Economics - TEST – 5
PART – III

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12th Economy

Unit – 1Introduction To Macro Economics

"Macroeconomics is very much about tying together facts and theories".
- Dorn Busch, Fischer and Startz

Introduction

- The subject Economics is classified into two branches, namely, Micro Economics and Macro Economics. Ragnar Frisch, a Norwegian economist and the co-recipient of the first Nobel Prize in Economic Sciences coined the words 'micro' meaning small and 'macro' meaning large in the year 1933. However, macroeconomics in its modern form, began with John Maynard Keynes and his book "The General Theory of Employment, Interest and Money" published in 1936. Keynes offered an explanation for fallout from the Great Depression, when goods remained unsold and workers unemployed. Hence, Keynes is regarded as the 'Father of Modern Macro Economics'.

Meaning of macro Economics

- The word 'Macro' is derived from the Greek word 'Makros' meaning 'large'. Hence, Macro Economics is the study of the economy as a whole. In other words, macro economics deals with aggregates such as national income, employment and output. Macro Economics is also known as 'Income Theory'.

- The subject matters covered in Macro Economics are the areas such as employment, national income, inflation, business cycle, poverty, inequality, disparity, investment and saving, capital formation, infrastructure development, international trade, balance of trade and balance of payments, exchange rate and economic growth.

Importance of Macro Economics

- The importance and the need for introducing a macro outlook of an economy are given below:

- There is a need to understand the functioning of the economy at the aggregate level to evolve suitable strategies and to solve the basic problems prevailing in an economy.

- Understanding the future problems, needs and challenges of an economy as a whole is important to evolve precautionary measures.

- Macro economics provides ample opportunities to use scientific investigation to understand the reality.

- Macro economics helps to make meaningful comparison and analysis of economic indicators

- Macro economics helps for better prediction about future and to formulate suitable policies to avoid economic crises.

Scope of Macro Economics

- The study of macro economics has wide scope and it covers the major areas as follows.

- **National Income:** Measurement of national income and its composition by sectors are the basic aspects of macroeconomic analysis. The trends in National Income and its composition provide a long term understanding of the growth process of an economy.

- **Inflation:** Inflation refers to steady increase in general price level. Estimating the general price level by constructing various price index numbers such as Wholesale Price Index, Consumer Price Index, etc, are needed.

- **Business Cycle:** Almost all economies face the problem of business fluctuations and business cycle. The cyclical movements (boom, recession, depression and recovery) in the economy need to be carefully studied based on aggregate economic variables.

- **Poverty and Unemployment:** The major problems of most resource - rich nations are poverty and unemployment. This is one of the economic paradoxes. A clear understanding about the magnitude of poverty and unemployment facilitates allocation of resources and initiating corrective measures.

- **Economic Growth:** The growth and development of an economy and the factors determining them could be understood only through macro analysis.

- **Economic Policies:** Macro Economics is significant for evolving suitable economic policies. Economic policies are necessary to solve the basic problems, to overcome the obstacles and to achieve growth.

Limitations

Macro economics suffers from certain limitations. They are:

1. There is a danger of excessive generalisation of the economy as a whole.
2. It assumes homogeneity among the individual units.
3. There is a fallacy of composition. What is good of an individual need not be good for nation and viceversa. And, what is good for a country is not good for another country and at another time.

4. Many non - economic factors determine economic activities; but they do not find place in the usual macroeconomic books.

Economy and its Types

- The term economy has been defined by A. J. Brown as, "A system by which people earn their living." J. R. Hicks defined as, "An economy is a cooperation of producers and workers to make goods and services that satisfy the wants of the consumers."

- In short, an economy is referred to any system or area where economic activities are carried out. Each economy has its own character. Accordingly, the functions or activities also vary. The functioning of an economy by its activities is explained in flow chart 1.

- In an economy, the fundamental economic activities are production and consumption. These two activities are supported by several other activities. The ultimate aim of these activities is to achieve growth. The 'exchange activity' supports the production and consumption activities. These activities are influenced by several economic and non-economic activities. The major economic activities include transportation, banking, advertising, planning, government policy and others. The major non-economic activities are environment, health, education, entertainment, governance, regulations etc. In addition to these supporting activities, external activities from other economies such as import, export, international relations, emigration, immigration, foreign investment, foreign exchange earnings, etc. also influence the entire functioning of the economy.

Economies can be classified into different types based on the

1. **Status of Development:** Developed, underdeveloped, undeveloped and developing economies.
2. **System of Activities:** Capitalistic, Socialistic and Mixed Economies.
3. **Scale of Activities:** Small and Large Economies.
4. **Nature of Functioning:** Static and Dynamic Economies.
5. **Nature of Operation:** Closed and Open Economies.
6. **Nature of Advancement:** Traditional and Modern Economies.
7. **Level of National Income:** Low Income, Middle Income and High Income Economies.

Economic Systems

- Economic System refers to the manner in which individuals and institutions are connected together to carry out economic activities in a particular area. It is the methodology of doing economic activities to meet the needs of the society. There are three major types of economic systems. They are:

1. Capitalistic Economy (Capitalism),
2. Socialistic Economy (Socialism)and

3. Mixed Economy (Mixedism)

Globalism

The term coined by Manfred D Steger (2002) to denote the new market ideology of globalisation that connects nations together through international trade and aiming at global development. This ideology is also termed as 'Extended Capitalism'.

- Capitalism and socialism are two extreme and opposite approaches. In capitalism, there is total freedom and private ownership of means of production. In socialism, there is no freedom for private and there is public ownership of means of production. Mixedism denotes the Co-existence of capitalism and socialism. The features, merits and demerits of various economic systems are discussed below.

Capitalistic Economy (Capitalism)

- Adam Smith is the 'Father of Capitalism'. Capitalistic economy is also termed as a free economy (Laissez faire, in Latin) or market economy where the role of the government is minimum and market determines the economic activities.

- The means of production in a capitalistic economy are privately owned. Manufacturers produce goods and services with profit motive. The private individual has the freedom to undertake any occupation and develop any skill. The USA, West Germany, Australia and Japan are the best examples for capitalistic economies. However, they do undertake large social welfare measures to safeguard the downtrodden people from the market forces.

Features of Capitalistic Economy

1. **Private Ownership of Property and Law of Inheritance:** The basic feature of capitalism is that all resources namely, land, capital, machines, mines etc. are owned by private individuals. The owner has the right to own, keep, sell or use these resources according to his will. The property can be transferred to heirs after death.

2. **Freedom of Choice and Enterprise**: Each individual is free to carry out any occupation or trade at any place and produce any commodity. Similarly, consumers are free to buy any commodity as per their choice

3. **Profit Motive:** Profit is the driving force behind all economic activities in a capitalistic economy. Each individual and organization produce only those goods which ensure high profit. Advance technology, division of labour, and specialisation are followed. The golden rule for a producer under capitalism is 'to maximize profit.'

4. **Free Competition:** There is free competition in both product and factor market. The government or any authority cannot prevent firms from buying or selling in the market. There is competition between buyers and sellers.

5. **Price Mechanism:** Price mechanism is the heart of any capitalistic economy. All economic activities are regulated through price mechanism i.e, market forces of demand and supply.

6. **Role of Government:** As the price mechanism regulates economic activity, the government has a limited role in a capitalistic economy. The government provides basic services such as, defense, public health, education, etc.

7. **Inequalities of Income:** A capitalist society is divided into two classes – 'haves' that is those who own property and 'have-nots' who do not own property and work for their living. The outcome of this situation is that the rich become richer and poor become poorer. Here, economic inequality goes on increasing.

Merits of Capitalism

1. Automatic Working: Without any government intervention, the economy works automatically.

2. Efficient Use of Resources: All resources are put into optimum use.

3. Incentives for Hard work: Hard work is encouraged and entrepreneurs get more profit for more efficiency.

4. Economic Progress: Production and productivity levels are very high in capitalistic economies.

5. Consumers Sovereignty: All production activities are aimed at satisfying the consumers.

6. Higher Rates of Capital Formation: Increase in saving and investment leads to higher rates of capital formation.

7. Development of New Technology: As profit is aimed at, producers invest on new technology and produce quality goods.

Demerits of Capitalism

1. **Concentration of Wealth and Income:** Capitalism causes concentration of wealth and income in a few hands and thereby increases inequalities of income.

2. **Wastage of Resources:** Large amount of resources are wasted on competitive advertising and duplication of products.

3. **Class Struggle:** Capitalism leads to class struggle as it divides the society into capitalists and workers.

4. **Business Cycle:** Free market system leads to frequent violent economic fluctuations and crises.

5. **Production of non essential goods:** Even the harmful goods are produced if there is possibility to make profit.

Socialistic Economy (Socialism)

- The **Father of Socialism** is Karl Marx. Socialism refers to a system of total planning, public ownership and state control on economic activities. Socialism is defined as a way of organizing a society in which major industries are owned and controlled by the government, A Socialistic economy is also knownas 'Planned Economy' or 'Command Economy'.

- In a socialistic economy, all the resources are owned and operated by the government. Public welfare is the main motive behind all economic activities. It aims at equality in the distribution of income and wealth and equal opportunity for all. Russia, China, Vietnam, Poland and Cuba are the examples of socialist economies. But, now there are no absolutely socialist economies.

Features of Socialism:

1. **Public Ownership of Means of Production:** All resources are owned by the government. It means that all the factors of production are nationalized and managed by the public authority.

2. **Central Planning:** Planning is an integral part of a socialistic economy. In this system, all decisions are undertaken by the central planning authority.

3. **Maximum Social Benefit:** Social welfare is the guiding principle behind all economic activities. Investments are planned in such a way that the benefits are distributed to the society at large.

4. **Non-existence of Competition:** Under the socialist economic system there is absence of competition in the market. The state has full control over production and distribution of goods and services. The consumers will have a limited choice.

5. **Absence of Price Mechanism:** The pricing system works under the control and regulation of the central planning authority.

6. **Equality of Income:** Another essential feature of socialism is the removal and reduction of economic inequalities. Under socialism private property and the law of inheritance do not exist.

7. **Equality of Opportunity:** Socialism provides equal opportunity for all through free health, education and professional training.

8. **Classless Society:** Under socialism, there is a classless society and so no class conflicts. In a true socialist society, everyone is equal as far as economic status is concerned.

Merits of Socialism

1. **Reduction in Inequalities:** No one is allowed to own and use private property to exploit others.

2. **Rational Allocation of Resources:** The central planning authority allocates the resources in a planned manner. Wastages are minimised and investments are made in a pre planned manner.

3. **Absence of Class Conflicts:** As inequalities are minimum, there is no conflict between rich and poor class. Society functions in a harmonious manner.

4. **End of Trade Cycles:** Planning authority takes control over production and distribution of goods and services. Therefore, economic fluctuations can be avoided.

5. **Promotes Social Welfare:** Absence of exploitation, reduction in economic inequalities, avoidance of trade cycles and increase in productive efficiency help to promote social welfare.

Demerits of Socialism

1. **Red Tapism and Bureaucracy:** As decision are taken by government agencies, approval of many officials and movement of files from one table to other takes time and leads to red tapism.

2. **Absence of Incentive:** The major limitation of socialism is that this system does not provide any incentive for efficiency. Therefore, productivity also suffers.

3. **Limited Freedom of Choice:** Consumers do not enjoy freedom of choice over the consumption of goods and services.

4. **Concentration of Power:** The State takes all major decisions. The private takes no initiative in making economic decisions. Hence, the State is more powerful and misuse of power can also take place.

Mixed Economy (Mixedism):

- In a mixed economy system both private and public sectors co-exist and work together towards economic development. It is a combination of both capitalism and socialism. It tends to eliminate the evils of both capitalism and socialism. In these economies, resources are owned by individuals and the government. India, England, France and Brazil are the examples of mixed economy.

Features of Mixed Economy

1. **Ownership of Property and Means of Production:** The means of production and properties are owned by both private and public. Public and Private have the right to purchase, use or transfer their resources.

2. **Coexistence of Public and Private Sectors:** In mixed economies, both private and public sectors coexist. Private industries undertake activities primarily for profit. Public sector firms are owned by the government with a view to maximize social welfare.

3. **Economic Planning:** The central planning authority prepares the economic plans. National plans are drawn up by the Government and both private and public sectors abide. In general, all sectors of the economy function according to the objectives, priorities and targets laid down in the plan.

4. **Solution to Economic Problems:** The basic problems of what to produce, how to produce, for whom to produce and how to distribute are solved through the price mechanism as well as state intervention.

5. **Freedom and Control:** Though private has freedom to own resources, produce goods and services and distribute the same, the overall control on the economic activities rests with the government.

Merits of Mixed Economy

1. **Rapid Economic Growth:** The best advantage of mixed economy is that it promotes rapid economic growth. Thus, both public requirements and private needs are taken care of.

2. **Balanced Economic Growth:**Mixedism promotes balanced growth of the economy. It promotes balanced growth between agriculture and industry, consumer goods and capital goods, rural and urban etc.

3. **Proper Utilization of Resources:** In a mixed economy, the government can ensure proper utilization of resources. The government controls most of the important activities directly and the private sector indirectly.

4. **Economic Equality:** The government uses progressive rates of taxation for levying income tax to bring about economic equality.

5. **Special Advantages to the Society:** The government safeguards the interest of the workers and weaker sections by legislating on minimum wages, and rationing, establishing fair price shops and formulating social welfare measures.

Demerits of Mixed Economy

1. **Lack of Coordination:** The greatest drawback of mixedism is lack of coordination between public sector and private sector. As both work with divergent motives, it creates many coordination related problems.

2. **Competitive Attitude:** It is expected that both government and private should work with a complementary spirit towards the welfare of the society, but in reality they are competitive in their activities.

3. **Inefficiency:** Most of the public sector enterprises remain inefficient due to lethargic bureaucracy, red tapism and lack of motivation.

4. **Fear of Nationalization:** In a mixed economy, the fear of nationalization discourages the private entrepreneurs in their business operations and innovative initiatives.

5. **Widening Inequality:** Ownership of resources, laws of inheritance and profit motive of people widens the gap between rich and poor.

Ultimately the inequality of capitalism and inefficiency of socialism are found in mixed economies.

Comparison of Different Economic Systems

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

				Ineffiency

Concepts of Macro Economics

The important concepts used in macro economics are presented below:

Stock and Flow Variables

- Variables used in economic analysis are classified as stock and flow. Both stock and flow variables may increase or decrease with time.

- Stock refers to a quantity of a commodity measured at a point of time. In macro economics, money supply, unemployment level, foreign exchange reserves, capital etc are examples of stock variables.

- Flow variables are measured over a period of time. National Income, imports, exports, consumption, production, investment etc are examples of flow variables.

- Economic Models A model is a simplified representation of real situation. Economists use models to describe economic activities, their relationships and their behaviour. A model is an explanation of how the economy, or part of the economy, works. Most economic models are built with mathematics, graphs and equations, and attempt to explain relationships between economic variables. The commonly used economic models are the supply-demand models and circular flow models and Smith models.

Circular Flow of Income

- The circular flow of income is a model of an economy showing connections between different sectors of an economy. It shows flows of income, goods and services and factors of production between economic agents such as firms, households, government and nations. The circular flow analysis is the basis of national accounts and macroeconomics.

- There are three models of circular flow of income, representing the major economic systems.

1. Two Sector Model: It is for a simple economy with households and firms.

2. Three Sector Model: It is for a mixed and closed economy with households, firms and government.

3. Four Sector Model: It is for an open economy with households, firms, government and rest of the world (External sector).

Circular Flow of Income in a Two-Sector Economy:

There are only two sectors namely, household sector and firm sector.

i. **Household Sector:** The household sector is the sole buyer of goods and services, and the sole supplier of factors of production, i.e., land, labour, capital and organisation. It spends its entire income on the purchase of goods and services produced by the business sector. The household sector receives income from firm sector by providing the factors of production owned by it.

ii. **Firms:** The firm sector generates its revenue by selling goods and services to the household sector. It hires the factors of production, i.e., land, labour, capital and organisation, owned by the household sector. The firm sector sells the entire output to households.

- In a two- sector economy, production and sales are equal and there will be a circular flow of Income and goods. The outer circle represents real flow (factors and goods) and the inner circle represents the monetary flow (factor price and commodity prices).Real flow indicates tha factor services flow from household sector to the business sector to tha household. Tha basic identities of tha two- sector economy are as under:

$$\boxed{Y = C + I}$$

Where
Y is income; C is Consumption; I is investment

Circular Flow of Income in a Three- Sector Economy:

- In addition to household and firms, inclusion of the government sector makes this model a three-sector model. The government levies taxes on households and firms, purchases goods and services from firms, and receive factors of production from household sector. On the other hand, the government also makes social transfers such as pension, relief, subsidies to the households. Similarly, Government pays the firms for the purchases of goods and services. The Flow Chart illustrates three- sector economy model:

- Under three sector model, national income (Y) is obtained by adding Consumption expenditure (C), Investment expenditure (I) and Government expenditure (G).

Therefore:

$$\boxed{Y = C + I + G}$$

Circular Flow of Income in a Four-Sector Economy:

- In a Four-sector economy, in addition to household, firms and government, a fourth sector namely, external sector is included. In real life, only four-sector economy exists. This model is composed of four sectors namely,

(i) Households, (ii) Firms,
(iii) Government, (iv) External sector

- The external sector comprises exports and imports. It is illustrated in the Flow Chart.

- In four-sector economy, expenditure for the entire economy include domestic expenditure (C+I+G) and net exports (X– M). Therefore,

$$\boxed{Y = C + I + G + (X - M)}$$

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.

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

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

$$\boxed{\text{Output} = \text{Income} = \text{Expenditure}}$$

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,

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

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,

$$\boxed{GNP = C + I + G + (X-M)}$$

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.

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

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

$$\boxed{MV = PT}$$

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).

$$MV = PT$$

$$\boxed{\text{Supply of Money = Demand for Money}}$$

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:

$$\boxed{\begin{array}{c} PT = MV + M_1V_1 \\ P = MV + M_1 V_1 / T \end{array}}$$

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 • Osborne Smith was the first Governor of RBI	• 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 appointed by the GOI.	• Issues currency • Banker to the government {It collects receipts of funds and makes payments on behalf of the government} • Regulator of Indian Banking system • 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 RBI will do the exact opposite in a deflationary environment.	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 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.

NABARD
↓
State Cooperative Bank
↓
Central Cooperative Bank
↓
Primary Cooperative Society

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

Unit -7

International Economics

> "Economies are linked internationally through trade in goods and through financial markets".
> - Dornbusch, Fischer and Startz

Introduction:

Thesubject'InternationalEconomics' evolved from a simple theory of international trade was formulated to answer a few basic questions. The subjectfirst originated in Western Europe on account of increasing importance of foreign trade in that part of the world. The contributions of classical economists like Adam Smith, DavidRicardo, F.W. Taussig, Haberler, J.S.Mill and Bela Balassa shaped the subject matter of International Economics.

International Economics studies the entire range of international economic transactions that consist of not only trade in goods and services but also capital flows, technology transfer, the rate of exchange, balance of payments, and issues relating to tariffs, protection, free trade, investment flows, role of fiscal and monetary policies pursued by individual countries.

Meaning of International Economics

International Economics is that branch of economics which is concerned with the exchange of goods and services between two or more countries. Hence the subject matter is mainly related to foreign trade.

In other words, International Economics is a specialized field of Economics which deals with the economic interdependence among countries and studies the effects of such interdependence and the factors that affect it.

Subject Matter of International Economics

The subject matter of International Economics includes large number of segments which are classified into the following parts.

1. Pure Theory of Trade

This component explains the causes for foreign trade, composition, direction and volume of trade, determination of the terms of trade and exchange rate, issues related to balance of trade and balance of payments.

2. Policy Issues

Under this part, policy issues such as free trade vs. protection, methods of regulating trade, capital and technology flows, use of taxation, subsidies and dumping, exchange control and convertibility, foreign aid, external borrowings and foreign direct investment, measures of correcting disequilibrium in the balance of payments etc are covered.

3. International Cartels and Trade Blocs

This part deals with the economic integration in the form of international cartels, customs unions, monetary unions, trade blocs, economic unions and the like.It also discusses the operation of Multinational Corporations (MNCs).

4. International Financial and Trade Regulatory Institutions

The financial institutions like International Monetary Fund IMF, IBRD, WTO etc which influence international economic transactions and relations shall also be the part of international economics.

Meaning of Trade

Trade is one of the powerful forces of economic integration. The term 'trade' means exchange of goods, wares or merchandise among people.

Trade is of two types. They are:

a. Internal Trade and
b. International Trade.

Internal Trade

It refers to the exchange of goods and services within the political and geographical boundaries of a nation. It is a trade within a country. This is also known as 'domestic trade' or 'home trade' or 'intra-regional trade'.

International Trade

It refers to the trade or exchange of goods and services between two or more countries. In other words, it is a trade among different countries or trade across political boundaries. It is also called as 'external trade' or 'foreign trade' or 'inter-regional trade'.

Differences between 'Internal Trade' and 'International Trade'

S.No	Internal Trade	International Trade
1.	Trade takes place between different individuals and firms within the same nation.	Trade takes place between different individuals and firms in different countries.

2.	Labour and capital move freely from one region to another.	Labour and capital do not move easily from one nation to another.
3.	There will be free flow of goods and services since there are no restrictions.	Goods and services do not easily move from one country to another since there are a number of restrictions like tariff and quota.
4.	There is only on common currency.	There are different currencies.
5.	The physical and geographical conditions of a country are more or less similar.	There are differences in phusical and geoprraphical conditions of the two countries.
6.	Trade and financial regulations are more or less the same.	Trade and financial regulations such as interest rate, trade laws differ between countries.
7.	There is no difference in political affiliations, customs and habits of the people and government policies.	Difference are pronounced in political affiliations, habits and customs of the people and government policies.

Theories of International Trade
The Classical Theory of International Trade

Introduction

Adam Smith (1776) developed the theory of absolute cost advantage. But itwas David Ricardo who formulated as an explicit and precise theory, namely, the theory of comparative cost advantage, which was later improved and refined by the economists like J.S Mill, Cairnes, Bastable,Taussig and Haberler. We shall first discuss the Adam Smith's theory of absolute cost advantage.

Classical Trade Theories		
Mercantilism (pre - 16th century)	**Free Trade theories**	**Free Trade refined**
• Takes an us-versus - them view of trade • Other country's gain is our country's loss	• Absolute Advantage (Adam Smith,1776) • Comparative Advantage (DavidRicardo, 1817) • Specializationof productionand free flow of goods benefit alltrading partner's economies	• Factor - proportions (Heckscher -Ohlin, 1919) • International Product life cycle (Ray Vernon, 1966)

Adam Smith's Theory of Absolute Cost Advantage

Adam Smith argued that all nations can be benefitted when there is free trade and specialization in terms of their absolute cost advantage.

The Theory

According to Adam Smith, the basis of international trade was absolute cost advantage. Trade between two countries would be mutually beneficial when one country produces a commodity at an absolute cost advantage over the other country which in turn produces another commodity at an absolute cost advantage over the first country.

Assumptions

1. There are two countries and two commodities (2 x 2 model).
2. Labour is the only factor of production.
3. Labour units are homogeneous.
4. The cost or price of a commodity is measured by the amount of labour required to produce it.
5. There is no transport cost.

Illustration

Absolute cost advantage theory can be illustrated with the help of the following example.

Absolute Cost Advantage

Country	**India**	**China**
	Output per unit of labour	
Wheat	20	8
Cloths	6	14

From the illustration, it is clear that India has an absolute advantage in the production of wheat over China and China has an absolute advantage in the production of cloth over India. Therefore, India should specialize in the production of wheat and import cloth from China. China should specialize in the productionof cloth and import wheat from India. This kind of trade would be mutually beneficial to both India and China.

Ricardo's Theory of Comparative Cost Advantage

David Ricardo, the British economist in his 'Principles of Political Economy and Taxation' published in 1817, formulated a systematic theory called 'Comparative Cost Theory'. Later it was refined by J.S Mill, Marshall, Taussig and others.

Ricardo demonstrates that the basis of trade is the comparative cost difference. In other words, trade can take place even if the absolute cost difference is absent but there is comparative cost difference.

According to Ricardo, a country can gain from trade when it produces at relatively lower costs. Even when a country enjoys absolute advantage in both goods, the country would specialize in the production and export of those goods which are relatively more advantageous. Similarly, even when a country has absolute disadvantage in production of both goods, the country would specialize in production and export of the commodity in which it is relatively less disadvantageous.

Assumptions

1. There are only two nations and two commodities (2x2 model)
2. Labour is the only element of cost of production.
3. All laborers are of equal efficiency.
4. Labour is perfectly mobile within the country but perfectly immobile between countries.
5. Production is subject to the law of constant returns.
6. Foreign trade is free from all barriers.
7. No change in technology.
8. No transport cost.
9. Perfect competition.
10. Full employment.
11. No government intervention.

Illustration

Ricardo's theory of comparative cost can be explained with a hypothetical example of production costs of cloth and wheat in America and India.

Comparative Cost Advantage
(Units of labour required to produce one unit)

Country	Cloth	Wheat	Domestic Exchange Ratios
America	100	120	1 wheat = 1.2 cloth
India	90	80	1 wheat = 0.88 cloth

It is evident from the examplethat India has an absolute advantagein production of both cloth and wheat.However, India should concentrate on the production of wheat in which she enjoys a comparative cost advantage. (80/120 < 90/100). For America the comparative cost disadvantage is lesser in cloth production. Hence America will specialize in the production of cloth and export it to India in exchange for wheat. (Any exchange ratio between 0.88 units and 1.2 units of cloth against one unit of wheat represents gain for both the nations). With trade, India can get 1 unit of cloth and 1 unit of wheat by using its 160 labour units. In the absence of trade, for getting this benefit, India will have to use 170 units of labour. America also gains from this trade. With trade, America can get 1 unit of cloth and one unit of wheat by using its 200 units of labour. Otherwise, America will have to use 220 units of labour for getting 1 unit of cloth and 1 unit of wheat.

Criticisms

1. Labour cost is a small portion of the total cost. Hence, theory based on labour cost is unrealistic.
2. Laborers in different countries are not equal in efficiency.

Modern Theory of International Trade
Introduction

The modern theory of international trade was developed by Swedish economist Eli Heckscher and his student Bertil Ohlin in 1919. This model was based on the Ricardian theory of international trade. This theory says that the basis forinternational trade is the difference in factor endowments. It is otherwise called as '**Factor Endowment Theory'.**

Factor endowment model

- Developed by Heckscher and Ohlin
- Countries with a relative factor abundance can specialize and trade
- Abundance of skilled labour → specialization → export → exchange for goods are services produced by countries with abundance of unskilled labour
- **Exports** embody the **abundant factor**
- **Imports** embody the scarce factor
- Assumes a high degree of factor mobility

The Theory

The classical theory argued that the basis for foreign trade was comparative cost difference and it considered only labour factor. But the modern theory of international trade explains the causes for such comparative cost difference. This theory attributes international differences in comparative costs to:

i. Difference in the endowments of factors of production between countries, and
ii. Differences in the factor proportions required in production.

Assumptions

1. There are two countries, two commodities and two factors. (2x2x2 model)
2. Countries differ in factor endowments.
3. Commodities are categorized in terms of factor intensity.
4. Countries use same production technology.

5. Countries have identical demand conditions.
6. There is perfect competition in both product and factor markets in both the countries.

Heckscher – Ohlin (H-O) theorem

H-O theorem	Factor	Exports
" A capital abundant country will export the capital – intensive good, while the labor – abundant country will export the labor – intensive good	Factor proportions model which links exports and imports to factor endowments.	A country exports those commodities produced with relatively large quantities of the country's relatively abundant factor.

Explanation

According to Heckscher - Ohlin, "a capital-abundant country will export the capital –intensive goods, while the labour-abundant country will export the labour-intensive goods". A factor is regarded abundant or scare in relation to the quantum of other factors. A country can be regarded as richly endowed with capital only if the ratio of capital to other factors is higher than other countries.

Illustration

Particulars	India	America
Supply of labour	50	24
Supply of capital	40	30
Capital – Labour Ratio	40/50= 0.8	30/24=1.25

In the above example, even though India has more capital in absolute terms, America is more richly endowed with capital because the ratio of capital in India is 0.8 which is less than that in America where it is 1.25. The following diagram illustrates the pattern of word trade.

Capital abundant country	*Export of capital – int ensive goods* → ← *Exports of labour – int ensivegoods*	Labour abundant country

Limitations

1. Factor endowment of a country may change over time.
2. The efficiency of the same factor (say labour) may differ in the two countries. For example, America may be labour scarce in terms of number of workers. But in terms of efficiency, the total labour may be larger.

9Comparison of Classical Theory and Modern Theory

S.No	Classical Theory of International Trade	Modern Theory of International Trade
1.	The classical theory explains the phenomenon of international trade on the basis of labour theory of value.	The modern theory explains the phenomenon of international trade on the basis of general theory of value.
2.	It present a one factor (labour) model	It presents a multi – factor (labour and capital) model.
3.	It attributes the differences in the comparative costs to differences in the productive efficiency of workers in the two countries.	It attributes the differences in comparative costs to the differences in factor endowments in the two countries.

Gains from International Trade

International trade helps a country to export its surplus goods to other countries and secure a better market for it. Similarly, international trade helps a country to import the goods which cannot be produced at all or can be produced at a higher cost. The gains from international trade may be categorized under four heads.

I. Efficient Production

International trade enables each participatory country to specialize in the production of goods in which it hasabsolute or comparative advantages. International specialization offers the following gains.

1. Better utilization of resources.
2. Concentration in the production of goods in which it has a comparative advantage.
3. Saving in time.
4. Perfection of skills in production.
5. Improvement in the techniques of production.
6. Increased production.
7. Higher standard of living in the trading countries.

II. Equalization of Prices between Countries

International trade may help to equalize prices in all the trading countries.

1. Prices of goods are equalized between the countries (However, in reality it has not happened).
2. The difference is only with regard to the cost of transportation.
3. Prices of factors of production are also equalized (However, in reality it has not happened).

III. Equitable Distribution of Scarce Materials

International trade may help the trading countries to have equitable distribution of scarce resources.

IV. General Advantages of International Trade

1. Availability of variety of goods for consumption.
2. Generation of more employment opportunities.
3. Industrialization of backward nations.
4. Improvement in relationship among countries (However, in reality it has not happened).
5. Division of labour and specialization.
6. Expansion in transport facilities.

Terms of Trade

The gains from international trade depend upon the terms of trade which refers to the ratio of export prices to import prices.

Meaning

It is the rate at which the goods of one country are exchanged for goods of another country. It is expressed as the relation between export prices and import prices. Terms of trade improves when average price of exports is higher than average price of imports.

Types of Terms of Trade

The different concepts of terms of trade were classified by Gerald M.Meier into the following three categories:

Terms of Trade related to the Ratio of Exchange between Commodities

Terms of Trade		
Net Barter Terms of Trade - Taussig	Gross Barter Terms of Trade - Taussig	Income Terms of Trade – G.s. Dorrance

1. Net Barter Terms of Trade

This type was developed by Taussig in 1927.The ratio between the prices of exports and of imports is called the "net barter terms of trade'. It is named by Viner as the 'commodity terms of trade'.

It is expressed as:

$$T_n = (P_x / P_m) \times 100$$

Where,

T_n = Net Barter Terms of Trade
P_x = Index number of export prices
P_m = Index number of import prices

This is used to measure the gain from international trade. If 'Tn' is greater than 100, then it is a favorable terms of trade which will mean that for a rupee of export, more of imports can be received by a country.

2. Gross Barter Terms of Trade

This was developed by Taussig in 1927 as an improvement over the net terms of trade. It is an index of relationship between total physical quantity of imports and the total physical quantity of exports.

$$T_q = (Q_m/Q_x) \times 100$$

If for a given quantity of export, more quantity of import can be consumed by a country, then one can say that terms of trade are favorable.

3. Income Terms of Trade

The income terms of trade was given by G.S.Dorrance in 1948. It is the index of the value of exports divided by the price index for imports multiplied by quantity index of experts. In other words, it is the net barter terms of trade of a country multiplied by its exports-volume index.

$$T_y = (P_x/P_m)Q_x$$

Where,

P_x = Price index of exports
P_m = Price index of imports
Q_x = Quantity index of exports

Terms of Trade related to the Interchange between Productive Resources

1. The Single Factoral Terms of Trade

Viner has devised another concept called ''the single factoral terms of trade'' as an improvement upon the commodity terms of trade. It represents the ratio of export-price index to the import-price index adjusted for changes in the productivity of a country's factors in the production of exports. Symbolically, it can be stated as

$$\boxed{Tf = (Px / Pm) Fx}$$

Where, T_f stands for single factoral terms of trade index. F_x stands for productivity in exports (which is measured as the index of cost in terms of quantity of factors of production used per unit of export).

2. Double Factoral Terms of Trade

Viner constructed another index called ''Double factoral terms of Trade''. It is expressed as

$$\boxed{Tf_f = (P_x / P_m) (F_x / F_m)}$$

Which takes into account the productivity in country's exports, as well as the productivity of foreign factors? Here, Fmrepresents import index (which is measured as the index of cost in terms of quantity of factors of production employed per unit of imports).

Balance of Trade Vs Balance of Payments

Balance of Trade and Balance of Payments are two different concepts in the subject of international trade.

Balance of Trade (BOT)

Balance of Trade (BOT) refers to the total value of a country's exports of commodities and total value of imports of commodities. Only export and import of commodities are included in the statement of Balance of Trade of a country. Movements of goods (export and imports of commodities) are also known as 'visible trade', because the movement of commodities between countries can be seen by eyes and felt by hands and can be verified physically by custom authorities of a country.

Favorable BOT

When the total value of commodity exports of a country exceeds the total value of commodity imports of that country, it is said that the country has a 'favorable' balance of trade.

Unfavorable BOT

If total value of commodity exports of a country is less than the total value of commodity imports of that country, that country is said to have an 'unfavorable' balance of trade.

Balance of Payments (BOP)

BoP is a systematic record of a country's economic and financial transactions with the rest of the world over a period of time.

When a payment is received from a foreign country, it is a credit transaction while a payment to a foreign country is a debit transaction. The principal items shown on the credit side are exports of goods and services, transfer receipts in the form of gift etc., from foreigners, borrowing from abroad, foreign direct investment and official sale of reserve assets including gold to foreign countries and international agencies.

The principal items on the debit side include imports of goods and services, transfer payments to foreigners, lending to foreign countries, investments by residents in foreign countries and official purchase of reserve assets or gold from foreign countries and international agencies.

Components of BOPs

The credit and debit items are shown vertically in the BOP account of a country. Horizontally, they are divided into three categories, i.e.

a. The current account,
b. The capital account and
c. The official settlements account or official reserve assets account.

a. **The Current Account:** It includes all international trade transactionsof goods and services, international service transactions (i.e. tourism, transportation and royalty fees) and international unilateral transfers (i.e. gifts and foreign aid).

b. **The Capital Account:** Financial transactions consisting of direct investment and purchases of interest- bearing financial instruments, non- interest bearing demand deposits and gold fall under the capital account.

c. **The Official Reserve Assets Account:** Official reserve transactions consist of movements of international reserves by governments and official agencies to accommodate imbalances arising from the current and capital accounts. The official reserve assets of a country include its gold stock, holdings of its convertible foreign currencies and Special Drawing Rights (SDRs) and its net position in the International Monetary Fund (IMF).

Credit (Receipts – Debit (Payments) = Balance [Deficit (-), Surplus (+)]

Deficit if Debit > Credit

Balance of Payments Disequilibrium

The BoP is said to be balanced when the receipts (R) and payments (P) are just equal, i.e,

Favorable BoP

When receipts exceed payments, the BoP is said to be favorable. That is,

$$\boxed{R / P > 1.}$$

Types BOP Disequilibrium:

There are three main types of BOP Disequilibrium, which are discussed below.

i. Cyclical Disequilibrium,
ii. Secular Disequilibrium,
iii. Structural Disequilibrium.

i. **Cyclical Disequilibrium:** Cyclical disequilibrium occurs because of two reasons. First, two countries may be passing through different phases of business cycle. Secondly, the elasticities of demand may differ between countries.

ii. **Secular Disequilibrium:** The secular or long-run disequilibrium in BOP occurs because of long-run and deep seated changes in an economy as it advances from one stage of growth to another. In the initial stages of development, domestic investment exceeds domestic savings and imports exceed exports, as it happens in India since 1951.

iii. **Structural Disequilibrium:** Structural changes in the economy may also causebalance of payments disequilibrium. Such structural changes include development of alternative sources of supply, development of better substitutes, exhaustion of productive resources or changes in transport routes and costs.

Causes for BoP Disequilibrium

The following are the major causes producing disequilibrium in the balance of payments of a country.

1. **Cyclical Fluctuation:** Cyclical disequilibrium in different countries is caused by their cyclical fluctuations, their phases and magnitude. World trade shrinks during depression while trade flourishes during prosperity

2. **Structural Changes:** Structural disequilibrium is caused by the structural changes brought by huge development and investment programmes in the developing economies. Such economies may have high propensity to import for want of capital for rapid industrialization, while export may not be boosted up to that extent.

3. **Development Expenditure:** Development disequilibrium is caused by rapid economic development which results in income and price effects. The less developed countries in the early stage of development are not self sufficient. Income, savings and investment are abysmally low. They depend upon developed countries for import of commodities, capital and technology. Export potential is low and import intensity is high. So the LDCs suffer from adverse BoP

4. **Consumerism:** Balance of payments position of a country is adversely affected by a huge increase in consumption. This increases the need for imports and decreases the capacity to export.

5. **Demonstration Effect:** Deficit in the balance of payments of developing countries is also caused by demonstration effect which influences the people in UDCs to imitate western styled goods. This will raise the propensity to import causing adverse balance of payments. This is good for the developed countries.

6. **Borrowing:** International borrowing and investment may cause a deficit in the balance of payments. When the international borrowing is heavy, a country's balance of payments will be adverse since it repays loans with interest. Servicing of debt is a huge burden. That is why the UDCs are forced to borrow more.

7. **Technological Backwardness:** Due to technological backwardness, the people (Indians) are unable to use the energy (Solar) available with them. As a result they import huge petroleum products from foreign countries, increasing the trade deficit. 8. Global Politics: The rich countries (Eg. USA) need to sell their weapons to promote their economy and generate employment. Hence, wars between countries (for example Iran and Irag, Pakistan and India) are stimulated In order to win the wars, the poor countries are forced to buy the weapons from weapon – rich countries, usingtheir export earnings and creating trade deficit. Thus UDCs are trapped forever.

Measures to Correct BOP Disequilibrium

There are a number of measures available for correcting the balance of payments disequilibrium. They are divided into two broad groups, namely, (i) automatic correction and (ii) deliberate measures.

I. Automatic Correction

If the market forces of demand and supply are allowed to play freely, equilibrium will be automatically restored in course of time. Under the free exchange rate system, the automatic adjustments of the balance of payments can take place through changes in the variables like price, interest, income and capital flows.

1. Price Adjustments

As a result of foreign exchange outflow from a deficit country to a surplus country, there will be a fall in the money supply in the deficit country and increase in the money supply in the surplus country. This will result in rise in the price in thesurplus country which will encourage imports and discourage exports. Fall in prices in the deficit country will encourage exports and discourage imports, leading to restoration of BoP equilibrium.

2. Interest Rate Adjustments

The contraction or expansion of money supply resulting from the BoP deficit or surplus leads to a rise or fall in the interest rates. A rise in interest rate in theto withdraw their funds from abroad and invest in their home country. The opposite happens in the surplus country.

3. Income Adjustments

A nation with payments surplus will experience rising income which will increase imports and thereafter equilibrium is restored in Balance of Payments.

4. Capital Flows

Changes in the interest rate consequent to the BoP disequilibrium will encourage capital flows from the surplus nations to deficit nations helping restoration of the BoP equilibrium

II. Deliberate Measures

The deliberate measures may be broadly grouped into (a) monetary measures (b) trade measures and (c) miscellaneous measures.

a. Monetary Measures

1. Monetary Contraction

High domestic price level is responsible for high imports and low exports. In order to control inflation, the central monetary authority controls credit. As a result, the prices come down and exports increase. This will help to correct adverse BoP. However, if credit is controlled, investment will decline, production will go down, prices will increase. This is the cause of confusion between government and RBI in India in 2010s.

2. Devaluation

Devaluation means deliberate reduction of the official rate at which domestic currency is exchanged for another currency. In other words, devaluation refers to a reduction in the external value of a currency in the terms of other currencies. For instance, instead of 70 ₹ per US$, making ₹ 80 per US$. A country with fundamental disequilibrium in the balance of payments may devalue its currency in order to stimulate its exports and discourage imports to correct the disequilibrium. Devaluation makes exports cheaper and imports dearer. That means making Indian good cheaper for foreigners and foreign goods costlier for Indians.

3. Exchange Control

Exchange control means the state intervention in the forex market. It is a popular method employed to influence the balance of payments position of a country. Under exchange control, the government or central bank assumes complete control over the foreign exchange reserves and earning of the country. The recipients of foreign exchange, like exporters, are required to surrender foreign exchange to the government / central bank in exchange for domestic currency. By virtue of its control over the use of foreign exchange, the government can control imports. Does it happen in India? Too much of imports control would invite more and more smuggled goods. Smuggling of gold into Indian airports regularly happens, as per the reports in the media.

III. Trade Measures

Trade measures include measures to promote exports and to reduce imports.

1. Export Promotion

Exports may be encouraged by i).reducing or abolishing export duties, ii). providing export subsidy, iii).encouraging export production by giving monetary, fiscal, physical and institutional incentives. (Then local people and domestic industries would suffer)

2. Import Control

Imports may be controlled by i).imposing or enhancing import duties, ii).restricting imports through import quotas, iii).licensing and even prohibiting altogether the import of certain non- essential items. But this would encourage smuggling.

IV. Miscellaneous Measures

In addition to the measures mentioned above, there are a number of other measures that can help make the balance of payments position more favorable, like foreign loans, encouraging foreign investment in the home country, development of tourism to attract foreign tourists, providing incentives to enhance inward remittances and import substitution.

Exchange Rate

Meaning of Foreign Exchange (FOREX)

FOREX refers to foreign currencies. The mechanism through which payments are effected between two countries having different currency systems is called FOREX system . It covers methods of payment, rules and regulations of payment and the institutions facilitating such payments.

Definition of FOREX

"FOREX is the system or process of converting one national currency into another, and of transferring money from one country to another".

Rate of Exchange

The transactions in the exchange market are carried out at exchange rates. It is the external value of domestic currency. Thus, exchange rate may be defined as the price paid in the home currency (say ` 75) for a unit of foreign currency (say 1 US $). It can be quoted in two ways:

1. One unit of foreign money (1 USD) to so many units of the domestic currency (`); or
2. A certain number of units of foreign currency (USD)to one unit of domestic money (` 1)

For instance:

1 U.S Dollar = ` 70 , or ` 1 = U.S.1.42 cents

Definition of Equilibrium Exchange Rate

"The equilibrium exchange rate is that rate, which over a certain period of time, keeps the balance of payments in equilibrium".

- RagnerNurkse

Determination of Equilibrium Exchange Rate

The equilibrium rate of exchange is determined in the foreign exchange market in accordance with the general theory of value, i.e., by the interaction of the forces of demand and supply. Thus, the rate of exchange is determined at the point where demand for forex is equal to the supply of forex.

In the above diagram, Y axis represents exchange rate, that is, value of rupee in terms of dollars. X axis represents demand and supply of forex. E is the point of equilibrium where DD intersects SS. The exchange rate is P2.

Types of Exchange Rate Systems

Broadly, there are two major exchange rate systems, namely, (1) fixed (or pegged) exchange rate system and (2) flexible (or floating) exchange rate system. Managed Floating Exchange Rate system also prevails in some countries (like India).

1. Fixed Exchange Rates

Countries following the fixed exchange rate (also known as stable exchange rate and pegged exchange rate) system agree to keep their currencies at a fixed rate as determined by the Government. Under the gold standard, the value of currencies was fixed in terms of gold.

2. Flexible Exchange Rates

Under the flexible exchange rate (also known as floating exchange rate) system, exchange rates are freely determined in an open market by market forces of demand and supply.

Types of Exchange Rates

Exchange rates are also in the form of (a) Nominal exchange rate (b) Real exchange rate (c) Nominal Effective Exchange Rate (NEER) and (d) Real Effective Exchange Rate (REER)

If 1 US Dollar = ₹ 75,Nominal exchange rate = 75/1 = 75.
This is the bilateral nominal exchange rate.

$$\boxed{\text{Real Exchange rate} = \frac{eP_f}{P}}$$

P = Price levels in India
Pf = Price levels in abroad (say US)
e = nominal exchange rate.
If a pen costs ₹ 50 in India and it costs 5 USD in the US,

Real Exchange Rate = $\frac{75 \text{ X } 5}{50}$ = 7.5

If real exchange rate is equal to 1, the currencies are at purchasing power parity.

It the price of the pen in US is 0.66 USD, then the real exchange rate $\frac{0.66\text{X}75}{50}$ then it could be said that the USD and Indian rupee are at purchasing power parity.

NEER and REER are not explained here.

Interested students and teachers can search for them.

Determinants of Exchange Rates

Exchange rates are determined by numerous factors and they are related to the trading relationship between two countries.

1. Differentials in Inflation

Inflation and exchange rates are inversely related. A country with a consistently lower inflation rate exhibits a rising currency value, as its purchasing power increases relative to other currencies.

2. Differentials in Interest Rates

There is a high degree of correlation between interest rates, inflation and exchange rates. Central banks can influence over both inflation and exchange rates by manipulating interest rates. Higher interest rates attract foreign capital and cause the exchange rate to rise and vice versa.

3. Current Account Deficits

A deficit in the current account implies excess of payments over receipts. The country resorts to borrowing capital from foreign sources to make up the deficit. Excess demand for foreign currency lowers a country's exchange rate.

Public Debt

Large public debts are driving out foreign investors, because it leads to inflation. As a result, exchange rate will be lower.

Terms of Trade

A country's terms of trade also determines the exchange rate. If the price of a country's exports rises by a greater rate than that of its imports, its terms of trade will improve. Favorable terms of trade imply greater demand for the country's exports and thus BoP becomes favorable.

Political and Economic Stability

If a nation's political climate is stable and economic performance is good, its currency value will be appreciated by attracting more foreign capital.

Recession

Interest rates are low during the recession phase. This will decrease inflow of foreign capital. As a result, a currency will be depreciated against other currencies, thereby lowering the exchange rate.

Speculation

If a country's currency value is expected to rise, investors will demand more of that currency in order to make a profit in the near future. This results in appreciation of the exchange rate. Beside the above determinants, relative dominance in the global politics and the power to announce economic sanctions over other countries also determine exchange rates.

Foreign Direct Investment (FDI) and Trade

FDI is an important factor in global economy. Foreign trade and FDI are closely related. In developing countries like India, FDI in the natural resource sector, including plantations, increases trade volume. Foreign production by FDI is useful to substitute foreign trade. FDI is also influenced by the income generated from the trade and regional integration schemes.

FDI is helpful to accelerate the economic growth by facilitating essential imports needed for carrying out development programmes like capital goods, technical know-how, raw materials and other inputs and even scarce consumer goods.

When the export earnings of a country are not sufficient to finance for imports, FDI may be required to fill the trade gap.

FDI is encouraged by the factors such as foreign exchange shortage, desire to create employment and acceleration of the pace of economic development. Many developing countries strongly prefer foreign investment to imports. However, the real impact of FDI on different sections of an economy (say India) may differ. It could be a boon for some as well as bane for others. This may be discussed in the class – room. Large demand for USD, generated by IMF and World Bank policies (FUND – BANK POLICIES), help the USD to gain value continuously. This is one of the hidden agenda of Fund – Bank policies.

Meaning of FDI

FDI means an investment in a foreign country that involves some degree ofcontrol and participation in management. It corresponds to the investment made by a multinational enterprise in a foreign country. It is different from portfolio investment, which is primarily motivated by short term profit and it does not seek management control.

Foreign Portfolio Investment (FPI)means the entry of funds into a nation where foreigners deposit money in a nation's bank or make purchase in the stock and bond markets, sometimes for speculation. FPI is part of capital account of BoP.

Objectives of FDI
FDI has the following objectives.

1. Sales Expansion
2. Acquisition of resources
3. Diversification
4. Minimization of competitive risk.

Foreign Institutional Investment (FII) is an investment in hedge funds, insurance companies, pension funds and mutual funds. Foreign institutional investment is a common term in the financial sector of India. For example, a mutual fund in the United States can make investment in an India-based company.

Advantages of FDI

Foreign investment mostly takes the form of direct investment. Hence, we deal here with the foreign direct investment.

The important advantages of foreign direct investment are the following:

1. FDI may help to increase the investment level and thereby the income and employment in the host country.
2. Direct foreign investment may facilitate transfer of technology to the recipient country.
3. FDI may also bring revenue to the government of host country when it taxes profits of foreign firms or gets royalties from concession agreements.
4. A part of profit from direct foreign investment may be ploughed back into the expansion, modernization or development of related industries.
5. It may kindle a managerial revolution in the recipient country through professional management and sophisticated management techniques.
6. Foreign capital may enable the country to increase its exports and reduce import requirements. And thereby ease BoP disequilibrium.
7. Foreign investment may also help increase competition and break domestic monopolies.
8. If FDI adds more value to output in the recipient country than the return on capital from foreign investment, then the social returns are greater than the private returns on foreign investment.
9. By bringing capital and foreign exchange FDI may help in filling the savings gap and the foreign exchange gap in order to achieve the goal of national economic development.
10. Foreign investments may stimulate domestic enterprise to invest in ancillary industries in collaboration with foreign enterprises.
11. Lastly, FDI flowing into a developing country may also encourage its entrepreneurs to invest in the other LDCs. Firms in India have started investing in Nepal, Uganda, Ethiopia and Kenya and other LDCs while they are still borrowing from abroad. Larger FDI to India comes from a small country (Mauritius).

Disadvantages of FDI

The following criticisms are leveled against foreign direct investment.

1. Private foreign capital tends to flow to the high profit areas rather than to the priority sectors.

2. The technologies brought in by the foreign investor may not be appropriate to the consumption needs, size of the domestic market, resource availabilities, stage of development of the economy, etc.
3. Foreign investment, sometimes, have unfavorable effect on the Balance of Payments of a country because when the drain of foreign exchange by way of royalty, dividend, etc. is more than the investment made by the foreign concerns.
4. Foreign capital sometimes interferes in the national politics.
5. Foreign investors sometimes engage in unfair and unethical trade practices.
6. Foreign investment in some cases leads to the destruction or weakening of small and medium enterprises.
7. Sometimes foreign investment can result in the dangerous situation of minimizing / eliminating competition and the creation of monopolies or oligopolistic structures.
8. Often, there are several costs associated with encouraging foreign investment.

FDI in India

The early 1990s witnessed reforms in the economic policy. This helped to open up Indian markets to FDI. FDI in India has increased over the years. In India, FDI has been advantageous in terms of free flow of capital, improved technology, management expertise and access to international markets.

The major sectors benefited from FDI in India are:

i. financial sector (banking and non-banking)
ii. insurance
iii. telecommunication
iv. hospitality and tourism
v. pharmaceuticals and
vi. software and information technology.

FDI is not permitted in the industrial sectors like

i. Arms and ammunition
ii. atomic energy,
iii. railways,
iv. coal and lignite and
v. mining of iron, manganese, chrome, gypsum, sulphur, gold, diamonds, copper etc.,

FDI inflow in India has increased from $97 million in 1990-91 to $5,535 million in 2004-2005. It amounted to $32,955 million in 2011-2012. UNCTAD's World Investment Report 2018 reveals that FDI to India declined to $40 billion in 2017 from $44 billion in 2016.

8. International Economic Organizations

"Foreign capital infinitely prefers situations where the upside potential is vast, if risks must be taken to get in". – Rudi Dorbush

Introduction

In the previous chapter, we have studied the basis of trade, gains from trade, terms of trade, BoP and foreign exchange. When trade takes place among countries, the developed countries always stand to gain and the LDCs suffer from adverse terms of trade as well as balance of payments and they affect their exchange rates. The Great Depression of 1930s and World War II led to purely nationalistic policies in which almost every country imposed trade restrictions, exchange controls and exchange depreciation so as to boost exports and to restrict imports considerably.

The Brettonwoods Conference proposed IMF, World Bank and International Trade Organisation (ITO) in 1944. The IMF and World Bank were started in 1945. Instead of ITO, an interim arrangement was made and named GATT (General Agreement on Tariff and Trade). The GATT was transformed into WTO (World Trade Organisation) from 1995. The IMF, IBRD and WTO headquarters are presented in the table.

Institution	Headquarters	Year of Establishment
International Monetary Fund	Washington D.C	1945
World Bank	Washington D.C	1945
World Trade Organisation	Geneva	1995

International Monetary Fund

The purpose of International Monetary Fund is to secure and promote economic and financial cooperation among member countries. The IMF was established to assist the member nations to tide over the Balance of Payments disequilibrium in the short term. At present, the IMF has 189 member countries with Republic of Nauru joined in 2016.

Objectives Of IMF

i) To promote international monetary cooperation among the member nations.
ii) To facilitate faster and balanced growth of international trade.

iii) To ensure exchange rate stability by curbing competitive exchange depreciations.
iv) To eliminate or reduce exchange controls imposed by member nations. v) To establish multilateral trade and payment system in respect of current transactions instead of bilateral trade agreements.
vi) To promote the flow of capital from developed to developing nations. vii) To solve the problem of international liquidity.

Functions of IMF

i) Bringing stability in exchange rate

The IMF is maintaining exchange rate stability and emphasising devaluation criteria, restricting members to go in for multiple exchange rates and also to buy or sell gold at prices other than declared par value.

ii) Correcting BOP Disequilibrium

The IMF is helping the member countries in eliminating or minimizing the short-period disequilibrium in their balance of payments either by selling or lending foreign currencies to the member nation.

iii) Determining par values

IMF enforces the system of determination of par values of the currencies of the member countries. According to the Articles of Agreement of the IMF, every member nation should declare the par value of its currency in terms of gold or US dollars. Under this article, IMF ensures smooth working of the international monetary system, in favour of some developed countries.

iv) Balancing demand and supply of currencies

IMF is entrusted with the important function of maintaining balance between demand and supply of various currencies. The Fund (IMF) can declare a currency as scarce currency which is in great demand and can increase its supply by borrowing it from the country concerned or by purchasing the same currency in exchange of gold.

v) Reducing trade restrictions

The Fund also aims at reducing tariffs and other trade barriers imposed by the member countries with the purpose of removing restrictions on remittance of funds or to avoid discriminating practices.

vi) Providing credit facilities

IMF is providing different borrowing and credit facilities with the objective of helping the member countries. These credit facilities offered by it include basic credit facility, extended fund facility for a period of three years, compensatory financing facility and structural adjustment facility.

The functions of the IMF are grouped under three heads.
1. Financial – Assistance to correct short and medium term deficit in BOP;
2. Regulatory – Code of conduct and
3. Consultative - Counseling and technical consultancy.

Facilities offered by IMF

The Fund has created several new credit facilities for its members. Chief among them are:

(i) Basic Credit Facility:

The IMF provides financial assistance to its member nations to overcome their temporary difficulties relating to balance of payments. A member nation can purchase from the Fund other currencies or SDRs, in exchange for its own currency, to finance payment deficits. The loan is repaid when the member repurchases itsown currency with other currencies or SDRs. A member can unconditionally borrow from the Fund in a year equal to 25% of its quota. This unconditional borrowing right is called the reserve tranche.

Special Drawing Rights (SDRs)

The Fund has succeeded in establishing a scheme of Special Drawing Rights (SDRs) which is otherwise called 'Paper Gold'. They are a form of international reserves created by the IMF in 1969 to solve the problem of international liquidity. They are allocated to the IMF members in proportion to their Fund quotas. SDRs are used as a means of payment by Fund members to meet balance of payments deficits and their total reserve position with the Fund. Thus SDRs act both as an international unit of account and a means of payment. All transactions by the Fund in the form of loans and their repayments, its liquid reserves, its capital, etc., are expressed in the SDR.

The achievements of the fund can be summed up in the words of Haien that 'Fund is like an International Reserve Bank.'

(ii) Extended Fund Facility

Under this arrangement, the IMF provides additional borrowing facility up to 140% of the member's quota, over and above the basic credit facility. The extended facility is limited for a period up to 3 years and the rate of interest is low.

(iii) Compensatory Financing Facility

In 1963, IMF established compensatory financing facility to provide additional financial assistance to the member countries, particularly primary producing countries facing shortfall in export earnings. In 1981, the coverage of the compensatory financing facility was extended to payment problem caused by the fluctuations in the cost of cereal inputs.

(iv) Buffer Stock Facility

The buffer stock financing facility was started in 1969. The purpose of this scheme was to help the primary goods (food grains) producing countries to finance contributions to buffer stock arrangements for the stabilisation of primary product prices.

(v) Supplementary Financing Facility

Under the supplementary financing facility, the IMF makes temporary arrangements to provide supplementary financial assistance to member countries facing payments problems relating to their present quota sizes.

(vi) Structural Adjustment Facility

The IMF established Structural Adjustment Facility (SAF) in March 1986 to provide additional balance of payments assistance on concessional terms to the poorer member countries. In December 1987, the Enhanced Structural Adjustment Facility (ESAF) was set up to augment the availability of concessional resources to low income countries. The purpose of SAF and ESAF is to force the poor countries to undertake strong macroeconomicand structural programmes to improve their balance of payments positions and promote economic growth.

Achievements Of IMF

The main achievements of International Monetary Fund are as follows:

i) Establishment of monetary reserve fund

The Fund has played a major role in achieving the sizeable stock of the national currencies of different countries. To meet the foreign exchange requirements of the member nations, IMF uses its stock to help the member nations to meet foreign exchange requirements.

ii) Monetary discipline and cooperation

The IMF has shown keen interest in maintaining monetary discipline and cooperation among the member countries. To achieve this objective, it has provided assistance only to those countries which make sincere efforts to solve their problems.

iii) Special interest in the problems of UDCs

The notable success of the Fund is the maintenance of special interest in the acute problems of developing countries. The Fund has provided financial assistance to solve the balance of payment problem of UDCs. However, many UDCs continue to be UDCs, while the developed countries have achieved substantial growth.

India and IMF

Till 1970, India stood fifth in the Fund and it had the power to appoint a permanent Executive Director. India has been one of the major beneficiaries of the Fund assistance. It has been getting aid from the various Fund Agencies from time to time and has been regularly repaying its debt. India's current quota in the IMF is SDRs (Special Drawing Rights) 5,821.5 million, making it the 13th largest quota holding country at IMF with shareholdings of 2.44%. Besides receiving loans to meet deficit in its balance of payments, India has benefited in certain other respects from the membership of the Fund.

International Bank For Reconstruction And Development (IBRD) or World Bank

The International Bank for Reconstruction and Development (IBRD), otherwise called the World Bank(WB) was established in 1945 under the Bretton Woods Conference in 1944. The purpose is to bring about a smooth transition from a war-time to peace-time economy. It is known as a sister institution along with the International Monetary Fund. The membership in International Monetary Fund is a prerequisite to become a member of IBRD. The IBRD was established to provide long term financial assistance to member countries.

Objectives of IBRD

Objectives of the World Bank	
1.	Reconstruction and Development
2.	Encouragement to Capital Investment
3.	Encouragement to International Trade
4.	Establishment of Peace-time Economy
5.	Environmental Protection

The following are the objectives of the World Bank:

1. To help member countries for economic reconstruction and development.
2. To stimulate long-run capital investment for restoring Balance of Payments (BoP) equilibrium and thereby ensure balanced development of international trade among the member nations.
3. To provide guarantees for loans meant for infrastructural and industrial projects of member nations.
4. To help war ravaged economies transform into peace economies.
5. To supplement foreign private investment by direct loans out of its own funds for productive purposes.

World Bank's Lending Procedure:

The Bank advances loans to members in three ways
i) Loans out of its own fund,
ii) Loans out of borrowed capital and
iii) Loans through Bank's guarantee.

The Bank(WB) has changed its development loan strategy and lays more emphasis on financing schemes which directly influence the well being of poor masses of the member countries, especially the developing countries. The amount of agricultural loans has increased more rapidly than in any other sector. The bank now also takes interest in the activities of the development of rural areas such as:

a) spread of education among the rural people
b) development of roads in rural areas and
c) electrification of the villages.

Functions of IBRD

The World Bank performs the major role of providing loans for development works to member countries, especially to underdeveloped countries. The World Bank provides long-term loans for various development projects. Article 1 of the Agreement states the functions performed by the world bank as follows.

1. Investment for productive purposes

The World Bank performs the function of assisting in the reconstruction and development of territories of member nations through facility of investment for productive purposes. It also encourages the development of productive facilities and resources in less developed countries.

2. Balanced growth of international trade

Promoting the long range balanced growth of trade at international level and the maintaining equilibrium in BOPs of member nations by encouraging international investment.

3. Provision of loans and guarantees

Arranging the loans or providing guarantees on loans by various other channels so as to execute important projects.

4. Promotion of foreign private investment

The promotion of private foreign investment by means of guarantees on loans and other investment made by private investors. The Bank supplements private investment by providing finance for productive purpose out of its own resources or from borrowed funds.

5. Technical services

The World Bank facilitates different kinds of technical services to the member countries through Staff College and experts.

Achievements of World Bank

The World Bank is said to be successful in achieving its primary objective of reconstruction and development of war ravaged nations. It helped greatly in the reconstruction of Europe after the World War II. It has been providing the developed and developing countries the same treatment in the process of growth.

i. It is noted that the Bank's membership has increased from the initial number of 30 countries to 68 countries in 1960 and to 151 countries in 1988. The IBRD has 189 member countries.
ii. The Bank grants medium and long-term loans (i.e., payable over a period of 15-20 years) for reconstruction and development purposes to the member countries. The actual term of a loan depends upon the estimated useful life of the equipment or plant financed.
iii. Initially the World Bank's loans were mainly directed at the European countries for financing their programmes of reconstruction. Later it changed its development loan strategy and lays more emphasis of financing schemes for the poor masses of the developing countries.
iv. The World Bank grants loans to member countries only for productive purposes particularly for agriculture, irrigation, power and transport. In other words, the Bank strengthens infrastructure needed for further development.
v. The International Development Association (IDA), the Soft Loan Window of the Bank provides loans to UDCs at very low rate of interest. However, the economic inequality among the member-countries goes on increasing. Many African countries are yet to improve their economic status.

India and World Bank:

The name "International Bank for Reconstruction and Development" was first suggested by India to the drafting committee. Since then the two have developed close relationship with each other from framing the policies of economic development in India to financing the implementation of these policies. The World Bank has given large financial assistance to India for economic development. Special mention may be made of the assistance World Bank has given to India in the development of infrastructure such as electric power, transport, communication, irrigation projects and steel industry.

The World Bank has assisted a number of projects in India. The IFC has identified five priority areas, namely, capital market development, direct foreign investment, access to foreign markets, equity investments in new and expanding companies and infrastructure. The World Bank has also assisted India in accelerating programmes of poverty alleviation and economic development. Until China became the member of World Bank in 1980, India was the largest beneficiary of the World Bank assistance.

- INDIA & IBRD : A Sustainable Relationship
    - India is a member of four of the five constituents of the World Bank Group.
    - International Bank for Reconstruction and Development(IBRD, 1945)
    - International Development Association (IDA, 1960)
    - International Finance Corporation (IFC, 1956)

- Multilateral Investment Guarantee Agency (MIGA, 1958)
- International Centre for Settlement of Investment Disputes (ICSID, 1966)
- [India is not its member]

- India is one of the founder members of IBRD, IDA and IFC. World Bank assistance in India started from 1948 when a funding for Agricultural Machinery Project was approved.
- First investment of IFC in India took place in 1959 with US$ 1.5 million.
- India became a member of MIGA in January 1994.
- India has an Executive Director, in the Board of Directors of IBRD / IFC / IDA/ MIGA.

World Trade Organization

The WTO was established in 1995 as a successor to the GATT. It is a new international organization set up as a permanent body and is designed to play the role of watch dog in the spheres of trade in goods and services, foreign investment and intellectual property rights. The Dunkel Draft, formulated by Arthur Dunkel, its Secretary General became the base for WTO.

Every two years, the member countries' Commerce Ministers Conference are being organized to discuss and settle the important souls and trade related matters. The first WTO conference was held at Singapore in 1996. The recent conference was held at Argentina in 2017. It was planned to organize 12th ministerial conference at Kazakhstan in 2020.

Objectives of WTO

The basic aim is to expand international trade and bring about economic prosperity by liberalizing trade restrictions.

i. To ensure reduction of tariff and other barriers.
ii. To eliminate discrimination in trade.
iii. To facilitate higher standard of living.
iv. To facilitate optimal use of world's resources.
v. To enable the LDCs to secure fair share in the growth of international trade.
vi. To ensure linkages between trade policies, environmental policies and sustainable development.

WTO Agreements

Agreement on Trade Related Intellectual Property Rights (TRIPs)

Intellectual Property Rights include copy right, trade marks, patents, geographical indications, trade secrets, industrial designs, etc. TRIPS Agreement provides for granting product patents instead of process patents. The period of protection will be 20 years for patents, 50 years for copy rights, 7 years for trade marks and 10 years for layout designs. As a result of TRIPS, the dependence of LDCs on advanced countries for seeds, drugs, fertilizers and pesticides has increased. Farmers are depending on the industrial firm for their seeds.

Agreement on Trade Related Investment Measures (TRIMs)

TRIMs are related to conditions or restrictions in respect of foreign investment in the country. It calls for introducing equal treatment for foreign companies on par with national companies. TRIMs were widely employed by developing countries. Restrictions on foreign investment on following grounds are to be removed.

- No restriction on area of investment.
- No binding on use of local material.
- No mandatory exports.
- No restriction on repatriation of royalty, dividend and interest.
- No trade balancing requirement,
- i.e. imports not exceeding exports.

General Agreement on Trade in Services (GATS)

GATS is the first multilateral set of rules covering trade in services like banking, insurance, transportation, communication, etc., All member countries are supposed to extend MFN (Most Favoured Nation) status to all other countries without any discrimination. Transparency should be maintained by publishing all relevant laws and regulations over services.

Phasing out of Multi Fibre Agreement (MFA)

The multi fibre agreement governed the world trade in textiles and garments since 1974. It imposed quotas on export of textiles by developing nations to the developed countries. This quota system was to be phased out over a period of ten years. This was beneficial to India.

Agreement on Agriculture (AoA)

Agriculture was included for the first time under GATT. The important aspects of the agreement are Tariffication, Tariff cuts and Subsidy reduction.

Dispute Settlement Body

The Disputes Settlement Body puts an end to procedural delays. It is mandatory to settle any dispute within 18 months. The disputes are resolved through multilateral trading system. However, India has lost a huge export earnings because of the conditions laid out by the Body.

Functions of WTO

The following are the functions of the WTO

i. It facilitates the implementation, administration and operation of the objectives of the Agreement and of the Multilateral Trade Agreements.
ii. It provides the forum for negotiations among its members, concerning their multilateral trade relations in matters relating to the agreements.
iii. It administers the Understanding on Rules and Procedures governing the Settlement of Disputes.
iv. It cooperates with the IMF and the World Bank and its affiliated agencies with a view to achieving greater coherence in global economic policy making.

Major WTO Functions

- ❖ Administering WTO trade agreements
- ❖ Forum for trade negotiations
- ❖ Handling trade disputes
- ❖ Monitoring national trade policies
- ❖ Technical assistance and training for developing countries
- ❖ Cooperation with other international organizations

Achievements of WTO

The major achievements of WTO are as follows

1. Use of restrictive measures for BoP problems has declined markedly;
2. Services trade has been brought into the multilateral system and many countries, as in goods, are opening their markets for trade and investment;
3. The trade policy review mechanism has created a process of continuous monitoring of trade policy developments.

WTO and India

India is the founding member of the WTO. India favours multilateral trade approach. It enjoys MFN status and allows the same status to all other trading partners. India benefited from WTO on following grounds:

1. By reducing tariff rates on raw materials, components and capital goods, it was able to import more for meeting her developmental requirements. India's imports go on increasing.
2. India gets market access in several countries without any bilateral trade agreements.
3. Advanced technology has been obtained at cheaper cost.
4. India is in a better position to get quick redressal from the trade disputes.
5. The Indian exporters benefited from wider market information.

Trade Blocks

- ❖ Some countries create business opportunities for themselves by integrating their economies in order to avoid unnecessary competition among them. Trade blocks cover different kinds of arrangements between or among countries for mutual benefit. Economic integration takes the form of Free Trade Area, Customs Union, Common Market and Economic Union.
- ❖ A free trade area is the region encompassing a trade bloc whose member countries have signed a free-trade agreement (FTA). Such agreements involve cooperation between at least two countries to reduce trade barriers. e.g. SAFTA, EFTA.
- ❖ A customs union is defined as a type of trade block which is composed of a free trade area with no tariff among members and (zero tariffs among members) with a common external tariff. e.g. BENELUX (Belgium, Netherland and Luxumbuarg).
- ❖ Common market is established through trade pacts. A group formed by countries within a geographical area to promote duty free trade and free movement of labour and capital among its members. e.g. European Common Market (ECM)
- ❖ An economic union is composed of a common market with a customs union. The participant countries have both common policies on product regulation, freedom of movement of goods, services and the factors of production and a common external trade policy. (e.g. European Economic Union)

Institution	Headquarters	Year of Establishment
South Asian Association for Regional Cooperation (SAARC)	Kathmandu	1985
ASEAN	Bangkok	1967
BRICS	Shangai	2001

South Asian Association For Regional Co-Operation (SAARC)

The South Asian Association for Regional Co-operation (SAARC) is an organisation of South Asian nations, which was established on 8 December 1985 for the promotion of economic and social progress, cultural development within the South Asia region and also for friendship and co-operation with other developing countries. The SAARC Group (SAARC) comprises of Bangaladesh, Bhutan, India, The Maldives, Nepal, Pakistan and Sri Lanka. In April 2007, Afghanistan became its eighth member. The basic aim of the organisation is to accelerate the process of economic and social development of member states through joint action in the agreed areas of cooperation. The SAARC Secretariat was established in Kathmandu (Nepal) on 16th January 1987. The first SAARC summit was held at Dhaka in the year 1985. SAARC meets once in two years. Recently, the 20th SAARC summit was hosted by Srilanka in 2018.

Objectives of SAARC

According to Article I of the Charter of the SAARC, the objectives of the Association are as follows:

i. To promote the welfare of the people of South Asia and improve their quality of life;

ii. To accelerate economic growth, social progress and cultural development in the region;
iii. To promote and strengthen collective self-reliance among the countries of South Asia;
iv. To contribute to mutual trust, understanding and appreciation of one another's problems;
v. To promote active collaboration and mutual assistance in the economic, social, cultural, technical and scientific fields;
vi. To strengthen co-operation with other developing countries;
vii. To strengthen cooperation among themselves in international forums on matters of common interest;
viii. To cooperate with international and regional organisations with similar aims and purposes.

Functions of SAARC

The main functions of SAARC are as follows.

1. Maintenance of the co operation in the region
2. Prevention of common problems associated with the member nations.
3. Ensuring strong relationship among the member nations.
4. Removal of the poverty through various packages of programmes.
5. Prevention of terrorism in the region.

Achievements of SAARC

1. The establishment of SAARC Preferential Trading Agreement (SAPTA) and reduction in tariff and non-tariff barriers on imports.
2. The setting up of Technical Committees for economic cooperation among SAARC countries relating to agriculture, communications, education, health and population, rural development, science and technology, tourism, etc.
3. SAARC has established a three-tier mechanism for exchanging information on poverty reduction programmes which is passed on to member countries.
4. SAARC Agricultural Information Centre (SAIC) in 1988 works as a central information institution for agriculture related resources like fisheries, forestry, etc.
5. South Asian Development Fund (SADF) for development projects, human resource development and infrastructural development projects. With all these tall claims, the inter-SAARC Trade has not gone beyond three percent in the last 30 years.

Association of South East Asian Nations (ASEAN)

ASEAN was established on 8 August 1967 in Bangkok by the five original member countries: Indonesia, Malaysia, Philippines, Singapore and Thailand. Later Brunei Darussalam, Vietnam, Laos and Myanmar and Cambodia joined. Besides ten members of the ASEAN, there are six "dialogue partners" which have been participating in its deliberations. They are China, Japan, India, South Korea, New Zealand and Australia. The

ASEAN nations are expected to benefit from the FTA as it will reduce tariff and non-tariff barriers. The common historical and cultural background made the member countries to maintain their unity and solidarity by establishing a trade block. Foreign trade is the life blood of the ASEAN countries following globalization and prudent macroeconomic policies. The ASEAN Summit of the Heads of Governments of member countries is the highest forum for ASEAN cooperation. Its meetings are held once in three years. The ASEAN \ministerial meeting of Foreign Ministers is the next highest decision-making body.

India's relationship with ASEAN started in 1992 when India became a "sectoral dialogue partner" of ASEAN. The geographic proximity of ASEAN countries to India facilitates faster exports and lower freight costs.

Objectives of ASEAN

The ASEAN Declaration states the aims and purposes of the Association as:

i. To accelerate the economic growth, social progress and cultural development in the region;
ii. To promote regional peace and stability and adherence to the principles of the United Nations Charter;
iii. To promote cooperation among the members of ASEAN through the exchange of knowledge and experience in the field of public sector auditing.
iv. To provide a conducive environment and facilities for research, training, and education among the members
v. To serve as a centre of information and as an ASEAN link with other international organizations.

Functions of the ASEAN

i. It facilitates free movement of goods, services and investments within ASEAN by creating a single regional market like the European Union.
ii. It provides free access to the marketers of one member country to the markets of all other member countries, thus fostering growth in the region.
iii. It improves business competitiveness between businesses from different countries and also narrow developmental gaps between member countries.
iv. It paves way for market and investment opportunities for the member nations.
v. It fosters co-operations in many areas including industry and trade.

All the ASEAN economies experienced a great economic crisis in the year 1997.

BRICS

BRICS is the acronym for an association of five major emerging national economies: Brazil, Russia, India, China and South Africa. Originally the first four were grouped as "BRIC" before the induction of South Africa in 2010. The term 'BRIC' was coined in 2001.

The BRICS members are known for their significant influence on regional affairs. Since 2009, the BRICS nations have met annually at formal summits. South Africa hosted the 10th BRICS summit in July 2018. The agenda for BRICS summit 2018 includes Inclusive growth, Trade issues, Global governance, Shared Prosperity, International peace and security.

It's headquarters is at Shanghai, China. The New Development Bank (NDB) formerly referred to as the BRICS Development Bank was established by BRICS States. The first BRICS summit was held at Moscow and South Africa hosted the Tenth Conference at Johanesberg in July 2018. India had an opportunity of hosting fourth and Eighth summits in 2012 and 2016 respectively.

Objectives of BRICS

1. To increase trade co-operation by making an exclusive trade block.
2. To use currency other than US Dollar. Since Dollar is a dominant currency and US can control the flow of dollar, BRICS helps in the countries countries operating with alternative currencies. How far have they succeeded in this respect? Not much.
3. To increase regional co-operation.
4. To create a separate trade block made for developing countries for trade co-operation.

Functions of BRICS

1. It acts as a promoter of more legitimate international system and also advocating reform of the UN Security Council.
2. This group of nations is especially meant for South-South framework for cooperation.
3. It performs as an agent to bridge the increasing gap between developed and developing countries. For instance, in the WTO, the BRICS countries are emphasizing to promote a fair order regarding agricultural policies.
4. It performs a commendable contribution for assisting developing countries in gaining in areas such as an advantage in trade and climate change negotiations.
5. It disseminates information and exchange platform beyond economic cooperation.
6. It acts as a catalytic in protecting the interests of middle powers on global forum.

Achievements of BRICS
Following are some of the major achievements of BRICS.

- The establishment of the Contingent Reserve Arrangement (CRA) has further deepened and consolidated the partnership of its members in the economic-financial area.

- In the sixth BRICS summit in Brazil, the member countries, signed an agreement to create a development bank (New Development Bank) with headquarters at

Shangai, China in 2015 on the lines of Asian Development Bank and the World Bank.

- The economic potential and demographic development are putting the BRICS countries, increasingly in a leading position in setting the global agenda and having a greater say in the global governance.

It has to be remembered that BRICS share 43% of world population, but only 21% of the global GDP.

Unit 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 36.1 crore 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."
-Anatol Murad

"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 governments and the State governments provide grants to the local government to carry out their functions.

- 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.

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 Or ZilaParishads:

- **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 Panchayat Samitis 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.

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.

Unit -11

Economics of Development and Planning

A good plan may fail due to faulty implementation. But a faulty plancannot succeed through good implementation.
"Plan your work for today and every day, then work your plan."
-Margaret Thatcher

Introduction

- The concept "development" refers to the structural changes towards betterment. Until the World War II, interest was rarely shown on the problems of the present day third World Countries. After the Second World War, economists started devoting their attention towards analyzing the problems of underdeveloped countries and formulating theories and models of development and growth. The Under Developed Countries (UDCs) were once the colonies of England and other European countries. After becoming free and independent, there was an awakening to march towards economic development.

Approaches to Economic Development

- There are two main approaches to the concept of development viz i) the traditional approach and ii) the new welfare oriented approach.

1. Traditional Approach : The traditional approach defines development strictly in economic terms. The increase in GNP is accompanied by decline in share of agriculture in output and employment while those of manufacturing and service sectors increase. It emphasizes the importance of industrialization. It was assumed that growth in GNP per capita would trickle down to people at the bottom.

2. New Welfare oriented Approach: During 1970s, economic development was redefined in terms of reduction of poverty, 'inequality' and unemployment within the context of a growing economy. In this phase, 'Redistribution with Growth' became the popular slogan.

- To quote Michael P. Todaro, "Development must, therefore, be conceived as a multidimensional process involving major changes in social structures, popular attitudes and national institutions as well as the acceleration of growth, the reduction of inequality and the eradication of absolute poverty".

Underdevelopment

- The UDCs are characterized by predominance of primary sector i.e. agriculture, low per capita income, widespread poverty, wide inequality in distribution of income and wealth, over population, low rate of capital formation, high rate of unemployment, technological backwardness, dualism etc.

Meaning of Underdevelopment

- The term underdevelopment refers to that state of an economy where levels of living of masses are extremely low due to very low levels of Percapita income, resulting from low levels of productivity and high growth rate of population.

Economic Growth Vs Economic Development

1. **State of Development**

- Generally speaking, economic development refers to the problems of underdeveloped countries and economic growth to those of developed countries.

2. **Nature and Level of Change**

- Development is a discontinuous and spontaneous change while growth is a gradual and steady change in the long run.

3. **Scope of Change**

- Growth simply means more output. But development refers to efficiency in production i.e. output per unit of input. It also implies changes in composition of output and in allocation of resources, reduction of poverty, inequality and unemployment.

4. **Extent of change**

- Economic development (wider concept than economic growth) is taken to mean growth plus structural change.

Differences between Economic Growth and Economic Development	
Economic Growth	**Economic Development**
Deals with the problems of Developed countries	Deals with the problems of UDCs
Change is gradual and steady	Change is discontinuous and spontaneous
Means more output	Means not only more output but also its composition
Concerns Quantitative aspects i.e. increase in per capita income	Quantitative as well as Qualitative
Narrow	Wider concept Development = Growth + Chang

Measurement of Economic Development

Economic development is measured on the basis of four criteria

- **Gross National Product (GNP):** GNP is the total market value of all final goods and services produced within a nation in a particular year, plus income earned by its citizens (including income of those located abroad), minus income of non-residents located in that country. GNP is one measure of the economic condition of a country, under the assumption that a higher GNP leads to a higher quality of living, all other things being equal.

- **GNP per capita:** This relates to increase in the per capita real income of the economy over the long period. This indicator of economic growth emphasizes that for economic development the rate of increase in real per capita income should be higher than the growth rate of population.

- **Welfare:** Economic development is regarded as a process whereby there is an increase in the consumption of goods and services by individuals. From the welfare perspective, economic development is defined as a sustained improvement in health, literacy and standard of living.

- **Social Indicators:** Social indicators are normally referred to as basic and collective needs of the people. The direct provision of basic needs such as health, education, food, water, sanitation and housing facilities check social backwardness.

Determinants of Economic Development

- Economic development is not determined by any single factor. Economic development depends on Economic, Social, Political and Religious factors.

Economic and Non-Economic Factors
Economic Factors

1. Natural Resource: The principal factor affecting the development of an economy is the availability of natural resources. The existence of natural resources in abundance is essential for development. A country deficient in natural resources may not be in a position to develop rapidly. But a country like Japan lacking natural resources imports them and achieve faster rate of economic development with the help of technology. India with larger resources is poor.

2. Capital Formation: Capital formation is the main key to economic growth. Capital formation refers to the net addition to the existing stock of capital goods which are either tangible likeplants and machinery or intangible like health, education and research. Capital formation helps to increase productivity of labour and thereby production and income. It facilitates adoption of advanced techniques of production. It leads to better utilization of natural resources, industrialization and expansion of markets which are essential for economic progress.

3. Size of the Market: Large size of the market would stimulate production, increase employment and raise the National per capita income. That is why developed countries expand their market to other countries through WTO.

4. Structural Change: Structural change refers to change in the occupational structure of the economy. Any economy of the country is generally divided into three basic sectors: Primary sector such as agricultural, animal husbandry, forestry, etc; Secondary sector such as industrial production, constructions and Tertiary sector such as trade, banking and commerce. Any economy which is predominantly agricultural tends to remain backward.

5. Financial System: Financial system implies the existence of an efficient and organized banking system in the country. There should be an organized money market to facilitate easy availability of capital.

6. Marketable Surplus: Marketable surplus refers to the total amount of farm output cultivated by farmers over and above their family consumption needs. This is a surplus that can be sold in the market for earning income. It raises the purchasing power, employment and output in other sectors of the economy. The country as a result will develop because of increase in national income.

7. Foreign Trade: The country which enjoys favorable balance of trade and terms of trade is always developed. It has huge forex reserves and stable exchange rate.

8. Economic System: The countries which adopt free market mechanism (laissez faire) enjoy better growth rate compared to controlled economies. It may be true for some countries, but not for every country.

Non- Economic Factors

- 'Economic Development has much to do with human endowments, social attitudes, political conditions and historical accidents. Capital is a necessary but not a sufficient condition of progress.

– RagnarNurkse.

1. **Human Resources:** Human resource is named as human capital because of its power to increase productivity and thereby national income. There is a circular relationship between human development and economic growth. A healthy, educated and skilled labour force is the most important productive asset. Human capital formation is the process of increasing knowledge, skills and the productive capacity of people. It includes expenditure on health, education and social services. If labour is efficient and skilled, its capacity to contribute to growth will be high. For example Japan and China.

2. **Technical Know-how:** As the scientific and technological knowledge advances, more and more sophisticated techniques steadily raise the productivity levels in all sectors. Schumpeter attributed the cause for economic development to innovation.

3. **Political Freedom:** The process of development is linked with the political freedom. DadabhaiNaoroji explained in his classic work 'Poverty and Un- British Rule in India' that the drain of wealth from India under the British rule was the major cause of the increase in poverty in India.

4. **Social Organization:** People show interest in the development activity only when they feel that the fruits of development will be fairly distributed. Mass participation in development programs is a pre-condition for accelerating the development process. Whenever the defective social organization allows some groups to appropriate the benefits of growth. majority of the poor people do not participate in the process of development. This is called crony capitalism.

5. **Corruption free administration:** Corruption is a negative factor in the growth process. Unless the countries root-out corruption in their administrative system, the crony capitalists and traders will continue to exploit national resources. The tax evasion tends to breed corruption and hamper economic progress.

6. **Desire for development:** The pace of economic growth in any country depends to a great extent on people's desire for development. If in some country, the level of consciousness is low and the general mass of people has accepted poverty as its fate, then there will be little scope for development.

7. **Moral, ethical and social values:** These determine the efficiency of the market, according to Douglas C. North. If people are not honest, market cannot function.

8. **Casino Capitalism:** If People spend larger propotion of their income and time on entertainment liquor and other illegal activities, productive activities may suffer, according to Thomas Piketty.

9. **Patrimonial Capitalism:** If the assets are simply passed on to children from their parents, the children would not work hard, because the children do not know the value of the assets. Hence productivity will be low as per Thomas Piketty.

Vicious Circle of Poverty

- There are circular relationships known as the 'vicious circles of poverty' that tend to perpetuate the low level of development in Less Developed Countries (LDCs). Nurkse explains the idea in these words: "It implies a circular constellation of forces tending to act and react upon one another in such a way as to keep a poor country in a state of poverty. For example, a poor man may not have enough to eat; being underfed, his health may be weak; being physically weak, his working capacityis low, which means that he is poor, which in turn means that he will not have enough to eat and so on. A situation of this sort relating to a country as a whole can be summed up in the proposition: “A county is poor because the country is poor”.

- The vicious circle of poverty operates both on the demand side and the supply side.

- On the supply side, the low level of real income means low savings. The low level of saving leads to low investment and to deficiency of capital. The deficiency of capital, in turn, leads to low levels of productivity and back to low income. Thus the vicious circle is complete from the supply side.

- The demand-side of the vicious circle is that the low level of real income leads to a low level of demand which, in turn, leads to a low rate of investment and hence back to deficiency of capital, low productivity and low income.

Breaking the Vicious Circle ofPoverty

- The vicious circle of poverty is associated with low rate of saving and investment on the supply side. In UDCs the rate of investment and capital formation can be stepped up without reduction in consumption. For this, the marginal rate of savings is to be greater than average rate of savings.

- To break the vicious circle on the demand side, Nurkse suggested the strategy of balanced growth. If investment is made in several industriessimultaneously the workers employed in various industries will become consumers of each other’s products and will create demand for one another. The balanced growth i.e. simultaneous investment in large number of industries creates mutual demand. Thus, through the strategy of balanced growth, vicious circle of poverty operating on the demand side of capital formation can be broken.

Planning
Meaning

- Planning is a technique, a means to an end being the realization of certain
pre-determined and well-defined aims and objectives laid down by a central planning authority. The end may be to achieve economic, social, political or military objectives.

Definitions

- Economic Planning is “collective control or suppression of private activities of production and exchange”. -Robbins

- “Economic Planning in the widest sense is the deliberate direction by persons in-charge of large resources of economic activity towards chosen ends”.
  -Dalton

Economic Planning in India

- Consists of economic decisions, schemes formed to meet certain predetermined economic objectives anda road map of directions to achieve specific goals within specific period of time. The current thinking of economic planning is fairly new, somewhat rooted in Marxist socialism. In the 20th century, intellectuals, theorists, thinkers from Europe put forward the idea of state involvement to stop capitalism and the inequality of society.

- Soviet Union adopted economic planning for the first time in 1928 that enabled the country to turn into an industrial superpower. The idea of economic planning was strengthened during the Great Depression in 1930s. The outbreak of the World War II also required adequate and suitable planningof economic resources for the effective management after the effects of post wareconomy.

- After Independence, in 1948, a declaration of industrial policy was announced. The policy suggested the creation of a National Planning Commission and the elaboration of the policy of a mixed economic system. On January 26, 1950, the Constitution came into force. In logical order, the PlanningCommission was created on March 15, 1950 and the plan era began on April 1,1951 with the launch of the first five year plan (1951-56). The evolution of planning in India is stated below:

1. **Sir M. Vishveshwarya (1934):** a prominent engineer and politician made his first attempt in laying foundation for economic planning in India in 1934 through his book, “Planned Economy of India”. It was a 10 year plan.

2. **Jawaharlal Nehru (1938):** set-up “National Planning Commission” by a committee but due to the changes in the political era and second World War, it did not materialize.

3. **Bombay Plan (1940):** The 8 leading industrialists of Bombay presented “Bombay Plan”. It was a 15 Year Investment Plan.

4. **S. N Agarwal (1944)** gave the “Gandhian Plan” focusing on the agricultural and rural economy.

5. **M.N. Roy (1945)** drafted ‘People’s Plan”. It was aiming at mechanization of agricultural production and distribution by the state only.

6. **J.P. Narayan (1950)** advocated, “Sarvodaya Plan” which was inspired by Gandhian Plan and with the idea of VinobaBhave. It gave importance not only for agriculture, but encouraged small and cottage industries in the plan.

- After considering all the plans, in the same year Planning Commission was set up to formulate Five Year Plan in India by Jawaharlal Nehru. He was the first Chairman of Planning Commission, Government of India.

Case for planning

- The economic planning is justified on the following grounds.

1. **To accelerate and strengthen market mechanism**: The market mechanism works imperfectly in underdeveloped countries because of the ignorance andeconomy comprises the non-monetized sector. The product, factor, money and capital markets are not organized properly. Therefore the planned economy will be a better substitute for free economy.

2. **To remove unemployment:**
Capital being scarce and labour being abundant, the problem of providing gainful employment opportunities to an ever-increasing labour force is a difficult task. The need for planning in underdeveloped countries is further stressed by the necessity of removing widespread unemployment and disguised unemployment in such economies.

3. **To achieve balanced development:**
In the absence of sufficient enterprise and initiative, the planning authority is the only institution for planning the balanced development of the economy. For rapid economic development, underdeveloped countries require the development of the agricultural and industrial sectors, the establishment of social and economic overheads, the expansion of the domestic and foreign trade sectors in a harmonious way.

1. **Development of Agriculture andIndustrial Sectors:** The need for developing the agriculture sector along with the industrial sector arises from the fact that agriculture and industry are interdependent. Reorganization of agriculture releases surplus labour force which can be absorbed by the industrial sector. Development of agriculture isalso essential to supply the raw material needs of the industrial sector.
2. **Development of Infrastructure:** The agriculture and industrial sectors cannot develop in the absence of economic and social overheads. The building of canals, roads, railways, power stations, etc., is indispensable for agricultural and industrial development. Infrastructure involves huge capital investment long gestation period and low rate of return. The state alone can provide strong infrastructural bases through planning.

3. **Development of Money and Capital Markets:** The expansion of the domestic and foreign trade requires not only the development of agricultural and industrial sectors along with social and economic overheads but also the existence of financial institutions. Money and capital markets are not adequate in underdeveloped countries. This factor acts as an obstacle to the growth of industry and trade. So planning alone can provide sound money market and capital market.

4. **To remove poverty and inequalities:** Planning is the only path open to underdeveloped countries, for raising national and per capita income, reducing

inequalities and poverty and increasing employment opportunities. Has it happened in India in the last 65 years?

- Hence, Arthur Lewis says, "Planning is more necessary in backward countriesto devise ways and means and to make concerted efforts to raise national income"

Case against planning

- The failure of market mechanism invited state intervention in economic activities through planning. The prime goals of economic planning are stabilization in developed countries and growth in LDCs. But the economic planning also is not free from limitations. It may retard private initiatives, hamper freedom of choice, involve huge cost of administration and stop the automatic adjustment of price mechanism. The arguments against planning are discussed below.

1. Loss of freedom

- The absence of freedom in decision making may act as an obstacle for economic growth. Regulations and restrictions are the backbone of a planned economy. The economic freedom comprises freedom of consumption, freedom of choice of occupation, freedom to produce and the freedom to fix prices for the products. Under planning, the crucial decisions are made by the Central Planning Authority. The consumers, producers and the workers enjoy no freedom of choice. Therefore, Hayek explains in his book 'Road to Serfdom' that centralized planning leads to loss of personal freedom and ends in economic stagnation. The decisions by the Government are not always rational.

  But, freedom to private producers will be misused; profit will be given top priority, welfare will be relegated.

2. Elimination of Initiative

- Under centralized planning, there will be no incentive for initiatives andinnovations. Planning follows routine procedure and may cause stagnation in growth. The absence of initiatives may affect progress in following ways.

  a. The absence of private ownership and profit motive discourages entrepreneurs from taking bold decisions and risk taking. Attractive profit is the incentive for searching new ideas, new lines and new methods. These are missing in a planned economy.

  b. As all enjoy equal reward under planned economy irrespective of their effort, efficiency and productivity, nobody is interested in undertaking new and risky ventures.

  c. The bureaucracy and red tapism which are the features of planned economy, cripple the initiative as they cause procedural delay and time loss. The ease of doing business is disrupted. It is because of this, even socialist countries like Russia and China offer incentives to private enterprises.

3. **High cost of Management**

- No doubt the fruits of planning such as industrialization, social justice and regional balance are good. But the cost of management of the economic affairs outweighs the benefits of planning. Plan formulation and implementation involveengagement of an army of staff for data collection and administration. As Lewisremarks, "The better we try to plan, themore planners we need". Inadequate data, faulty estimations and improper implementation of plans result in wastage of resources and cause either surplus or shortages.

4. **Difficulty in advance calculations**

- Price mechanism provides for the automatic adjustment among price, demand and supply in a Laissez Faire economy. The producers and consumers adjust their supply and demand based on price changes. There is no such mechanism in a planned economy. Advance calculations in a precise manner are impossible to make decisions regarding the consumption and production. It is also very difficult to put the calculations into practice under planning. Excess supplyand excess demand can also happen in the market oriented economy. Infact it has happened in many expitalistic economies, including the US.

- The arguments against planning are mostly concerned with centralized and totalitarian planning. The democratic planning, planning by inducement and decentralized planning especially under mixed economies give equal role for private sector and public sector. Planned economy appears to be more efficient operationally than a market economy. So the question is not one of plan or no plan but one of the type of plan. The right mix of market mechanism and state intervention in right proportion will promise accelerated economic growth accompanied by stability and social justice.

Types of planning

- Economic planning is a process under which attempts are made to achieve desired targets of economic development within a specified period of time. There are different types of planning which differ in ideology and the procedure in execution

1. **Democratic Vs Totalitarian:**

- Democratic planning implies planning within democracy. People are associated at every step in the formulation and implementation of the plan. A democratic plan is characterized by the widest possible consultations with the various state governments and private enterprises at the stage of preparation. The plan prepared by the Planning Commission is not accepted as such. It can be accepted, rejected or modified by the Parliament of the country.

- Under totalitarian planning, there is central control and direction of all economic activities in accordance with a single plan. Consumption, production, exchange, and distribution are all controlled by the state. In authoritarian planning, the planning authority is the supreme body. It decides about the targets, schemes, allocations, methods and procedures of implementation of the plan.

2. **Centralized Vs Decentralized:**

- Under centralized planning, the entire planning process in a country is under a central planning authority. This authority formulates a central plan, fixes objectives, targets and priorities for every sector of the economy. In other words, it is called 'planning from above'

- Under decentralized planning local organizations and institutions formulate, adopt, execute and supervise the plan without interference by the central authorities. In other words, it is called 'planning from below'.

3. **Planning by Direction Vs Inducement:**

- Under planning by direction, there is a central authority which plans, directs and orders the execution of the plan in accordance with pre-determined targets and priorities.

- Under planning by inducement, the people are induced to act in a certain way through various monetary and fiscal measures. If the planning authority wishes to encourage the production of a commodity, it can give subsidy to the firms. Thus, planning by inducement is able to achieve the same results as under planning by direction but with less sacrifice of individual liberty.

4. **Indicative Vs Imperative Planning:**

- Indicative planning is peculiar to the mixed economies. It has been in practicein France since the Monnet Plan of 1947-50. In a mixed economy, the private sector and the public sector work together. Under this plan, the outline of plan is prepared by the Government. Then it is discussed with the representatives of private management, trade unions, consumer groups, finance institutions and other experts. The essential function of planning is coordination of different economic units. The state provides all types of facilities to the private sector. The private sector is expected to fulfill the targets and priorities. The state does not force the private sector but just indicate the areas of operation and targets to be fulfilled. In short, the planning procedure is soft and flexible.

- Under imperative planning, the state is all powerful in preparation and implementation of the plan. Once a plan is drawn up, its implementation is a matter of enforcement. The USSR President Stalin used to say, 'Our plans are our instructions'.

There is complete control over the entire resources by the state. There is no consumer sovereignty. The Government policies and procedures are rigid. China and Russia follow imperative planning.

5. **Short, Medium and Long term Planning:**

- Short-term plans are also known as 'controlling plans'. They encompass the period of one year, therefore, they are also known as 'annual plans'. The medium-term plans last for the period of 3 to 7 years. But normally, the medium term plan is made for the period of five years. The medium-term planning is not only related to allocation of financial resources but also physical resources.

- Long-term plans last for the period of 10 to 30 years. They are also knownas 'perspective plans'. The basic philosophy behind long-term planning is to bring structural changes in the economy.

6. **Financial Vs Physical Planning:**

- Financial planning refers to the technique of planning in which resources are allocated in terms of money while physical planning pertains to the allocation of resources in terms of men, materials and machinery.

7. **Functional Vs Structural Planning:**

- Functional planning refers to that planning which seeks to remove economic difficulties by directing all the planning activities within the existing economic and social structure. The structural planning refers to a good deal of changes in the socioeconomic framework of the country. This type of planning is adopted mostly in under developed countries.

8. **Comprehensive Vs Partial Planning:**

- General planning which concerns itself with the major issues for the whole economy is known as comprehensive planning whereas partial planning is to consider only the few important sectors of the economy.

- 13th August, 2014. The Prime Minister is the Chairperson of NITI Aayog and Union Ministers will be Ex-officio members. The Vice- Chairman of the NITI Aayog is the functional head and the first Vice- Chairman was ArvindPanangariya.

Functions of NITI Aayog

1. **Cooperative and CompetitiveFederalism:** To enable the States to have active participation in the formulation of national policy.

2. **Shared National Agenda:** To evolve a shared vision of national developmentpriorities and strategies with the active involvement of States.

3. **Decentralized Planning:** To restructure the planning process into a bottom-up model.

4. **Vision and Scenario Planning:** To design medium and long-term strategic frameworks towards India's future.

5. **Network of Expertise:** To mainstreamexternal ideas and expertise into government policies and programmes through a collective participation.

6. **Harmonization:** To facilitate harmonization of actions across different layers of government, especially when involving cross-cutting and overlapping issues across multiple sectors; through communication, coordination, collaboration and convergence amongst all the stakeholders.

7. **Conflict Resolution:** To provide platform for mutual consensus to intersectoral, inter-departmental, inter-state as well as centre-state issues for all speedy execution of the government programmes.

8. **Coordinating Interface with the World:** It will act nodal point to harness global expertise and resources coming from International organizations for India's developmental process.

9. **Internal Consultancy:** It provides internal consultancy to Central and State governments on policy and programmes.

10. **Capacity Building:** It enables to provide capacity building and technology up-gradation across government, benchmarking with latest global trends and providing managerial and technical know-how.

11. **Monitoring and Evaluation:** It will monitor the implementation of policies and progammes and evaluate the impacts.

- Initiatives like Atal Innovation Mission, Ayushmaan Bharat approach towards water conservation measures and the draft bill to establish the ationalMedical Commission to replace the Medical Council of India have all been conceptualized in NITI Aayog.

- NITI Aayog is also bringing about a greater level of accountability. It has established a development monitoring and evaluation office which collects data on the performance of various ministries. Using such data, the Aayog makes performance based ranking of states to foster a spirit of competitive federalism. The success of NITI Aayog can be evaluated after a substantial period of time.