currency loans sanctioned by this institution to industries. Since its inception, nearly 50 per cent of its disbursement had been in foreign currencies. This is possible because of the facility it enjoys of raising funds in foreign currencies. The World Bank has been the single largest source of such funds. Since 1973, the ICICI has entered the international capital markets also for raising foreign currency loans.

The major portion of its rupee resources is raised by way of debentures in the capital market. The ICICI also borrows from the Industrial Development Bank of India and the Government. The major portion of its assistance has gone to the private sector.

Industrial Development Bank of India (IDBI)

The Industrial Development Bank of India has been conceived with the primary object of creating an apex institution to co-ordinate the activities of other financial institutions, including banks. The Development Bank was a wholly owned subsidiary of the Reserve Bank of India upto February 15, 1976. It was delinked from the RBI with effect from February 16, 1976 and made an autonomous corporation fully owned by the Government of India.

Functions of IDBI: The functions of IDBI fall into two groups (i) Assistance to other financial institutions; and (ii) Direct assistance to industrial concerns either on its own or in participation with other institutions. The IDBI can provide refinance in respect of term loans to industrial concerns given by the IFC, the SFCs, other financial institutions notified by the Government, scheduled banks and state cooperative banks.

A special feature of the IDBI is the provision for the creation of a special fund known as the Development Assistance Fund. The fund is intended to provide assistance to industries which require heavy investments with low anticipated rate of return. Such industries may not be able to get assistance in the normal course. The financing of exports was also undertaken by the IDBI till the establishment of EXIM BANK in March, 1982.

State Level Institutions

1. State Financial Corporation (SFCs)

The government of India passed in 1951 the State Financial Corporations Act and SFCs were set up in many states. TheSFCs are mainly intended for the development of small and medium industrial units within their respective states. However, in some cases they extend to neighbouring states as well.

The SFCs provide loans and underwriting assistance to industrial units having paid-up capital and reserves not exceeding Rs. 1 crore. The maximum amount that can be sanctioned to an industrial concern by SFC is Rs. 60 lakhs.

SFCs depend upon the IDBI for refinance in respect of the term loans granted by them. Apart from these, the SFCs can also make temporary borrowings from the RBI and borrowings from IDBI and by the sale of bonds.

State Industrial Development Corporations (SIDCOs)

The Industrial Development Corporations have been set up by the state governments and they are wholly owned by them. These institutions are not merely financing agencies; they are entrusted with the responsibility of accelerating the industrialization of their states.

SIDCOs provide financial assistance to industrial concerns by way of loans guarantees and underwriting of or direct subscriptions to shares and debentures. In addition to these, they undertake various promotional activities, such as conducting techno-economic surveys, project identification, preparation of feasibility studies and selection and training of entrepreneurs. They also promote joint sector projects in association with private promoter in such type of projects. SIDCOs take 26 percent, private co-promoter takes 25 percent of the equity, and the rest is offered to the investing public. SIDCOs undertake the development of industrial areas by providing all infrastructural facilities and initiation of new growth centers. They also administer various State government incentive schemes. SIDCOs get refinance facilities form IDBI. They also borrow through bonds and accept deposits.

Monetary Policy

Monetary Policy is the macroeconomic policy being laid down by the Central Bank towards the management of money supply and interest rate. It is the demand side economic policy used by the government of a country to achieve macroeconomic objectives like inflation, consumption, growth and liquidity. The monetary policy gained its significance after the World War II, thanks to the initiation made by Milton Friedman, who is associated with the doctrine of "monetarism" and who received Nobel Prize in 1976. He boldly announced in his book "Monetary History of the UnitedStates, 1867 – 1960" that the Great Depression of the 1930's was largely the outcome of the bungling monetary policies of the Federal Reserve System.

Monetary Policy: Expansionary Vs. Contractionary

Expansionary policy is cheap money policy when a monetary authority uses its tools to stimulate the economy. An expansionary policy maintains short-term interest rates at a lower than usual rate or increases the total supply of money in the economy more rapidly than usual. It is traditionally used to try to combat

unemployment by lowering interest rates in the hope that less expensive credit will entice businesses into expanding. This increases aggregate demand (the overall demand for all goods and services in an economy), which boosts short-term growth as measured by gross domestic product (GDP) growth.

The Contractionary monetary policy is dear money policy, which maintains short-term interest rates higher than usual or which slows the rate of growth in the money supply or even shrinks it. This slows short-term economic growth and lessens inflation. Contractionary monetary policy can lead to increased unemployment and depressed borrowing and spending by consumers and businesses, which can eventually result in an economic recession if implemented too vigorously.

Objectives of Monetary Policy

The monetary policy in developed economies has to serve the function of stabilization and maintaining proper equilibrium in the economic system. But in case of underdeveloped countries, the monetary policy has to be more dynamic so as to meet the requirements of an expanding economy by creating suitable conditions for economic progress. It is now widely recognized that monetary policy can be a powerful tool of economic transformation.

The specific objectives of monetary policy are

1. Neutrality of Money
2. Stability of Exchange Rates
3. Price Stability
4. Full Employment
5. Economic Growth
6. Equilibrium in the Balance of Payments

1. Neutrality of Money

Economists like Wicksteed, Hayek and Robertson are the chief exponents of neutral money. They hold the view that monetary authority should aim at neutrality of money in the economy. Monetary changes could be the root cause of all economic fluctuations. According to neutralists, the monetary change causes distortion and disturbances in the proper operation of the economic system of the country.

2. Exchange Rate Stability

Exchange rate stability was the traditional objective of monetary authority. This was the main objective under Gold Standard among different countries. When there was disequilibrium in the balance of payments of the country, it was automatically corrected by movements. It was popularly known as "Expand Currency and Credit when gold is coming in; contract currency and credit when

gold is going out." This system will correct the disequilibrium in the balance of payments and exchange rate stability will be maintained.

It must be noted that if there is instability in the exchange rates, it would result in outflow or inflow of gold resulting in unfavorable balance of payments. Therefore, stable exchange rates are advocated.

3. Price Stability

Economists like Crustave Cassel and Keynes suggested price stabilization as a main objective of monetary policy. Price stability is considered the most genuine objective of monetary policy. Stable prices repose public confidence. It promotes business activity and ensures equitable distribution of income and wealth. As a consequence, there is general wave of prosperity and welfare in the community.

But it is admitted that price stability does not mean 'price rigidity' or price stagnation'. A mild increase in the price level provides a tonic for economic growth. It keeps all virtues of a stable price.

4. Full Employment

During world depression, the problem of unemployment had increased rapidly. It was regarded as socially dangerous, economically wasteful and morally deplorable. Thus, full employment was considered as the main goal of monetary policy. With the publication of Keynes' General Theory of Employment, Interest and Money in 1936, the objective of full employment gained full support as the chief objective of monetary policy.

5. Economic Growth

Economic growth is the process whereby the real per capita income of a country increases over a long period of time. It implies an increase in the total physical or real output, production of goods for the satisfaction of human wants.

Therefore, monetary policy should promote sustained and continuous economic growth by maintaining equilibrium between the total demand for money and total production capacity and further creating favourable conditions for saving and investment. For bringing equality between demand and supply, flexible monetary policy is the best course.

6. Equilibrium in the Balance of Payments

Equilibrium in the balance of payments is another objective of monetary policy which emerged significant in the post war years. This is simply due to the problem of international liquidity on account of the growth of world trade at a more faster speed than the world liquidity.

It was felt that increasing of deficit in the balance of payments reduces the ability of an economy to achieve other objectives. As a result, many less developed countries have to curtail their imports which adversely affects development activities. Therefore, monetary authority makes efforts to maintain equilibrium in the balance of payments.

Recent Advancements in Banking Sector

E- Banking

Online banking, also known as internet banking, is an electronic payment system that enables customers of a bank or other financial institution to conduct a range of financial transactions through the financial institution's website. The online banking system typically connects to or be part of the core banking system operated by a bank and is in contrast to branch banking which was the traditional way customers accessed banking services.

Today, "virtual banks" (or "direct banks") have only an internet presence, which enables them to lower costs than traditional brick-and-mortar banks.

RTGS and NEFT

Inter Bank Transfer enables electronic transfer of funds from the account of the remitter in one Bank to the account of the beneficiary maintained with any other Bank branch. There are two systems of Inter Bank Transfer - RTGS and NEFT. Both these systems are maintained by RBI. NEFT operates in half hourly batches. Currently there are twenty three settlements from 8 am to 7 pm on all working days including working Saturdays. Therefore, the beneficiary can expect to get the credit for the transactions put through between 8 am to 5.30 pm on all working days including working Saturdays on the same day.
For transactions settled in the 6.30 and 7 pm batches on all working days including working Saturdays, the credit will be afforded either on the same day or on the next working day.

NEFT	RTGS
National electronic Fund Transfer	Real Time Gross Settlement
Transactions happens in batches hence slow	Transactions Happens in real time hence fast
Timings : 8:00 am to 6:30 pm (12: 30 pm on Saturday)	Timings : 9:00 am to 4:30 pm (1:30 pm on Saturday)
No minimum limit	Minimum amount for RTGS transfer is ₹ 2 lakhs

ATM (Automated Teller Machine)

ATMs transformed the bank tech system when they were first introduced in 1967. The next revolution in ATMs is likely to involve contactless payments. Much like Apple Pay or Google Wallet, soon we will be able to conduct contactless ATM transactions using a smartphone.
Some ATM innovations are already available overseas. For example, biometric authentication is already used in India, and its recognition is in place at QatarNational Bank ATMs. These technologies can help overall bank security by protecting against ATM hacks.

Paytm

Payments Bank. In August 2015, Paytm received a license from RBI to launch a payments bank. The Paytm Payments Bank is a separate entity in which founder Vijay Shekhar Sharma will hold 51% share, One97 Communications holds 39% and 10% will be held by a subsidiary of One97 and Sharma.

Debit card and Credit Card

A Debit card is a card allowing the holder to transfer money electronically from their bank account when making a purchase.

A credit card is a payment card issued to users (cardholders) to enable the cardholder to pay a merchant for goods and services based on the cardholder's promise to the card issuer to pay them for the amounts so paid plus the other agreed charges. The card issuer (usually a bank) creates a revolving account and grants a line of credit to the cardholder, from which the cardholder can borrow money for payment to a merchant or as a cash advance. In other words, credit cards combine payment services with extensions of credit. Complex fee structures in the credit card industry may limit customers' ability to shopping.

Recent Issues

Once the borrower fails to make interest or principal payments for 90 days the loan is considered to be a non- performing asset (NPA). NPAs are problematic for financial institutions since they depend on interest payments for income. As on now the size of NPAs is estimated to be around 10 lakh crores. As a result, the banks do not have adequate capital. Hence the Government (of India) is forced to infuse capital to the banks by using poor tax – payers money. Already more than a sum of Rs. 2 lakh crores have been injected. During 2018 - 19, the GOI has infused Rs. 68,000 crores into the banking system. Thus the NPAs ultimately affect the common people.

Merger of Banks

Union Cabinet decided to merge all the remaining five associate banks of State Bank Group with State Bank of India in 2017. After the Parliament passed the merger Bill, the subsidiary banks have ceased to exist. Five associates and the BharatiyaMahila Bank have become the part of State Bank of India (SBI) beginning April 1, 2017. This has placed State Bank of India among the top 50 banks in the world. The five associate banks that were merged are State Bank of Bikaner and Jaipur (SBBJ), State Bank of Hyderabad (SBH), State Bank of Mysore (SBM), State Bank of Patiala (SBP) and State Bank of Travancore (SBT). The other two Associate Banks namely State Bank of Indore and State Bank of Saurashtra had already been merged with State Bank of India. After the merger, the total customer base of SBI increased to 37 crore with a branch network of around 24,000 and around 60,000 ATMs across the country.

Money Market

Money market is the mechanism through which sthort term funds are loaned and borrowed. It designates financial instittutions which handle the purchase, sale and transfer of short term credit instruments. Commercial banks, acceptance houses, Non Banking Financial Institutions and the Central Bank are the institutions catering to the requirements of short term funds in the money Market.

Capital Market

Capital Market is a part of financial system which is concerned with raising capital by dealing in shares, bonds and other long term investments. The market where investment instruments like bonds, equities and mortgages are traded is known as the capital market

Demonisation

Demonitisation is the act of stripping a currency unit of its status as legal tender. It occurs whenever there is a change of national currency. The current form or forms of money is pulled from circulation, often to bereplaced with new coins or notes. On 8 November 2016, the Indian Prime Minister Mr.NarendraModi announced the demonetization of all Rs. 500 and Rs. 1000 bank notes of the Mahatma Gandhi Series. However, more than 99% of those currencies came back to the RBI.

Objectives of Demonetisation

1. Removing Black Money from the country.
2. Stopping of Corruption.
3. Stopping Terror Funds.
4. Curbing Fake Notes

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9. Fiscal Economic

"Incomings may be scant; but yet, no failures there,If in expenditure you rightly learn to spare".
- Thirukkural No.478

Introduction

The term 'Fiscal Economics' is a new one; the old and popular term of the subject is 'Public Finance'. The subject Public Finance is related to the financing of the State activities and it discusses the financial operations of the Government treasury. The term fiscal is derived from Greek word which means basket and symbolizes the public purse. Hence the subject 'Public Finance' has been newly termed 'Fiscal Economics'.

Public Finance studies the manner in which the state raises and spends the resources. The state is concerned with the collective wants of the citizens.

The modern state is a welfare state. The activities of the state have increased extensively and intensively. To perform these activities, the state needs funds. This chapter deals with the Public Revenue, Public Expenditure, Public Debt, Budget, Federal Finance and Local Finance.

Meaning of Public Finance

Public finance is a study of the financial aspects of Government. It is concerned with the revenue and expenditure of the public authorities and with adjustment of the one to the other.

Definitions

"Public finance is one of those subjects that lie on the border line between Economics and Politics. It is concerned with income and expenditure of public authorities and with the adjustment of one to the other".
-Huge Dalton
"Public finance is an investigation into the nature and principles of the state revenue and expenditure".
-Adam Smith

Subject Matter / Scope of Public Finance

In Modern times, the subject 'Public Finance' includes five major sub-divisions, viz., Public Revenue, Public Expenditure, Public Debt, Financial Administration and Fiscal Policy.

1. Public Revenue

Public revenue deals with the methods of raising public revenue such as tax and non-tax, the principles of taxation, rates of taxation, impact, incidence and shifting of taxes and their effects.

2. Public Expenditure

This part studies the fundamental principles that govern the Government expenditure, effects of public expenditure and control of public expenditure.

3. Public Debt

Public debt deals with the methods of raising loans from internal and external sources.The burden, effects and redemption of public debt fall under this head.

4. Financial Administration

This part deals with the study of the different aspects of public budget. The budget is the Annual master financial plan of the Government. The various objectives and steps in preparing a public budget, passing or sanctioning, allocation evaluation and auditing fall within financial administration.

5. Fiscal Policy

Taxes, subsidies, public debt and public expenditure are the instruments of fiscal policy.

Public finance and Private finance

Public finance deals with study of income, expenditure, borrowing and financial administration of the government. Private finance is the study of income, expenditure, borrowing and financial administration of individual or private companies. Both public and private finance are fundamentally similar in nature but different from each other on various operational aspects. The similarities and dissimilarities between public and private finance have been explained below.

Similarities

1. Rationality

Both public finance and private finance are based on rationality. Maximization of welfare and least cost factor combination underlie both.

2. Limit to borrowing

Both have to apply restraint with regard to borrowing. The Government also cannot live beyond its means. There is a limit to deficit financing by the state also.

3. Resource utilisation

Both the private and public sectors have limited resources at their disposal. So both attempt to make optimum use of resources.

4. Administration

The effectiveness of measures of the Government as well as private depends on the administrative machinery. If the administrative machinery is inefficient and corrupt it will result in wastages and losses.

Dissimilarities

1. Income and Expenditure adjustment

The government adjusts the income to the expenditure while individuals adjust their expenditure to the income. Private finance involves stitching coat according to cloth available whereas public finance decides the cloth according to the need for the coat.

2. Borrowing

The government can borrow from internal and external sources; it can borrow from the people by issuing bonds. However, an individual cannot borrow from himself.

3. Right to print currency

The government can print currency. This involves the creation, distribution and monitoring of currency. The private sector cannot create currency.

4. Present vs. future decisions

The public finance is more involved with future planning and making long-term decisions. These investments could include building of schools, hospitals and infrastructure. The private finance makes financial decisions on projects with a short term vision.

5. Objective

The public sector's main objective is to provide social benefit in the economy. The private sector aims to maximize personal benefit i.e. Profit.

6. Coercion to get revenue

The sources of income of a private individual is relatively limited while those of the Government is wide. The Government can use its power and authority.

7. Ability to make huge and deliberate changes

The public finance has the ability to make big decisions on income. For example, it can effectively and deliberately adjust the revenue. But individuals cannot make such massive decisions.

Functions of Modern State

The modern state is a welfare state and not just police state. The state assumes greater roles by creating economic and social overheads, ensuring stability both internally and externally, conserving resources for sustainable development and so on.

(i) Defence

The primary function of the Government is to protect the people from external aggression and internal disorder. The government has to maintain adequate police and military forces and render protective services.

(ii) Judiciary

Rendering justice and settlement of disputes are the concern of the government. It should provide adequate judicial structure to render justice to all classes of citizens.

(iii) Enterprises

The regulation and control of private enterprise fall under the purview of the modern State. Ownership of certain enterprises and operating them successfully are the responsibilities of the government.

(iv) Social Welfare

It is the duty of the state to make provisions for education, social security, social insurance, health and sanitation for the betterment of the people in the country.

(v) Infrastructure

Modern States have to build the base for the economic development of the country by creating social and economic infrastructure.

(vi) Macro-economic policy

The Government has to administer fiscal policy and monetary policy to achieve macro-economic goals.

(vii) Social Justice

During the process of growth of an economy, certain sections of the society gain at the cost of others. The Government needs to intervene with fiscal measures to redistribute income.

(viii) Control of Monopoly

Concentration of economic power is another evil to be corrected by the Government. So, the state intervenes through control of monopolies and restrictive trade practices to curb concentration of economic power.
In fine, the state can play three kinds of roles.
i) As a producer of goods and services.
ii) As a supplier of public goods and social goods.
iii) As a regulator of the system.

Public Expenditure

Meaning

Public expenditure refers to Government spending incurred by Central, State and Local governments of a country.

Definition

Public expenditure can be defined as, "The expenditure incurred by public authorities like central, state and local governments to satisfy the collective social wants of the people is known as public expenditure".

Classification of public expenditure are as follows:

1. Classification on the Basis of Benefit:
Cohn and Plehn have classified the public expenditure on the basis of benefit into four classes:
a) Public expenditure benefiting the entire society, e.g., the expenditure on general administration, defence, education, public health, transport.
b) Public expenditure conferring a special benefit on certain people and at the same time common benefit on the entire community, e.g. administration of justice etc.
c) Public expenditure directly benefiting particular group of persons and indirectly the entire society, e.g. social security, public welfare, pension, unemployment relief etc.
d) Public expenditure conferring a special benefit on some individuals, e.g., subsidy granted to a particular industry.

2. Classification on the Basis of Function:

Adam Smith classified public expenditure on the basis of functions of government in the following main groups:

a) Protection Functions: This group includes public expenditure incurred on the security of the citizens, to protect from external invasion and internal disorder, e.g., defence, police, courts etc.

b) Commercial Functions: This group includes public expenditure incurred on the development of trade and commerce, e.g., development of means of transport and communication etc.

c) Development Functions: This group includes public expenditure incurred for the development infrastructure and industry.

Causes for the Increase in Government Expenditure

The modern state is a welfare state. In a welfare state, the government has to perform several functions viz Social, economic and political. These activities are the cause for increasing public expenditure.

1. Population Growth

During the past 67 years of planning, the population of India has increased from 36.1crore in 1951, to 121 crore in 2011. The growth in population requires massive investment in health and education, law and order, etc. Young population requires increasing expenditure on education & youth services, whereas the aging population requires transfer payments like old age pension, social security & health facilities.

2. Defence Expenditure

There has been enormous increase in defence expenditure in India during planning period. The defence expenditure has been increasing tremendously due to modernisation of defence equipment. The defence expenditure of the government was ₹ 10,874 crores in 1990-91 which increased significantly to ₹ 2,95,511crores in 2018-19.

3. Government Subsidies

The Government of India has been providing subsidies on a number of items such as food, fertilizers, interest on priority sector lending, exports, education, etc. Because of the massive amounts of subsidies, the public expenditure has increased manifold.

The expenditure on subsidies by central government in 1990-91 was ₹ 9581 crores which increased significantly to ₹ 2, 29,715.67 crores in 2018-19. Besides this, the corporate sectors also receive subsidies (incentives) of more than ₹ 5 lakh crores.

4. Debt Servicing

The government has been borrowing heavily both from the internal and external sources, As a result, the government has to make huge amounts of repayment towards debt servicing.

The interest payment of the central government has increased from ₹ 21,500 crores in 1990-91 to ₹5, 75,794crores in 2018-19.

5. Development Projects

The government has been undertaking various development projects such as irrigation, iron and steel, heavy machinery, power, telecommunications, etc. The development projects involve huge investment.

6. Urbanisation

There has been an increase in urbanization. In 1950-51 about 17% of the population was urban based. Now the urban population has increased to about 43%. There are more than 54 cities above one million population. The increase in urbanization requires heavy expenditure on law and order, education and civic amenities.

7. Industrialisation

Setting up of basic and heavy industries involves a huge capital and long gestation period. It is the government which starts such industries in a planned economy. The under developed countries need a strong of infrastructure like transport, communication, power, fuel, etc.

8. Increase in grants in aid to state and union territories

There has been tremendous increase in grant-in-aid to state and union territories to meet natural disasters.

Public Revenue

Public revenue occupies an important place in the study of public finance. The Government has to perform several functions for the welfare of the people. They involve substantial amount of public expenditure which can be financed only through public revenue. The amount of public revenue to be raised depends on the necessity of public expenditure and the people’s ability to pay.

Meaning

The income of the government through all sources is called public income or public revenue.

According to Dalton, the term "Public Income" has two senses — wide and narrow. In its wider sense it includes all the incomes or receipts which a public authority may secure during any period of time. In its narrow sense, it includes only those sources of income of the public authority which are ordinarily known as "revenue resources." To avoid ambiguity, the former is termed "public receipts" and the latter "public revenue."

In a narrow sense, it includes only those sources of income of the Government which are described as "revenue resources". In broad sense, it includes loans raised by the Government also.

Classification of Public Revenue.

Public revenue can be classified into two types.

Meaning

Tax is a compulsory payment by the citizens to the government to meet the public expenditure. It is legally imposed by the government on the tax payer and in no case taxpayer can refuse to pay taxes to the government.

Definitions

"A Tax is a compulsory payment made by a person or a firm to a government without reference to any benefit the payer may derive from the government."
-AnatolMurad

"A Tax is a compulsory contribution imposed by public authority, irrespective of the exact amount of service rendered to the tax payer in return and not imposed as a penalty for any legal offence."
- Dalton

Characteristics of Tax

1. A tax is a compulsory payment made to the government. People on whom a tax is imposed must pay the tax. Refusal to pay the tax is a punishable offence.
2. There is no quid pro quo between a taxpayer and public authorities. This means that the tax payer cannot claim any specific benefit against the payment of a tax.

3. Every tax involves some sacrifice on part of the tax payer.
4. A tax is not levied as a fine or penalty for breaking law.

Some of the tax revenue sources are

- Income tax
- Corporate tax
- Sales tax
- Surcharge and
- Cess

Non-Tax Revenue

The revenue obtained by the government from sources other than tax is called Non-Tax Revenue. The sources of non-tax revenue are

1. Fees

Fees are another important source of revenue for the government. A fee is charged by public authorities for rendering a service to the citizens. Unlike tax, there is no compulsion involved in case of fees. The government provides certain services and charges certain fees for them. For example, feesa re charged for issuing of passports, driving licenses, etc.

2. Fine

A fine is a penalty imposed on an individual for violation of law. For example, violation of traffic rules, payment of income tax after the stipulated time etc.

3. Earnings from Public Enterprises

The Government also gets revenue by way of surplus from public enterprises. Some of the public sector enterprises do make a good amount of profits. The profits or dividends which the government gets can be utilized for public expenditure.

4. Special assessment of betterment levy

It is a kind of special charge levied on certain members of the community who are beneficiaries of certain government activities or public projects. For example, due to a public park or due to the construction of a road, people in that locality may experience an appreciation in the value of their property or land.

5. Gifts, Grants and Aids

- A grant from one government to another is an important source of revenue in the modern days. The government at the Centre provides grants to State

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governments and the State governments provide grants to the local government to carry out their functions.

- u Grants from foreign countries are known as Foreign Aid. Developing countries receive military aid, food aid, technological aid, etc. from other countries.

6. Escheats

It refers to the claim of the state to the property of persons who die without legal heirs or documented will.

Canons of Taxation:

The characteristics or qualities which a good tax should possess are described as canons of taxation. It must be noted that canons refer to the qualities of an isolated tax and not to the tax system as a whole. A good tax system should have a proper combination of all kinds of taxes having different canons. According to Adam Smith, there are four canons or maxims of taxation. They are as follows:

1. Canon of Ability

The Government should impose tax in such a way that the people have to pay taxes according to their ability. In such case a rich person should pay more tax compared to a middle class person or a poor person.

2. Canon of Certainty

The Government must ensure that there is no uncertainty regarding the rate of tax or the time of payment. If the Government collects taxes arbitrarily, then these will adversely affect the efficiency of the people and their working ability too.

3. Canon of Convenience

The method of tax collection and the timing of the tax payment should suit the convenience of the people. The Government should make convenient arrangement for all the tax payers to pay the taxes without difficulty.

4. Canon of Economy

The Government has to spend money for collecting taxes, for example, salaries are given to the persons who are responsible for collecting taxes. The taxes, where collection costs are more are considered as bad taxes. Hence, according to Smith, the Government should impose only those taxes whose collection costs are very less and cheap

Direct Tax and Indirect Tax

Direct Tax

A direct tax is referred to as a tax levied on person's income and wealth and is paid directly to the government; the burden of such tax cannot be shifted. The tax is progressive in nature. It is levied according to the paying capacity of the person, i.e. the tax is collected more from the rich and less from the poor people.

The plans and policies of the Direct Taxes are being recommended by the Central Board of Direct Taxes (CBDT) which is under the Ministry of Finance, Government of India

Merits of Direct Taxes

1. Equity

Direct taxes are progressive i.e. rate of tax varies according to tax base. For example, income tax satisfies the canon of equity.

2. Certainity

Canon of certainty can be ensured by direct taxes. For example, an income tax payer knows when and at what rate he has to pay income tax.

3. Elasticity

Direct taxes also satisfy the canon of elasticity. Income tax is income elastic in nature. As income level increases, the tax revenue to the Government also increases automatically.

4. Economy

The cost of collection of direct taxes is relatively low. The tax payers pay the tax directly to the state.

Demerits of Direct Taxes

1. Unpopular
Direct taxes are generally unpopular. It is inconvenient and less flexible.

2. Productivity affected

According to many economists direct tax may adversely affect productivity. Citizens are not willing to earn more income because in that case they have to pay more taxes.

3. Inconvenient

The tax payers find it inconvenient to maintain accounts, submit returns and pay tax in lump sum.

4. Tax Evasion

The burden of direct tax is so heavy that tax-payers always try to evade taxes. This ultimately leads to the generation of black money, which is harmful to the economy.

Indirect Tax

Indirect Tax is referred to as a tax charged on a person who purchases the goods and services and it is paid indirectly to the government. The burden of tax can be easily shifted to the another person. It is levied on all persons equally whether rich or poor.

There are several types of Indirect Taxes, such as:

Excise Duty: Payable by the manufacturer who shifts the tax burden to retailers and wholesalers.

Sales Tax: Paid by a shopkeeper or retailer, who then shifts the tax burden to customers by charging sales tax on goods and services.

Custom Duty: Import duties levied on goods from outside the country, ultimately paid for by consumers and retailers.

Entertainment Tax: Liability is on the cinema theatre owners, who transfer the burden to cinema goers.

Service Tax: Charged on services like telephone bill, insurance premium such as food bill in a restaurant etc.

Merits of Indirect Taxes

(1) Wider Coverage

All the consumers, whether they are rich or poor, have to pay indirect taxes. For this reason, it is said that indirect taxes can cover more people than direct taxes. For example, in India everybody pays indirect tax as against just 2 percent paying income tax.

(2) Equitable

The indirect tax satisfies the canon of equity when higher tax is imposed on luxuries used by rich people.

(3) Economical

Cost of collection is less as producers and retailers collect tax and pay to the Government. The traders act as honorary tax collectors.

(4) Checks harmful consumption

The Government imposes indirect taxes on those commodities which are harmful to health e.g. tobacco, liquor etc. They are known as sin taxes.

(5) Convenient

Indirect taxes are levied on commodities and services. Whenever consumers make purchase, they pay tax along with the price. They do not feel the pinch of paying tax.

Demerits of Indirect Taxes

(1) Higher Cost of Collection

The cost of collection of indirect taxes is higher than the direct taxes. The Government has to spend huge money to collect indirect taxes.

(2) Inelastic

Indirect taxes are less elastic compared to direct taxes. As indirect taxes are generally proportional.

(3) Regressive

Indirect taxes are sometimes unjust and regressive in nature since both rich and poor persons have to pay same amount as taxes irrespective of their income level.

(4) Uncertainity

The rise in indirect taxes increase the price and reduces the demand for goods. Therefore, the Government is uncertain about the expected revenue collection. So Dalton says under indirect taxes 2+2 is not 4 but 3 or even less than 3.

(5) No civic Consciousness

As the tax is hidden in price, the consumers are not aware of paying tax.

Basis For Comparison	Direct Tax	Indirect Tax

Meaning	Direct tax is referred to as thetax, levied on person's incomeand wealth and is paid directlyto the government.	Indirect Tax is referred to as the tax, levied on a person whoconsumes the goods and servicesand is paid indirectly to thegovernment.
Nature	Progressive	Regressive
Incidence and Impact	Falls on the same person.	Falls on different persons.
Tax base	Income or wealth of the assesse	Purchase/sale/manufacture ofgoods and provision of services
Evasion	Tax evasion is possible.	Tax evasion is hardly possiblebecause it is included in the priceof the goods and services.
Inflation	Direct tax helps in controllingthe inflation.	Indirect taxes push up price inflation.
Imposition and collection	Imposed on and collectedfrom assesses, i.e. Individual,HUF (Hindu UndividedFamily), Company, Firm etc.	Imposed on and collected fromconsumers of goods and servicesbut paid and deposited by theassesse.
Burden	Cannot be shifted.	Can be shifted

GST (Goods and Service Tax)

- GST is an Indirect Tax which has replaced many Indirect Taxes in India. The Goods and Service Tax Act was passed in the Parliament on 29th March 2017. The Act came into effect on 1st July 2017; Goods & Services Tax in India is a comprehensive, multi-stage, destination-based tax that is levied on every value addition.

- In simple words, Goods and Service Tax (GST) is an indirect tax levied on the supply of goods and services. This law has replaced many indirect tax laws that previously existed in India.

- GST is one indirect tax for the entire country.

- Under the GST regime, the tax will be levied at the final point of sale. In case of intra-state sales, Central GST and State GST will be charged. Inter-state sales will be chargeable to Integrated GST.

Destination Based

Consider goods manufactured in Tamil Nadu and are sold to the final consumer in Karnataka. Since Goods & Service Tax is levied at the point of

consumption, in this case, Karnataka, the entire tax revenue will go to Karnataka and not Tamil Nadu.

Components of GST

The component of GST are of 3 types. They are: CGST, SGST & IGST.

CGST: Collected by the Central Government on an intra-state sale (Eg: Within state/ union territory)

SGST: Collected by the State Government on an intra-state sale (Eg: Within state/ union territory)

IGST: Collected by the Central Government for inter-state sale (Eg: Maharashtra to Tamil Nadu)

In most cases, the tax structure under the new regime will be as follows:

Transaction	New Regime	Old Regime	
Sale within the State	CGST + SGST	VAT + Central Excise/Service tax	Revenue will be shared equally between the entre and the State
Sale to another State	IGST	Central Sales Tax + Excise/Service Tax	There will only be one type of tax (central) in case of inter-state sales. The Center will then share the IGST revenue based on the destination of goods.

Nature of Sales tax, VAT and GST

1. Sales tax was multipoint tax with cascading effect.
2. VAT was multipoint tax without cascading effect.
3. GST is one point tax without cascading effect.

Advantages of GST

1. GST will mainly remove the cascading effect on the sale of goods and services. Removal of cascading effect will directly impact the cost of goods. Since tax on tax is eliminated in this regime, the cost of goods decreases.

2. GST is also mainly technologically driven. All activities like registration, return filing, application for refund and response to notice need to be done online on the GST Portal. This will speed up the processes.

Public Debt

In the 18th and 19th centuries, the role of the state was minimum. But since 20th century there has been enormous increase in the r e sponsibi l i t i e s of the state. Hence the state has to supplement the traditional revenue sources with borrowing from individuals, and institutions within and outside the country. The amount of borrowing is huge in the under developed countries to finance development activities. The debt burden is a big problem and most of the countries are in debt trap.

Definitions

"The debt is the form of promises by the Treasury to pay to the holders of these promises a principal sum and in most instances interest on the principal. Borrowing is resorted to in order to provide funds for financing a current deficit."

– Philip E.Taylor

"The receipt from the sale of financial instruments by the government to individuals or firms in the private sector, to induce the private sector to release manpower and real resources and to finance the purchase of these resources or to make welfare payments or subsidies".

– Carl S.Shoup

Types of Public Debt

i)Internal public debt

An internal public debt is a loan taken by the Government from the citizens or from different institutions within the country. An internal public debt only involves transfer of wealth.

The main sources of internal public debt are as follows:

- Individuals, who purchase government bonds and securities;
- Banks, both private and public, buy bonds from the Government.
- Non-financial institutions like UTI, LIC, GIC etc. also buy the Government bonds.
- Central Bank can lend the Government in the form of money supply. The Central Bank can also issue money to meet the expenditures of the Government.

ii) External public debt

When a loan is taken from abroad or from an international organisation it is called external public debt. The main sources of External public debt are IMF, World Bank, IDA and ADB etc. Loan from other countries and the Governments.

Causes for the Increase in Public debt

The causes for enormous growth of public debt may be studied under the following sub-headings:

1. War and Preparation of war

Waging war has become one of the important causes for incurring debts by the governments. In modern times, the preparation for war and nuclear defence programmes take away the major share of the government's revenue and so it incurs debt.

2. Social obligations

Modern states are considered to be 'Welfare States' and they have to undertake many social obligations like public health, sanitation, education, insurance, transport and communications, etc., besides providing the minimum necessaries of life to the citizens of the country. To finance these, the State has to incur a heavy public debt.

3. Economic Development and Deficit

The government has to undertake many projects for economic development of the country. Construction of railways, power projects, irrigation projects, heavy industries, etc., could be thought of only by means of mobilising resources in the form of public debt. Due to heavy public expenditure, the governments always face deficit budget. Such deficits have to be financed only through borrowings.

4.Employment

Most of the governments of modern days face the problem of unemployment and it has become the duty to solve this by making huge public expenditure. To solve the unemployment problem, and to fight recession, the government has to make huge expenditures. For this the States have to resort to public debt.

5.Controlling inflation

The Government can withdraw excess money from circulation, by raising public debt and thus prevent prices from rising.

6. Fighting depression

During the depression phase, private investment is lacking. The Government applies compensatory public spending by borrowing from internal and external sources.

Methods of Redemption of Public Debt

The process of repaying a public debt is called redemption. The Government sells securities to the public and at the time of maturity, the person who holds the security surrenders it to the Government. The following methods are adopted for debt redemption.

(1) Sinking Fund

Under this method, the Government establishes a separate fund known as "Sinking Fund". The Government credits every year a fixed amount of money to this fund. By the time the debt matures, the fund accumulates enough amount to pay off the principal along with interest. This method was first introduced in England by Walpol.

(2) Conversion

Conversion of loans is another method of redemption of public debt. It means that an old loan is converted into a new loan. Under this system a high interest public debt is converted into a low interest public debt. Dalton felt that debt conversion actually relaxes the debt burden.

(3) Budgetary Surplus
When the Government presents surplus budget, it can be utilised for repaying the debt. Surplus occurs when public revenue exceeds the public expenditure. However, this method is rarely possible.

(4) Terminal Annuity

In this method, Government pays off the public debt on the basis of terminal annuity in equal annual instalments. This is the easiest way of paying off the public debt.

(5) Repudiation

It is the easiest way for the Government to get rid of the burden of payment of a loan. In such cases, the Government does not recognise its obligation to repay the loan. It is certainly not paying off a loan but destroying it. However, in normal case the Government does not do so; if done it will lose its credibility.

(6) Reduction in Rate of Interest

Another method of debt redemption is the compulsory reduction in the rate of interest, during the time of financial crisis.

(7) Capital Levy

When the Government imposes levy on the capital assets owned by an individual or any institution, it is called capital levy. This levy is imposed on capital assets above a minimum limit on a progressive scale. The fund so collected can be used by the Government for paying off war time debt obligations. This is the most controversial method of debt repayment.

Budget

The word 'budget' is said to have its origin from the French word "Bougett" which refers to 'a small leather bag'.The budget is an annual financial statement which shows the estimated income and expenditure of the Government for the forthcoming financial year.

Definitions

"It is a document containing a preliminary approved plan of public revenue and expenditure".
-ReneyStourn.

"The budget has come to mean the financial arrangements of a given period, with the usual implication that they have been submitted to the legislature for approval".
- Bastabale

Union Budget and State Budget

India is a federal economy,hence public budget is divided into two layers of the Government. According to the Indian Constitution, the Central Government has to submit annual financial statement, i.e., Union Budget under Article 112 to the Parliament and each State Government has to submit the same for the State in the Legislative Assembly under Article 202.

Types of Budget

Revenue and Capital Budget

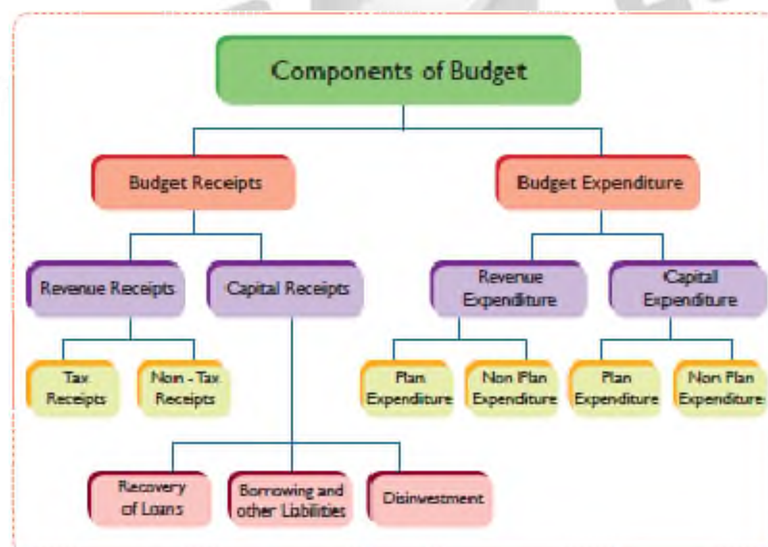
On the basis of expenditure on revenue account and other accounts, a budget can be presented in two ways:

i) Revenue Budget: It consists of revenue receipts and revenue expenditure. Moreover, the revenue receipts can be categorised into tax revenue and non-tax revenue. Revenue expenditure can also be categorised into plan revenue expenditure and non-plan revenue expenditure.

ii) Capital Budget: It consists of capital receipts and capital expenditure. In this case, the main sources of capital receipts are loans, advances etc. On the other side capital expenditure can be categorised into plan capital expenditure and non-plan capital expenditure.

iii) Supplementary Budget: During the time of war emergencies and natural calamities like tsunami, flood etc, the expenditures allotted in the budget provisions are not always enough. Under these circumstances, a supplementary budget can be presented by the Government to tackle these unforeseen events.

iv) Vote - on - Account: Under Article 116 of the Indian Constitution, the budget can be presented in the middle of the year. The reason may be political in nature. The existing Government may or may not continue for the year, on account of the fact that elections are due, then the Government places a 'lame duck budget'. This is also called 'Vote-on-account Budget'.



The vote on account budget is a special provision by which the Government gets permission from the parliament to incur expenditures on necessary items till the budget is finally passed in the parliament. The legal permission of both the Houses of the parliament for the withdrawal of money from the Consolidated Fund of India to meet the requisite expenses till the budget is finally approved is known as vote-on - account budget. This type of budget is generally sanctioned for not more than two months.

v) Zero Base Budget: The Government of India presented Zero-Base-Budgeting (ZBB first) in 1987-88. It involves fresh evaluation of expenditure in the Government

budget, assuming it as a new item. The review has been made to provide justification or otherwise for the project as a whole in the light of the socio-economic objectives which have been already set up for this project and as well as in view of the priorities of the society.

vi) Performance Budget: When the outcome of any activity is taken as the base of any budget, such budget is known as 'Performance Budget'. For the first time in the world, the performance budget was made in USA. The Administrative Reforms Commission was set up in 1949 in America under Sir Hooper. This commission recommended making of a 'Performance Budget' in USA. In the Performance Budget, it is the compulsion of the government to tell 'what is done', 'how much done' for the betterment of the people. In India, the Performance Budget is also known as 'Outcome Budget'.

vii) Balanced Budget Vs. Unbalanced Budget

A. Balanced Budget

Balanced budget is a situation, in which estimated revenue of the government during the year is equal to its anticipated expenditure.

Government's estimated Revenue = Government's Proposed Expenditure

B. Unbalanced Budget

The budget in which Revenue & Expenditure are not equal to each other is known as Unbalanced Budget.

Unbalanced budget is of two types:

1. Surplus Budget
2. Deficit Budget

1. Surplus Budget

The budget is a surplus budget when the estimated revenues of the year are greater than anticipated expenditures.

Government Estimated Revenue > Estimated Government Expenditure

2. Deficit Budget

Deficit budget is one where the estimated government expenditure is more than expected revenue.

Government's estimated Revenue < Government's proposed Expenditure

Budgetary Procedure

Budgetary procedure refers to the system through which the budget is prepared, enacted and executed.

(A) Preparation of the Budget

The Ministry of Finance prepares the Central Budget every year. At the state level the finance department is responsible for the Annual State Budget. While preparing the budget, the following factors are taken into account:

- The macro economic targets to be achieved within a plan period;
- The basic strategy of the budget;
- The financial requirements of different projects;
- Estimates of the revenue expenditures (includes defence expenditure, subsidy, interest payment on debt etc.);
- Estimates of the capital expenditures (includes development of railways, roadways, irrigations etc.);
- Estimates of revenue receipts from tax and non-tax revenues;
- Estimates of capital receipts from the recovery of loans, disinvestment of public sector units, market borrowings etc.
- Estimates of the gap between revenue receipts and revenue expenditure; and
- Estimates of fiscal deficit, primary deficit, and revenue deficit.

(B) Presentation of the Budget

The hon'ble Minister of Finance, on behalf of the Central Government, places the Union Budget before Parliament on the eve of a new financial year. Similarly at state levels, the Hon'ble Finance Minister of the respective State Government places the State Budget before the State Legislature.

According to the Indian Constitution, all money bills must be initiated in the Lower House. All the money bills are first placed before the LokSabha at the Centre, and before the VidhanSabha at the State level. The demands of various tax proposals are included in the budget. After the finance bill is passed, an appropriation bill is presented to give legal effect to the voted demands, and to authorise the expenditure as per the budget. In this way, the budgets are enacted in India.

(c) Execution of the Budget

The budget is mainly executed by different departments of the Government. Proper execution of the budgetary provisions is important for the efficient utilisation of the allocated funds.

Parliamentary Control over the Budget

In India,the Government Accounts are maintained in three parts:

(i) Consolidated Fund
(ii) Contingency Fund
(iii) Public Accounts

There are also two committees of parliament, viz,

(i) The Public Accounts Committee, and
(ii)The Estimates Committee.

These committees keep a constant vigil on the expenditure so that no Ministry or Department exceeds the amount sanctioned to it.

Budgetary Deficits

Budget deficit is a situation where budget receipts are less than budget expenditures. This situation is also known as government deficit.

In reference to the Indian Government budget, budget deficit is of four major types.

(a) Revenue Deficit
(b) Budget Deficit
(c) Fiscal Deficit, and
(d) Primary Deficit

(A) Revenue Deficit

It refers to the excess of the government revenue expenditure over revenue receipts. It does not consider capital receipts and capital expenditure. Revenue deficit implies that the government is living beyond its means to conduct day-to-day operations.

Revenue Deficit (RD) = Total Revenue Expenditure (RE) - Total Revenue Receipts (RR),

When RE - RR > 0

(B) Budget Deficit

Budget deficit is the difference between total receipts and total expenditure (both revenue and capital)

Budget Deficit = Total Expenditure – Total Revenue

(C) Fiscal Deficit

Fiscal deficit (FD) = Budget deficit + Government's market borrowings and liabilities

(D) Primary Deficit

Primary deficit is equal to fiscal deficit minus interest payments. It shows the real burden of the government and it does not include the interest burden on loans taken in the past. Thus, primary deficit reflects borrowing requirement of the government exclusive of interest payments.

Primary Deficit (PD) = Fiscal deficit (PD) - Interest Payment (IP)

Federal Finance

Federal finance refers to the system of assigning the source of revenue to the Central as well as State Governments for the efficient discharge of their respective functions i.e. clear-cut division is made regarding the allocation of resources of revenue between the central and state authorities.

- Division of Powers: In our Constitution, there is a clear division of powers so that none violates its limits and tries to encroach upon the functions of the other and functions within own sphere of responsibilities. There are three lists enumerated in the Seventh Schedule of constitution. They are: the Union list, the State list and the Concurrent List.
- The Union List consists of 100 subjects of national importance such as Defence, Railways, Post and Telegraph, etc.
- The State List consists of 61 subjects of local interest such as Public Health, Police etc.
- The Concurrent List has 52 subjects important to both the Union and the State, such as Electricity, Trade Union, Economic and Social Planning, etc.

Central State Financial Relationship

(I) Union Sources

1. Corporation tax

2. Currency, coinage and legal tender, foreign exchange.
3. Duties of customs including export duties.
4. Duties of excise on tobacco and certain goods manufactured or produced in India.
5. Estate duty in respect of property other than agricultural land.
6. Fees in respect of any of the matters in the Union List, but not including any fees taken in any Court.
7. Foreign Loans.
8. Lotteries organized by the Government of India or the Government of a State.
9. Post Office Savings Bank.
10. Posts and Telegraphs, telephones, wireless, Broadcasting and other forms of communication.
11. Property of the Union.
12. Public Debt of the Union.
13. Railways.
14. Rates of stamp duty in respect of Bills of Exchange, Cheques, Promissory Notes, etc.
15. Reserve Bank of India.
16. Taxes on income other than agricultural income.
17. Taxes on the capital value of the assets, exclusive of agricultural land of individuals and companies.
18. Taxes other than stamp duties on transactions in stock exchanges and future markets.
19. Taxes on the sale or purchase of newspapers and on advertisements published therein.
20. Terminal taxes on goods or passengers, carried by railways, sea or air.

(II) State Sources

1. Capitation tax
2. Duties in respect of succession to agricultural land.
3. Duties of excise on certain goods produced or manufactured in the State, such as alcoholic liquids, opium, etc.
4. Estate duty in respect of agricultural land.
5. Fees in respect of any of the matters in the State List, but not including fees taken in any Court.
6. Land Revenue.
7. Rates of stamp duty in respect of documents other than those specified in the Union List.
8. Taxes on agricultural income.
9. Taxes on land and buildings.
10. Taxes on mineral rights, subject to limitations impose by Parliament relating to mineral development.
11. Taxes on the consumption or sale of electricity.

12. Taxes on the entry of goods into a local area for consumption, use or sale therein.
13. Taxes on the sale and purchase of goods other than newspapers.
14. Taxes on the advertisements other than those published in newspapers.
15. Taxes on goods and passengers carried by road or on inland waterways.
16. Taxes on vehicles.
17. Taxes on animals and boats.
18. Taxes on professions, trades, callings and employments.
19. Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling.
20. Tolls.

(III) Taxes Levied and Collected by the union but Assigned to the States (Art.269)

1. Duties in respect of succession to property other than agricultural land.
2. Estate duty in respect of property other than agricultural land.
3. Taxes on railway fares and freights.
4. Taxes other than stamp duties on transactions in stock exchanges and future markets.
5. Taxes on the sale or purchase of newspapers and on advertisements published therein
6. Terminal taxes on goods or passengers carried by railways, sea or air.
7. Taxes on the sale or purchase of goods other than newspapers where such sale or purchase taxes place in the course of inter-State trade or commerce.

(IV) Duties levied by the Union but collected and Appropriated by the states (Art.268)

Stamp duties and duties of excise on medicinal and toilet preparation (those mentioned in the Union List) shall be levied by the Government of India but shall be collected.

(i) In the case where such duties are liveable within any Union territory, by the Government of India.

(ii) In other cases, by the States within which such duties are respectively liveable.

(v) Taxes which are Levied and Collected by the Union but which may be Distributed between the Union and the States (Arts.270 and 272)

1. Taxes on income other than agricultural income.
2. Union duties of excise other than such duties of excise on medicinal and toilet preparations as are mentioned in the Union List and collected by the Government of India.

"Taxes on income" does not include corporation tax. The distribution of income-tax proceeds between the Union and the States is made on the recommendations of the Finance Commission.

Principles of Federal Finance

In the case of federal system of finance, the following main principles must be applied:

1. Principle of Independence.
2. Principle of Equity.
3. Principle of Uniformity.
4. Principle of Adequacy.
5. Principle of Fiscal Access.
6. Principle of Integration and coordination.
7. Principle of Efficiency.
8. Principle of Administrative Economy.
9. Principle of Accountability.

1. Principle of Independence

Under the system of federal finance, a Government should be autonomous and free about the internal financial matters concerned. It means each Government should have separate sources of revenue, authority to levy taxes, to borrow money and to meet the expenditure. The Government should normally enjoy autonomy in fiscal matters.

2. Principle of Equity

From the point of view of equity, the resources should be distributed among the different states so that each state receives a fair share of revenue.

3. Principle of Uniformity

In a federal system, each state should contribute equal tax payments for federal finance. But this principle cannot be followed in practice because the taxable capacity of each unit is not of the same.

4. Principle of Adequacy of Resources

The principle of adequacy means that the resources of each Government i.e. Central and State should be adequate to carry out its functions effectively. Here adequacy must be decided with reference to both current as well as future needs. Besides, the resources should be elastic in order to meet the growing needs and unforeseen expenditure like war, floods etc.

5. Principle of Fiscal Access

In a federal system, there should be possibility for the Central and State Governments to develop new source of revenue within their prescribed fields to meet the growing financial needs. In nutshell, the resources should grow with the increase in the responsibilities of the Government.

6. Principle of Integration and coordination

The financial system as a whole should be well integrated. There should be perfect coordination among different layers of the financial system of the country. Then only the federal system will survive. This should be done in such a way to promote the overall economic development of the country.

7. Principle of Efficiency

The financial system should be well organized and efficiently administered. There should be no scope for evasion and fraud. No one should be taxed more than once in a year. Double taxation should be avoided.

8. Principle of Administrative Economy

Economy is the important criterion of any federal financial system. That is, the cost of collection should be at the minimum level and the major portion of revenue should be made available for the other expenditure outlays of the Governments.

9. Principle of Accountability

Each Government should be accountable to its own legislature for its financial decisions i.e the Central to the Parliament and the State to the Assembly.

History of Finance Commission

- Finance commission is a quasi-judicial body set up under Article 280 of the Indian Constitution. It was established in the year 1951, to define the fiscal relationship framework between the Centre and the state.
- Finance Commission aims to reduce the fiscal imbalances between the centre and the states (Vertical imbalance) and also between the states (horizontal imbalance). It promotes inclusiveness.
- A Finance Commission is set up once in every 5 years. It is normally constituted two years before the period. It is a temporary Body.
- The 14th Finance Commission was set up in 2013. Its recommendations were valid for the period from 1st April 2015 to 31st March 2020.

- The 15th Finance Commission has been set up in November 2017. Its recommendations will be implemented starting 1 April 2020.

Finance Commission	Year of establishment	Chairman	Operational duration
First	1951	K. C. Neogy	1952-57
Second	1956	K. Santhanam	1957–62
Third	1960	A. K. Chanda	1962–66
Fourth	1964	P. V. Rajamannar	1966–69
Fifth	1968	MahaveerTyagi	1969–74
Sixth	1972	K. Brahmananda Reddy	1974–79
Seventh	1977	J. M. Shelat	1979–84
Eighth	1983	Y. B. Chavan	1984-89
Ninth	1987	N. K. P. Salve	1989-95
Tenth	1992	K. C. Pant	1995-2000
Eleventh	1998	A. M. Khusro	2000-05
Twelfth	2002	C. Rangarajan	2005-10
Thirteenth	2007	Dr. Vijay L. Kelkar	2010-15
Fourteenth	2013	Dr. Y. V Reddy	2015-20
Fifteenth	2017	N. K. Singh	2020-25

Functions of Finance Commission of India

Article 280 (3) speaks about the functions of the Finance Commission. The Article states that it shall be the duty of the Commission to make the recommendations to the President as to:

The distribution between the Union and the States of the net proceeds of taxes, which may be divided between them and the allocation among the states of the respective shares of such proceeds;

To determine the quantum of grants-in-aid to be given by the Centre to states [Article 275 (1)] and to evolve the principles governing the eligibility of the state for such grant-in-aid;

Article 280 of the Constitution mandates the finance commission to recommend the distribution of the net proceeds of taxes between the Centre and the states every five years.

15th Finance Commission’s recommendations on tax sharing between Centre and States are to kick in form April 2020

Any other matter referred to the Commission by the President of India in the interest of sound finance. Several issues like debt relief, financing of calamity relief of states, additional excise duties, etc. have been referred to the Commission invoking this clause.

APPOLO STUDY CENTRE CHENNAI

Local Finance

Local finance refers to the finance of local bodies in India. There is a large variety of local bodies in India. We have the following main four local bodies which are functioning today in our country:

Types of Local Bodies

1. Village Panchayats
2. District Boards or ZilaParishads
3. Municipalities
4. Municipal Corporations

Village Panchayats:

- **Establishment:** The jurisdiction of a panchayat is usually confined to one revenue village. In some cases, though not very frequently, two or more small villages are grouped under one panchayat. The establishment of panchayat raj is the avowed policy of most states in India.

- **Functions**

  a. The functions of panchayats range over a wide area including civil, economic and so on. Thus small disputes may be disposed of by panchayats on the spot.

  b. Roads, primary schools, village dispensaries etc. are to be managed by panchayats.

  c. The supply of water, both for drinking and irrigation, falls within their field of responsibility, and in some cases farming, marketing, storage, etc. are entrusted to them.

Sources of revenue of Village Panchayats

The following are the sources of revenue of village panchayats.
(i) general property tax,
(ii) taxes on land,
(iii) profession tax, and
(iv) tax on animals and vehicles.

Other taxes include service tax, octroi, theatre tax, pilgrim tax, tax on marriage, tax on birth and deaths, and labour tax. As a matter of fact, taxes are levied by the panchayats only with the sanction of the state government, and there are certain limits in respect of tax rates which have to be observed.

2. District Boards OrZilaParishads:

- **Establishment**: In rural areas, district boards or ZilaParishads are established at district level. The territorial jurisdiction of a district board is generally a revenue district.

- **Functions**
  In Tamil Nadu, the ZilaParishad is a co-ordinating body which exercises general supervision over the working of PanchayatSamitis and advises them on implementation of Development Schemes.

Sources of revenue of District Boards

i. Grants-in-aid from the state government.
ii. Land Cesses.
iii. Toll, fees etc.
iv. Income from the property and loans from the state governments.
v. Grants for the centrally sponsored schemes relating to development work.
vi. Income from fairs and exhibitions.
vii. Property tax and other taxes which the state governments may authorise the district boards.

3. Municipalities

Establishment and Functions: The municipalities are bodies or institutions which are established in urban areas for looking after local affairs, such as, sanitation, public health, local roads, lighting, water supply, cleaning of streets, maintenance of parks and gardens, maintenance of hospitals, dispensaries and veterinary hospitals, provision of drainage, provision of primary education, organising of fairs and exhibitions etc. However, all these functions are performed subject to the control of the state government.

Sources of revenue of municipalities

(i) taxes on property
(ii) taxes on goods, particularly octroi and terminal tax
(iii) personal taxes, taxes on profession, trades and employment
(iv) taxes on vehicles and animals
(v) theatre or show tax, and
(vi) grants-in-aid from state government.

4. Municipal Corporations

Establishment and Functions:

The municipal corporations have wide powers and enjoy greater freedom as compared to municipalities. The municipal corporations are usually entrusted with the functions, such as, water supply and drainage, lighting, roads, slum clearance,

housing and town planning etc. The rapid increase in the population of cities has definitely added to the functions of municipal corporations.

Sources of revenue of Corporations

(i) tax on property,
(ii) tax on vehicles and animals,
(iii) tax on trades, calling and employment,
(iv) theatre and show tax,
(v) taxes on goods brought into the cities for sale,
(vi) taxes on advertisements,
(vii) octroi and terminal tax etc.

The corporations have a fair degree of freedom in respect of their choice and modification of these taxes, subject to the maximum and minimum rates laid down by the law.

Unit 9 – Fiscal Economics

Fiscal policy

As an instrument of macro-economic policy, fiscal policy has been very popular among modern governments. The growing importance of fiscal policy was due to the Great Depression and the development of 'New Economics' by Keynes.

Meaning of Fiscal Policy

In common parlance fiscal policy means the budgetary manipulations affecting the macro economic variables – output, employment, saving, investment etc.

Definitions

"The term fiscal policy refers to a policy under which the Government uses its expenditure and revenue programmes to produce desirable effects and avoid undesirable effects on the national income, production and employment"

– Arthur Smithies

"By fiscal policy is meant the use of public finance or expenditure, taxes, borrowing and financial administration to further our national economic objectives"

– Buehler

Fiscal Instruments

Fiscal Policy is implemented through fiscal instruments also called 'fiscal tools' or fiscal levers: Government expenditure, taxation and borrowing are the fiscal tools.

i) **Taxation**: Taxes transfer income from the people to the Government. Taxes are either direct or indirect. An increase in tax reduces disposable income. So taxation should be raised to control inflation. During depression, taxes are to be reduced.

ii) **Public Expenditure**: Public expenditure raises wages and salaries of the employees and thereby the aggregate demand for goods and services. Hence public expenditure is raised to fight recession and reduced to control inflation.

iii) Public debt: When Government borrows by floating a loan, there is transfer of funds from the public to the Government. At the time of interest payment and repayment of public debt, funds are transferred from Government to public.

Objectives of Fiscal Policy:

1. Full Employment
2. Price Stability
3. Economic Growth
4. Equitable Distribution
5. External Stability
6. Capital Formation
7. Regional Balance

The Fiscal Policy is useful to achieve the following objectives:

1. Full Employment

Full Employment is the common objective of fiscal policy in both developed and developing countries. Public expenditure on social overheads help to create employment opportunities. In India, public expenditure on rural employment programmes like MGNREGS is aimed at employment generation.

2. Price Stability

Price instability is caused by mismatch between aggregate demand and aggregate supply. Inflation is due to excess demand for goods. If excess demand is caused by Government expenditure in excess of real output, the most effective measure is to cut down public expenditure. Taxation of income is the best measure if excess demand is due to private spending. Taxation reduces disposable income and so aggregate demand.

To fight depression, the Government needs to increase its spending and reduce taxation.

3. Economic Growth

Fiscal Policy is used to increase the productive capacity of the economy. Tax is to be used as an instrument for encouraging investment. Tax holidays and tax rebates for new industries stimulate investment. Public sector investments are to be increased to fill the gap left by private investment. When resource mobilization through tax measures is inadequate, the Government resorts to borrowing both from internal and external sources to finance growth projects.

4. Equitable distribution

Progressive rates in taxation help to reduce the gap between rich and poor. Similarly progressive rates in public expenditure through welfare schemes such as free education, noon meal for school children and subsidies promote the living standard of poor people.

5. Exchange Stability

Fluctuations in international trade cause movements in exchange rate. Tax concessions and subsidy to export oriented units help to boost exports. Customs duties on import of non-essential items help to cut import bill. The reduction in import duty on import of raw material and machinery enables reduction in cost and make the exports competitive.

6. Capital formation

Capital formation is essential for rapid economic development. Tax relief helps to increase disposable income, savings and thereby capital formation. Government expenditure on infrastructure development like power and transport encourages private investment.

7. Regional balance

Fiscal incentives for industries in the backward regions help to narrow down regional imbalances. Public expenditure may be used to start industrial estates so that industrial activity is stimulated in backward regions.

APPOLO STUDY CENTRE