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Directorate of Distance Education

M.A. (Economics)

I - Semester

362 13

INDIAN ECONOMY

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INTRODUCTION

The colonial rule in India brought a significant change in the taxation and agricultural policies. This led to commercialization of agriculture with a focus on trade. It had many adverse effects on Indian economy, such as decreased production of food crops, mass impoverishment and destitution of farmers and many famines. Thus, Indian economic policy after independence was influenced by the colonial experience. Independent India's domestic policy tended towards protectionism, concentrating on import substitution industrialization, economic interventionism, a large public sector, business regulation and central planning.

India initiated the principles of free market in 1991. This move was aimed at enabling the country to survive in internationally competitive market and attract foreign investment. Today, the economy of India is the tenth largest in the world by nominal GDP and the fourth largest by purchasing power parity (PPP). Our country is the second largest economy in the world, in terms of both population and arable land. It has 16 per cent of the world's population and 12 per cent of the world's arable land. According to the World Bank, the per capita GDP in India in 2016 was US\$ 1,709.39. However, despite its rapid economic growth, India continues to face massive income inequalities, high unemployment and malnutrition. This book, *Indian Economy*, discusses all these aspects in detail.

This book is divided into fourteen units that follow the self-instruction mode with each unit beginning with an Introduction to the unit, followed by an outline of the Objectives. The detailed content is then presented in a simple but structured manner interspersed with Check Your Progress Questions to test the student's understanding of the topic. A Summary along with a list of Key Words and a set of Self-Assessment Questions and Exercises is also provided at the end of each unit for recapitulation.

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BLOCK - I
INDIAN ECONOMY AND STRUCTURES

*Indian Economy at the
Time of Independence*

**UNIT 1 INDIAN ECONOMY AT THE
TIME OF INDEPENDENCE**

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- 1.1 Objectives
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- 1.3 Adoption of the Mixed Economy Model
- 1.4 Performance of Planning
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1.0 INTRODUCTION

The first unit of the book will begin with a discussion on the Indian economy at the time of independence.

At the dawn of independence, India was an extremely poor nation with an overwhelmingly illiterate population that was mostly employed in the agriculture sector. The leaders of the independence movement had to think about how to develop the nation so as to satisfy the aspirations of the newly freed people. They collectively decided to follow the state planning method of development under a mixed economy model as they considered it the most appropriate method to bring about rapid development. The first Indian Prime Minister Jawaharlal Nehru had been deeply impressed with the developments in the Soviet Union, and as such decided to adopt their five-year plans approach in India. We will be discussing all these aspects in this unit.

1.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the objectives and rationale for planning
- Explain why India adopted the mixed economy model
- Examine the performance of the different five year plans

1.2 PLANNING: OBJECTIVES AND RATIONALE

NOTES

A planned economy is an economic system in which the economy is directed by the state. It is an economic system in which the central government controls industry by making major decisions regarding the production and distribution of goods and services. The two major types of planning are central or centralized planning and indicative planning. After the end of the British Raj, Independent India decided to follow a centralized planning approach to its development. In this regard the Planning Commission was set up.

India's first Prime Minister, Jawaharlal Nehru set up the Planning Commission with a Government of India resolution in March 1950. The Planning Commission was set up in pursuance of the declared objectives of the government, which was to promote a swift rise in the standard of living of the people by the efficient utilization of the resources of the country, increasing production and offering opportunities to all for employment in the service of the community. Nehru was the first chairman of the Planning Commission, a post that has been held by all subsequent prime ministers. The charge of the Planning Commission was to assess all the resources of the country, increasing deficient resources, formulating plans for the most effective and balanced utilization of resources and determining priorities.

The various five year plans were formulated and executed by the Planning Commission of India since its inception. This state led development model of development was largely followed by India till 1991 when the balance of payment crisis and subsequent pressure from monetary agencies like the World Bank and the International Monetary fund made India liberalise its economy and abandon the centralized planning approach.

The 'Nehru-Mahalanobis' model was formulated by Prof. P. C. Mahalanobis under the guidance of Nehru. The 'Nehru-Mahalanobis Model' became the basis of the second five-year plan and continued to be guiding principle of all subsequent plans with small alterations until 1977 when the Janata Party came into power and conceived of the Gandhian model. The emphasis of the model was on the rapid development of heavy industry with the objective of creating an indigenous industrial base so as to make India even more self-reliant into arms father capital-goods sector. The justification of the heavy goods strategies was stated in the framework of the second year-year plan as being 'In long run, the rate of Industrialization and the growth of the national economy would depend upon the increasing production of coal, electricity, iron and steel, heavy machinery, heavy chemicals and heavy industries generally – which would increase the capacity for capital formation. One important aim is to make India independent as quickly as possible of foreign imports of producer goods so that the accumulation of capital would not be hampered by difficulties in securing supplies of essential producer goods from

other countries. The heavy industry must, therefore, be expanded with all possible speed.' The Nehru–Mahalanobis Model's justifications for greater emphasis on heavy industry were given as follows:

- (i) The British colonial government intentionally denied the development of heavy industry in India and kept the country, primarily an agrarian economy, as an appendage of the British colonial system.
- (ii) The Indian industrial structure was mainly dependent on the consumer goods industries. Therefore, it was necessary to broaden this base by developing heavy industries and infrastructure. The argument was made that a diversified industrial structure could absorb a huge population of labour and raise labour productivity. Such a situation would reduce the nation's dependence on agriculture as a provider of employment.
- (iii) Since the productivity of labour was higher in manufacturing than in agriculture, a push towards industrialisation promised to bring about a swift increase in national and per capita income.
- (iv) The rapid development of the Industrial sector was not only critical for the development of agriculture, but also for the growth of all other sectors of the Indian economy.

Although admitting that foreign aid assisted in the development of capital goods and the infrastructure sector, the 'Nehru-Mahalanobis Model' stressed that the major burden of development would have to be borne by domestic savings. Since foreign aid would largely come in the form of loans, the model emphasised the growth of exports so as to pay for the bulk of imports by the increase in exports. The model was also conscious of the fact that enormous investments in heavy industry, although very important, would not increase employment significantly, since such investments were capital-intensive. Therefore, in order to generate employment and support the production of consumer goods, investment had to be made in small scale industries. The emphasis of enormous investment in heavy industry did not mean that the model did not give due importance to the role of agriculture for developing the Indian economy. Nehru recognised how critical agriculture was to the Indian economy stating, "We shall find that this industrial progress cannot be achieved without agricultural advances and progress... Everyone knows that unless we are self-sufficient in agriculture we cannot have the wherewithal to advance in industries. If we have to import food, then we are doomed so far as progress is concerned. We cannot import both food and machinery."

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Check Your Progress

1. What is a planned economy?
2. Why was the Planning Commission set up?

1.3 ADOPTION OF THE MIXED ECONOMY MODEL

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A mixed economy may be defined as ‘an economic system in which both the private enterprise and a degree of state monopoly (usually in public services, defence, infrastructure, and basic industries) coexist’. All modern economies are mixed where the means of production are shared between the private and public sectors. Mixed economy is a term used to describe an economic system, where some important production is undertaken by the State, directly or through its nationalized industries, and some is left for private enterprise. It is also defined as an economy containing the characteristics of both capitalism and socialism, that is, a combination of private and public ownership of the means of production, with some measure of control by the central government. It is a type of economy in which private and public sectors co-exist and try to retain the advantages of capitalism and socialism while trying to eliminate the evils of both the systems.

The term-mixed economy arose in the context of political debate in the United Kingdom in the post-War period, although the set of policies later associated with the term had been advocated from at least the 1930s. Supporters of the mixed economy, including R.H. Tawney, Anthony Crossland and Andrew Shonfield were mostly associated with the British Labour Party, although similar views were expressed by Conservatives including Harold Macmillan.

In broad terms, a mixed economy usually is an economic system where both the public and the private sector direct the economy. Mixed economies reflect the characteristics of both market driven liberal economies and state controlled socialist economies. Nehru favoured the mixed economy approach towards development, but he did not regard the mixed economy as a ‘half-way house’ between the capitalistic or liberal and the communistic or socialist forms of economic organization. For Nehru, the mixed economy was an amalgamation of the two economic systems and since it was free from both their dogmatic approaches, the mixed economy represented a higher form of economic organization. Nehru also took the position that the continuous exceptional growth of science and technology that resulted in phenomenal changes in human activity and the modes of production could only be absorbed by the mixed economy, which alone possessed the flexibility and resilience to do so.

Types of Economic Systems

Any economic system must address four fundamental questions. One can differentiate among the various economic systems based on how they answer these questions. The four fundamental questions are as follows:

- What goods and services should be produced?
- How should the goods and services be produced?

- Should producers use more human labour or more capital (machines) for producing things?
- How should the goods and services be distributed among people?

*Indian Economy at the
Time of Independence*

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A capitalist or market driven economy answers these questions by the forces of demand and supply. In a capitalist economy only those consumer goods that are in demand and can be sold for profit in the domestic or foreign markets are produced. For example, if televisions and cars are in demand, they will be produced. Moreover, if labour is cheaper than capital, more labour-intensive methods of production will be used and vice-versa. In a capitalist economy, the goods produced are distributed among people on the basis of their purchasing power, which is the ability to buy goods and services, and not on the basis of what people need. Poor people in a country like India require housing, but since the poor do not have the purchasing power, their needs will not be counted by the market. Thus, housing for the poor will not be produced and supplied by market forces.

A socialist economy answers these questions in a radically different manner. In a socialist economy, the goods and services produced is decided by the government based on what people need. The assumption of socialist economies is that the government knows what people need. For example, the rich may desire luxury items, but the government will use the resources not to produce luxury items for the rich, but rather use resources to produce goods which are needed by the poor. Similarly, the distribution of goods in a socialist country is also based on what people need and not on what they can afford to purchase. Ideally, a socialist nation would provide free education, health care and other civic amenities to all its citizens.

In a mixed economy, the question of what goods and services need to produce and distributed is answered by both the market and the government. In a mixed economy, ideally speaking, the market will provide whatever goods and services it can produce well, and the government will provide essential goods and services which the market fails to do.

Salient Features of Mixed Economy

The capitalist economy did not appeal to Jawaharlal Nehru. For Nehru, the 'acquisitive society' was not suited for the present age and sought its replacement by "a classless society, based on co-operative effort, with opportunities for all." Nehru observed that "the strongest urge in the world today is that of social justice and equality" and came to the conclusion that any social structure that was based on the possession of land and capital by a few with 'the others living on the verge of existence' stood 'self-condemned' and had to be changed.

Although Nehru took the view that the capitalist system had outlived its relevance, he did not approve of a system where the state controlled the entire means of production because of two reasons, one of which was institutional and the other was historical. The institutional reason was that he felt the introduction of

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complete control over the means of production was not possible without introducing 'authoritarianism' and 'totalitarianism,' both of which he despised as a staunch democrat. Nehru sought a system which could "realize economic growth and social justice without the sacrifice of freedom and the democratic rights of the common citizen." He also felt that with every little growth that took place in the economy, the system would increasingly gravitate towards "monopolies and aggregations of economic power." He wanted to change the course of history but in a manner that did not break sharply with the country's geographical, historical, religious, economic and social background. Thus he favoured a mixed economy characterized by the following features:

- (i) a balance between the market economy and the planning mechanism
- (ii) a clear demarcation of the boundaries of public sector and private sector so that the crucial and strategic sectors are invariably in the public sector
- (iii) while profit motive influences decision-making in the private sector, the economic viability criteria for investment decisions in the public sector is based on social cost-benefit analysis
- (iv) the ownership of means of production as between the public sector, private sector, joint sector and the cooperative sector is so decided that there is a balance between personal and social incentives and sectional and general interests
- (v) there is occupational freedom and freedom of consumers' choice
- (vi) the government intervenes to prevent undue concentration of economic power, and monopolistic and restrictive trade practices
- (vii) the government endeavours to take care of the consumption levels and objectives of the weaker sections of the society through the public distribution system (PDS), poverty alleviation programmes, etc.
- (viii) social objectives of equity, employment, balanced regional development, family welfare are emphasised
- (ix) the dogmatic rigidities of socialism are avoided and a pragmatic approach to decision-making for promoting economic growth is usually adopted
- (x) the mixed economy is not merely an economic concept, it is a economy where the rights of the individual are respected and protected subject only to the requirements of public law and order and morality

Evolution of Mixed Economy in India

The evolution of the mixed economy in India can be traced to the national freedom movement, especially in the 1930s with the socialist tilt of the Congress. At the 1931 Karachi session of the Indian National Congress, a socialist pattern of development was set as the goal for independent India. Moreover, the 1955 Avadi Resolution of the Indian National Congress made a socialistic pattern of

development as the goal of the party. The resolution mandated that “the State will necessarily play a vital part in starting and operating big projects through overall controls of resources, trends and essential balances in the economy ... with strategic controls over the private sector to prevent the evils’ of anarchic industrial development.” A year later, the Indian parliament adopted ‘socialistic pattern of development’ as official its policy, a policy that included the regulation of industries and land reforms. Subsequently, the industry policy resolutions of 1977 and 1980 were focused on mixed economy model.

Industrial Policy Resolution, 1956

The resolution recognized need and the importance of both public sector and private sector enterprises. Among other things, the resolution emphasized that fair and non-discriminatory treatment would be given to private sector industries and their development would be encouraged by developing transport facilities and by providing financial assistance. The resolution considered that the private sector by itself could not bring about rapid industrialization of the country. It, therefore, provided vital and expanding scope for public sector industries. At the same time, the private sector was assured of an important place in the industrial structure of the country. The resolution also acknowledged the important role of village, cottage and small scale industries. At the same time, the resolution accorded a prominent role to the public sector. The apprehensions of the private sector that the public sector would develop at their cost did not turn out to be correct and the private sector found ample scope for its expansion. The resolution classified industries into three categories:

- **Schedule A:** Those industries which were to be the sole responsibility of the state. This list included 17 industries- arms and ammunition, atomic energy, iron and steel, heavy machinery required for mining, heavy electrical industries, coal, mineral oils, mining, iron ore and other important minerals like copper, lead and zinc, etc., aircraft, air transport, railways, ship-building, telephone, telegraph and wireless equipment, and generation and distribution of electricity.
- **Schedule B:** The Schedule B industries were those industries where the state could establish new units or where existing units might be progressively nationalised. There were about a dozen industries in this list. In these industries, the private sector was guaranteed plenty of opportunities to develop and expand. It included the following industries- Other mining industries, aluminium and other non-ferrous metals not included in Schedule A, machine tools, ferro alloys and steel tools, chemicals, antibiotics and other essential drugs, synthetic rubber, pulp, road and sea transport.
- **Schedule C:** Those industries which were not included in the Schedule A or B lists were part of Schedule C. These industries were open for the private sector, subject to the social and economic policy of the government.

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1.4 PERFORMANCE OF PLANNING

Some of the achievements of Five Year Plans in India are as follows:

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- (i) **National income:** Indian economy is no longer stagnant; it is moving on the path to development. The growth rate during the planning period was 4.4 per cent. As a result, the growth in per capita income has been around 1.8 per cent.
- (ii) **Agricultural sector:** On the eve of independence, Indian agriculture was backward, stagnant and non-vibrant. After independence, planner and politicians realized the need for major transformation in agriculture. In fact, the First Five Year Plan was exclusively an agricultural plan. During this period, the production of food grain rose from 50.8 million tonnes in 1950-1951 to 66.9 million tonnes in 1955-1956 against the target of 61.6 million tonnes. The performance of agricultural sector in terms of total food grain production from independence to the year 2016 is shown in Figure 1.1.

Total food grain production in India has seen a secular increase since independence. In the year 2001-2002, the total food grain production was 212.9 million tonnes. However, the next year (2002-2003) saw a steep decline to 174.8 million tonnes. Since then, food grain production has once again seen an upward trend. In 2013-2014, it reached a high of 265 million tonnes.

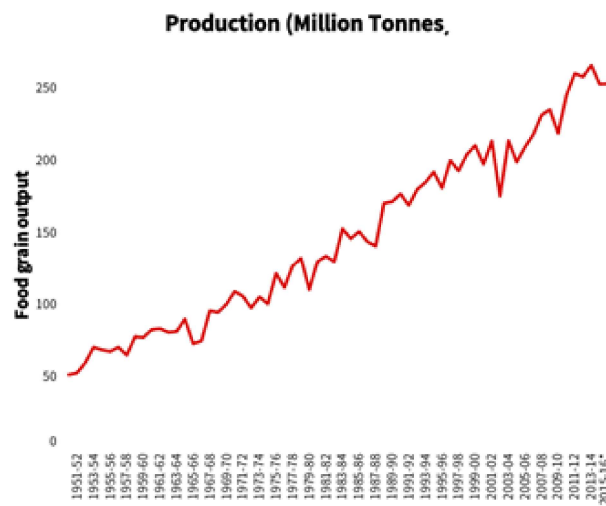


Fig. 1.1 Food Grain Production Trends in India

- (iii) **Industrial sector:** The compound annual growth rate of industrial output was quite impressive during the first three Five Year Plans. It rose from 5.7 per cent in the First Five Year Plan to 7.2 per cent in the Second Five Year Plan and 9.0 per cent in the Third Five Year Plan. After this, the performance of industrial sector was not good from 1966 to 1984.

During 1985-90, production increased at a satisfactory rate in almost all types of industries. The sector registered a growth of 9.0 per cent in 1990-91 as well. During Ninth Five Year Plan, industrial output increased only by 5.5 per cent. The slow-down was due to a number of structural and cyclical factors. Industrial growth rate rose to 6 per cent in 2002-03 and 8 per cent in 2004-05. According to economic survey 2006-07, industrial sector grew at 10.6 per cent in 2006-07. This growth rate is the highest since 1995-96. The Eleventh Plan aims at raising the rate of growth of industrial sector to 10 per cent per annum.

- (iv) **Self-reliance:** The ultimate goal of planning economic development in India is to make the country self-reliant. Self-reliance implies that the nation must have economic security, political security and social security. The minimum condition for this is the elimination of dependence on foreign aid. Due to rapid increase in population, increase in food grains production was inadequate to meet the demands. Thus, India had to import food grains on a large-scale. This large-scale import of food grains puts considerable pressure on the balance of payment. Right from the beginning of the First Five Year Plan, the balance of trade has always been against India. Thus, the gap has to be filled up through foreign aid.

The percentage of foreign aid was quite high in the initial years of development but with the passage of time, it has declined. During the Plan period, considerable progress has been made in the achievement of this goal. Foreign aid was recorded to be 28 per cent in the Second Plan. It declined to 27.2 per cent in the Third Plan and 5.5 per cent in the Eighth Plan.

India's external sector performed well during the Ninth Five Year Plan. Therefore, account deficit came down from 1.4 per cent to 0.7 per cent of GDP in 2001-2002. Many critical products like steel and machinery have started been produced in India. This has reduced our dependence on the import of these goods. The growth rate of exports has increased from 4.8 per cent in the Third Plan to 12.5 per in the Sixth Plan. It further increased to 15 per cent in the Seventh Plan and 11.4 in the Eighth Plan. In the Ninth Plan period, the growth rate of exports declined in the initial year because of global slow down but picked up later.

- (v) **Social justice:** From the Second Plan onwards, all Five Year Plans in India have been emphasizing the objective of planned growth with social justice. These Plans have been focusing on improving the standard of living of people, reducing poverty, eliminating unemployment and reducing inequality of income and wealth. The number of poor people below the poverty line has no doubt declined, but the magnitude of poverty continues to be large with 260 million people living below the poverty line. This constitutes about 22 per cent of the total population.

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One of the most important objectives of economic planning in India has been to create employment opportunities. This was sought to be done through expansion programmes in large industries, cottage industries, small industries, agricultural sector and service sector of the economy. Various surveys show that unemployment has reduced in the last few years, however, situation has not changed much as large number of people are either under employed or seasonally employed. This is because the rate of growth in population is faster than the rate of increase in employment opportunities. In addition, large inequalities in income distribution are still there in India.

- (vi) **Modernization:** A variety of structural and institutional changes in the framework of economic activities can be termed as modernization. Indian economy has shown a number of such changes. For instance, a number of Indian industrial units are now using modern and sophisticated technologies. The development of public sector has also contributed to the modernization of Indian economy. It has played a dominant role in the establishment of heavy industries such as steel, petrochemicals, petroleum and fertilizers. Structural changes in the industrial sector are also reflected due to the development of a network of banking institutions and money market.

A number of institutions have been set up to provide infrastructure, raw material and marketing facility to small-scale sector. The country has made rapid strides in the production of food grains, cash crops and horticulture crops. Agricultural sector has also been modernized with the help of new technologies. The production of coal and crude oil also increased during the Plan period. There has been a marked improvement in transport facilities.

Check Your Progress

3. When did the term mixed economy arise?
4. What is a socialist economy?
5. What does self-reliance imply?

1.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. A planned economy is an economic system in which the economy is directed by the state. It is an economic system in which the central government controls industry by making major decisions regarding the production and distribution of goods and services.
2. The Planning Commission was set up in pursuance of the declared objectives of the government, which was to promote a swift rise in the standard of living of the people by the efficient utilization of the resources of the country,

increasing production and offering opportunities to all for employment in the service of the community.

3. The term-mixed economy arose in the context of political debate in the United Kingdom in the post-War period, although the set of policies later associated with the term had been advocated from at least the 1930s.
4. In a socialist economy, the goods and services produced is decided by the government based on what people need.
5. Self-reliance implies that the nation must have economic security, political security and social security.

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1.6 SUMMARY

- A planned economy is an economic system in which the economy is directed by the state. It is an economic system in which the central government controls industry by making major decisions regarding the production and distribution of goods and services.
- India's first Prime Minister, Jawaharlal Nehru set up the Planning Commission with a Government of India resolution in March 1950.
- The various five year plans were formulated and executed by the Planning Commission of India since its inception.
- The 'Nehru-Mahalanobis Model' became the basis of the second five-year plan and continued to be guiding principle of all subsequent plans with small alterations until 1977.
- A mixed economy may be defined as 'an economic system in which both the private enterprise and a degree of state monopoly (usually in public services, defence, infrastructure, and basic industries) coexist'.
- The evolution of the mixed economy in India can be traced to the national freedom movement, especially in the 1930s with the socialist tilt of the Congress.
- The growth rate during the planning period was 4.4 per cent. As a result, the growth in per capita income has been around 1.8 per cent.

1.7 KEY WORDS

- **Mixed Economy:** It is an economic system blending elements of market economies with elements of planned economies, free markets with state interventionism, or private enterprise with public enterprise.
- **Five-Year Plans:** It is any plan for national economic or industrial development specifying goals to be reached within a period of five years.

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- **Self-Reliance:** It is a quality of depending on yourself for things instead of relying on others.
- **Socialist Economy:** It refers to the government ownership of the means of production, planning by the government and income distribution.

1.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Write a short-note on the planning commission.
2. What was the Industrial Policy Resolution, 1956?
3. How did Nehru view the capitalist system?

Long Answer Questions

1. What was the Nehru-Mahalanobis' model? What were the justifications given for greater emphasis on heavy industry under this model?
2. Discuss the different types of economic system. Describe the salient features of the mixed economy.
3. Examine some of the achievements of the five-year plans.

1.9 FURTHER READINGS

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UNIT 2 NEW ECONOMIC REFORMS

NOTES

Structure

- 2.0 Introduction
- 2.1 Objectives
- 2.2 Appraisal of Economic Reforms
- 2.3 Answers to Check Your Progress Questions
- 2.4 Summary
- 2.5 Key Words
- 2.6 Self Assessment Questions and Exercises
- 2.7 Further Readings

2.0 INTRODUCTION

In the previous unit, you learned about foreign trade and the trends in exports and imports. In this unit you will learn in detail about the economic reforms introduced in India.

When India gained its independence, India's leaders decided that the nation needed to follow a state led model of development. In this regard, many restrictions were put on private industry. These restrictions reached such an extent in the 1970s that industrialists started referring to the state led model of development as License Raj. The state-led model of development was more or less continued till 1991 when India decided to reform its economy by opening it up to the private sector and outside competition. This decision was taken in light of the balance of payment crisis that India was facing in 1991. As you have read in the previous unit, during the balance of payment crisis, the current account deficit had widened to such a degree that India was in jeopardy of defaulting on its loan. The crisis resulted in India mortgaging its gold reserves for a loan from the IMF. The loan came with certain conditions, known as 'structural adjustment policies' which India had to comply with to fulfil the conditions of the loan. Thus, the process of economic reform began. Since 1991, we have moved away from a state led model of development to the LPG (Liberalisation, Privatisation, Globalisation) model of development. In this unit, we will look at the economic reforms that have taken place since 1991 and assess its impact on the Indian economy.

2.1 OBJECTIVES

After going through this unit, you will be able to:

- Explain the aims of privatisation and liberalisation
- Discuss the performance of the Indian economy after the economic reforms

2.2 APPRAISAL OF ECONOMIC REFORMS

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Economic reforms in India were started by late Prime Minister Rajiv Gandhi. He said, “The public sector has entered into too many areas where it should not be. We shall open the economy to the private sector in several areas hitherto restricted to it.” Consequently, a number of measures were taken to remove control and open areas to private sector players. However, Rajiv Gandhi did not take a very strong and categorical position on the issue of Privatisation and Globalisation, though some Liberalisation of the economy did take place. It was when Mr. Narasimha Rao took over as Prime Minister in 1991 that a new industrial policy was announced, which marked a sharp departure from the earlier industrial policy of 1956. There were three aims of the new economic policy—Liberalisation, Globalisation and Privatisation.

Liberalisation

The main aim of Liberalisation was to dismantle the excessive regulatory framework which acted as a shackle on freedom of enterprise. Over the years, the country had developed a system of *licence-permit-control raj*. The aim of the new economic policy was to save the entrepreneur the unnecessary harassment of seeking permission from the bureaucracy to start an undertaking.

Similarly, the big business houses were unable to start new enterprises because the MRTP Act had prescribed a ceiling on the asset ownership to the extent of ` 100 crore. In case a business house had assets more than ` 100 crore, its application was rejected. It was believed that on account of the rise in prices this limit had become outdated and needed reviewing. The second objection by the private sector lobby was that it prevented big business houses from investing in heavy industry and infrastructure, which required lump sum investment. The NDA in its election manifesto had suggested that the asset limit of MRTP companies should be raised to ` 1000 crore. The government thought it wise to abolish the limit altogether so that big businesses could establish big projects in the core sectors—heavy industry, petrochemicals, electronics, etc. The Government was of the view that in the context of Liberalisation, the MRTP limit had become irrelevant and needed to be scrapped. The major purpose of Liberalisation was to free the large private corporate sector from bureaucratic controls. It therefore, started dismantling the regime of industrial licensing and control. In pursuance of this policy, the industrial policy of 1991 abolished industrial licensing for all projects except for a small set of 18 industries.

The list of industries in which industrial licensing is compulsory is as follows:

1. Coal and lignite
2. Petroleum and its distillation products
3. Distillation and brewing of alcoholic drinks
4. Sugar

5. Animal fats and oils
6. Cigars and cigarettes
7. Asbestos and asbestos-based products
8. Plywood and other wood-based products
9. Raw hides and skins
10. Tanned furskins
11. Paper and newsprint
12. Electronics, aerospace and defence equipment
13. Industrial explosives
14. Hazardous chemicals
15. Drugs and pharmaceuticals

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Privatisation

Privatisation is the process of involving the private sector in the ownership or operation of a state-owned or public sector undertaking. It can take three forms: (i) Ownership measures, (ii) Organizational measures and (iii) Operational measures.

- (i) **Ownership Measures:** The degree of Privatisation is judged by the extent of ownership transferred from the public enterprise to the private sector. Ownership may be transferred to an individual, co-operative or corporate sector. This can have three forms:
- (a) *Total denationalisation* implies 100 per cent transfer of ownership of a public enterprise to the private sector.
 - (b) *Joint venture* implies partial transfer of a public enterprise to the private sector. It may have several variants—25 per cent transfer to private sector in a joint venture implies that majority ownership and control remains with the public sector. Fifty one per cent transfer of ownership to the private sector shifts the balance in favour of the private sector, though the public sector retains a substantial stake in the undertaking. seventy-four per cent transfer of ownership to the private sector implies a dominant share being transferred. In such a situation, the private sector is in a better position to change the character of the enterprise.
 - (c) *Liquidation* implies sale of assets to a person who may use them for the same purpose or for some other purpose. This depends solely on the preference of the buyer.
 - (d) *Workers' Cooperative* is a special form of denationalisation. In this form, ownership of the enterprise is transferred to workers who may form a co-operative to run the enterprise. In such a situation, appropriate provision of bank loans is made to enable workers to buy the share of the enterprise. The burden of running the enterprise

rests on the workers in a workers' cooperation. The workers become entitled to ownership dividends besides getting wages for their services.

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(ii) **Organisational Measures:** These include a variety of measures to limit state control, such as:

(a) *A holding company structure* may be designed in which the government limits its control to top-level major decisions and leaves a sufficient degree of autonomy for the operating companies in their day-to-day operations. A big company like the Steel Authority of India may acquire a holding company status, thereby transferring a number of functions to its smaller units. In this way, a decentralized pattern of management emerges.

(b) *Leasing:* In this arrangement, the government agrees to transfer the use of assets of a public enterprise to a private bidder for a specified period, say five years. While entering into a lease, the bidder is required to give an assurance of the quantum of profits that would be made available to the state. This is a kind of tenure ownership. The government reserves the right to review the lease to the same person or to grant the lease to another bidder, depending upon the circumstances of the case.

(c) *Restructuring:* It is of two types—Financial Restructuring and Basic Restructuring.

- Financial Restructuring implies the writing-off of accumulated losses and rationalisation of capital composition in respect of debt–equity ratio. The main purpose of this restructuring is to improve the financial health of the enterprise.
- Basic Restructuring is said to occur when the public enterprise decides to shed some of its activities to be taken up by ancillaries or small-scale units.

(iii) **Operational Measures:** The efficiency of public sector enterprises depends upon the organisational structure. Unless this structure grants a sufficient degree of autonomy to the operators of the enterprise or develops a system of incentives, it cannot raise its efficiency and productivity. These measures include

- (a) Grant of autonomy to public enterprises in decision-making
- (b) Provision of incentives for workers and executives consistent with increase in efficiency and productivity
- (c) Freedom to acquire certain inputs from the markets with a view to reducing costs
- (d) Development of proper criteria for investment planning
- (e) Permission to public enterprises to raise resources from the capital market to execute plans of diversification. The basic purpose of

operational measures is to infuse the spirit of private enterprise in public enterprises so that government control is effectively reduced and private initiative is promoted

Privatisation in a narrow sense indicates transfer of ownership of a public sector undertaking to private sector, either wholly or partially. But in another sense, it implies the opening up of the private sector areas which were hitherto reserved for the public sector. Such deliberate encouragement of investment to the private sector in the economy, while emphasizing to a lesser degree the expansion of the public sector, will increase the overall share of the private sector in the economy. The basic purpose is to limit the areas of the public sector and to extend the areas of private sector operation.

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Aims of Liberalisation, Globalisation and Privatisation

Liberalisation, Globalisation and Privatisation are all means to achieve certain ends of the society just as nationalization and regulatory frameworks were intended to achieve certain goals. These are:

1. To achieve a high rate of growth of national and per capita income.
2. To achieve full employment.
3. To achieve self-reliance.
4. To reduce inequality of income and wealth.
5. To reduce the number of people living below the poverty line.
6. To develop a pattern of society based on equality and absence of exploitation.

The operation of the public sector and the regulatory framework led to certain problems, namely:

- (i) The excessive development of bureaucratic controls acted as shackles on growth.
- (ii) Overstaffing in public sector enterprises led to an increase in the cost of operation.
- (iii) Low rate of return on investment in public sector.
- (iv) Poor work ethic in public sector enterprises due to excessive job security and absence of incentives for better work.
- (v) Entry of public sector in areas of consumer goods for which it was never meant. Thus, unnecessary expansion resulted in the absence of focus and dilution in the quality of management.
- (vi) Some public sector enterprises were incurring losses year after year and as such had become a burden on the public exchequer, instead of being an asset to the nation.

The measures undertaken are all designed to rectify these problems so that the working of the economy becomes more efficient and its rate of growth improves.

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Review of Economic Reforms: There is general agreement among all political parties that reforms are a historical necessity and it is not possible to reverse the reform process. Even the Left parties, after the collapse of the former Soviet Union, have accepted the view that some reforms in the form of Liberalisation, Privatisation and Globalisation will have to be undertaken. However, recent events like the global financial crisis have once again started the debate in India on whether to continue the process of economic reforms. While there can be no doubt that the reforms process has helped to accelerate growth, the benefits of growth have not percolated to the poor and weaker sections of the society. In fact, income inequality has risen sharply in the last 20 years. India may be now home to around 50 U.S. dollar billionaires, but at the same time, around 800 million people live on two dollars a day. Considering the size of India's population, such large-scale income disparity is untenable and can only result in instability in the country. Moreover, the recent unearthing of corporate scams running into multiple lakh crores has put serious question marks on India's growth story. Questions are now being raised whether India is following a path of 'crony capitalism'.

Table 2.1 Rate of Growth of GDP

Data categories and components	Units	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
GDP and Related Indicators							
GDP (current market prices)							
	₹ crore	4294706	4987090	5630063	6457352 ^{PE}	7674148 ^{OE}	8912178 ^{AE}
Growth Rate	%	1b.3	16.1	12.9	14.7	18.8	16.1
GDP (factor cost, 2004-05 prices)							
	₹crore	3564364	3896636	4158676	4507637 ^{PE}	4885954 ^{OE}	5222027 ^{AE}
Growth Rate	%	9.6	9.3	6.7	8.4	8.4	6.9
Savings Rate	% of GDP	34.6	36.8	32.0	33.8	32.3	na
Capital Formation (rats)	% of GDP	35.7	38.1	34.3	36.6	35.1	na
Pet Capita Net National Income (factor cost at current prices)	₹	31206	35825	40775	46117	53331	60972

Higher growth rate achieved: Since the reform process was initiated the growth rate of the economy has started picking up. The growth rate of GDP slumped to 0.9 per cent in 1991–92, but picked up thereafter. The average growth rate of over 6 per cent during the five years (1992–93 to 1996–97) is an achievement of the reform process. This would result in an average 4 per cent growth rate of per capita GDP.

Control of Inflation: During 1993–94 and 1994–95, the wholesale price index rose by 10.8 per cent and 10.4 per cent respectively. Thereafter, due to strong measures taken during 1995–96, the rate of inflation slowed down to 5 per cent.

The impact of inflation on the common man is measured by the consumer price index. The consumer price index has shown an average rise of over 10 per cent during 1991–1997. This implies the failure of the reform process to control inflation despite the achievement of high growth rate.

Reform of the Public Sector: The major aim of economic reforms is to improve the public sector so that the rate of return improves. To remedy the situation, it was necessary that overstaffing of the public sector undertakings be reduced. The government has already taken steps in this direction by its voluntary retirement scheme. It set up the National Renewal Fund to provide compensation for voluntary retirement and also arranged for retraining and redeployment of workers. As a result of the VRS, the employee strength of PSUs has been reduced by 8 per cent.

Another step taken by the government was disinvestment in PSUs. The government has been offering equity of 31 selected public sector enterprises, varying from 5 per cent to 20 per cent to Mutual Funds and Financial Institutions. This is only a token Privatisation and the government was able to raise ` 9793 crore during the four-year period (1991–92 to 1994–95).

Critics describe disinvestment as deficit Privatisation because the proceeds of disinvestment are being used to reduce the budget deficit. The Common Minimum Programme of the NDF Government stipulated that the proceeds of disinvestment would be used in two vital areas—health and education. On the whole, the reforms of PSUs have not gathered as much momentum as expected. Disinvestment has been piecemeal and the funds so raised are being used to reduce budget deficits rather than strengthen the PSUs. In addition, labour problems, political and bureaucratic interference have not been effectively used. Since it is not possible to privatise a large component of the public sector, it would be advisable to reform it.

Large dose of Foreign Capital to help Indian Economy: The reforms process, especially its emphasis on Globalisation, was intended to accelerate the growth process by attracting a larger dose of foreign capital. However, the efforts of the state met with only partial success. The data reveal that during 1991–92 to 1995–96, total investment flows of the order of ` 1,174 billion were made, out of which portfolio investment was of the order of ` 8.05 billion and direct foreign investment accounted for barely \$ 3.69 billion. Critics point out that mainly 39 per cent of foreign investment is in the non-priority sector. The entry of multinationals in consumer goods only displaces Indian labour and capital employed in the production of these commodities.

Reform Process and the Foreign Trade Scenario: The reform process has led to growth of exports but simultaneously, it has also led to a larger growth of imports. As a result, the trade gap has not been reduced.

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Check Your Progress

1. What was the main aim of liberalisation?
2. What does liquidation imply?
3. When does basic restructuring occur?

2.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

NOTES

1. The main aim of Liberalisation was to dismantle the excessive regulatory framework which acted as a shackle on freedom of enterprise.
2. Liquidation implies sale of assets to a person who may use them for the same purpose or for some other purpose.
3. Basic Restructuring is said to occur when the public enterprise decides to shed some of its activities to be taken up by ancillaries or small-scale units.

2.4 SUMMARY

- It was when Narasimha Rao took over as Prime Minister in 1991 that a new industrial policy was announced, which marked a sharp departure from the earlier industrial policy of 1956.
- The main aim of Liberalisation was to dismantle the excessive regulatory framework which acted as a shackle on freedom of enterprise.
- Privatisation is the process of involving the private sector in the ownership or operation of a state-owned or public sector undertaking. It can take three forms: (i) Ownership measures, (ii) Organizational measures and (iii) Operational measures.
- There is general agreement among all political parties that reforms are a historical necessity and it is not possible to reverse the reform process.
- The reforms process, especially its emphasis on Globalisation, was intended to accelerate the growth process by attracting a larger dose of foreign capital. However, the efforts of the state met with only partial success.
- The reform process has led to growth of exports but simultaneously, it has also led to a larger growth of imports. As a result, the trade gap has not been reduced.

2.5 KEY WORDS

- **Privatisation:** It refers to the transfer of a business, industry, or service from public to private ownership and control.
- **Liquidation:** It means the winding up of a firm by selling off its free (unpledged) assets to convert them into cash to pay the firm's unsecured creditors.
- **Leasing:** It is a financial arrangement in which a person, company, etc. pays to use land, a vehicle, etc. for a particular period of time.

2.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What were the aims of liberalisation and privatisation under the economic reforms that were announced in 1991?
2. What are the three forms of privatisation?

Long Answer Questions

1. Describe the economic reforms that were undertaken in 1991.
2. Assess the performance of the Indian economy after the economic reforms of 1991.

2.7 FURTHER READINGS

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UNIT 3 GROWTH AND STRUCTURE OF INDIAN ECONOMY

Structure

- 3.0 Introduction
- 3.1 Objectives
- 3.2 Growth of National Income and Per Capita Income
 - 3.2.1 Personal Income
- 3.3 Answers to Check Your Progress Questions
- 3.4 Summary
- 3.5 Key Words
- 3.6 Self Assessment Questions and Exercises
- 3.7 Further Readings

3.0 INTRODUCTION

This unit discusses growth in GDP and National Income. According to the Central Statistics Organizations (CSO), India has emerged as the fastest growing economy in the world. According to the International Monetary Fund (IMF), Indian economy grew by more than 7 per cent annually in 2017. In 2015, India was ranked as the most global in terms of the consumer confidence. Currently, the manufacturing sector in India contributes over 15 per cent of the gross domestic product (GDP). The Government of India, under the 'Make in India' initiative, is trying to give boost to the contribution made by the manufacturing sector and aims to take it up to 25 per cent of the GDP.

The total income of a country is known as the 'national income'. It shows the overall economic performance of an economy. There are various aspects of national income, such as the GDP and gross national product (GNP). There are various estimates that are being made at the constant prices of various aspects like agriculture, industry and services. The unit discusses the sectoral composition of national income. The demographic features of Indian economy are the age and population, which are discussed in the unit in detail. The aspects like distribution of population and sex composition are given special attention in the unit. Lastly, the unit describes the various aspects of the National Population Policy, 2000, such as its objectives and scope.

3.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss concepts such as National Income and Per Capita Income
- Explain personal income

NOTES

3.2 GROWTH OF NATIONAL INCOME AND PER CAPITA INCOME

The total income of a country is known as 'national income'. It shows the overall economic performance of an economy. This economic performance can be measured in terms of national income. According to Prof. D. M. Mithani, 'National income is the flow of goods and services produced in an economy in a year or a particular period of time.'

Gross domestic product (GDP)

If you include the monetary value of all the goods and the services produced within a country, it is known as gross domestic product (GDP). Such a total (sum) represents the gross value of the final products, produced within a country in a year. Few things should be noted about GDP:

1. The word 'Gross' tells us that the value of depreciation because of production has not deducted from the monetary value of the goods and services.
2. The word 'Domestic' tell us that GDP is the monetary value of the goods and the services produced within the boundaries of a country. The value of trade in terms of money (export and import) with other countries is not included in this.
3. The value of final product should be taken for the measurement of national income. It is necessary to avoid the duplication in the accounting of national income. For example, if we have taken the monetary value of mangoes, but some quantity of it is used for juice, than we should deduct the monetary value of those mangoes from national income, and should add the monetary value of juice produced.

Gross national product (GNP)

Gross national product (GNP) is the monetary value of the goods and the services produced in a country, and the value of net export.

In equation form:

$$\text{GNP} = C + I + G + (X - M) + (R - P)$$

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where 'C' stands for consumer goods, 'I' stands for capital goods, 'G' for government purchases and $(X - M)$ represents net exports; where 'X' stands for exports and 'Y' stands for imports. $(R - P)$ represents the net income, where 'R' stands for income receipts and 'P' stands for payments.

For example, if consumption $(C) = 715$, investment $(I) = 373$, government purchases $(G) = 197$, then net export $(X - M) = +97$, net income $(R - P) = +12$ and gross national product $(GNP) = 1,394$.

In GNP, the value of each finished goods and services is multiplied by their prices. The relative prices of the products shows the relative importance of each particular product. Such a total (discussed earlier) represents the actual gross value of the final products produced by the whole economy in a year. The word 'Gross' indicates that the value of depreciation has not deducted from the value of GNP.

Net national product (NNP)

$NNP = GNP - D$, where $D =$ Depreciation allowance

The meaning of the term 'depreciation' is wear and tear of the machines. As we know that when we regularly use the machine, the value of the machines decreases with the passage of time. After some years when the value of the machines becomes zero, then the machines have to be replaced. The same methodology is applicable on other fixed assets, for example, building and tools, etc. So, when we subtract the value of depreciation from GNP, we get net national product (NNP).

However, national income, in its technical sense, is obtained by deducting indirect taxes from the net product measured at current market prices. Such a figure is also called NNP at factor cost, as it represents payments made to the factors of production during the production process.

Estimation of National Income at Current and Constant Price

Current price in general economics refers to the prevailing price or the actual price in the year in which the goods or services are produced. Constant price on the other hand refers to the prices prevalent in one particular year, which is taken as a base for calculation of increase or decrease in prices or other measures in the current year.

National income of a country can be computed using both current and constant prices.

National Income at Current Price

In this calculation, we take up the prevailing prices of the year for computing the total amount of the goods and services produced. This is also referred to as nominal national income.

National Income at Constant Price

In this calculation, we use fixed prices for determining the total income. This means, that a particular year is set as a base and the prices prevailing in that particular year is used for measuring the national income of the current year. Another name for such a calculation is real national income.

The base year which decides the fixed or constant price is selected on carefully, one year which is free from unusual fluctuations are usually set as base year.

Comparison between Real and Nominal National Income

Nominal national income or National income at current prices are generally not preferred by economies for it is influenced by two very important factors: change in price levels and change in physical output. For example, if the prices in the current year rise abnormally rise or falls without a real increase or decrease in the physical output, then the national income will be inflated.

On the other hand, the only factor which plays a dominant in the measurement of national income at constant prices is the change in physical output. Therefore, the change in prices is normalized here as per the change in level of output, giving us a clearer picture of growth or decline in the actual production.

Real national income is then the true indicator of economic growth. It helps in tracking real changes in the production of goods and services, as well as helps in making not only yearly comparisons but also international comparisons with other economies.

Estimates of gross/net national product, gross/net domestic product and per capita income, alongwith GDP at factor cost by kind of economic activity and the expenditures on GDP from the years 1991-2006, 2009-10 and 2010-11 and 2011-12, at constant (2004-05) and current prices are given in Tables 3.1 to 3.6.

Table 3.1 GDP, NDP, GNP and NNP at Factor Cost from the Years 1991-2006

Year	(At Constant Prices) (` crore)					
	GDP at factor Cost	NDP at factor cost	GNP at factor cost	NNP at factor cost	GDCF	Per Capita NNP at factor cost
1	2	3	4	5	6	7
Old series (Base : 1993-94)						
1991-92	701863	628092	691143	617372	171553	7212
1992-93	737792	659599	726375	648182	187478	7433
1993-94	781345	697992	769265	685912	198412	7690
1994-95	838031	747573	824816	734358	243882	8070
1995-96	899563	800411	886961	787809	271015	8489
1996-97	970082	862807	959359	852084	268435	9007
1997-98	1016595	901735	1005946	891086	289058	9244
1998-99	1082747	960554	1070773	948580	290971	9650
1999-00	1148367	1019296	1137185	1008114	351624	10071

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New Series (Base: 1999-2000)						
1999-00	1792292	1605643	1776861	1590212	509289	15886
2000-01	1870387	1675632	1847842	1653087	486369	16223
2001-02	1978055	1775951	1957384	1755280	477158	16910
2002-03	2052586	1841931	2033781	1823126	555762	17281
2003-04 (P)	2226041	2004703	2208196	1986858	643480	18517
2004-05 (QE)	2393671	2158718	2376729	2141776	744522	19649
2005-06 (RE)	2595339	2349311	2571310	2325282	-	21005

P: Provisional

QE: Quick Estimates

RE: Revised Estimates

Source: Central Statistical Organisation (CSO), Government of India

Table 3.2 Advance Estimates of National Income and Expenditures on GDP, 2011-12
(At 2004-05 prices)

Item	2009-10	2010-11 (QE)	2011-12 (AE)
A. ESTIMATES AT AGGREGATE LEVEL			
1. NATIONAL PRODUCT (` Crore)			
1.1 Gross National Income (GNI) at factor cost	4,479,973	4,833,178	5,171,538
		(7.9)	(7.0)
1.2 Net National Income (NNI) at factor cost	3,959,653	4,268,715	4,568,249
		(7.8)	(7.0)
2. DOMESTIC PRODUCT (` Crore)			
2.1 Gross domestic product (GDP) at factor cost	4,507,637	4,885,954	5,222,027
		(8.4)	(6.9)
2.2 Gross domestic product (GDP) at market prices	4,780,179	5,236,823	5,627,685
		(9.6)	(7.5)
2.3 Net domestic product (NDP) at factor cost	3,987,317	4,321,491	4,618,739
		(8.4)	(6.9)
B. ESTIMATES AT PER CAPITA LEVEL			
Population (million)	1,170	1,186	1,202
Per capita NNI at factor cost (`)	33,843	35,993	38,005
		(6.4)	(5.6)
Per capita GDP at factor cost (`)	38,527	41,197	43,444

Source: http://mospi.nic.in/mospi_new/upload/nad_pr_7feb12.pdf

Note: The figures in parenthesis show the percentage change over previous year

QE: Quick Estimate; AE: Advance Estimate

Table 3.3 Advance Estimates of National Income for the year 2011-12
(At current prices)

Item	2009-10	2010-11 (QE)	2011-12 (AE)
A. ESTIMATES AT AGGREGATE LEVEL			
1. NATIONAL PRODUCT (` Crore)			
1.1 Gross National Income (GNI) at factor cost	6,053,585	7,078,512	8,198,276
		(16.9)	(15.8)
1.2 Net National Income (NNI) at factor cost	5,395,688	6,325,039	7,328,878
		(17.2)	(15.9)
2. DOMESTIC PRODUCT (` Crore)			
2.1 Gross domestic product (GDP) at factor cost	6,091,485	7,157,412	8,279,976
		(17.5)	(15.7)
2.2 Gross domestic product (GDP) at market prices	6,457,352	7,674,148	8,912,179
		(18.8)	(16.1)
2.3 Net domestic product (NDP) at factor cost	5,433,588	6,403,939	7,410,578
		(17.9)	(15.7)
2.4 Gross National Disposable Income	6,665,252	7,837,248	9,113,410
B. ESTIMATES AT PER CAPITA LEVEL			
Population (million)	1,170	1,186	1,202
Per capita NNI at factor cost (`)	46,117	53,331	60,972
		(15.6)	(14.3)
Per capita GDP at factor cost (`)	52,064	60,349	68,885

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Source: http://mospi.nic.in/mospi_new/upload/nad_pr_7feb12.pdf

Note: The figures in parenthesis show the percentage change over previous year

QE: Quick Estimate; RE: Revised Estimate

Table 3.4 Advance Estimates of GDP at Factor Cost by Economic Activity
(at constant 2004-05 prices)

` Crore

Industry	2009-10	2010-11 (QE)	2011-12 (AE)	Percentage change over previous year	
				2010-11	2011-12
1. agriculture, forestry & fishing	662,509	709,103	727,161	7.0	2.5
2. mining & quarrying	104,225	109,421	107,029	5.0	-2.2
3. manufacturing	719,728	774,162	804,256	7.6	3.9
4. electricity, gas & water supply	88,266	90,944	98,464	3.0	8.3
5. construction	355,717	384,199	402,610	8.0	4.8
6. trade, hotels, transport and communication	1,197,213	1,330,455	1,479,748	11.1	11.2
7. financing, insurance, real estate & business services	769,883	849,995	927,546	10.4	9.1
8. community, social & personal services	610,096	637,675	675,213	4.5	5.9
9. GDP at factor cost	4,507,637	4,885,954	5,222,027	8.4	6.9

Source: http://mospi.nic.in/mospi_new/upload/nad_pr_7feb12.pdf

**Table 3.5 Advance Estimates of GDP at Factor Cost by Economic Activity
(at current prices)**

Crore

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Industry				Percentage change over previous year	
	(QE)	(AE)		2010-11	2011-12
1. agriculture, forestry & fishing	1,079,365	1,269,888	1,430,418	17.7	12.6
2. mining & quarrying	157,400	191,207	219,978	21.5	15.0
3. manufacturing	907,032	1,040,345	1,163,653	14.7	11.9
4. electricity, gas & water supply	112,522	124,038	135,452	10.2	9.2
5. construction	502,190	585,265	670,778	16.5	14.6
6. trade, hotels, transport and communication	1,485,476	1,755,531	2,084,171	18.2	18.7
7. financing, insurance, real estate & business services	962,186	1,170,522	1,395,853	21.7	19.3
8. community, social & personal services	885,314	1,020,616	1,179,672	15.3	15.6
9. GDP at factor cost	6,091,485	7,157,412	8,279,975	17.5	15.7

Note: The figures in parenthesis show the percentage change over previous year
QE: Quick Estimate; AE: Advance Estimate

Table 3.6 Expenditures of GDP at Market Prices in 2011-12 (at current prices)

Industry	₹ in Crore Expenditures of Gross Domestic Product			Rates of GDP at Market Prices (%)	
	2009-10	2010-11 (QE)	2011-12 (AE)	2010-11	2011-12
1. Private Final Consumption Expenditure (PFCE)	3,708,136	4,338,392	5,025,486	56.5	56.4
2. Government Final Consumption Expenditure	774,272	910,719	1,023,829	11.9	11.5
3. Gross Fixed Capital Formation (GFCF)	2,041,758	2,331,382	2,609,963	30.4	29.3
4. Change in Stocks	174,310	254,970	286,834	3.3	3.2
5. Valuables	116,312	162,837	258,015	2.1	2.9
6. Exports	1,300,034	1,747,500	2,180,793	22.8	24.5
7. Less Imports	1,646,936	2,066,000	2,634,397	26.9	29.6
8. Discrepancies	-10,534	-5,652	161,655	-0.1	1.8
GDP at market prices	6,457,352	7,674,148	8,912,178	100.0	100.0

Source: http://mospi.nic.in/mospi_new/upload/nad_pr_7feb12.pdf

Note: The figures in parenthesis show the percentage change over previous year
QE: Quick Estimate; AE: Advance Estimate

Sectoral Composition of National Income

There are basically three sectors into which the Indian economy is classified:
Agriculture and allied, Industry and Services.

The agriculture sector comprises the following:

- Agriculture (agriculture proper & livestock)

- Forestry and logging
- Fishing and related activities

The industry sector comprises the following:

- Manufacturing (both registered and unregistered)
- Electricity
- Gas
- Water supply
- Construction

The services sector comprises the following:

- Trade
- Repair
- Hotels and restaurants
- Transport
- Storage
- Communication and services related to broadcasting
- Financial, real estate and professional services
- Community, social and personal services

In India, the largest sector is the services sector. Gross Value Added (GVA) at current prices for services sector was estimated at ` 61.18 lakh crore in 2014-15. Services sector accounts for 52.9 per cent of total India's GVA of ` 115.50 lakh crore. With GVA of ` 34.67 lakh crore, Industry sector contributes 30.02 per cent. The agriculture and allied sector shares are 17.01 per cent and GVA being approximately ` 19.65 lakh crore.

The prices that prevailed during 2011-12, the contribution made by agriculture & allied, Industry, and Services sectors stood at 16.11 per cent, 31.37 per cent, and 52.52 per cent, respectively.

Based on the CIA Factbook, the sector wise Indian GDP composition in 2014 are Agriculture (17.9 per cent), Industry (24.2 per cent) and Services (57.9 per cent).

Other important facts are as follows:

- Total production of agriculture sector is \$366.92 billion.
- India is the second largest producer of agriculture product.
- India accounts for 7.68 per cent of total global agricultural output.
- GDP of industry sector is \$495.62 billion and the world rank is 12.
- In services sector, India's world rank is 11 and GDP is \$1185.79 billion.
- Contribution of agriculture sector in Indian economy is much higher than world's average (6.1 per cent).

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- Contribution of industry and services sector is lower than the world's average 30.5 per cent for industry sector and 63.5 per cent for services sector.

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With the previous methodology, composition of Agriculture & allied, Industry and Services sectors was 51.81 per cent, 14.16 per cent, and 33.25 per cent, respectively at current prices in 1950-51. The share of Agriculture & allied sector declined at 18.20 per cent in 2013-14. The share of Services sector improved to 57.03 per cent. The share of industry sector also increased to 24.77 per cent.

Another way to divide an economy is on the basis of sectors are as follows: primary, secondary and tertiary. As an economy develops, the role played by its primary sector begins to decline and the secondary and tertiary sectors begin to gain increasing prominence.

Similar changes have also taken place in the Indian economy post-independence. There was a decline in the primary sector's share in the GDP from 59 per cent in 1950-51 to about 17 per cent in 2009-10. In the primary sector itself, agriculture and allied activities' share of the GDP fell from the 57 per cent to about 15 per cent during the same time period. It is essential to understand that the decline is only of percentage share of agriculture in national income, while there is a steady rise in the agriculture production volume.

There has been a decline as far as percentage of GDP is concerned due to the fact that there has been a faster increase in industrial output and value of products in the service sector than growth in the agricultural sector. The secondary sector's share nearly went double: 13 per cent in 1950-51 to 24.5 per cent in 1990-91.

Nevertheless, there has not been any significant change in its share of the GDP in the later years, oscillating between 24 per cent to 26 per cent from 2000-01. The registered manufacturing units' share increased from the 4 per cent of 1950-51 to more than 12 per cent during 2009-10.

Within the secondary sector, the percentage share of manufacturing, especially registered manufacturing, and construction is constantly on the rise, with gas, electricity and water supply being nearly constant.

There has been a substantial growth in the service sector (tertiary sector) since 1950-51, and its GDP share has risen from 28 per cent in 1950-51 to about 60 per cent in 2014-15.

In the tertiary sector, every one of the sectors has displayed a rapid growth. Trade, hotels, transport and communication is the largest sector and its contribution is approximately 22.5 per cent share to GDP. Since independence, the fastest growing sector is the financial sector, and more so since the banks were nationalized during 1969 and 1980.

Post-1980s, India's process of growth has included a healthy performance and contribution by the services sector. There was a rise in the growth rate of the services sector, going up from 6.6 per cent of the 1981-90 decade to 7.6 per cent

in the 1991-2000 period. There was a steady growth in this sector of 10 per cent during the periods 2001-02 and 2009-10.

While the primary sector has grown slower than the tertiary and the secondary sectors, the rise in the share of tertiary sector has been more than that of the secondary sector. The primary sector's average growth rate has been 2.5 per cent per annum and of the tertiary and secondary sector has hovered about 5 per cent in the planning period.

In the Indian economy, the secondary sector was at no point the dominant sector. In the earlier period, the primary sector dominated and in the current times the dominance is of the tertiary sector. This pattern of structural changes has deviated from the development pattern of the nations of the western world.

Public Sector and Private Sector

A mixed economy was adopted by India post its independence. This structure provided for a greater place for the public sector (government sector) and due to this move, there has been a steady rise in the significance of public sector. When India gained independence, the public sector share in the GDP stood at 7 per cent and 1990 91 it had gone up to one-fourth. The share in 2004 05 was 23.0 per cent. Post the introduction of the New Economic Policy in the 1990, the public sector's share is nearly stagnant with a fall expected in future due to globalization and privatization.

3.2.1 Personal Income

Personal income may be defined as the current income of persons or households derived from all sources. Personal income is not, however, a correct measure of the current economic activities which are represented by the production of goods and services in the economy since it includes several items which are not related to the current production of goods and services and excludes certain items which are related to the current production of goods and services in the economy. In other words, it includes both the earnings from the productive services (economic activities) and the receipts against which no productive services have been rendered. Personal income is, therefore, obtained from national income by subtracting from the national income that part of it which is earned but is not received by the persons and by adding to it those personal receipts which are derived from sources which are not included in the national income. Thus, in order to derive personal income from the national income, we should deduct from it the undistributed corporate profits, tax, employers' and employees' contributions to social insurance and add to it the government and business transfer payments, net interest paid by the government, interest paid by consumers and the dividends distributed by the corporate business sector to the shareholders.

Disposable personal income is derived from personal income by deducting from personal income direct personal taxes, such as personal income tax. The residue left is the *disposable personal income* because it represents the total

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amount of income which is available for disposal by the person concerned. The difference between the disposable personal income and personal saving is personal outlays which may be incurred in the form of consumption expenditure and interest paid by the consumers.

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Check Your Progress

1. What is national income?
2. Define gross national product.
3. How is disposable personal income derived?

3.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The total income of a country is known as 'national income'. It shows the overall economic performance of an economy.
2. Gross national product (GNP) is the monetary value of the goods and the services produced in a country, and the value of net export.
3. Disposable personal income is derived from personal income by deducting from personal income direct personal taxes, such as personal income tax.

3.4 SUMMARY

- The total income of a country is known as 'national income'. It shows the overall economic performance of an economy.
- If you include the monetary value of all the goods and the services produced within a country, it is known as gross domestic product (GDP).
- Current price in general economics refers to the prevailing price or the actual price in the year in which the goods or services are produced.
- Constant price on the other hand refers to the prices prevalent in one particular year, which is taken as a base for calculation of increase or decrease in prices or other measures in the current year.
- Nominal national income or National income at current prices are generally not preferred by economists for it is influenced by two very important factors: change in price levels and change in physical output.
- Personal income may be defined as the current income of persons or households derived from all sources.

3.5 KEY WORDS

- **National Income:** It refers to the total amount of money earned within a country.
- **GDP:** Gross Domestic Product or GDP is a monetary measure of the market value of all the final goods and services produced in a period of time, often annually or quarterly.
- **Personal Income:** It refers to an individual's total earnings from wages, investment enterprises, and other ventures.

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3.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Differentiate between current price and constant price.
2. Write a short-note on personal income.

Long Answer Questions

1. Explain concepts such as gross national product and net national product.
2. Discuss how to estimate national income at current price and constant price.

3.7 FURTHER READINGS

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UNIT 4 DEMOGRAPHIC FEATURES

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Structure

- 4.0 Introduction
- 4.1 Objectives
- 4.2 Population Growth
 - 4.2.1 Urbanization
- 4.3 Answers to Check Your Progress Questions
- 4.4 Summary
- 4.5 Key Words
- 4.6 Self Assessment Questions and Exercises
- 4.7 Further Readings

4.0 INTRODUCTION

This unit will introduce you to the broad demographic features of the Indian economy.

According to the Indian Census of 2011, India's population is 1.21 billion. One of the features of Indian demographic behaviour which has been the cause for considerable concern is, more or less, the steady decline in the sex ratio. The factors responsible for this continued decline are as yet not clearly identified. However, it is well recognized that the adverse sex ratio is a reflection of gender disparity and appropriate steps to correct this trend need to be taken. While demographic transition reflects quantitative and qualitative changes in the population profile, the on-going changes in disease burden is producing a major health transition. The growth rate of the population between the ages of 15–60 is considerably higher than that of population as a whole. Since this is the age group which is actively seeking employment, the need for expanding work opportunities is considerably higher than before. However, the total dependency ratio has been significantly declining. This occurs through a sharp reduction in the dependency ratio pertaining to the young, with that of the old remaining more or less constant. Therefore, if gainful employment can be provided to the entire labour force, the economic conditions of the households would improve significantly faster than before. The rural–urban composition of Indian population and its occupational distribution show that India is gradually moving towards urbanization and modernization. The rural population of the country has decreased from 82.7 per cent in 1951 to 68.2 per cent in 2011, while the urban population of the country has increased from 17.3 per cent to 31.8 per cent in the same period.

4.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the population growth in India since independence
- Describe the problems associated with overpopulation
- Explain the phenomenon of urbanization in India

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4.2 POPULATION GROWTH

India is the second most populated country in the world with nearly a fifth of the world's population. Throughout history, India's population has always been high. Since independence, due to failure of family planning initiatives of the government as well as a steep fall in death rates, has led to a rapid increase in the population. This has both advantages and disadvantages. Let us look at some aspects related to population growth.

Demographic transition is the transition from a stable population with high mortality and fertility to a stable population with low mortality and fertility. During the transition, population growth and changes in the age structure of the population are inevitable. In India, the demographic transition has been relatively slow but steady. As a result the country was able to avoid adverse effects of too rapid changes in the number and age structure of the population on social and economic development.

Challenge

- To meet all the needs of rapidly growing adolescent and young adult population
- To cater to their increasing expectations for improved quality, spectrum and access to services
- By meeting their felt needs it will be possible to accelerate demographic and socio-economic transition
- Invest adequately in Human Resource Development (HRD)/skill development
- Provide appropriate employment with adequate emoluments to large work force

Paradigm shift needed

- Utilize human resources to accelerate socio-economic growth and improvement in quality of life.

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- Bring about convergence and synergy between ongoing programmes to hasten demographic, socio-economic and educational transitions to achieve rapid population stabilization.
- There are significant differences in the age structure between countries of the world and different states in India.
- This is partly due to differences in the period of onset of demographic transition and partly due to differences in rate of transition.
- Age structure of India is similar to that of the world.
- Population pyramid of Kerala is approaching that of more developed countries while that of UP resembles the less developed countries.
- In the period between 1996-2016, population in the:
 - o age group 15-59 will increase from 519 to 800 million
 - o age group < 15 yrs will decline from 353-350 million
 - o age group > 60 yrs will increase from 62.3 to 112.9 million
 - o Dependency ratio will continue to decline

Opportunity

- Utilize human resources to accelerate socio-economic growth
- Unmet need for contraception exists in all states and among all segments of population, but the magnitude of unmet need varies
- Andhra Pradesh has the lowest unmet need for contraception in spite of low age at marriage, low female literacy, problems in accessing health care in some regions
- Unmet needs for contraception is highest in the four states with high CBR
- It is imperative that all the unmet needs for contraception are met through improved quality and coverage of services
- Under-nutrition and IMR are high in Madhya Pradesh, Orissa, Uttar Pradesh and Bihar
- Some of the surveys indicate that under-nutrition is more common in girls than among boys
- Low birth weight, poor dietary intake, poor caring practices, lack of access to safe drinking water, infection due to poor environmental sanitation, lack of access to health care are some of the factors responsible for the prevailing high under-nutrition in children
- It is essential to provide integrated health, nutrition and contraceptive care to achieve rapid improvement
- Women's literacy is one of the critical factors that determines and enables them to achieve their reproductive goals

- Literacy improves awareness and enables women to access services; this improves their own well-being, survival of their offspring, and access to contraception
- In spite of relatively low female literacy, Andhra Pradesh will be achieving replacement level of fertility shortly as will Karnataka, West Bengal
- These data suggest that high female literacy is not an essential pre-requisite for reduction in fertility
- There are wide differences between states in the proportion of persons living below the poverty line
- This is partly due to differences in the per capita State Domestic Product and partly due to differences in distribution of income between different groups
- Over the years there has been a decline in the proportion of population living below poverty line but in terms of actual numbers there has been an increase
- States with largest percentage of BPL families have high CBR; this in turn will further reduce per capita income and result in increased number of BPL families.

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Table 4.1 shows the growth in India's population as well as the compound annual growth rate of India's population from 1891.

Table 4.1 Growth of India's Population from 1891-2008

Census Year	Population in million	Increase or decrease (in millions)	Percentage Increase or Decrease
1891	236		
1901	236	0.0	0.0
1911	252	+16	+5.7
1921	251	-1	-0.3
(1891-1921)		+15	+0.19
1931	279	+28	+11.0
1941	319	+40	+14.2
1951	361	+42	+13.3
(1921-1951)		+110	+1.22
1961	439	+78	+21.6
1971	548	+109	+24.8
1981	683	+135	+24.7
(1951-1981)		+322	+2.14
1991	846	+161	+23.9
2001	1,029	+183	+21.5
2011	1,210	+181	17.64
(1981-2011)			
Compound annual growth rate of population			
1891-1921		0.19	
1921-1951		1.22	
1951-1981		2.15	
1981-1991		2.11	
1991-2001		1.93	
2001-2011		1.64	
Source: Census of India 2001, Series 1, Paper 1 of 2001, Provisional Population Totals. Economic Survey, 2009-10, Census 2011 (Provisional Population Tools)			

Source: Census of India 2001, Series 1, Paper 1 of 2001, Provisional Population Totals. Economic Survey, 2009-10, Census 2011 (Provisional Population Tools).

Sex Composition**NOTES**

Population enumeration by gender composition is one of the basic demographic characteristics and provides meaningful demographic analysis. Indian census has the tradition of bringing out information by gender composition on various aspects of the population. Changes in gender composition largely reflect the underlying social, economic and cultural patterns of the society in different ways.

Sex ratio is defined as the number of females per 1000 males in the population and is an important social indicator to measure the extent of prevailing equity between males and females in a society at a given point of time. It may be noted that the sex ratio is expected to be almost at parity in nature. According to experts, sex differential in mortality, sex selective outmigration and skewed sex ratio at birth are the major contributory factors that influence changes in sex ratio.

In India, sex ratio is skewed in favour of males and has continued to rise and expand in various forms. This has drawn wide attention of policy makers and planners to reverse the trend to bring it back to parity.

As per the provisional results of Census 2011, total population of India is 1,21,01,93,422 which comprises of 62,37,24,248 males and 58,64,69,174 females with the sex ratio of 940 females per 1000 males. The sex ratio in India from the year 1901 to 2011 is given in Table 4.2. States/Union Territories which account for the highest and lowest sex ratios in the country are mentioned in Tables 4.3 and 4.4. As per Census 2011, top five states/Union territories which have the highest sex ratio are Kerala (1,084) followed by Puducherry (1,038), Tamil Nadu (995), Andhra Pradesh (992) and Chhattisgarh (991). Five states which have the lowest sex ratio are Daman & Diu (618), Dadra & Nagar Haveli (775), Chandigarh (818), NCT of Delhi (866) and Andaman & Nicobar Islands (878).

Table 4.2 Sex Ratio in India

Year	Females per 1000 males
1901	972
1911	964
1921	955
1931	950
1941	945
1951	946
1961	941
1971	930
1981	934
1991	927
2001	933
2011	940

Table 4.3 Top Five States/Union Territories having the Highest Sex Ratio

S.No.	States/Union Territories	Sex Ratio (Females per 1000 Males)
1	Kerala	1,084
2	Puducherry	1,038
3	Tamil Nadu	995
4	Andhra Pradesh	992
5	Chhattisgarh	991

Table 4.4 Five States having the Lowest Sex Ratio

S.No.	States/Union Territories	Sex Ratio (Females per 1000 Males)
1	Daman & Diu	618
2	Dadra & Nagar Haveli	775
3	Chandigarh	818
4	NCT of Delhi	866
5	Andaman & Nicobar Islands	878

NOTES**Distribution of Population**

- Uttar Pradesh has the highest total population followed by Maharashtra, Bihar, West Bengal and Andhra Pradesh.
- Top ten states together have about 76 per cent of the total population of India.
- Population is very small in the states like Jammu & Kashmir, Arunachal Pradesh and Uttarakhand even though they are large states.
- Rajasthan, Jharkhand and peninsular states have moderate to high proportion of population.

Uneven distribution of population in India reflects a close relationship between population and physical, socioeconomic and historical factors.

1. Physical factors including climate, terrain and availability of water affect and determine the pattern of the population distribution. Some examples of this are as follows:
 - The North Indian Plains, deltas and Coastal Plains have higher proportion of population because of suitable climate for agriculture and fertile plains.
 - Mountainous and forested regions of southern and central Indian states, Himalayan states and some of the north-eastern states are less populated.
 - Development of irrigation (Rajasthan), availability of mineral and energy resources (Jharkhand) and development of transport network (peninsular states) have resulted in moderate to high proportion of population.

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2. Socio-economic and historical factors also impact and determine the distribution of population of India. Some examples are:
 - Traditional settled agriculture and early human settlement has resulted in large population in the river plains and coastal areas of India.
 - Development of transport and better agricultural development has resulted in large population in North Plains.
3. The industrialization and urbanization also influenced the distribution of population.

Problem of Overpopulation

India is suffering from innumerable problems due to overpopulation. The current population is over a billion, but India does not have the large land mass that China has to support its rapidly increasing populace. India is experiencing major problems with declining water tables due to over-extraction beyond sustainable yield. It is developing desalination plants to solve this issue. However, according some analysts, as India has the same population density as Japan, underdevelopment, and not overpopulation, is the cause of India's poverty.

Some problems associated with or intensified by human overpopulation are as follows:

1. Inadequate fresh water for drinking water use as well as sewage treatment and effluent discharge. Some countries use desalination to solve the problem of water shortages.
2. Depletion of natural resources, especially fossil fuels, increased levels of air pollution, water pollution, soil contamination and noise pollution. Once a country has industrialized and become wealthy, a combination of government regulation and technological innovation causes pollution to decline substantially, even as the population continues to grow.
3. The persistent failure of many of these countries to escape from the 'Malthusian trap' through economic growth exceeding population growth. Many Third World countries simply lack the economic or infrastructural base to provide a rising standard of living for most of their people, especially in Africa, the Arab world and parts of Latin America.
4. Changes in atmospheric composition and consequent global warming.
5. Irreversible loss of arable land and increases in desertification. Deforestation and desertification can be reversed by adopting property rights, and this policy is successful even while the human population continues to grow.
6. Illegal (and legal) immigration to the developed world on an unparalleled scale, resulting in an unprecedented demographic and political problem in Europe and the US. Even the controlled and legal migration of talented and well-educated people from the Third World to the developed world denudes

it of its limited skills base. Mass species extinctions from reduced habitat in tropical forests due to slash-and-burn techniques that sometimes are practiced by shifting cultivators, especially in countries with rapidly expanding rural populations; present extinction rates may be as high as 140,000 species lost per year. The IUCN Red List lists a total of 698 animal species having gone extinct during recorded human history.

7. High infant and child mortality. High rates of infant mortality are caused by poverty. Rich countries with high population densities have low rates of infant mortality.
8. Increased incidence of hemorrhagic fevers and other infectious diseases from crowding, lack of adequate sanitation and clean potable water and scarcity of available medical resources.
9. Starvation, malnutrition or poor diet with ill health and diet-deficiency diseases (e.g., rickets). Famine is aggravated by poverty. Rich countries with high population densities do not have famine.
10. Poverty coupled with inflation in some regions and a resulting low level of capital formation. Poverty and inflation are aggravated by bad government and bad economic policies. Many countries with high population densities have eliminated absolute poverty and keep their inflation rates very low.
11. Low birth weight due to the inability of mothers to get enough resources to sustain a foetus from fertilization to birth. Low life expectancy in countries with fastest growing populations.
12. Unhygienic living conditions for many based upon water resource depletion, discharge of raw sewage and solid waste disposal.
13. Increased crime rate due to drug cartels and increased theft by people stealing resources to survive.
14. Conflict over scarce resources and crowding, leading to increased levels of warfare.
15. Over-utilization of infrastructure, such as mass transit, highways and public health systems.
16. Higher land prices.

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4.2.1 Urbanization

In brief, urbanization refers to the population shift from rural to urban residency, the gradual increase in the proportion of people living in urban areas, and the ways in which each society adapts to this change. In India, there is a high incidence of internal migration of poor labourers from rural areas to the urban centres. The poor migrants end up working as casual labourers in the informal sector. This population is also the one that is more susceptible to diseases and stands the risk of not getting access to health services.

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Around 14.4 million Indians migrated within India for work purposes either to cities or areas with higher expected economic gains during the 2001 census period. 25 lakh migrants are engaged in plantations or farms, construction sites, brick-kilns, quarries, and fish processing (NCRL, 2001). Many migrants also work as casual labourers in the informal manufacturing units, services or transport sectors. They work as head loaders, rickshaw pullers and hawkers.

Among the migrants who are vulnerable, the Internally Displaced People (IDPs) are estimated to be around 6 lakhs (IDMC, 2006). Internal displacement is caused due to conflicts of not just ethnic or religious nature but also of political nature, natural disasters, development projects, etc.

There is separate migration data for males & females, migrant households, return-migrants, the structure of the residence of the migrants' households before & after migration, status of the migrants before and after migration and other details on migration.

Only 1.1 per cent of rural households and 2.2 per cent of urban households are classified as migrant households, which have moved to their "current" place of residence during the year preceding the date of survey.

The rate of migration for ST households is higher than the rate for other groups in both the sectors. The difference is more pronounced in rural India than urban India.

At All India level, movements within state account for 77.5 per cent of total migrant households in urban India & 85.5 per cent in rural India.

The rate of migration of households from rural India is less than the corresponding rate for urban India.

Movement of households is mainly guided by the employment angle. It accounts for 67.5 per cent of the household migration to rural India & 60.2 per cent of the household migration to urban India. Another important reason of migration of households is 'Study' which accounts for 10.6 per cent of the household migration to rural India and 24.6 per cent of the household migration to urban India.

There is an inverse relationship between the land possessed and migration of the household.

Industrial Distribution

Several economists have analysed the changes in industrial distribution of the work force over the entire period from 1961–2000 and have presented their study to the government. Their findings are as follows:

- According to a study done by K. Sundaram (July, 2001), for the total work force, there is a 16 percentage point decline in the share of the agriculture, forestry and fishing sector. This decline is greater than the 10 percentage point decline in the share of this sector in the rural work force and reflects

the effect of a shift in the rural-urban composition of the work force towards the latter.

- Of this 16 percentage point decline in the share of the agriculture sector, less than 3 percentage points represent the gain in the share of the manufacturing (and repair services) sector. The construction sector recorded a 3 percentage point gain in its share in the work force.
- The service sector, as a group, recorded a 10 percentage point gain in its (collective) share in the work force. Half of this was accounted for by the trade, hotels and restaurants sector. The transport, storage and communications, and, the community, social and personal services sectors gained 2 percentage points each in their (respective) shares in the work force.
- In respect of female work force, starting from a much higher share (861 per 1000) instead of 759 per 1000), the decline in the share of the agriculture (and allied activities) sector over the thirty-nine year period has been significantly less (108 points per 1000 instead of 160 points per 1000) than was recorded for the total work force. In the same way, the profits of the other sectors too have been less marked.
- During the 1990s, the rate of decline in the share of the agriculture sector in the total work force has been faster. It has been about twice as fast as that realized over the thirty-three year period between 1961 and 1994. Similarly, the profits in the shares of the other sectors have also occurred at an equally accelerated pace during the 1990s. However, in the case of the manufacturing (and repair services sector), this pace has been much less marked (from 0.6 per cent per annum between 1961 and 1994 to 0.8 per cent per annum in the 1990s).
- In terms of the total number of workers together in the agriculture and allied activities sector, the decline in the number of workers is seen to be more moderate (0.9 million) than indicated in our earlier paper. In reality, in rural areas and among male workers, the number of workers in this industry division has increased between 1993-94 and 1999-2000.
- Within the agriculture and allied activities sector, crop production has recorded a reduction in the size of its work force of 1.5 million in the aggregate but not in the rural areas - where, in fact, we have a marginal increase in the number of workers in crop production. Considerably, both in the broader agricultural and allied activities sector and in the crop production sub-sector, the reduction in the number of female workers has been much greater than in the total work force. The reduction in the size of the work force in the livestock sector is almost totally among female workers but is somewhat more evenly split across the rural-urban divide.
- Regulating the reduction in the size of the work force in the agriculture and allied activities sector in the total work force and among female workers

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(and contributing to the increase in the rural work force in this sector) is the increase of about 2 million workers engaged in providing agricultural support services in the aggregate which is concentrated, almost exclusively, in the rural areas.

- With the alliance of repair services with the manufacturing sector in line with the current practice in National Accounts, the total additions to the work force in the manufacturing and repair services sector, and subsequently also the profits in the share of this sector in the work force, is greater than what was reported earlier.
- The addition of a little over 5 million to the work force of the manufacturing and repair services sector between 1994 and 2000 is more or less evenly split across the rural-urban divide. However, across the gender divide, female workers in this sector comprise of only 20 per cent of the additional work force.
- In contrast to the rising share of the manufacturing sector as a whole, a major sub-sector, namely, textiles and textile products has suffered a sizeable decline in its workforce.

Check Your Progress

1. What is demographic transition?
2. List the five states or union territories that have the highest sex ratio?
3. Define urbanization.

4.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Demographic transition is the transition from a stable population with high mortality and fertility to a stable population with low mortality and fertility.
2. As per Census 2011, top five states/Union territories which have the highest sex ratio are Kerala (1,084) followed by Puducherry (1,038), Tamil Nadu (995), Andhra Pradesh (992) and Chhattisgarh (991).
3. Urbanization refers to the population shift from rural to urban residency, the gradual increase in the proportion of people living in urban areas, and the ways in which each society adapts to this change.

4.4 SUMMARY

- India is the second most populated country in the world with nearly a fifth of the world's population.

- Since independence, due to failure of family planning initiatives of the government as well as a steep fall in death rates, has led to a rapid increase in the population. This has both advantages and disadvantages. Let us look at some aspects related to population growth.
- Population enumeration by gender composition is one of the basic demographic characteristics and provides meaningful demographic analysis.
- The Indian Census has the tradition of bringing out information by gender composition on various aspects of the population.
- Changes in gender composition largely reflect the underlying social, economic and cultural patterns of the society in different ways.
- In India, sex ratio is skewed in favour of males and has continued to rise and expand in various forms.
- In India, there is a high incidence of internal migration of poor labourers from rural areas to the urban centres. The poor migrants end up working as casual labourers in the informal sector.

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4.5 KEY WORDS

- **Paradigm Shift:** It means a fundamental change in approach or underlying assumptions.
- **Sex Ratio:** It is the ratio of males to females in a population.
- **Migration:** It is the process of a person or people travelling to a new place or country, usually in order to find work and live there temporarily or permanently.
- **Census:** It is an official count or survey, especially of a population.

4.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the challenges and opportunities of India's demographic transition?
2. Define sex ratio.
3. Write a short-note on the changes in the industrial distribution of the work force.

Long Answer Questions

1. The Indian census has the tradition of bringing out information by gender composition on various aspects of the population. Discuss in reference to the 2011 Census.

2. Describe the problems of overpopulation.
3. Discuss the problem of urbanization in India.

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4.7 FURTHER READINGS

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UNIT 5 INTER-STATE DISPARITIES IN THE PATTERN OF DEVELOPMENT

NOTES

Structure

- 5.0 Introduction
- 5.1 Objectives
- 5.2 Regional Disparities
- 5.3 Poverty
 - 5.3.1 Reasons for Poverty in India
- 5.4 Unemployment
- 5.5 Answers to Check Your Progress Questions
- 5.6 Summary
- 5.7 Key Words
- 5.8 Self Assessment Questions and Exercises
- 5.9 Further Readings

5.0 INTRODUCTION

In the previous unit, the demographic features of the Indian population were discussed. Here, we will turn towards poverty, unemployment and regional disparities in India.

Since independence, a lot of development has taken place in India. However, this development has been uneven. The major urban areas like Mumbai and New Delhi and others have developed rapidly, leaving the countryside far behind. Moreover, if one were to look at the development patterns state-wise, we would find that there are some states in India that are far ahead of other states in economic and human development indices. We will examine these aspects in this unit. We will also discuss two of the major problems of underdevelopment in India, i.e., poverty and unemployment.

5.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss regional disparities in India
- Examine the reasons for poverty in India
- Describe the reasons and effect of unemployment in India

5.2 REGIONAL DISPARITIES

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Independent India inherited an economy which was not only slightly backward but also regionally imbalanced. It reflected the distorted pattern of development imposed by the colonial reign to subserve its own interests. Most industrial and commercial activities were concentrated in the metros, that is, Mumbai, Kolkata and Chennai. Other cities like Ahmedabad, Kanpur and Delhi were also experiencing a lot of action. The other regions of the country remained underdeveloped. Getting rid of the existing regional disparities was therefore the primary challenge for the policy makers. The economic reforms that began in the country in 1991 brought about a drastic change in the economic policy regime. The policy of development led and directed by the state gave way to market-led growth. The regulatory mechanism gradually gave way to a policy of liberalization of domestic and external market.

Following the new economic policy, private investment began to flow to the high profit-yielding regions instead of the regions requiring higher investment. More private investment went to the richer states which had better infrastructure. The pattern of investment as well as growth was more concentrated. This led to an interest in the study of regional disparities.

The fiscal capacity of the states varied significantly. The poorer states were incapable of raising enough revenue from their tax and non-tax resources for providing the required level of public services to their people. These fiscal imbalances also got reflected in the differences in per capita expenditure of the states.

The capita revenue capacity of the richer states such as Punjab, Haryana and Maharashtra was much more than that of the poorer states like Bihar and Uttar Pradesh. In fact it was more than double.

The generous transfers by the Finance Commissions failed to remove disparities in revenue capacities of the states in any substantial measure.

Not only were the quality and level of public services and infrastructure much better in the richer states, they also had a much better capacity for investing. They were in a better position to attract funds from the Planning Commission and private investors.

This kind of complexity is the root cause of the persistent and growing inter-regional disparities at the state level in the country.

Trends since 1991

With the skewed investment pattern and resource flow, the pattern of growth has been far from uniform across states. During the eighties, the differences in growth rates of Gross State Domestic Product (GSDP) in different states were not very significant. However, growth rates of GSDP in the poorer states fell in the 1990s

as compared to the 1980s, while the growth rates rose in the richer states. Kerala, West Bengal, Gujarat, Karnataka, Tamil Nadu and Madhya Pradesh were the states that gained the most. All these states with the exception of Madhya Pradesh belong to high or medium per capita income category.

While the growth rate of GSDP has been slower in the poorer states, population growth has been faster in these states. As a result, the increase in per capita income has been slower. Not surprisingly, indicators of inter-state disparities in per capita SDP like minimum-maximum ratio and coefficient of variation clearly show that the situation worsened in the 1990s as per the Twelfth Finance Commission's report.

Table 5.1 shows trends in inter-state disparity in per capita Gross State Domestic Product (GSDP) 2000-2009

Table 5.1 Trends in Inter-State Disparity in Per Capita Gross State Domestic Product (GSDP) 2000-2009

Year	State with lowest per capita GSDP	State with highest per capita GSDP	Ratio of Minimum to Maximum per capita GSDP (%)	Coefficient of variation (%)
2001-02	Bihar	Punjab	30.02	4.78
2002-03	Bihar	Haryana	28.90	6.06
2003-04	Bihar	Haryana	22.71	5.93
2004-05	Bihar	Haryana	20.11	6.18
2005-06	Bihar	Haryana	20.38	7.13
2006-07	Bihar	Haryana	21.89	7.77
2007-08	Bihar	Haryana	21.87	8.31

Note: Based on CSC) data. Data relates to 16 the general category states excluding Goa. Source: Calculated from CSC) data based on 1999-2000 constant prices.

While the Indian economy has progressed to a higher growth path, the growth pattern has been concentrated regionally. Many regions have been overlooked in the race towards higher economic growth.

This uneven growth pattern that is responsible for the demands for creation of separate states in different regions of the country. These regional pressures have led to the creation of three separate states of Uttarakhand, Chhattisgarh and Jharkhand, which were created in 2000 as a result of the bifurcation of the states of Uttar Pradesh, Madhya Pradesh and Bihar. Similar demands are now coming from other regions of India such as Bundelkhand and Vidharbha.

Check Your Progress

1. What was the pattern of development in pre-independent India in terms of regional disparities?
2. What is responsible for the demand for the creation of separates states in different regions of the country?

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5.3 POVERTY

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Generally, the poor is identified on the basis of their occupation and ownership of assets. According to scholars, the rural poor mainly work as:

- Landless agricultural labourers
- Cultivators with very small landholdings
- Landless labourers who are engaged in a variety of non-agricultural jobs
- Tenant cultivators with small land holdings

The urban poor are majorly born out of the rural poor who had migrated to urban areas in search of alternative employment and better livelihood, labourers who do a variety of casual jobs and the self-employed who sell a variety of things on roadsides and are engaged in various activities.

In post-independent India, several attempts have been made by the government to define a mechanism in order to identify the number of poor in the country. People are divided into two categories for the purpose of defining poverty—the poor and the non-poor - and these two categories are further separated by the poverty line. However, there are several kinds of poor, including the absolutely poor, the very poor and the poor. Similarly, there are various kinds of non-poor, including the middle class, the upper middle class, the rich, the very rich and the absolutely rich.

Several factors, other than income and assets, are associated with poverty; for instance, the accessibility to basic education, health care, drinking water and sanitation. However, the mechanism to determine the poverty line does not consider social factors that initiate and is responsible for causing poverty such as illiteracy, ill health, lack of access to resources, discrimination or lack of civil and political freedoms. The government should make sure that the aim of poverty alleviation schemes should be to improve human lives by expanding the range of things that a person could be and could do, such as to be healthy and well-nourished, to be knowledgeable and participate in the life of a community. From this standpoint, development means removing the obstacles to the things that a person can do in life, such as illiteracy, ill health, lack of access to resources, or lack of civil and political freedoms.

Therefore, population growth plays a significant role in resulting in very low growth in per capita income terms. This further result in widening the gap between the poor and the rich. The Green Revolution aggravated the inequalities regionally and between large and small farmers. This was further aggravated by the unwillingness and inability to redistribute land and thus very little land reforms. More recently, economists now state that the benefits of economic growth rather than reaching the poor, has resulted in greater inequality. In fact, the Gini coefficient, the measure of income inequality in a country, has gone up in India in the last 20

years. This means that while a minority may have benefitted greatly by the reforms process, the lives of the majority of people in India is no different than it was 20 years ago. Recognizing this, the Government has started to talk about creating policies for 'inclusive growth'. Whether the formulation of such policies will have an impact in reducing the huge levels of poverty and inequality in India remains to be seen. Table 5.2 shows the poverty ratios in per cent.

Table 5.2 Poverty Ratios (per cent)

	Earlier estimates (URP) based on the Lakdawala methodology		Estimates (MRP) based on the Tendulkar methodology	
	1993-1994	2004-2005	1993-1994	2004-2005
Rural	37.3	28.3	50.1	41.8
Urban	32.4	25.7	31.8	25.7
Total	36.0	27.5	45.3	37.2

Source: Planning Commission. URP - Uniform Reference Period, MRP- Mixed Reference Period.

Head Count Poverty Index

The Planning Commission, which is the nodal agency for estimating the number and proportion of people living below the poverty line at national and regional levels, separately for rural and urban areas; makes poverty estimates every five years. The survey is based on a large sample survey of household consumption expenditure carried out by the National Sample Survey Organization (NSSO) after an interval of approximately five years. The Commission has been estimating the poverty line and poverty ratio since 1997 on the basis of the methodology spelt out in the report of the Expert Group on 'Estimation of Number and Proportion of Poor' (known as Lakdawala Committee Report). On the basis of NSS 61st Round (July 2004 to June 2005) consumer expenditure data, the poverty ratio is estimated at 28.3 per cent in rural areas, 25.7 per cent in urban areas, and 27.5 per cent for the country as a whole in 2004–05 using uniform recall period (URP). In URP, consumer expenditure data for all the items are collected for a 30-day recall period. Based on mixed recall period (MRP) for the same period, the poverty ratios are 21.8 per cent in rural areas, 21.7 per cent in urban areas, and 21.8 per cent for the country as a whole. In MRP, consumer expenditure data for five non-food items, namely clothing, footwear, durable goods, education, and institutional medical expenses, are collected for a 365-day recall period and the consumption data for the remaining items are collected for a 30-day recall period. The poverty estimate in 2004–05 based on URP consumption (27.5) is comparable to that of 1993–94 (36). The poverty estimates in 2004–05 based on MRP consumption (about 21.8) is roughly (but not strictly) comparable to that of 1999–2000 (26.1). Poverty ratio for rural India is considerably higher than the poverty ratio for urban areas on the basis of URP while it is almost the same on the basis of MRP.

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5.3.1 Reasons for Poverty in India

There are several reasons responsible for poverty in India. Some of them are discussed below:

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- (i) **Growth of population:** One of the major problems of poverty in India is the high growth rate of population especially among the poor. This is because of their strong belief in traditions, illiteracy and also their preference for the male child, which results in increase in population. With limited income, and numerous mouths to feed, they are unable to make ends meet.
- (ii) **Low rate of economic development:** Low rate of economic development is another major cause of poverty. The rate of economic development in India has been below the required level. It implies low per capita income, leading to a low standard of living. The population in India has been increasing at an annual average rate over 2 per cent during the plan period. Employment opportunities increase slowly because of low growth rate in the economy. This has kept the poor families in the state of poverty.
- (iii) **Unemployment:** With more than 2 crores unemployed people (in 2003–2004), India is in the grip of unemployment and underemployment. There is less job opportunities compared to the number of job seekers. Though efforts have been made to promote small and cottage industries to generate employment; however, even these industries could not absorb sufficient workforce so as to reduce poverty. Thus, the problem of unemployment and indebtedness is responsible for making the problem of poverty more acute.
- (iv) **Lack of education:** Growth of population has long been associated with the lack of education. Since the poor have limited access to education, they usually end up with low-paid jobs. This in turn, results in low income. Since, most underprivileged people are illiterate; they think that more the number of members in the family, more it will help in acquiring wealth.
- (v) **Inflationary pressure:** The constant rise in price has only added to the miseries of the poor. Sharp rise in prices has led to fall in the real income of fixed and low-income earners. Because of this, the poor reduced their purchasing power. This in turn, has led to low standard of living.
- (vi) **Socio-cultural factors:** Socio-cultural set-up of the country also contributes to poverty to a large extent. Usually, people belonging to lower castes and tribal groups, comprise the poor. Illiteracy and limited chances of mobility perpetuates poverty. Factors such as caste system, joint family system, religious faith and beliefs, and law of inheritance have hindered the process of economic growth.
- (vii) **Growth strategy:** Various strategies designed in the government plans have not been implemented properly. Some are yet to be developed. In fact, the growth strategy has kept the poor out of the development process. Prof.

H. Meghnad Desai points out, 'India's poverty-creating programmes is larger than its poverty removal programme.'

- (viii) **Inequalities in income:** Inequalities of income in rural and urban areas of the country is another cause of poverty. During the plan period, a large proportion of increased income has been cornered by the affluent ones. Due to inequalities in the distribution of income and assets, even a small rise in per capita income could not affect the poor. Hence, the problem of poverty has become acute.
- (ix) **Inadequate anti-poverty measures:** In view of the large magnitude of the problem of poverty in the country, the anti-poverty measures taken by the government are far from adequate. Some of them have been implemented half-heartedly and the ones, which have been implemented, have benefited only selected sections of the populace. Despite implementation of measures, the success in alleviating poverty has been limited.
- (x) **Capital deficiency:** Capital formation is a very important factor that can lead to economic growth and fall in poverty. There is a dearth of capital in India which results in low productivity, low per capita income and the end result happens to be poverty.
- (xi) **Globalization:** Globalization has pushed many households below poverty line. It is because production of some of the most important food crops have declined as agricultural land is being used for production of export crops after the inception of the globalization process. Liberalization has also forced small farmers to compete in a global market where prices of agricultural good are low.
- (xii) **Political factors:** Political structure of the country is also one of the factors accounting for the continued poverty. Political power is concentrated in the hands of the upper strata of the society, both in the urban area and rural areas. Economic policies are formulated to promote the interest of the richer section of the society. Poor people, particularly peasants, landless labourers, tribal people and slum dwellers suffer in the process.

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5.4 UNEMPLOYMENT

One of the most acute challenges that the Indian economy has been facing is the mounting rate of unemployment. It promotes poverty and inequalities, lowers social standards and is a huge loss of manpower resources to the nation. Unemployment is a chronic malady in India that deprives able bodied people to work on the current wages. It lowers the standard of living of the people since unemployed people do not have enough purchasing power. They face social degradation and suffer from inferiority complex. Therefore, some economists call unemployment problem as a socio-economic challenge to the society.

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Unemployment is becoming a serious problem in India, though accurate estimate is difficult to obtain. About 7 million people are added to the labour force every year and the number is also increasing at faster rate. But on the contrary, the economy growth is not creating enough jobs.

The number of unemployment in India increased from 2.01 crore in 1993–94 to 2.66 crore in 1999–2000. The labour force in 1999–2000 was about 363.33 million (36.33 crore) which has gone up significantly during Tenth Plan period. According to the data released by the NSSO, employment on Current Daily Status (CDS) basing during the periods 1999–2000 and 2004–05, had increased considerably in comparison to the augmentation registered during the periods 1993–94 and 1999–2000. During this period, about 47 million work opportunities were created compared to only 24 million in the period between 1993–94 and 1999–2000. Employment growth accelerated from 1.25 per cent per annum to 2.62 per cent per annum. However, the labour force grew at faster rate of 2.84 per cent than the work force, and unemployment force also rose. The incidence on unemployment on CDS basis increased from 7.31 per cent in 1999–2000 to 8.28 per cent in 2004–05.

Employment growth in the organized sector, public and private combined declined during the period 1994–2007. This can be attributed to the increase in employment rate in the public organized sector.

The compound annual unemployment growth rate in the organized sector, including public and private sectors in the country during 2008 to 2011 was 1.72 per cent. It was –0.24 for the public sector and 5.06 for the private sector.

Unemployment and Underemployment: Definitions

Unemployment is defined as a situation wherein able bodied persons fail to find a job even though they are willing to work at the prevailing wage rate. Unemployment is a two-fold phenomenon:

- An individual is not currently employed
- He/She is ready to work at the prevailing wage rates
- An individual must make an effort to find work

According to the Bureau of Labour Statistics, USA, the unemployed include people who do not have a job, have actively looked for work in the past four weeks, and are currently available for work. Also, people who were temporarily laid off and are waiting to be called back to that job are included in the unemployment statistics. In another sense, workers are considered to be the producer of services and when they are unable to sell their services, they are said to be unemployed. Underemployment, however, refers to a situation when a worker does not work for full hours (normally 8 hours a day). It is again the under-exploitation of manpower resources of the country. The Indian agriculture sector is facing such unemployment.

Extent of Unemployment in Developing Countries

It should, however, be mentioned that the problem of unemployment and underemployment represents a challenge to the developing countries just as the problem of cyclical unemployment is a challenge to the countries where advanced industrial development has taken place. The major problems of employment in the developing countries have been conceived of as follows:

- The provision of productive work for the farm population during long periods of seasonal unemployment has not been addressed properly.
- The prevention of the annual increase in employable population from further aggravating the situation of chronic underemployment and disguised unemployment in agriculture—which in many parts of these countries have already reached the point of saturation—has not been taken seriously. This occurs in urban areas also.
- The Indian planning has not paid any attention to manpower planning. It had always concentrated on the development of agriculture and industry. The eradication of unemployment has never been the prime objective of any plan.
- The Indian education system produces simple graduates and postgraduates and not professionals. It has never matched the needs of the economy. Our education system is neither job-oriented nor skill-oriented.
- Overpopulated countries like India need to stress upon the development of cottage and small-scale industries because it needs less capital and low technical skills. But the lack of communication and knowledge creates hurdles in its performance.
- The Indian agriculture absorbs the excessive pressure of overpopulation resulting into disguised unemployment. From each family farm, if we withdraw one or two members, the total productivity will not be affected, but at the same time, alternative job opportunities must be made available which unfortunately does not happen.
- The Indian labour is attached with their families and native places. They do not move far off to search a job and source of their livelihood.
- Illiteracy creates unskilled labour. Skilled and trained labour is required in modern industries. Thus, the illiterate and unskilled labourers remain unemployed in the country.

Reasons, Effects and Measures for Unemployment in India

The various reasons for the unemployment in India are mentioned below:

- **Voluntary unemployment:** People who take voluntary unemployment do not avail of an employment opportunity, because they consider such a job as below their dignity. Sometimes, people prefer remaining idle over availing low wage unemployment.

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- **Disguised unemployment:** It is invisible in nature since even if some workers are withdrawn from the work, the total production remains unchanged. Technically, disguised unemployment or invisible unemployment exists when marginal productivity of a labour is zero.
- **Cyclical unemployment:** It arises due to the cyclical activities in a capitalist system.
- **Structural unemployment:** It arises due to the changes in demand pattern and supply structure.
- **Frictional unemployment:** It arises due to imperfections of labour market.
- **Seasonal unemployment:** This arises due to change in season, it is termed as seasonal unemployment.
- **Technological unemployment:** It arises due to change in technology.
- **Educated unemployment:** It arises due to the following reasons:
 - Expansion of education facilities
 - Educational system is not job oriented
 - Educated persons consider many jobs to be beneath themselves
- **Agricultural unemployment:** It can be attributed to a number of reasons: the farmer can remain employed only for some parts of the year; the farms can no longer employ the available hands; the villages lack subsidiary industries and the vagaries of monsoons and weather conditions increase the rate of agricultural unemployment, etc.
- **Industrial unemployment:** It takes place due to the following reasons: high population rate in comparison with employment opportunities in the industry; uneconomic and non-geographic distribution of industries; conditions of depression and recession, etc.

Effects of Unemployment

The following is a list of the outcomes of unemployment:

- The gravest problem that the unemployed have to face is the lack of financial resources. They find it difficult to make ends meet. This directly impacts their standard of living.
- They might find it difficult to pay their economic obligations such as home loans, car loans and insurance premiums, or even house rent. This can lead them to become homeless.
- One of the related problems is underemployment. Unemployment may force people to undertake jobs that are not in accordance with their skills, experience and education qualifications.
- Unemployed people have to undergo psychological angst and anxiety. Generally, they will suffer too much stress, and so, they might resort to drugs and alcohol.

- Unemployment is a hindrance to social progress. It relegates people to lower status than they have been in the habit of enjoying.

Measures for Unemployment in India

The following measures are suggested in this regard:

- (i) **Increase in the rate of economic growth:** It is believed that higher economic growth rate will lead to larger production and thereby larger increase in employment. Therefore, the government should plan to introduce labour intensive technique of production which should give more emphasis on those levels of production which have high potential of employment opportunities.
- (ii) **High rate of capital formation:** The rate of capital formation must be increased in India. Capital formation should be encouraged only in those areas which generate greater employment opportunities. Presently, this rate is 30 per cent of the GDP, but it needs to be raised to the level of 35 per cent to 35 per cent.
- (iii) **Education reforms:** The Indian education system should be made more employment oriented. From the very beginning, emphasis should be laid on vocational education.
- (iv) **More expansion of employment exchange:** Employment exchanges are the institutions that bring together jobs and jobs seekers. More employment exchanges will make the labour more mobile. However, there is a need to improve the functioning of employment exchanges in the country.
- (v) **Policy towards seasonal unemployment:** Indian agriculture is of a seasonal nature, due to which the Indian farmers remain unemployed for some time. The employment policy in India should act in the following direction to remove these problems:
 - Promotion of multiple cropping
 - Promotion of activities allied to agriculture
 - Investment programmes for rural areas
 - Setting up of seasonal industries
- (vi) **Policy towards seasonal unemployment:** Nearly, 62 per cent people are self-employed in India, and most of them are engaged in agriculture sector. The government should provide different facilities and encouragement to the people who are engaged in their own occupations.
- (vii) **Employment opportunities for women:** Presently, 12 per cent of women are employed in organized sector, which is a quite low percentage. The Government of India should take the following steps to promote women employment:
 - Residential accommodation for working women on a large scale

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- Education and training facilities for working mothers
- Availability of crèches for the children of working mother

(viii) Promotion of co-operative industry: The industries in cooperative sector should be encouraged. It requires lesser investment for the promotion of employment.

(ix) Encouragement to small-scale units: Small-scale units can provide more employment opportunities for men and women. There is a need of lesser skill and training in such units. The government should encourage such units by offering them special incentives.

(x) Special employment programmes: The government should introduce special programmes for poor people, Schedule Caste and Schedule Tribes, landless labourers and unemployed women. These programmes should be centrally sponsored and properly monitored.

Check Your Progress

3. How are people divided into categories for the purpose of defining poverty?
4. Which is the nodal agency responsible for estimating poor in India?
5. Define unemployment.

5.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Most industrial and commercial activities were concentrated in the metros, that is, Mumbai, Kolkata and Chennai. Other cities like Ahmedabad, Kanpur and Delhi were also experiencing a lot of action. The other regions of the country remained underdeveloped.
2. The uneven growth pattern seen in the country is responsible for the demands for creation of separate states in different regions of the country.
3. People are divided into two categories for the purpose of defining poverty- the poor and the non-poor - and these two categories are further separated by the poverty line.
4. The Planning Commission, which is the nodal agency for estimating the number and proportion of people living below the poverty line at national and regional levels, separately for rural and urban areas; makes poverty estimates every five years.
5. Unemployment is defined as a situation wherein able bodied persons fail to find a job even though they are willing to work at the prevailing wage rate.

5.6 SUMMARY

- Independent India inherited an economy which was not only slightly backward but also regionally imbalanced.
- Following the new economic policy, private investment began to flow to the high profit-yielding regions instead of the regions requiring higher investment. More private investment went to the richer states which had better infrastructure.
- With the skewed investment pattern and resource flow, the pattern of growth has been far from uniform across states.
- Generally, the poor is identified on the basis of their occupation and ownership of assets.
- The urban poor are majorly born out of the rural poor who had migrated to urban areas in search of alternative employment and better livelihood, labourers who do a variety of casual jobs and the self-employed who sell a variety of things on roadsides and are engaged in various activities.
- One of the major problems of poverty in India is the high growth rate of population especially among the poor.
- Inequalities of income in rural and urban areas of the country is another cause of poverty.
- One of the most acute challenges that the Indian economy has been facing is the mounting rate of unemployment. It promotes poverty and inequalities, lowers social standards and is a huge loss of manpower resources to the nation.
- It is believed that higher economic growth rate will lead to larger production and thereby larger increase in employment.

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5.7 KEY WORDS

- **Gini Coefficient:** It is a statistical measure of the degree of variation represented in a set of values, used especially in analysing income inequality.
- **Underemployment:** It is the under-use of a worker due to a job that does not use the worker's skills, or is part time, or leaves the worker idle.
- **Purchasing Power:** It is the financial ability to buy products and services.
- **Capital Formation:** It is a term used to describe the net *capital* accumulation during an accounting period for a particular country.

5.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

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Short Answer Questions

1. What do the rural poor generally work as?
2. Write a short-note on the head count poverty index.
3. Differentiate between unemployment and underemployment.

Long Answer Questions

1. Discuss regional disparities in India.
2. Examine the reasons for poverty in India.
3. Describe the reasons, effects and measures for unemployment in India.

5.9 FURTHER READINGS

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BLOCK - II
ECONOMY AND SECTORAL DEVELOPMENT

UNIT 6 AGRICULTURE

NOTES**Structure**

- 6.0 Introduction
- 6.1 Objectives
- 6.2 Pattern of Growth of Indian Agriculture
 - 6.2.1 Regional Variations in Agricultural Development
- 6.3 WTO and Indian Agriculture
- 6.4 Answers to Check Your Progress Questions
- 6.5 Summary
- 6.6 Key Words
- 6.7 Self Assessment Questions and Exercises
- 6.8 Further Readings

6.0 INTRODUCTION

In the previous unit, you learnt about poverty and unemployment in India. In this unit, you will learn about the importance of agriculture in the Indian economy and the major trends in agricultural production in India.

Agriculture in India has a long history. It was started ten thousand years ago. Even today, a significant majority of the people in India are dependent either directly or indirectly on agriculture. At present, India holds the second position in the world in agricultural output. Agriculture and linked sectors such as forestry and logging have around 17 per cent share in the GDP in 2013-14. These sectors employed 52 per cent of the total workforce and, despite a steady decline of their share in the GDP they are the largest economic sectors and play a significant role in the social-economic development of the country. Along with industry, agriculture forms the backbone of the Indian economy. These two economic activities provide employment to a huge number of Indians. Therefore, the Indian government, at several times, in order to facilitate the optimum utilization of these economic resources, makes several policies. These are often the sequels of pre-existing policies. Several such policies are also made on the basis of seasonal changes, as agriculture depends on these seasonal changes.

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6.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the pattern of Indian agriculture after independence
- Describe the steps taken to improve agricultural productivity
- Examine the features and impact of the WTO Agreement on Agriculture

6.2 PATTERN OF GROWTH OF INDIAN AGRICULTURE

Even though the share of agriculture in the total national income has been coming down due to the development of the secondary and tertiary sectors the contribution of agriculture remains very significant. It has gone from 57 per cent in 1950 to more than 26 per cent now. It is a known fact that the more developed a country is the lesser is the contribution of agriculture. Today almost 60 per cent of the population depends directly or indirectly on agriculture. The greater independence of working population on agriculture indicates the underdevelopment of non-agricultural activities in the country. Agriculture provides raw materials to leading industries such as cotton textiles and sugar industries. Not only this, the workers in industries depend on agriculture for their food. Agriculture also provides the market for a variety of goods.

A number of the agricultural commodities like tea, coffee, spices and tobacco constitute our main items of export. This amounts to almost 15 per cent of our total exports. Hence, agriculture provides foreign exchange which helps us to buy machines from abroad. It also maintains a balance of payments and makes our country self-sufficient. Tertiary sector provides helpful services to the industries and agriculture like banking, warehousing etc. Internal trade is mostly done in agricultural produce. For example, various means of transport get the bulk of their business by the movement of agricultural goods. State governments get a major part of their revenue in terms of land revenue, irrigation charges, agricultural income tax etc. The Central Government also earns revenue from export duties on the agricultural production. Moreover our government can raise substantial revenue by imposing agricultural income tax. However, this has not been possible due to some political reasons.

Our agriculture has brought fame to the country. India enjoys first position in the world as far as the production of tea and groundnuts are concerned. Agriculture plays an important role in internal trade. It is because of the fact that 90 per cent of our population spends 60 per cent of their income on the purchase of the items like food, tea, milk, etc.

Agriculture has been a way of life and continues to be the single most important livelihood of the masses. Agricultural policy focus in India across decades

has been on self-sufficiency and self-reliance in food-grains production. Considerable progress has been made on this front. Foodgrains production rose from 52 million tonnes in 1951-52 to 244.78 million tonnes in 2010-11. Table 6.1 provides the key indicators of the agricultural sector in India.

Table 6.1 Agriculture Sector: Key Indicators (per cent)

Sl. No.	Item	2009-10@	2010-11*	2011-12 **
1.	GDP – share and growth (at 2004-05 prices) Growth in GDP in agriculture & allied sectors	1.0	7.0	2.5
	Share in GDP - Agriculture and allied sectors	14.7	14.5	13.9
	<i>Agriculture</i>	12.4	12.3	
	<i>Forestry and logging</i>	1.5	1.4	
	<i>Fishing</i>	0.8	0.7	
2.	Share in total Gross Capital Formation in the Country (per cent at 2004-05 prices) Share of agriculture & allied sectors in total			
	<i>Gross Capital Formation</i>	7.1	7.2	
	<i>Agriculture</i>	6.6	6.6	
	<i>Forestry and logging</i>	0.1	0.1	
	<i>Fishing</i>	.05	0.5	
3.	Employment in the agriculture sector as share of total workers as per census 2001	58.2		

Source: Central Statistics Office (CSO) and Department of Agriculture and Cooperation.

Notes: @ Provisional Estimates * Quick estimates ** Advance Estimates

For five consecutive years, from 2004-05 to 2008-09, food-grains production recorded an increasing trend in India. However, it declined to 218.11 million tonnes in 2009-10 due to severe drought conditions in various parts of the country. Normal monsoon in the subsequent year, 2010-11, helped the country reach a significantly higher level of 244.78 million tonnes of food-grains production. As per the second Advance Estimates, production of food-grains during 2011-12 is estimated at an all time record level of 250.42 million tonnes which is a significant achievement mainly due to increase in the production of rice and wheat (Table 6.2).

Table 6.2 Agricultural Production (Kharif) (Million Tonnes)

Crops	2010-2011	2011-2012 (2 nd Advance Estimates)	Percentage increase
Rice	95.98	102.75	7.1
Coarse cereals	43.68	42.08	-3.7
Pulses	18.24	17.28	-5.3
Oilseeds	32.48	30.53	-6.0
Sugarcane	342.38	347.87	1.6
Cotton (Million bales of 170 kgs each)	33.00	34.09	3.3
Jute and Mesta (Million bales of 180 kgs each)	10.60	11.61	9.3

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Trends in Agriculture Production and Productivity

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The Department of Agriculture and Cooperation under the Ministry of Agriculture is the nodal organization responsible for development of the agriculture sector. It is responsible for formulation and implementation of national policies and programmes aimed at achieving rapid agricultural growth through optimum utilization of land, water, soil and plant resources of the country.

Agriculture being a State subject, it is the responsibility of the State Governments to ensure growth and development of the sector within their respective State. Accordingly, separate departments have been set up in several states.

Several significant initiatives have been taken in recent years by the Government Rashtriya Krishi Vikas Yojana (RKVY), National Policy for Farmers, 2007, Expansion of Institutional Credit to Farmers, National Rural Health Mission, National Food Security Mission, Rashtriya Krishi Vikas Yojana to incentivise the states to invest more in agriculture, Integrated Food Law, Legislative Framework for Warehousing Development and Regulation, Protection of Plant Varieties and Farmers' Rights (PPVFR) Act, 2001, National Bamboo Mission, etc.

The rapid growth of agriculture is essential not only for self-reliance but also for meeting the food and nutritional security of the people, to bring about equitable distribution of income and wealth in rural areas as well as to reduce poverty and improve the quality of life. Growth in agriculture has a maximum cascading impact on other sectors, leading to the spread of benefits over the entire economy and the largest segment of population.

India's total geographical area is 328.7 million hectares, of which 141 million hectares is the net sown area, while 190 million hectares is the gross cropped area. The net irrigated area is 57 million hectares with a cropping intensity of 134 per cent. The total irrigation potential in the country has increased from 81.1 million ha in 1991-92 to 102.8 million ha in 2006-07.

The overall production of foodgrains was estimated at 217.3 million tonnes in 2006-07. Between 1950-51 and 2006-07, production of foodgrains increased at an average annual rate of 2.5 per cent compared to the growth of population which averaged 2.1 per cent during this period. As a result, India almost became self-sufficient in foodgrains and there were hardly any imports during 1976-77 to 2005-06, except occasionally.

The increase in foodgrain production in 2006-07 was largely because of higher production of wheat by 6.5 million tonnes (9.3 per cent) and of pulses by 0.8 million tonnes (6 per cent). There was a decline in production of oilseeds (3.7 million tonnes or 13 per cent) compared to the production in 2005-06. The production of non-food crops, particularly sugarcane, cotton and jute (including Roselle), in 2006-07, however, exceeded both the targets and the levels achieved in the previous year.

During the year 2006-07 (up to 30 September 2006), the value of agricultural exports was worth Rs.28,157.52 crore as compared to Rs.21,673.25 crore during April-September 2005. The share of agricultural exports in total export was more than 10 per cent during April- September 2006. Agricultural imports registered a decline during April-September, 2005. The share of agricultural imports in India's total imports showed a decline from 3.70 per cent to 2.88 per cent during the corresponding period. India is the third largest producer and consumer of fertilizers in the world after China and the USA, and contributes about 11.4 and 11.9 per cent to the total world production/ consumption of NPK nutrients respectively. Per hectare consumption of fertilizers has increased from 69.8 kg in 1991-92 to 113.3 kg in 2006-07 at an average rate of 3.3 per cent.

Several significant initiatives have been taken in recent years by the Government in order to reverse the downward trend in agricultural production. Some of these important initiatives include:

- Bharat Nirman
- National Rural Employment Guarantee Programme
- National Horticulture Mission
- Expansion of Institutional Credit to Farmers
- Establishment of the National Bee Board
- Establishment of the National Rainfed Area Authority
- Establishment of the National Fisheries Development Board (NFDB)
- Watershed Development and Micro Irrigation Programmes
- Reforms in Agricultural Marketing and Development of Market Infrastructure
- Revitalisation of Cooperative Sector
- Agri-business Development through Venture Capital Participation by the Small Farmer
- Agri-business Consortium
- Reform and Support for Agriculture Extension Services
- National Rural Health Mission
- National Food Security Mission
- Rashtriya Krishi Vikas Yojana to incentivise the states to invest more in agriculture
- Integrated Food Law
- Legislative Framework for Warehousing Development and Regulation
- Protection of Plant Varieties and Farmers Rights (PPVFR) Act, 2001
- National Bamboo Mission

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- Knowledge Connectivity through Common Service Centres (CSC) and IT initiatives

Rashtriya Krishi Vikas Yojana (RKVY)

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It was launched to incentivise the States to increase the share of investment in agriculture in their State plans. It aims at achieving the 4 per cent annual growth in the agriculture sector during the Eleventh Five Year Plan period by ensuring a holistic development of agriculture and allied sectors. It is a State Plan Scheme and the eligibility for assistance under the scheme depends upon the amount provided in the State budgets for agriculture and allied sectors, over and above the baseline percentage expenditure incurred on agriculture and allied sectors. The funds under the RKVY are to be provided to the States as 100 per cent grant by the Central Government. The main objectives of the schemes are to:

- Incentivise the States to increase public investment in agriculture and allied sectors
- Provide flexibility and autonomy to the States in planning and executing agriculture and allied sector schemes
- Ensure the preparation of plans for the districts and the States based on agro-climatic conditions, availability of technology and natural resources
- Ensure that the local needs/crops/priorities are better reflected
- Achieve the goal of reducing the yield gaps in important crops, through focused interventions
- Maximize returns to the farmers

National Food Security Mission (NFSM)

It is a centrally-sponsored scheme, launched with the objective of increasing the production of rice, wheat and pulses by 10, 8 and 2 million tonnes, respectively, over the benchmark levels of production, by the end of the Eleventh Five Year Plan period. The Mission aims at increasing foodgrains production of the above crops through area expansion and productivity enhancement; restoring soil fertility and productivity; creating employment opportunities; and enhancing farm level economy to restore confidence of farmers of targeted districts. It is being implemented in 305 districts of 16 States of the country. Various activities of NFSM relate to demonstration of improved production technology, distribution of quality seeds of HYVs and hybrids, popularization of newly released varieties, support for micronutrients, and training and mass media campaign including awards for best performing districts. The identified districts are given flexibility to adopt any local area specific interventions as are included in the Strategic Research and Extension Plan (SREP) prepared for the agriculture development of the district.

6.2.1 Regional Variations in Agricultural Development

In India, there are huge regional variation in agro-climatic conditions. For example, output in different regions is varied due to varied agro-climatic factors, physical resource endowment and also varying level of investment in rural infrastructure and technological innovation. After the Green Revolution and the use of High Yield Variety (HYV) seeds, the improvement in growth in output and yield per hectare in India has become more dependent on irrigation condition, use of inputs i.e. use of fertilizers, tractors, pumpsets, rural electrification etc. The use of HYV seeds is very much amenable to the fertilizers and irrigation. As a result, the states with better irrigation status have better yields than the states with poorer irrigation condition.

There are also regional variations in terms of the use of agricultural inputs. According to statistics, for the year 2007-08, the use of fertilizer per hectare varies from 44.41 to 215.73 Kg/ha for different states. In addition, the percentage of area irrigated to GCA differs from 2.4 hectare in Assam to 97.7 hectare in Punjab in the same year. Moreover, in per capita credit to agriculture the state of Jammu & Kashmir lags behind other Indian states. There are also huge differences in the percentage use of electricity for agriculture purpose across states. It varies from 0.53% in Himachal Pradesh to 40.17% in Haryana.

There are also regional variations in terms of foodgrain and non-foodgrain production. Although, India is mostly a foodgrain producing country, recently, there has been a shift towards non-food crops in some states. In foodgrain crop, the proportion of area declined at a high rate in the states like Andhra Pradesh, Gujarat, Rajasthan, Tamil Nadu, Madhya Pradesh and West Bengal. The other states like Haryana, Himachal Pradesh, Jammu & Kashmir, Uttar Pradesh also experienced deceleration in the composition of area under foodgrain, but at a moderate rate. In Bihar around 90% of GCA was under foodgrain crop in 1970-71. In 1980-81 this percentage decreased to 66.55. Again the same proportion faced a sharp increase from 66.55 to 80.2% in 1991-92, 90.7% in 2000-01 and 88.9% in 2007-08 respectively. Further, the state of Punjab experienced an increase in the proportion of area under foodgrain from 69.2% in 1970-71 to 80.1% in 2007-08. Except Punjab and Bihar, all most all the states show a diversification of cropping pattern in favour of non-food crops.

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Check Your Progress

1. What is the percentage of population that depends directly or indirectly on agriculture?
2. What was the National Food Security Mission?

6.3 WTO AND INDIAN AGRICULTURE

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The Agreement on Agriculture forms a part of the Final Act of the Uruguay Round of Multilateral Trade Negotiations, which was signed by the member countries in April 1994 at Marrakesh, Morocco and came into force on 1st January, 1995. The Uruguay Round marked a significant turning point in world trade in agriculture. For the first time, agriculture featured in a major way in the GATT round of multilateral trade negotiations. Although the original GATT – the predecessor of the World Trade Organisation (WTO) – applied to trade in agriculture, various exceptions to the disciplines on the use of non-tariff measures and subsidy meant that it did not do so effectively. The Uruguay Round agreement sought to bring order and fair competition to this highly distorted sector of world trade by establishment of a fair and market oriented agricultural trading sector.

The root cause of distortion of international trade in agriculture has been the massive domestic subsidies given by the industrialised countries to their agricultural sector over many years. This in turn led to excessive production and its dumping in international markets as well as import restrictions to keep out foreign agricultural products from their domestic markets. Hence, the starting point for the establishment of a fair agricultural trade regime has to be the reduction of domestic production subsidies given by industrialised countries, reduction in the volume of subsidised exports and minimum market access opportunities for agricultural producers world-wide.

The obligations and disciplines incorporated in the Agreement on Agriculture, therefore, relate to (a) market access; (b) domestic subsidy or domestic support; and (c) export subsidy.

Salient Features

The Agreement on Agriculture contains provisions in the following three broad areas of agriculture and trade policy:

- (a) **Market Access:** On market access, the Agreement has two basic elements:
 - (i) **Tariffication of all non-tariff barriers.** That is to say, non-tariff barriers such as quantitative restrictions and export and import licensing etc. are to be replaced by tariffs to provide the same level of protection. Tariffs, resulting from this “tariffication” process together with other tariffs on agricultural products, are to be reduced by a simple average of 36 per cent over 6 years in the case of developed countries and 24 per cent over 10 years in the case of developing countries. With India being under balance of payments cover (which is a GATT-consistent measure), we had not undertaken any commitments with regard to market access and this has been clearly stated in our schedule filed under GATT. The only commitment India has undertaken is to bind its

tariffs on primary agricultural products at 100 per cent; processed foods at 150 per cent; and edible oils at 300 per cent.

- (ii) The second element relates to setting up of a minimum level for imports of agricultural products by member countries as a share of domestic consumption. Countries are required to maintain current levels (1986-88) of access for each individual product. Where the current level of import is negligible, the minimum access should not be less than 3 per cent of the domestic consumption, during the base period and tariff quotas are to be established when imports constitute less than 3 per cent of domestic consumption. This minimum level is to rise to 5 per cent by the year 2000 in the case of developed countries and by 2004 in the case of developing countries. However, special Safeguards Provisions allow for the application of additional duties when shipments are made at prices below certain reference levels or when there is a sudden import surge. The market access provision, however, does not apply when the commodity in question is a 'traditional staple' of a developing country.

- (b) **Domestic support:** Provisions of the Agreement regarding domestic support have two main objectives – first to identify acceptable measures that support farmers and second, to deny unacceptable, trade distorting support to the farmers. These provisions are aimed largely at the developed countries where the levels of domestic agricultural support have risen to extremely high levels in recent decades.

All domestic support is quantified through the mechanism of total Aggregate Measurement of Support (AMS). AMS is a means of quantifying the aggregate value of domestic support or subsidy given to each category of agricultural product. Each WTO member country has made calculations to determine its AMS wherever applicable. Commitment made requires a 20 per cent reduction in total AMS for developed countries over 6 years. For developing countries, this percentage is 13 per cent and no reduction is required for the least developed countries. The base period external reference price on which the reductions were calculated was 1986-88.

AMS consists of two parts—product-specific subsidies and non-product specific subsidies. Product-specific subsidy refers to the total level of support provided for each individual agricultural commodity, essentially signified by procurement price in India. Non-product specific subsidy, on the other hand, refers to the total level of support for the agricultural sector as a whole, i.e., subsidies on inputs such as fertilisers, electricity, irrigation, seeds, credit etc.

There are three categories of support measures that are not subject to reduction under the Agreement, and support within specified de-minimis level is allowed. These three categories of exempt support measures are:

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- (i) Measures which have a minimum impact on trade and which meet the basic and policy specific criteria set out in the Agreement (the so-called Green Box measures in the terminology of WTO). These measures include Government assistance on general services like (i) research, pest and disease control, training, extension, and advisory services; (ii) public stock holding for food security purposes; (iii) domestic food aid; and (iv) direct payment to producers like governmental financial participation in income insurance and safety nets, relief from natural disasters, and payments under environmental assistance programmes.
- (ii) Developing country measures otherwise subject to reduction which meet the criteria set out in paragraph 2 of Article 6 of the Agreement (the so-called 'Special and Differential Treatment' or the S&D Box). Examples of these are (i) investment subsidies which are generally available to agriculture in developing countries; and (ii) agricultural input services generally available to low income and resource poor producers in developing countries.
- (iii) Direct payments under production limiting programme which conform to the requirement set out in paragraph 5 of Article 6 of the Agreement (the so-called Blue Box measures). These are relevant from the developed countries point of view only.

Under the de-minimis provision of Article 6.4 of the Agreement, there is no requirement to reduce support in this residual category whose value in any year, in the case of product specific support does not exceed 10 per cent for developing countries of the total value of production of the basic agricultural product in question or of the value of total agricultural production in the case of non-product specific support. Where the support is below 10 per cent, as in the case of India, product-specific and non-specific de-minimis ceiling may be raised to those levels.

- (c) **Export subsidies:** The Agreement on Agriculture lists several types of subsidies to which reduction commitments apply. However, such subsidies are virtually non-existent in India as exporters of agricultural commodities do not get direct subsidy. Even exemption of export profits from income tax under Section 80-HHC of the Income Tax Act is not among the listed subsidies. It is also worth noting that developing countries are free to provide three of the listed subsidies, namely, reduction of export marketing costs, internal and international transport and freight charges.

In general, it may be noted that the virtual explosion of export subsidies in the industrialised countries in the years leading to the Uruguay Round was one of the key issues addressed in the agricultural negotiations. While under GATT 1947, prohibition of export subsidies for industrial products has been effective since 1956, in the case of agricultural primary products, such subsidies were only subject

to limited disciplines which, moreover, did not prove to be operational or effective. As a result, in the 1970s and 1980s, success in international markets for agricultural products was increasingly determined by the financial power and largesse of national treasuries rather than the efficiency and marketing skills of agricultural producers and exporters. Export subsidies also became a major factor in depressing or destabilising world market prices for many agricultural commodities. The Uruguay Round marked a radical departure from the earlier GATT disciplines in the areas of agricultural export subsidies. Members are required to reduce the value of direct export subsidies to a level of 36 per cent below the 1986-90 base period level over a six year implementation period. The quantity of subsidised export is to be reduced by 21 per cent over the same period. In the case of developing countries, the reductions are two-thirds those of the developed countries over a ten-year period and there are no reductions for least developed countries. Under the Agreement, export subsidies are defined as “subsidies contingent on export performance” and the list covers export subsidy practices such as direct export subsidies contingent on export performance; sales of non-commercial stocks of agricultural products for export at prices lower than comparable prices for such goods in the domestic markets; producer-financed subsidies such as government programmes which require a levy on production which is then used to subsidise the export of the product; cost-reduction measures such as subsidies to reduce marketing costs for exports including handling costs and costs of international freight; internal transport subsidies applying only to exports; subsidies on incorporated products i.e., subsidies on agricultural products such as wheat contingent on their incorporation in export products made of wheat etc. All such export subsidies are subject to reduction commitments in terms of both the volume of subsidised export and budgetary outlays for such subsidies. As indicated earlier, such measures are virtually non-existent in India and, hence, the issue of reduction of export subsidy on agricultural products is not of particular relevance for India.

Product coverage

The Agreement defines agricultural products by reference to the harmonised system of product classification. The definition covers not only basic agricultural products such as wheat, milk and live animals, but the products derived from them such as bread, butter, other dairy products and meat, as well as all processed agricultural products such as chocolates and sausages. The coverage includes wines, spirits and tobacco products, fibres such as cotton, wool and silk, and raw animal skins destined for leather production. Fish and fish products are not included nor are forestry products.

Impact of the Agreement

Implications of the Agreement would differ from country to country and would depend largely on the overall agricultural scenario in the country. Indian agriculture is characterised by a preponderant majority of small and marginal farmers holding

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less than two hectares of land, less than 35.7 per cent of the land, is under any assured irrigation system and for the large majority of farmers, the gains from the application of the science & technology in agriculture are yet to be realised. Farmers, therefore, require support in terms of development of infrastructure as well as extension of improved technologies and provisions of requisite inputs at reasonable cost. India's share of world's agricultural trade is of the order of 1 per cent. There is no doubt that during the last 30 years, Indian agriculture has grown at a reasonable pace, but with stagnant and declining net cropped area it is indeed going to be a formidable task to maintain the growth in agricultural production. The implications of the Agreement would thus have to be examined in the light of the food demand and supply situation. The size of the country, the level of overall development, balance of payments position, realistic future outlook for agricultural development, structure of land holdings etc. are the other relevant factors that would have a bearing on India's trade policy in agriculture.

Implications of the Agreement on Agriculture for India should thus be gauged from the impact it will have on the following:

- (i) Whether the Agreement has opened up markets and facilitated exports of our products; and
- (ii) Whether we would be able to continue with our domestic policy aimed at improving infrastructure and provision of inputs at subsidised prices for achieving increased agricultural production.

Short Term Impact

As far as opening of markets and impact on trade in agriculture is concerned, it may be noted that the share of developing countries in world exports of food remained at 44 per cent and of agricultural raw materials increased insignificantly from 32 per cent in 1994 to 34 per cent in 1996, that is the post-Agreement period. The average growth of developed countries imports of agricultural products increased by just 1 per cent during 1994-96. Nearer home, agricultural exports of ten Asian developing countries increased from US \$ 49252 million in 1994 to US \$ 55902 million in 1996. India's share in total agricultural exports from developing Asia is 8 per cent, behind China's 19 per cent, Thailand's 17 per cent, Malaysia's 14 per cent and Indonesia's 10 per cent. India's exports of agricultural products have increased from US \$ 4151 million in 1993-94 to US \$ 7054 million in 1997-98. No tangible opening up of the markets has thus been noticed in the post-Agreement period so far. However, it may be premature on this basis to assess the long-term impact of the Agreement on opening up of markets.

Regarding freedom to pursue our domestic policies, it is quite evident that in the short term India will not be affected by the WTO Agreement on Agriculture. The safeguards provided for developing countries give enough manoeuvre to insulate ourselves from any major impact of trade liberalisation in agricultural commodities.

India has been maintaining quantitative restrictions (QRs) on import of 825 agricultural products as on 1.4.97. QRs are proposed to be eliminated within the overall time frame of six years in three phases – 1.4.97 to 31.3.2003. (All our trading partners barring the US have agreed to this phase-out plan and dispute with the US is pending with Dispute Settlement Body of WTO for adjudication). Within the provisions of the GATT Agreement India has bound tariffs at high levels of 100 per cent, 150 per cent and 300 per cent for primary products, processed products and edible oils respectively. Therefore, the QRs can be replaced with high import tariff in case we want to restrict imports of these commodities.

In India, for the present, the minimum support price provided to commodities is less than the fixed external reference price determined under the Agreement. Therefore, the AMS is negative. Theoretically, therefore, we could increase the product-specific support upto 10 per cent, the only restraint being the fiscal sustainability in the country's context.

Long Term Impact

As mentioned earlier, for a large majority of farmers in different parts of the country, the gains from the application of science and technology in agriculture are yet to be realised which would require infrastructural support, improved technologies and provision of inputs at reasonable cost. The Agreement on Agriculture thus recognised this and developing countries have been given the freedom to implement such policies under Article 6 relating to differential treatment, but any attempt in future to dilute provisions relating to differential treatment for developing countries could affect us adversely.

Regarding the impact of liberalisation of trade in agriculture in the long term, Indian agriculture enjoys the advantage of cheap labour. Therefore, despite the lower productivity, a comparison with world prices of agricultural commodities would reveal that domestic prices in India are considerably less with the exceptions of a few commodities (notably oilseeds). Hence, imports to India would not be attractive in the case of rice, tea, sunflower oil and cotton. On the whole, large scale import of agricultural commodities as a result of trade liberalisation is ruled out. Even the exports of those foodgrains which are cheaper in the domestic market, but are sensitive from the point of view of consumption by the economically weaker sections are not likely to rise to unacceptable levels because of high inland transportation cost and inadequate export infrastructure in India. Through proper tariffication, however, we will have to strike a balance between the competing interest of 10 per cent farmers who generate marketable surpluses and consumers belonging to the economically poor sections of the society.

It is also argued that because of increasing price of domestic agricultural commodities following improved export prospects, farmers would get benefits which in turn would encourage investment in the resource scarce agricultural sector. With the decrease in production subsidies as well as export subsidies, the

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international prices of agricultural commodities will rise and this will help in making our exports more competitive in world market. Given our agro diversity, we have the potential to increase our agro exports in a substantial way. In the words of Shri A.V. Ganesan, “There will be growing pressure from the farmers to realise higher prices for their produce and to narrow the gap between the domestic and external prices. Our industrialists are pressing for a ‘level playing field’ vis-a-vis foreign enterprises; our farmers will press for a ‘level playing field’ for the prices of their products vis-a-vis international prices. Both the pattern of production and price expectations will increasingly be influenced by the demands and trends in world markets. On the one hand, the price incentive could be the best incentive and could give a strong boost to investment in agriculture as well as adoption of modern technologies and thereby to the raising of agricultural production and productivity. On the other hand, the rise in domestic prices would put pressure on the public distribution system and accentuate the problem of food subsidy. Furthermore, freedom to export agricultural products without restrictions will also need shedding the long-nurtured inhibition against their imports. The nature and character of State intervention and State support will have to undergo qualitative changes in order not only to realise the opportunities for exports, but also to cope with the implications of our agriculture coming into increasing alignment with the international market place”.

Check Your Progress

3. When was the WTO Agreement on Agriculture signed?
4. What is the root cause of distortion of international trade in agriculture?

6.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Today almost 60 per cent of the population depends directly or indirectly on agriculture.
2. The National Food Security Mission was a centrally-sponsored scheme, launched with the objective of increasing the production of rice, wheat and pulses by 10, 8 and 2 million tonnes, respectively, over the benchmark levels of production, by the end of the Eleventh Five Year Plan period.
3. The Agreement on Agriculture forms a part of the Final Act of the Uruguay Round of Multilateral Trade Negotiations, which was signed by the member countries in April 1994 at Marrakesh, Morocco and came into force on 1st January, 1995.
4. The root cause of distortion of international trade in agriculture has been the massive domestic subsidies given by the industrialised countries to their agricultural sector over many years.

6.5 SUMMARY

- Even though the share of agriculture in the total national income has been coming down due to the development of the secondary and tertiary sectors the contribution of agriculture remains very significant. It has gone from 57 per cent in 1950 to more than 26 per cent now.
- A number of the agricultural commodities like tea, coffee, spices and tobacco constitute our main items of export.
- Agricultural policy focus in India across decades has been on self-sufficiency and self-reliance in food-grains production.
- The department of agriculture and cooperation under the ministry of agriculture is the nodal organization responsible for development of the agriculture sector.
- Several significant initiatives have been taken in recent years by the government such as Rashtriya Krishi Vikas Yojana (RKVY), National Policy For Farmers, 2007, expansion of institutional credit to farmers, and so on.
- Although, India is mostly a foodgrain producing country, recently, there has been a shift towards non-food crops in some states.
- The agreement on agriculture forms a part of the final act of the Uruguay round of multilateral trade negotiations, which was signed by the member countries in April 1994 at Marrakesh, Morocco and came into force on 1st January, 1995.
- The obligations and disciplines incorporated in the Agreement on Agriculture, relate to (a) market access; (b) domestic subsidy or domestic support; and (c) export subsidy.

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6.6 KEY WORDS

- **Minimum Support Price:** It is an agriculture product price set by the government of India to purchase directly from the farmer.
- **Tariff:** It is a tax or duty to be paid on a particular class of imports or exports.
- **Agricultural Inputs:** They are products permitted for use in organic farming. These include feedstuffs, fertilizers and permitted plant protection products as well as cleaning agents and additives used in food production.
- **Export Subsidy:** It is a government policy to encourage export of goods and discourage sale of goods on the domestic market through direct payments, low-cost loans, tax relief for exporters, or government-financed international advertising.

6.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

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Short Answer Question

1. Discuss the regional variations in agricultural development in India.
2. Write a short-note on the Rashtriya Krishi Vikas Yojana (RKVY) and the national food security mission (NFSM).
3. Discuss the salient features of the Agreement on Agriculture.

Long Answer Questions

1. Discuss some of the initiatives to reverse the downward trend in agricultural production in India.
2. Describe the short-term and long-term impact of the Agreement on Agriculture in the WTO.
3. Examine the pattern of growth of Indian agriculture.

6.8 FURTHER READINGS

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UNIT 7 INDUSTRY

Structure

- 7.0 Introduction
- 7.1 Objectives
- 7.2 Trends in Growth and Structure of Indian Industry
 - 7.2.1 Pattern of Industrial Development since Independence
- 7.3 Impact of New Economic Policy on Indian Industry
- 7.4 Answers to Check Your Progress Questions
- 7.5 Summary
- 7.6 Key Words
- 7.7 Self Assessment Questions and Exercises
- 7.8 Further Readings

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7.0 INTRODUCTION

Almost all economists agree that for any nation to develop, industry must play a crucial, if not the most significant role. India started its quest for industrial development after Independence in 1947. The Industrial Policy of 1948 was the first industrial policy of independent India. It basically delineated the role of the state in industrial development both as an entrepreneur and as an authority. Successive policy resolutions also emphasized this basic tilt in favour of the public sector. In 1991, India moved away from state-led industrialisation and began to follow a market led approach.

One basic rationale for privatization was the concept that private ownership leads to better use of resources and their more efficient allocation. Another reason for adoption for privatization policy around the world has been the inability of the governments to raise high taxes and develop money markets and private entrepreneurship. In India, the New Industrial Policy Statement of 1991 based on economic reform measures envisaged disinvestment of a part of government holding in the case of select PSEs to provide financial support and improve the performance of PSEs. Disinvestment policy of the Government of India was based on three principles: (i) citizens have every right to own part of the shares of PSEs, (ii) PSEs are the wealth of the nation and this wealth should rest in the hands of the people and (iii) while pursuing disinvestment, the government has to retain majority shareholding, i.e., at least 51 per cent and management control of the PSEs.

The Industrial Policy initiatives undertaken by the Government since July 1991 have been built on the past industrial achievements and to accelerate the process of making Indian industry internationally competitive. It recognizes the strength and maturity of the industry and attempts to provide the competitive stimulus for higher growth. The thrust of these initiatives has been to increase the domestic

and external competition through extensive application of market-mechanisms and facilitating the forging of dynamic relationships with foreign investors. We will discuss these aspects in detail in the unit.

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7.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the Industrial Policy Resolution of 1948
- Examine the pattern of industrial development in India since independence
- Describe the different phases of industrialization in India during the plan period
- Explain the features of the New Economic Policy of 1991

7.2 TRENDS IN GROWTH AND STRUCTURE OF INDIAN INDUSTRY

India started her quest for industrial development after Independence in 1947. The Industrial Policy Resolution of 1948 marked the beginning of the evolution of the Indian Industrial Policy. The resolution not only defined the broad contours of the policy, it delineated the role of the state in industrial development both as an entrepreneur and as an authority. Successive policy resolutions also emphasized this basic tilt in favour of the public sector. The Industrial Policy Resolution of 1956 gave the public sector a strategic role in the economy. It categorized industries which would be the exclusive responsibility of the state or would progressively come under state control and others. Earmarking the pre-eminent position of the public sector, it envisaged private sector co-existing with the state and thus attempted to give the policy framework flexibility.

The Industrial Policy initiatives undertaken by the Government since July 1991 have been designed to build on the past industrial achievements and to accelerate the process of making Indian industry internationally competitive. It recognizes the strength and maturity of the industry and attempts to provide the competitive stimulus for higher growth. The thrust of these initiatives has been to increase the domestic and external competition through extensive application of market-mechanisms and facilitating forging of dynamic relationships with foreign investors.

The Industrial Policy of 1948

The first industrial policy statement was issued in the Government's Industrial Policy Resolution of April 1948. The resolution contemplated a mixed economy. There was a sphere reserved for private enterprise and another for public ownership. The Government of India felt that for some time the state could continue to increase

of national wealth by expanding its present activities wherever it was already operating and by concentrating on new units of production in other fields rather than on acquiring and running existing units. Meanwhile, private enterprise, property directed and regulated had valuable role to play.

Thus it was decided that India would be a mixed economy in which both the public and private enterprises would work side by side for the economic development of the country. It was a compromise between private capitalism and state socialism.

Categories of industry: In the Industrial Policy Statement of 1948, industries were divided into four categories:

The *first category* included such strategic industries as the manufacture of arms and ammunition, the production and control of atomic energy and the ownership and management of railway transport. It was decided that these should be the exclusive monopoly of the state and private enterprise was not to be permitted.

The *second category* included such basic and key industries as coal, iron and steel, ship-building, aircraft manufacture and manufacture of telephone, telegraph and wireless apparatus and mineral oils. For these industries it was laid down that the State would be exclusively responsible for the establishment of new undertakings while existing units would be allowed to operate for a period of 10 years at the end of which the position was to be reviewed. Since the responsibility of inviting new concerns was assumed by the State, private enterprise lost interest in this category of industries.

In the *third category* there was a list of 18 basic industries. These industries would ordinarily be operated by private enterprise but would be subject to central regulation and control since their locations had to be governed by economic factors of all-India importance or they required considerable investment and a high degree of technical skill.

The other industries would normally be opened to private enterprise, individual as well as co-operative. But even here the State would also participate progressively in this field and would not hesitate to intervene whenever the progress of an industry under private enterprise was unsatisfactory.

In addition to the four categories of industries, there was a fifth one in which the Government took a very keen interest. These were the cottage and small industries. The role of cottage and small industries in the national economy was emphasized in as much as they offer scope for individual, village or co-operative enterprise and means for the rehabilitation of displaced persons.

Foreign capital: As regards foreign capital, it was recognized that in securing rapid industrial development, it had an important part to play. A free flow of foreign capital would be welcome because it would ensure the supply of capital goods and of technical know-how. But at the same time the conditions under which

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foreign capital would participate in Indian industry should be carefully regulated in the national interest. The Government's policy gives the following assurances to foreign capital: (i) there will be no discrimination between foreign and Indian undertakings in the application of general industrial policy; (ii) reasonable facilities would be given for the remittance of profits and repatriation of capital consistent with foreign exchange position of the country; and (iii) in the event of nationalization, fair and equitable compensation would be paid.

For increasing industrial production, the resolution enunciated a policy of social justice, fair wages, increasing participation of labour in industrial affairs as a basis of harmonious relations between labour and management.

Mixed economy: The Industrial Policy of 1948 envisaged a mixed economy. Mixed economy is the outcome of compromise between two diametrically opposite schools of thought—one which champions the cause of *laissez faire* capitalism and another which supports the cause of socialization of all means of production.

In a mixed economy the entire economic system is divided into three parts:

- (i) Sectors exclusively controlled and managed by the private enterprise subject to the general control and regulation by the state;
- (ii) Sectors which are exclusively controlled and managed by the state; and
- (iii) Sectors which are jointly managed and controlled by the State and private enterprise.

Structure and Growth of Indian Industry

Before the First Plan, industrial development in India was confined largely to the consumer goods sector, the important industries being cotton textiles, sugar, salt, soap, paper and leather goods. Thus, the industrial structure exhibited the features of an underdeveloped economy. Industries manufacturing coal, cement, steel, power, non-ferrous metals, chemicals, etc., were also established but their production was small. As far as the capital goods sector was concerned, only a small beginning was made. On the whole, while consumer goods industries were well-established, producer goods industries lagged considerably behind.

The First Plan did not envisage any large-scale programmes of industrialization. Only ` 55 crore out of the total expenditure of ` 1960 crore in the First Plan was spent on industry and minerals. The Second Plan accorded top priority to programmes of industrialization which would be clear from the fact that the expenditure on industry and minerals was increased to ` 938 crore under this plan which was 20.1 per cent of the total expenditure of ` 4672 crore. Based on the Mahalanobis Model, the Second Plan set out to establish basic and capital goods industries on a large scale so that a strong base for industrial development in the future could be built. Three steel plants of one million tonnes ingot capacity each were set up in the public sector.

The Third Plan also emphasized the establishment of basic capital and producer goods industries. Expenditure on industry in the Third Plan was ` 1726 crore, which was 20.1 per cent of the total expenditure of ` 8577 crore under the plan. The structure of industrial development was further nurtured in the Fourth and Fifth Plans with minor changes. The expenditure on industry was hiked to 22.8 per cent in the Fifth Plan. The Sixth Plan emphasized optimum utilization of existing capacities and improvement of productivity and enhancement of manufacturing capacity. Of the total expenditure of ` 109,292 crore under the Sixth Plan, the share of the industrial sector was ` 15,002 crore which comes to 13.7 per cent. During this period, industrial and trade policies were substantially liberalized.

Objectives for the industrial sector in the Seventh Plan were kept as follows: (i) to ensure adequate supply of wage goods at reasonable prices, (ii) to maximize the utilization of the existing facilities through restructuring and upgradation of technology, (iii) to concentrate on development of industries with large domestic market and export potential, (iv) to usher in 'sunrise' industries with high growth potential and relevance to our needs, and to evolve an integrated policy towards self-reliance in strategic fields and open up avenues for employment. The overall outlay envisaged in the Seventh Plan for industrial and mineral programmes in the public sector was ` 22,416 crore. Industrial production was targeted to grow at the rate of 8.7 per cent per annum. The actual average rate of growth during the Seventh Plan was 8.5 per cent per annum. As far as the Eighth Plan is concerned, the overall outlay for industrial and mineral programmes in the public sector was kept at ` 40,588 crore. This is only 9.3 per cent of the total outlay of ` 434,100 crore in the Plan. The Ninth Plan envisages an industrial growth of 8.2 per cent per annum. Policies advocated to achieve this growth rate are (i) ensuring adequate availability and requisite quality of infrastructure; (ii) adoption of special measures to promote the development of industries in backward areas, (iii) introducing a special package for the industrial development of the North Eastern States; (iv) reviewing the working of Board for Industrial and Financial Reconstruction (or BIFR) and bringing about necessary changes to make it an effective instrument of reviving sick industrial units, (v) initiating steps to close down potentially unrevivable public units, (vi) promoting production and productivity in the small-scale industries through technological upgradation and (vii) adoption of a cluster approach in the unorganized sector for provision of training, upgradation of skills and improvement in tool kits, equipment and production techniques to increase production and income levels of artisans and workers.

Trends in Industrial Production

Industrial development during the Plan period can be divided into the following four phases:

Phase I (1951–56): Building up of strong industrial base: Phase I laid the basis for industrial development in the future. The Second Plan, based on the

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Mahalanobis Model emphasized the development of capital goods industries and basic industries. Accordingly, huge investments were made in industries like iron and steel, heavy engineering and machine-building industries. The same pattern of investment was continued in the Third Plan as well. As a result there occurred a noticeable acceleration in the compound growth rate of industrial production over the first three plan periods up to 1965 from 5.7 per cent in the First Plan to 7.2 per cent in the Second Plan and further to 9.0 per cent in the Third Plan. The rate of growth of capital goods industries shot up considerably from 9.8 per cent per annum in the First Plan to 13.1 per cent per annum in the Second Plan and further to 19.6 per cent per annum in the Third Plan.

Phase II (1965–80): Industrial deceleration and structural retrogression:

The period 1965 to 1976 was marked by a sharp deceleration in industrial growth. The rate of growth fell sharply from 9.0 per cent per annum during the Third Plan to a mere 4.1 per cent per annum during the period 1965 to 1976. The last year of Phase II, i.e., 1979–80, recorded negative growth of industrial production of 1.6 per cent over the preceding year.

Several explanations were offered for the phenomenon of deceleration and retrogression in the industrial sector during Phase II. The government expressed the view that exogenous factors such as the wars of 1965 and 1971, drought conditions in some years, infrastructural constraints and bottlenecks and the oil crisis of 1973 were responsible for slowdown of growth. K.N. Raj argued that low growth in the agricultural sector accounted for the slowdown of industrial growth by restricting the supply of raw materials on the one hand and by constraining the demand for industrial goods on the other. T.N. Srinivasan argued that there was a considerable slackening of real investment in Phase II particularly in the public sector and this brought down the rate of growth in the industrial sector. Some economists like Jagdish Bhagwati blamed the wrong industrial policies, complex bureaucratic system of licensing and irrational and inefficient system of controls for industrial deceleration.

Phase III (1981–1991): Period of industrial recovery: The period of the 1980s can broadly be termed as a period of industrial recovery.

The rate of industrial growth was 6.4 per cent per annum during 1981-85, 8.5 per cent per annum during the Seventh Plan and 8.3 per cent in 1990-91. This is a marked upturn from growth rates of around 4 per cent achieved during the latter half of the 1960s and 1970s.

The main causes of industrial recovery during the 1980s were as follows:

1. ***New industrial policy and liberal fiscal regime:*** One of the main causes of industrial recovery during the 1980s was the liberalization of industrial and trade policies by the Government. The most important changes were related to bringing down the domestic barriers to entry and expansion, to inject a measure of competition in domestic industry, simplify the procedures and provide easier access to better technology and intermediate material

imports as well as more flexibility in the use of installed capacity with a view to enabling easier supply responses to changing demand conditions. These factors operating from the supply side were helped by the pursuit of what may be termed as a liberal fiscal regime. The important features of liberal fiscal regime were (i) maintenance of high budgetary deficits year after year, (ii) resort to massive borrowing often at high interest rates and (iii) the encouragement of dissaving. Liberal fiscal regime helped in generating demand for manufactured goods, liberal industrial and trade policies ensured that an adequate supply response was following.

2. **Contribution of the agricultural sector:** Increased prosperity of large farmers in certain regions of the country helped to increase additional demand for industrial goods. The rural sector's demand for non-agricultural consumer products rose considerably from 35 per cent in 1967–68 to 47 per cent in 1983.
3. **Growth of service sector:** There was a significant increase in government expenditure on all services in the 1980s. The consumption pattern of the service class is less food-intensive and more oriented towards durable consumer goods. Therefore, the consumption pattern effective demand in the 1980s changed in favour of consumer durable goods.
4. **The infrastructure factor:** There was a market resurgence in infrastructure investment in the 1980s. As against only 4.2 per cent per annum increase in infrastructure investment during 1965–66 to 1975–76, the increase was as high as 9.7 per cent per annum during 1979–80 to 1984–85. Infrastructure investment rose further by 16.0 per cent in 1985–86 and 18.3 per cent in 1986–87.

Phase IV (The Period 1991–92 onwards): The year 1991 heralded a new era of economic liberalization. Major liberalization measures designed to affect the performance of the industrial sector were — wide-scale reduction in the scope of industrial licensing, simplification of procedural rules, reductions of areas exclusively reserved for the public sector, disinvestment of equity of selected public sector, undertakings, enhancing the limit of foreign equity participation in domestic industrial undertakings, liberalization of trade and exchange rate policies, reduction of customs and excise duties and personal and corporate income tax, etc.

The rate of growth of industrial production, which was 7.8 per cent per annum during the pre-reform decade fell to 6.0 per cent per annum during the post-reform decade. This disappointing performance was basically due to a steep fall in the rate of growth of capital goods sector as well as the basic goods sector.

The average annual rate of growth of the industrial sector in the Eighth Plan was 7.4 per cent per annum—the same as the targeted rate of growth.

An important reason for the slowdown of industrial growth in the recent past has been the slowdown of investment. It is a fact that capital formation in the

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public and private sectors provides a stimulus for industrial growth in the form of both the direct demand that such expenditures involve and the indirect demand resulting from income generation by investments. However, as a result of the adoption of the macroeconomic adjustment programme of the IMF in 1991, the Government of India was forced to cut down public expenditure drastically. Since there is a strong complement between public investment and private investment, a reduction in the rate of growth of public investment had a depressing effect on private investment as well.

However, the most important reason for the unsatisfactory performance of the industrial sector has been the deteriorating state of infrastructure. Industrial production has suffered not only on account of inadequate availability of infrastructure like power and transportation bottlenecks but also due to poor quality of infrastructure. All these factors added to the real costs of manufacture and thus adversely affected the competitiveness of domestic industry. The addition to power capacity in the Eighth Plan was less than in the Seventh Plan even in absolute terms. The performance of the industrial sector in 1998–99 was particularly disappointing with the rate of growth in this sector being just 41 per cent. The factors responsible for poor industrial growth in 1998–99 were listed in the Economic Survey under two heads (i) Domestic and (ii) External. The domestic factors were—(a) The decline in agricultural production in 1997–98 affected rural income, which directly resulted in lowering the demand for certain industrial products, (b) Capital markets remained depressed drying up sources of investment funds for industry, (c) Larger enterprises were in a better position to access funds. However, some of these units utilized the resources largely in mergers and acquisitions, rather than additional capacity creation and (d) Deficiencies in infrastructure services.

The external factors were—(a) Export growth being sluggish since 1996–97. This low demand for exports adversely affected industrial production. (b) Although the Indian rupee depreciated somewhat since August 1997, there was much greater depreciation in East Asian currencies following the East Asian crisis in mid-1997. This higher depreciation eroded the competitiveness of Indian products overseas by making them more expensive and (c) Several industries like steel, chemicals and electronic components were subject to competitive pressures from imports.

7.2.1 Pattern of Industrial Development since Independence

At the time of independence, India did not have a balanced and well-developed industrial structure due to which the country had to depend upon other countries for importing capital goods, after independence, changes have taken place in our economy. The second five-year plan was designed to provide strong base for Industrialization and development of the public sector. The Indian economy has witnessed important changes in the industrial pattern during the whole period of planning. The major changes are as follow:

1. **Development of heavy and capital goods industries:** The second five-year plan laid special stress on developing strong capital base industries in the country. This plan emphasized on growth and diversification of heavy, capital goods and machine-making industries. Accordingly, heavy investment was made in these industries. As a consequence we have achieved a well-developed industrial base. The most striking feature of Indian Industrialization is the industrial diversification, which has been achieved over a short period. Industrial diversification was significantly achieved by 1965–66 and it maintain thereafter as well. During the first fifteen years of Indian planning, the growth rate of basic and capital goods was significantly higher than the consumer goods industries.
2. **Expansion of public sector:** The public sector plays a pivotal role in the industrial development of a nation. There has been a phenomenal increase in the size and diversification of the public sector. Public sector exists in both basic and strategic areas. They produce large variety of goods ranging from electronic to mass consumption goods. Most of the public industries have been established in the underdeveloped areas, they helped in the development of those areas.
3. **Development of infrastructure:** After independence, efforts were made to develop basic facilities in industrial sectors such as power, transport and communication, banking and finance. Since then a remarkable expansion had taken place in infrastructural facilities though there still remains tremendous scope. Tapping indigenous energy resources, petroleum and thermal and hydro reserves, atomic power generation have substantially expanded. Many engineering and management institutes have also been established with both government and private initiative.
4. **Growth of small units:** One of the important results of the planning exercise has been the tremendous growth of small-scale industrial units, both registered and unregistered. These industries contribute about 40 per cent of the industrial production and provide the job to millions of peoples.
5. **Progress of science and technology:** India has achieved great success in the Research and Development (R&D) sector. Laboratories have been set up throughout the country. A number of medical, management, and professional institutes have been set up. Both the private and the public sector have contributed immensely in boosting up the R&D sector. Currently India ranks highest in the world with respect to technological talent and workforce.
6. **Growth of consumer durable goods:** Consumer durable goods have experienced remarkable growth especially during the 1980s. The output of radios, television, refrigerators, air-conditioners, cars, scooters and others has increased tremendously during the planning period. On the other hand, mass goods failed to acquire their due share in the economy. However, in

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the recent years, the consumer goods both durable and non-durable segments have recorded a good performance.

7. **Diversification of private sector:** In 1991, greater emphasis was laid on the role of private sector in the Industrialization process. Accordingly, the government followed the policy of delicensing, liberalisation, privatization and globalization.

Check Your Progress

1. What marked a beginning of the evolution of the Indian Industrial Policy?
2. List one cause of the industrial recovery during the 1980s.
3. In reference to industry, what was the objective of the second five year plan?

7.3 IMPACT OF NEW ECONOMIC POLICY ON INDIAN INDUSTRY

As you have already studied in the previous unit, the Government of India announced a New Industrial Policy on 24 July 1991. The major objectives of the new policy were ‘to build on the gains already made, correct the distortions or weaknesses that might have crept in, maintain a sustained growth in productivity and gainful employment, and attain international competitiveness.’

To recap, the main features of the new policy were:

1. **Abolition of industrial licensing:** In order to liberalize the economy and to allow the entrepreneurs to make investment decisions on the basis of their own commercial judgment, the Industrial Policy of 1991 abolished industrial licensing for all industries except eighteen industries. With the passage of time, most of these industries have also been delicensed. As of now, licensing is compulsory only for five industries viz., alcohol, cigarettes, hazardous chemicals, electronics aerospace and defence equipment and industrial explosives.
2. **Public sector:** The 1956 resolution had reserved seventeen industries for the public sector. The 1991 industrial policy reduced this number to eight. In 1993, the number was reduced to six. On 9 May 2001, the government opened up the arms and ammunition division to the private sector, which now leaves only three industries reserved exclusively for the public sector. The new industrial policy indicates the government’s intention to invite a greater degree of participation by the private sector in important areas of the economy.
3. **Free entry to foreign investment and technology:** As in case of domestic industrial investment, foreign investment has also been regulated in India. In

case of both foreign technology agreements sought by Indian firms as well as foreign investment, it was necessary to obtain specific prior approval from the government for each project. Approval will be given for direct foreign investment up to 51 per cent foreign equity in high priority industries. The limit was subsequently raised from 51 per cent to 74 per cent and then to 100 per cent for many industries. Presently FDI is permitted up to 100 per cent in most sectors subject to sectoral rules/regulations applicable.

4. **Monopolies and restrictive trade practice (MRTP) act:** The new industrial policy scrapped the threshold limit of assets in respect of MRTP and dominant undertakings. These firms will now be at par with others, and not require prior approval from the government for investment in the delicensed industries. Under the MRTP Act, all firms with assets above a certain size were classified as MRTP firms such firms were permitted to enter selected industries only and this on a case-by-case approval basis. The MRTP Act was accordingly amended. The amended Act gave more emphasis to the prevention and control of monopolistic, restrictive and unfair trade practices so that consumers are adequately protected from such practice.

Some other measures

Some of the other measures of the new economic policy were:

Industrial location policy: The new industrial policy provided that in locations other than cities of more than 1 million population there will no requirement of obtaining industrial approval from the Centre except for industries subject to compulsory licensing. Major amendment in the industrial location policy was effected during 1997–98. The requirement of obtaining industrial approval from the Central government for establishing units at locations not falling within 25 kilometres of the periphery of cities having a population of more than 1 million was dispensed with.

Abolition of phased manufacturing programmes for new projects: To increase the pace of indigenization in manufacturing, phased Manufacturing Programmes have been in force in a number of engineering and electronic industries. The new industrial policy has abolished such programmes in future as the government feels that due to devaluation of the rupee, substantial reforms made in the trade policy and there is no longer any need for enforcing the local content requirements on a case-by-case, administrative basis. Various incentives that are currently available to manufacturing units with existing Phased Manufacturing programmes will continue.

Removal of mandatory convertibility clause: Banks and financial institutions have an important role to play in the industrial development in India. These institutions followed a mandatory practice of convertibility clause. The new industrial policy decided that financial institutions will no longer impose this mandatory convertibility.

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Outcomes of New Industrial Policies

The following were the outcomes of new industrial policies:

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Costly and time-consuming controls were abolished. Until 1991, the industrial approval implied that private investors and companies had to spend considerable time and resources to obtain the necessary clearances. Most of the big companies had to maintain a special lobbying unit in Delhi to deal with government officials both formally and informally to speed up the approval procedures. After 1991, much fewer approvals were needed from the central government. Most clearances, which are still required, can be obtained at the state government level.

1. It has been made easier for big companies to expand monopolies. Respective trade practices legislation has been radically transformed so that even big companies with market share of above one third can expand their production and sales without prior approval from the government.
2. Several sectors, which used to be reserved for the public sector, have been opened up for private investment and in some of the sectors, special incentives are offered to foreign investors as well.
3. Foreign majority ownership is now allowed as the general rule while earlier the general rule allowed only 40 per cent of foreign ownership. Quantitative import restrictions have been abolished and tariffs lowered. On average, weighted tariffs were brought down from 87 per cent in 1991 to less than 30 per cent in 1997. Convertibility of the rupee on the current account has been introduced. This change of policy has been a marked improvement in Indian economic reforms.

The new industrial policy overnight altered the industrial scenario in India. In intent and scope, the industrial policy was a watershed, which became as significant for the economy as the Industrial Policy Resolutions (IPR) 1956, which gave primacy to the role of the state in industrial development. Henceforth industrial enterprise, efficiency and the market became the determinants of industrial advancement. The delicensing of a host of industries and the abolition of all registration schemes enabled entrepreneurs to quick decision-making and move quickly to seize business opportunities. The scrapping of any asset threshold or market share prescription for the definition of a Monopolies and Restrictive Trade Practices (MRTP) company and dominant undertaking might on paper suggest the giving up of an important social and economic objective. However, the then existing law had proved futile in achieving the result. Thus, little was lost but much gained, in terms of allowing companies to go ahead with investment programmes immediately. So also with the scrapping of the mandatory convertibility clause for term loans from the financial institutions—a provision which had prevented many entrepreneurs from investing borrowing for fear of indirectly losing shareholding control to the government.

The other area, in which the government has taken a giant leap breaking new and hitherto sacred ground, happens to be foreign participation in Indian companies, both in industries and external trade. The liberalisation of the rules relating to direct foreign investment, permitting 51 per cent and even 74 per cent equity in a wide range of the industries on a generalized basis, the easier facilitation of foreign technology agreements and other related measures constitute historic landmark in the evolution of industrial policy in India. So, the changes in respect of foreign investment and foreign technology agreements are designed to attract capital, technology and managerial expertise from abroad. This will improve the efficiency level of production. Another important component of this happens to be the scrapping of the policy on phased manufacturing programmes which is to be welcomed because it does away with the case-by-case approach and because suitable financial incentives for indigenization have been built into the new external value of the rupee and the trade policy.

Criticism of the New Policy

The new industrial policy was criticized to a certain extent. Some of the points are discussed as follows:

1. The new industrial policy blurred the barriers between domestic and foreign investors. It was hoped that this more competitive environment would in itself induce higher growth rates in industrial sector. However, the decade of 1990s witnessed erratic and fluctuating growth rate in different years leading to conditions of instability and uncertainty. This suggested liberalisation has not been enough to ensure high rates of growth of investment and productive activity, and other strategies may be necessary to encourage the animal spirits of entrepreneurs.
2. The new liberalised scenario that has emerged in the post-1991 reform phase, the Indian businessmen are facing unequal competition from MNCs. The private sector industrialists welcome the new industrial policy 1991 but soon they realized that opening up the Indian economy to foreign competition meant more and cheaper imports, more foreign investment, opportunities to MNCs to raid and takeover their enterprises and worse their inability to meet the challenges from MNCs due to their weak economic strength.
3. The various measures to promote foreign investment contained in the new industrial policy and the various concessions to such investment announced in recent years have provided opportunities to MNCs to penetrate the Indian economy and gobble up Indian enterprises.

However, recently, Indian industrialists were of the opinion that the new policy framework is somewhat biased towards foreign companies and investors. Some of the demerits are enlisted as follows:

1. Compared to Indian promoters, foreign investors can access capital funds at a much lower rate.

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2. While foreign companies can obtain exemptions, Indian companies end up paying heavy customs duties.
3. Only Indian companies are bound to pay sales tax in relation to interstate transfers.
4. Indian companies are compelled to pay excise duty on an immediate basis while foreign companies can postpone their payment.

Check Your Progress

4. What decision did the Industrial Policy of 1991 take in regard to industrial licensing?
5. What decision did the Industrial Policy of 1991 take in regard to the convertibility clause?

7.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The Industrial Policy Resolution of 1948 marked the beginning of the evolution of the Indian Industrial Policy.
2. One of the main causes of industrial recovery during the 1980s was the liberalization of industrial and trade policies by the Government.
3. Based on the Mahalanobis Model, the second five year plan set out to establish basic and capital goods industries on a large scale so that a strong base for industrial development in the future could be built. Three steel plants of one million tonnes ingot capacity each were set up in the public sector.
4. In order to liberalize the economy and to allow the entrepreneurs to make investment decisions on the basis of their own commercial judgment, the Industrial Policy of 1991 abolished industrial licensing for all industries except eighteen industries.
5. Banks and other financial institutions followed a mandatory practice of convertibility clause. The new industrial policy decided that financial institutions will no longer impose this mandatory convertibility.

7.5 SUMMARY

- The Industrial Policy Resolution of 1948 marked the beginning of the evolution of the Indian industrial policy.
- The Resolution of 1948 not only defined the broad contours of the policy, it delineated the role of the state in industrial development both as an entrepreneur and as an authority.

- The government's Industrial Policy Resolution of 1948 contemplated a mixed economy. There was a sphere reserved for private enterprise and another for public ownership.
- The first plan did not envisage any large-scale programmes of industrialization.
- The second plan accorded top priority to programmes of industrialization which would be clear from the fact that the expenditure on industry and minerals was increased to ₹ 938 crore under this plan which was 20.1 per cent of the total expenditure of ₹ 4672 crore.
- The government expressed the view that exogenous factors such as the wars of 1965 and 1971, drought conditions in some years, infrastructural constraints and bottlenecks and the oil crisis of 1973 were responsible for slowdown of growth.
- The period of the 1980s can broadly be termed as a period of industrial recovery. The rate of industrial growth was 6.4 per cent per annum during 1981-85, 8.5 per cent per annum during the Seventh Plan and 8.3 per cent in 1990-91.
- The Government of India announced a New Industrial Policy on 24 July 1991.
- The major objectives of the new policy were 'to build on the gains already made, correct the distortions or weaknesses that might have crept in, maintain a sustained growth in productivity and gainful employment, and attain international competitiveness.'
- The new industrial policy overnight altered the industrial scenario in India.
- In intent and scope, the new industrial policy was a watershed, which became as significant for the economy as the Industrial Policy Resolutions (IPR) 1956, which gave primacy to the role of the state in industrial development.
- Henceforth industrial enterprise, efficiency and the market became the determinants of industrial advancement.
- The new industrial policy blurred the barriers between domestic and foreign investors.
- The various measures to promote foreign investment contained in the new industrial policy and the various concessions to such investment announced in recent years have provided opportunities to MNCs to penetrate the Indian economy and gobble up Indian

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7.6 KEY WORDS

- **Industrial Licensing:** It refers to the regulations and restrictions with regard to establishing industries in certain categories. This is done by making it mandatory to obtain licenses before setting up such an industry.

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- **Convertibility Clause:** It is a *provision* that can be found on some bonds allowing the bondholder to exchange their debt into common stock. The resulting number of shares is specified in this *provision* as well.
- **Delicensing:** It means to remove a license.
- **Public Expenditure:** It is spending made by the government of a country on collective needs and wants such as pension, provision, infrastructure, etc.

7.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Write a short note on what the Industrial Policy Resolution of 1948 had to say in regards to foreign capital.
2. What were the reasons offered for the phenomenon of deceleration and retrogression in the industrial sector during the 1960s to the 1980s?
3. Why was the period of 1980s termed as a period of industrial recovery?
4. Discuss some of the criticisms of the New Economic Policy of 1991.

Long Answer Questions

1. Describe the different categories of industry under the Industrial Policy Resolution of 1948.
2. Examine the different phases of industrial development under the plan period.
3. Explain the pattern of industrial development in India since independence.
4. What was the New Economic Policy of 1991 in terms of industry? Examine the impact of the new policies.

7.8 FURTHER READINGS

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BLOCK - III
FINANCIAL SECTOR

*Overview of the
Financial Sector*

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**UNIT 8 OVERVIEW OF THE
FINANCIAL SECTOR**

Structure

- 8.0 Introduction
- 8.1 Objectives
- 8.2 Nationalisation of Banks
- 8.3 Financial Sector Reforms
- 8.4 Interest Rate Policy
- 8.5 Answers to Check Your Progress Questions
- 8.6 Summary
- 8.7 Key Words
- 8.8 Self Assessment Questions and Exercises
- 8.9 Further Readings

8.0 INTRODUCTION

In the previous unit, you learnt about industrial development in India post-independence. In this unit, we will discuss the financial sector of the Indian economy. We will begin with a discussion on bank nationalisation in India. Bank nationalisation was a landmark event for the Indian economy. The step of nationalisation was taken in accordance with India's economic objectives and developmental goals. After the discussion on bank nationalisation, we will turn towards financial sector reforms in India. The final section of the unit will deal with interest rate policies in India since independence.

8.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss bank nationalisation undertaken in India
- Describe the various financial sector reforms undertaken in India
- Examine the interest rate policy in India in the pre and post reform period

8.2 NATIONALISATION OF BANKS

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When India became independent, all banks except the State Bank of India were under private control. However, in the 1960s, the government felt that private banks were not in accordance with the economic objectives of the country. Therefore, the Government of India promulgated an Ordinance called the Banking Companies (Acquisition and Transfer of Undertakings) Ordinance on 19 July 1969, in terms of which the Central Government acquired the undertakings of the following 14 major Indian banks which had deposits of not less than ₹ 50 crore each as on the last Friday of June 1969:

1. Central Bank of India Limited
2. Bank of India Limited
3. Punjab National Bank Limited
4. Bank of Baroda Limited
5. United Commercial Bank Limited
6. Canara Bank Limited
7. United Bank of India Limited
8. Dena Bank Limited
9. Syndicate Bank Limited
10. Union Bank of India Limited
11. Allahabad Bank Limited
12. Indian Bank Limited
13. Bank of Maharashtra Bank Limited
14. Indian Overseas Bank Limited

These banks together had total deposits of ₹ 2,741.76 crore. Together with the State Bank of India and its subsidiaries this constituted 85 per cent of the total deposits.

After the takeover, the undertaking of each bank including its assets, liabilities, rights, etc was transferred to and vested in the corresponding new bank which became a new statutory corporate body. The general superintendence and direction of affairs of each of the nationalized banks were vested in a custodian who was authorized to exercise all powers that might be exercised by the bank. The Chairman of each of the nationalized banks who was holding office as such immediately prior to the nationalization was appointed as custodian for the corresponding new bank.

Immediately after the promulgation of the Ordinance, some writ petitions were filed in the Supreme Court, and a full bench of 12 judges passed on 22 July 1969 an interim stay order, pending the disposal of the writ petitions in respect of

three matters in the Ordinance. Under the stay order, the Central Government was prevented from appointing any Advisory Board for any of the 14 banks removing any of the 14 Chairmen of the banks who were given the designation of custodians, and issuing any direction to any of the 14 banks contrary of the existing provisions of the Banking Regulation Act.

A bill to replace the Ordinance was passed on 9 August 1969. A fresh stay order was issued on 8 September 1969, following writ petitions filed against the Act. This order did not debar the government from appointing Advisory Boards, but earlier prohibitions in respect of removal of Chairmen and issue of directions by the government to any of the 14 banks were re-imposed.

On 10 February 1970, the Supreme Court, while upholding the legislative competence of Parliament in the matter of acquisition of undertakings of the banking companies, held firstly that there had been a hostile discrimination against the 14 banking companies in so far as they had been debarred, after the acquisition of undertakings, from carrying on banking business when other banks were permitted to do so and secondly, the principles and methods laid down in the Act for determining the quantum of compensation proposed to be paid by the government were invalid. As the provisions held void by the Court were not severable from the main Act, the entire Act was struck down.

The undertakings of the 14 banks which had been acquired by the Central Government under the authority of the Act reverted to those companies following the Act being declared void. A fresh ordinance was issued on 14 February 1970 which did not contain the offending provisions of the earlier Act. Under the Ordinance, the government again took over the undertaking of each of these banks with effect from the original date, i.e., 19 July 1969. This Ordinance, unlike the void Act, did not set out any principles for the determination of compensation to be paid to each of the 14 limited companies whose undertakings were acquired, but fixed a specific amount of compensation to each of the 14 nationalized banks to be paid within 60 days from the date the banking company applies for it. These banking companies were given three options or any mix of these, i.e., in the form of cash, 10-year Central Government securities at par carrying interest at 4 ½ per cent per annum and 30-year Central Government securities at par carrying interest at 5 ½ per cent per annum. Of the 14 nationalized banks, two banks opted for payment of the entire amount of compensation in cash and the remaining 12 banks opted for payment of compensation partly in cash and partly in government securities.

The Banking Companies (acquisition and Transfer of Undertakings) Act was passed by both Houses of Parliament towards the end of March 1970 and received the assent of the President on 31 March 1970.

In July 1970, the Central Government in consultation with the Reserve Bank constituted the first Board of Directors for each of the nationalized banks. With the constitution of the first Board of Directors, the Reserve Bank's directive requiring

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the nationalized banks to obtain its prior approval for certain types of transactions was withdrawn and the banks were advised that the matters referred to therein should thenceforward be decided by their respective Board of Directors. Subsequently, a scheme called the Nationalized Banks (Management and Miscellaneous Provisions) Scheme, 1970 was framed by the Central Government under Section 9 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970. Under the scheme, each nationalized bank will have on its Board directors not exceeding 15. And every Board so constituted shall include representatives of the employees and depositors of such banks and such other persons as may represent the interests of each of the following categories, viz., farmers, workers and artisans. The government is empowered to appoint not more than five directors from among persons having special knowledge or practical experience in respect of one or more matters which are likely to be useful for the working of the nationalized banks. There will also be not more than two full time directors, of whom one shall be the Managing Director. Besides, there will be one official of the Reserve Bank of India and one official of the Central Government on each of these Boards. As indicated earlier, the scheme makes provision for the appointment in each nationalized bank two employees on the Board—one from among those who are workmen in the bank and the other from the employees in the bank other than workmen. The director from the employees who are workmen is to be appointed by the government out of a panel of three names furnished by the Representative Union in the concerned bank. The other director from among employees who are not workmen would be appointed by the government in consultation with the Reserve Bank.

With regard to their overseas branches, the nationalized banks have taken suitable steps according to local laws in each country for effecting the transfer of properties and other assets, etc standing in the names of the then existing banks to the corresponding new banks.

Objectives of Nationalization

The then Prime Minister, in a broadcast to the nation on the nationalization of banks, observed thus:

‘An institution, such as the banking system, which touches and should touch the lives of millions, has necessarily to be inspired by a larger social purpose and has to subserve national priorities and objectives. That is why there has been a widespread demand that major banks should be not only socially controlled but publicly owned....’

The broad aims of nationalization of banks as stated in the preamble to the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 are *to control the heights of the economy and to meet progressively and serve better the needs of development of the economy in conformity with national policy and objectives.*

More specifically, the important objectives of bank nationalization are:

1. the removal of control by a few;
2. provision of adequate credit for agriculture and small industry and exports;
3. the giving of a professional bent to bank management;
4. the encouragement of new classes of entrepreneurs and
5. the provision of adequate training as well as reasonable terms of service for bank staff.

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Criticisms

Nationalization of banks has been assailed by a number of people, mainly on the following grounds:

1. The Scheme of Social Control over banks has not been given a fair trial.
2. Foreign banks and the smaller banks are left out of the purview of nationalization.
3. Public ownership will lead to inefficiency in the working of banks.
4. Public ownership will mean elimination of healthy competition and initiative.

All these criticisms have been satisfactorily answered during the debate on the Banking Companies (Acquisition and Transfer of Undertakings) Bill. It has been observed that ‘...the weakness of social control was that in many banks people who had been controlling their policies in the past continued to exercise their influence over them in one way or another, sometimes by the continued presence of the old chairman or vice-chairman on the Boards. The banks might, as some did, obey the instructions and directions given to them. But there is all the difference in the world between people who carry out a policy wholeheartedly and with enthusiasm and those who do so only because of certain instructions. Even these directions were not followed by many of the banks and we cannot continue to ignore the impatience and frustration with which the under privileged look at our efforts to help them stand on their own feet...’

The criticism that nationalization will lead to inefficient functioning of banks can best be answered by pointing out the example of the State Bank of India. The enormous growth in the deposits of the State Bank of India since its inception and its performance in the priority sector credit as compared to the other commercial banks stand to prove that the efficiency of an organization need not necessarily depend on its ownership. Professionalization of bank managements and adequate training to bank staff are important objectives under the new system.

It has been made clear that there will be autonomy for each bank and the Boards of Directors will have well defined powers. Directions will be issued only on policy and general issues, and not on specific loans to specific parties. Thus, public ownership need not necessarily mean the elimination of healthy competition or initiative.

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As against the criticism of leaving out the small banks, it has been pointed out that the operations of smaller banks are limited to certain specific regions, and with their wider coverage the bigger banks would be in a better position to implement the policies of the government as compared to smaller banks.

Answering the criticism that foreign banks are not included in the legislation, it has been observed that they are part of world-wide organization and this enables them to give certain special facilities and services to exporters and importers. They have a distinctive part to play in advancing foreign currency loans and administering them on behalf of their parent offices, rendering services to tourists and in disseminating information about business opportunities in India and in other countries in which they operate.

There is often a misconception that nationalization is a peculiarly socialistic measure. The peculiar nature of banking industry which distinguishes it from other industries has been the main consideration for many countries to bring their banking systems under public ownership. France and Sweden are such examples.

Second Phase of Nationalization

As a further step in the government's action when it wanted the larger banks to fall in line with its goal of attaining national objectives, six more banks have been nationalized in April 1980. These banks are:

1. Andhra Bank
2. Corporation Bank
3. New Bank of India
4. Punjab and Sind Bank
5. Oriental Bank of Commerce
6. Vijaya Bank

The individual deposits of all these newly nationalized banks were below ₹ 50 crore at the time of the first nationalization of banks in July 1969. Between 1969 and 1978, almost all of them had crossed the ₹ 200 crore mark in their deposits, the only exception being Oriental Bank of Commerce which had about ₹ 180 crore at the end of 1978.

Achievements of Banking Nationalisation

In the context of the objectives set before the nationalized banks, it became necessary for them to reorient the concept of security for loans, to pay special attention to the growth potential and developmental needs of local areas where the branches are situated, to take better care of the requirements of underdeveloped areas and backwards sections of the population, to forge close relations with developmental and term financing institutions, to reach mutual understanding with state governments, to ensure that large borrowers do not have more access to

resources of the bank than is actually required for productive use, and to prevent use of credit for speculative and other unproductive purposes. Simultaneously, they were required to intensify their efforts, through a coordinated branch expansion programme, for mobilization of deposits in all parts of the country and from all sections of people.

It is gratifying to note that the nationalized banks have considerably diversified their lending policies. Simultaneously, they effected organizational changes to set up different cells or departments to handle proposals for advances to small scale industries as well as to agriculture. To handle this work, trained staff have been appointed and services of experts have been secured for consultation. Field officers have also been recruited, whose primary function would be to find out prospective customers, contact them for ascertaining their requirements, prepare regular proposals and put them before the cells/departments and, where necessary, to transmit them to Head Offices. They would also ensure proper utilization of advances granted and arrange to effect the recovery of loans as an when due. Arrangements have been made to give extensive publicity through newspapers and periodicals in regional languages regarding the type of facilities provided by the banks.

Check Your Progress

1. When was the ordinance passed for the first phase of bank nationalisation?
2. List one criticism of bank nationalisation.

8.3 FINANCIAL SECTOR REFORMS

A radical restructuring of the economic system consisting of industrial deregulation, liberalization of policies relating to foreign direct investment, public enterprise reforms, reform of taxation system, trade liberalization and financial sector reforms was initiated in 1992-93. Financial sector reforms in the area of commercial banking, capital markets and non-banking finance companies have also been undertaken.

The focus of reforms in the financial markets has been on removing structural weaknesses and developing the markets on sound lines. The money and foreign exchange market reforms have attempted to broaden and deepen them. Reforms in the government securities market sought to smoothen the maturity structure of debt, raising of debt at close-to-market rates and improving the liquidity of government securities by developing an active secondary market. In the capital market, the focus of reforms has been on strengthening the disclosure standards, developing the market infrastructure and strengthening the risk management systems at stock exchanges to protect the integrity and safety of the market. Elements of the structural reforms in various market segments are introduction of free pricing of financial assets such as interest rate on government securities, pricing of capital

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issues and exchange rate, enlargement of the number of participants and introduction of new instruments.

Improving financial soundness and credibility of banks is a part of banking reforms undertaken by the RBI, the regulatory and supervisory agency over commercial banks under the Banking Companies Regulation Act, 1949. The improvement of the financial health of banks is sought to be achieved by capital adequacy norms in relation to the risks to which banks are exposed, prudential norms for income recognition and provision of bad debts. The removal of external constraints in norms of pre-emption of funds, benefits and prudential regulation and recapitalization and writing down of capital base are reflected in the relatively clean and healthy balance sheets of banks. The reform process has, however, accentuated the inherent weaknesses of public sector dominated banking system. There is a need to further improve financial soundness and to measure up to the increasing competition that a fast liberalizing and globalizing economy would bring to the Indian banking system.

In the area of capital market, the Securities and Exchange Board of India (SEBI) was set up in 1992 to protect the interests of the investors in securities and to promote development and regulation of the securities market. SEBI has issued guidelines for primary markets, stipulating access to capital market to improve the quality of public issues, allotment of shares, private placement, book building, takeover of companies and venture capital. In the area of secondary markets, measures to control volatility and transparency in dealings by adoption of rolling settlement, laying down insider regulations to protect integrity of markets, uniform settlement, introduction of screen-based online trading, dematerializing shares by setting up depositories and trading in derivative securities (stock index futures) have been undertaken. There is a sea change in the institutional and regulatory environment in the capital market area.

Regarding Non-banking Financial Companies (NBFCs), the Reserve Bank of India has issued several measures aimed at encouraging disciplined NBFCs which run on sound business principles. The measures seek to protect the interests of depositors and provide more effective supervision, particularly over those that access public deposits. The regulations stipulate an upper limit for public deposits which NBFCs can accept. This limit is linked to credit rating by an approved rating agency. An upper limit is also placed on the rate of interest on deposits in order to restrain NBFCs from offering incentives and mobilizing excessive deposits which they may not be able to service. The heterogeneous nature, number, size, functions (deployment of funds) and level of managerial competence of the NBFCs affect their effective regulation.

Since the liberalization of the economy in 1992-93 and the initiation of reform measures, the financial system is getting market-oriented. Market efficiency would be reflected in the wide dissemination of information, reduction of transaction costs and allocation of capital to the most productive users. Further, freeing the

financial system from government interference has been an important element of economic reforms. The economic reforms also aim at improved financial viability and institutional strengthening. To improve the effective implementation of the monetary policy, linkages among money and foreign exchange markets have been forged.

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8.4 INTEREST RATE POLICY

Interest rate policy of a government is an extremely important monetary policy measure. *Monetary policy essentially is the process by which the monetary authority of a country, typically the central bank or currency board, controls either the cost of very short-term borrowing or the monetary base, often targeting an inflation rate or interest rate to ensure price stability and general trust in the currency.* Thus, we can say that the interest rate policy is set by the RBI in order to influence the evolution of the primary monetary variables in the economy such as consumer prices, exchange rate, credit expansion, and so on.

In India, before the early 1990s (i.e., during the pre-reform period), major monetary instruments used by the RBI were direct methods such as interest rate regulations, selective credit controls and cash reserve ratio system so as to neutralize the monetary impact of the government's budgetary operations. The administered interest rate regime during that period kept the yield rate of government securities artificially low. Demand for these securities was created through increases in Statutory Liquidity Ratio (SLR).

To be more precise, the logical evolution of the monetary policy setting in India in the 1970s were in the direction of credit rationing as an internal element of developmental planning. The rationing of credit evolved with food credit being given the first charge, followed by the prescribed priority sector lending, sectoral limits for credit deployment and selective credit controls. Sectoral credit limits became the proximate targets for monetary policy which were operated through allocation of non-food commercial bank credit. Selective credit controls were strengthened by the institution of Credit Authorization Scheme in 1966–68. With the nationalization of banks, the institutional apparatus for conducting monetary policy through the credit channel, with the virtual exclusion of other channels, was complete. Refinance was provided in order to make up for the shortfall of credit targets in relation to demand. The interest rate structure was administered, rendering it inflexible and sterile as an instrument of monetary policy. The policy of setting up interest rate ceilings up to 1997–98 in situations of excess demand reinforced the rationing of bank credit in order to influence aggregate demand.

The situation during the post-reform period (since the early 1990s) has changed. The government securities were made market related. Also, an array of other market related products was created. Simultaneously, the interest rate structure was rationalized and deregulated. Banks were given a free hand in the

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determination of the major rates. These developments enable the RBI to make use of open market operations as an effective instrument for liquidity management. The impact of large capital inflows during this period has been sterilized through open market operations.

In short, the conduct of monetary management has undergone significant changes in the 1990s in terms of objectives, framework and instruments, reflecting broadly the progressive liberalization of the economy. The RBI announced a multiple indicator approach in 1998–99, which accord the necessary flexibility to respond to changes in domestic and international economic and financial market conditions more effectively. The monetary stance of the RBI in the recent period has been to ensure that all legitimate requirements for credit are adequately met without affecting adversely the objective of price stability.

During the pre-reform period, the Bank Rate had only a limited role as an instrument of monetary policy. It was activated in 1997. Along with the Bank Rate, open market operations have also been actively used. With the stance of the RBI to move away from sector-specific refinance scheme, the liquidity in the system is managed through the ‘liquidity adjustment facility’ (LAF). As explained in detail subsequently, the RBI influences liquidity on a day-to-day basis through this facility. The facility is being used as an effective flexible instrument for smoothening interest rates. The liquid adjustment facility has evolved as an effective mechanism for absorbing and/or injecting liquidity on a day-to-day basis in a flexible manner and, in the process, providing a corridor for the call money market and other short term interest rates. The operating procedures of the liquid adjustment facility are refined periodically to make it more efficient. As such, the repo and the reverse repo rates emerging from the LAF auctions essentially reflect the market conditions of availability of liquidity in the system along with the rate at which liquidity is available from the RBI.

The LAF operations coupled with judicious use of open market operations are expected to evolve into a principal operating procedure of monetary policy of the RBI. To this end, the RBI may have to reduce substantially the liquidity through refinance to banks and primary dealers. As cash reserve ratio gets lowered and repo market develops, the refinance facilities should also be lowered imparting more effectiveness to the conduct of monetary policy. The Bank Rate changes combined with cash reserve ratio and repo rate changes have emerged as signalling devices for interest rate changes and important tools of liquidity and monetary management.

Several landmark initiatives have been recently announced to make the conduct of monetary policy more effective. The decision to divest ownership functions in commercial banking, development of finance and securities trading activities, separation of supervisory functions in regard to cooperative banks, separation of public debt management functions from monetary policy, changes in

operational conduct of monetary and fiscal policies suggested by Advisory Group on Transparency in Monetary and Fiscal Policies (Chairman being Shri M.Narasimham) and the tabling of Fiscal Responsibility and Budget Management Legislation mark a new phase in the evolution of monetary policy in India in the new millennium.

As observed in the report on Currency and Finance 2000–01: ‘the conduct of monetary policy in India would continue to involve the constant rebalancing of objectives in terms of the relative importance assigned, the selection of instruments and operating frameworks, and a search for an improved understanding of the working of the economy and the channels through which monetary policy operates.’

In conclusion, it may be observed that in the conduct of monetary policy, a number of common features could be identified. The more important among them are:

1. There have been significant reductions in the reserve ratio to relieve the pressure on the banking sector and reduce the costs of intermediation. As a matter of fact, many countries now have no reserve requirements. And, in some countries, the level of minimum deposit at the central bank has fallen to such low levels that it is no longer considered to be an active monetary policy instrument.
2. The deepening of financial markets and the growth of non-bank intermediation has induced the central banks to increase the market orientation of their instruments. A consequence of this is greater activism of central banks in liquidity management.
3. The greater activism through indirect instruments led to more intensive use of open market operations through flexible instruments like repo. The open market operations can be used for net injection or absorption of liquidity and can be resorted to irrespective of whether the operating target works through the rate channel or quantity channel.
4. The market environment has induced many central banks to focus more on the interest rates rather than bank reserves in trying to influence liquidity.

Check Your Progress

3. What has been the focus of reforms in the financial markets in India?
4. In reference to the banking reforms undertaken by the RBI, how is the improvement of the financial health of banks sought to be achieved?
5. Why was the SEBI established?
6. What were the major monetary instruments used by the RBI in the pre-reform period?

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8.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The Government of India promulgated an Ordinance called the Banking Companies (Acquisition and Transfer of Undertakings) Ordinance on 19 July 1969, in terms of which the Central Government acquired the undertakings of 14 major Indian banks which had deposits of not less than ₹ 50 crore each.
2. One criticism of bank nationalisation was that public ownership would mean elimination of healthy competition and initiative.
3. The focus of reforms in the financial markets has been on removing structural weaknesses and developing the markets on sound lines.
4. The improvement of the financial health of banks is sought to be achieved by capital adequacy norms in relation to the risks to which banks are exposed, prudential norms for income recognition and provision of bad debts.
5. In the area of capital market, the Securities and Exchange Board of India (SEBI) was set up in 1992 to protect the interests of the investors in securities and to promote development and regulation of the securities market.
6. Before the early 1990s (i.e., during the pre-reform period), major monetary instruments used by the RBI were direct methods such as interest rate regulations, selective credit controls and cash reserve ratio system so as to neutralize the monetary impact of the government's budgetary operations.

8.6 SUMMARY

- When India became independent, all banks except the State Bank of India were under private control. However, in the 1960s, the government felt that private banks were not in accordance with the economic objectives of the country,
- The Government of India promulgated an Ordinance called the Banking Companies Ordinance on 19 July 1969, under which acquired the undertakings of 14 major Indian banks.
- The broad aims of nationalization of banks are to control the heights of the economy and to meet progressively and serve better the needs of development of the economy in conformity with national policy and objectives.
- In the context of the objectives set before the nationalized banks, it became necessary for them to reorient the concept of security for loans, to pay special attention to the growth potential and developmental needs of local

areas where the branches are situated, to take better care of the requirements of underdeveloped areas and backwards sections of the population.

- A radical restructuring of the economic system consisting of industrial deregulation, liberalization of policies relating to foreign direct investment, public enterprise reforms, reform of taxation system, trade liberalization and financial sector reforms was initiated in 1992-93.
- The focus of reforms in the financial markets has been on removing structural weaknesses and developing the markets on sound lines. The money and foreign exchange market reforms have attempted to broaden and deepen them.
- Reforms in the government securities market sought to smoothen the maturity structure of debt, raising of debt at close-to-market rates and improving the liquidity of government securities by developing an active secondary market.
- In the area of capital market, the Securities and Exchange Board of India (SEBI) was set up in 1992 to protect the interests of the investors in securities and to promote development and regulation of the securities market.
- Since the liberalization of the economy in 1992-93 and the initiation of reform measures, the financial system is getting market-oriented.
- The interest rate policy is set by the RBI in order to influence the evolution of the primary monetary variables in the economy such as consumer prices, exchange rate, credit expansion, and so on.
- In India, before the early 1990s (i.e., during the pre-reform period), major monetary instruments used by the RBI were direct methods such as interest rate regulations, selective credit controls and cash reserve ratio system so as to neutralize the monetary impact of the government's budgetary operations.
- The conduct of monetary management has undergone significant changes in the 1990s in terms of objectives, framework and instruments, reflecting broadly the progressive liberalization of the economy.

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8.7 KEY WORDS

- **Nationalisation:** It means the transfer of a major branch of industry or commerce from private to state ownership or control.
- **Monetary Policy:** It is the macroeconomic policy laid down by the central bank. It involves management of money supply and interest rate and is the demand side economic policy used by the government of a country to achieve macroeconomic objectives like inflation, consumption, growth and liquidity.
- **Ordinance:** It is an authoritative order passed by the executive in India without legislative backing.

- **Financial System:** It is a system that allows the exchange of funds between lenders, investors, and borrowers. Financial systems operate at national, global, and firm-specific levels.

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8.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Write a short-note on the second phase of bank nationalisation in 1980.
2. What were the measures issued by the RBI in regards to the non-banking financial companies under the financial sector reforms?
3. Discuss some of the regulations undertaken by SEBI.

Long Answer Questions

1. What was bank nationalisation? What were its objectives, achievements and criticisms?
2. Describe the reforms in the financial markets in the 1990s.
3. Discuss India's interest rate policy in the pre and post reform period.

8.9 FURTHER READINGS

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UNIT 9 FINANCIAL INSTITUTIONS

Structure

- 9.0 Introduction
- 9.1 Objectives
- 9.2 Money Market and the Capital Market
- 9.3 Working of SEBI In India
- 9.4 Answers to Check Your Progress Questions
- 9.5 Summary
- 9.6 Key Words
- 9.7 Self Assessment Questions and Exercises
- 9.8 Further Readings

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9.0 INTRODUCTION

The growth of output in any economy depends on the increase in the proportion of savings/investments to a nation's output of goods and services. The financial system and financial institutions help in the diversion of rising current income into savings/investments.

A financial system may be defined as a set of institutions, instruments and markets that fosters savings and channels them to their most efficient use. The system consists of individuals (savers), intermediaries, markets and users of savings (government, public and private sector entities). Economic activity and growth are greatly facilitated by the existence of a financial system developed in terms of the efficiency of the market in mobilizing savings and allocating them among competing users.

Here, we will discuss financial institutions. For the realization of full potential, economies need institutions that impartially enforce property rights, low transaction costs and transparency. It is essential that financial institutions are developed sufficiently and the market operations be free, fair, competitive and transparent. The unit will also discuss the functions and objectives of the Securities and Exchange Board of India. The Securities and Exchange Board of India or SEBI is the regulator for the securities market in India. It was established in 1988 and given statutory powers on 30 January 1992 through the SEBI Act, 1992.

9.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the money market and the capital market in India
- Examine the functions and objectives of the Securities and Exchange Board of India

9.2 MONEY MARKET AND THE CAPITAL MARKET

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Let us begin with a discussion on the money market.

Money market

The financial system consists of the money market and the capital market as found elsewhere in the world. The money or credit market is the centre for dealings in monetary assets of short-term nature generally below one year. The instruments are: call money/notice money, term money, treasury bills, commercial paper, certificates of deposit, participation certificates (PCs) and forward rate agreements/interest rate swaps. The money market has organized and unorganized components. The organized credit market is dominated by commercial banks. The other major players are the Reserve Bank of India, Life Insurance Corporation, General Insurance Corporation, Unit Trust of India, Securities Trading Corporation of India Ltd and Discount and Finance House of India. In the money market, the short-term surplus investible funds at the disposal of financial institutions are bid by borrowers generally comprising institutions and governments. The rates struck between borrowers and lenders represent an array of money market rates. Besides call rates, other yields are on treasury bills and rates on commercial paper and certificates of deposit. The core of the money market is the interbank call money market. The Reserve Bank of India occupies a strategic position by varying liquidity through open market and repo, thereby influencing the cost and availability of credit.

Functions of the Money Market

The functions of the money market are:

- It acts as an equilibrating mechanism to even out short-term surpluses and deficits
- Provides a focal point for RBI's intervention to bring about changes in liquidity and cost of credit in the economy
- Provides access to short-term funds at market cleared prices.

Despite rapid strides in the expansion of the organized money market, there is still an unorganized market consisting of indigenous bankers and moneylenders. In the unorganized market, there is no clear demarcation between short-term and long-term finance or even between the purposes of finance in as much as there is nothing on a *hundi* (which is the indigenous bill of exchange) to indicate accommodation. *Hundis* are usually accommodation bills. The role of the unorganized sector in providing finance for trade has considerably diminished with the geographical coverage of the organized banking sector and increase in the flow of bank finance to small borrowers. Still, the inability of the poor to meet the requirements of the banking sector leaves them at the mercy of money lenders.

Self-help groups: In this connection, the novel scheme of self-help groups (SHGs) of the National Bank for Agriculture and Rural Development (NABARD) may be noted, which is likely to reduce the dependence on moneylenders in the unorganized sector, especially in the rural areas. NABARD found that lending to the poor through SHGs is a viable proposition. SHGs are voluntary associations of people formed to attain some common goal. The groups have a similar identity, heritage, caste or traditional occupations and come together for a common cause and manage resources for the benefit of the group members. These groups generally deal with thrift and credit as an important component of their activities.

The RBI launched a pilot project for linking SHGs with banks in 1991-92. Banks are taking the initiative as facilitators in the formation of SHGs. Actually, the process of group formation is faster at the bank's initiative than that of any non-governmental organizations (NGOs); the general time-lag being 15 days. Some of the rural banks found that SHGs had reduced their non-performing assets (NPAs) marginally and in SHG lending, the recovery was more than 90 per cent, mainly on account of peer pressure. Further, transaction costs were reduced by about a third, due to externalization of the activity. Recently, the recovery methods adopted by SHGs and NGOs have been found to be coercive.

Capital Market

The capital market consists of primary and secondary markets. The primary market deals with the issue of new instruments by the corporate sector such as equity shares, preference shares and debentures. The public sector consisting of Central and state governments, various public sector industrial units (PSUs), statutory and other authorities such as state electricity boards and port trusts which also issue bonds and shares especially as a part of disinvestment of government holdings. New capital issues by non-government companies, banks and financial institutions reached a peak in 1994-95 both in terms of the number of issues and value. In the same year, the market witnessed the floating of 1,704 new issues which raised ` 31,001.5 crore as compared to 1,156 issues for ` 29,502.8 crore in 1993-94. In 2003-04, resources were mobilized by private sector through prospectus and rights from 27 issues declined to ` 1,826 crore. It has since recovered to ` 63,637.9 crore in 2007-08 from 115 issues. The decline in the retail market was more than offset by the growth in private placement market. Since 1995-96 private placement market has emerged and has grown from ` 13,361 crore to ` 66,948 crore (from 1,144 issues) and ` 59,215 crore (from 800 issues). In 2007-08, ` 2,12,568 crore from 1,812 issues were raised. Mutual funds numbering 21, of which 10 were in the public sector and 11 in the private sector, mobilized ` 11,343.9 crore as compared to ` 11,243.3 crore in 1993-94. In 2003-04, the private mutual funds (22) raised ` 42,873 crore and public sector funds (14) ` 4,812 crore. In 2007-08, public sector funds mobilized ` 9,965 crore and private sector mutual funds ` 1,83,917 crore.

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The secondary market consists of 23 stock exchanges, including the National Stock Exchange, the Over-the-counter Exchange of India (OTCEI) and Interconnected Stock Exchange of India Ltd (ISEIL) where existing instruments including negotiable debts are traded. The market value of listed stock on the stock exchanges in India was ` 23,22,183 crore in July 2003-04. Capital formation occurs in the primary market while the secondary market provides a continuous market for the securities already issued to be bought and sold in volume with little variation in the current market price. It also provides liquidity to the initial buyers in the primary market to reoffer the securities to any interested buyer at any price, if mutually accepted. An active secondary market actually promotes the growth of the primary market and capital formation because investors in the primary market are assured of a continuous market and should the occasion arise, they can liquidate their investments in the stock exchange.

There is a symbiotic relationship between the primary and secondary markets. The major players in the primary market are the merchant bankers, mutual funds, financial institutions, foreign institutional investors (FIIs) and the anchor of the market, the individual investors; and in the secondary market, the stockbrokers who are members of the stock exchanges, mutual funds, financial institutions, FIIs and individual investors.

With a view to protect investors' interest and orderly development of the capital market, Securities and Exchange Board of India (SEBI) regulates the capital market and intermediaries.

Perfect Capital Market

A perfect capital market is only a concept, a benchmark for evaluating the operations of a capital market which has no taxes, transaction costs, regulations, has perfectly divisible assets, existence of a number of buyers or sellers and free access to information. No trader has the power to change prices of goods and services. There are never any arbitrage opportunities. A perfect capital market is externally efficient because of the prices of assets being equal to the risk-adjusted rates of return for all participants. It is internally efficient because transaction costs are zero and there are no taxes.

Perfect capital markets have the following characteristics:

- Trading is costless and access to the financial markets is free
- Information about borrowing and lending opportunities is freely available
- Has a large number of traders and no single trader can have significant impact on market prices

The real world, however, is characterized by imperfections. However, markets can be efficient if the costs of imperfections are small. Asset prices can still convey information about the company. The cost should be low enough to provide for a fair rate of return to ensure internal efficiency of the market. Flow of low cost

information to a sufficient number of market participants leads to determination of prices, reflecting the economic value of the asset. Trading on the basis of insider information is prohibited because the information is not available to all. A liquid market has depth, breadth and resilience. A market has depth if the buy and sell orders are forthcoming around the price at which it is transacting. A market that lacks depth is shallow. Further, the orders forthcoming should be in adequate volume. This is what gives breadth to the market. If the adequate volume needed to provide liquidity is not sufficient, the markets are called thin markets. The response of orders to price changes renders the market resilient.

Role of Financial Institutions

A financial institution is basically an establishment that conducts financial transactions such as investments, loans and deposits. Almost everyone deals with financial institutions on a regular basis. Everything from depositing money to taking out loans and exchanging currencies must be done through financial institutions.

There are five main types of financial institutions.

- Commercial banks
- Investment Banks
- Insurance Company
- Brokerage
- Investment Company

The primary role of financial institutions is to provide liquidity to the economy and permit a higher level of economic activity than would otherwise be possible. Let us discuss these in more detail.

The primary functions of financial institutions are as follows:

- Accepting Deposits
- Providing Commercial Loans
- Providing Real Estate Loans
- Providing Mortgage Loans
- Issuing Share Certificates

Finance firms such as commercial banks provide loans, business inventory financing and indirect consumer loans. These organizations get their funds by issuing bonds and other obligations. On the other hand, the functions of financial institutions, such as stock exchanges, commodity markets, futures, currency, and options exchanges encompass creating and providing ownership for financial claims, being responsible for maintaining liquidity in the market and managing price change risks. As part of their various services, these institutions provide investment opportunities and help businesses to generate funds for various purposes. The functions of financial institutions like investment banks are also important and related to the investment

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sector. These firms are involved in numerous financial activities, such as underwriting securities, selling securities to investors, providing brokerage services, and fundraising advice.

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Check Your Progress

1. What is the centre for dealings in monetary assets of short-term nature?
2. Which institution regulates the capital market and its intermediaries in India?
3. What is the role of financial institutions such as commercial banks?

9.3 WORKING OF SEBI IN INDIA

The Securities and Exchange Board Act of 1992 provides for the establishment of a board to protect the interests of investors in securities and to promote the development and regulation of the securities market. The board consists of a Chairman, two members from the Government of India, the ministries of Law and Finance, one member from the RBI and two other members. Popularly known as SEBI, this financial body is headquartered in Mumbai. Let us now discuss the functions of SEBI.

Functions of SEBI

The Board may provide for (1) regulating business in stock exchanges and any other securities market; (2) registering and regulating the working of stockbrokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisors and other intermediaries associated with securities markets; (3) registering and regulating the working of depositories, custodians of securities, FIIs, credit rating agencies; (4) registering and regulating the working of venture capital funds and collective investment schemes, including mutual funds; (5) promoting and regulating Self-Regulatory Organizations (SROs); (6) prohibiting fraudulent and unfair trade practices relating to securities market; (7) promoting investor's education and training intermediaries of securities market; (8) prohibiting insider trading in securities; (9) regulating substantial acquisition of shares and takeover of companies; (10) calling for information from, undertaking inspection, conducting inquiries and audits of the stock exchanges, mutual funds, intermediaries and self-regulatory organizations in the securities market and (11) levying fees and other charges for carrying out its work.

The board may specify the matters relating to the issue of capital, transfer of securities and the manner in which such matters shall be disclosed by the companies.

The board conducts an enquiry of the securities market to protect the interests of the investors. Accordingly, it issues directions to people associated with the market or to companies in the securities market. It maintains proper management

and development of the securities market. Securities Appellate Tribunal is also provided.

SEBI is bound by the Central government. The Central government directs the SEBI on the policies to be adopted, which it gives in writing from time to time.

The board of SEBI may be superseded by the Central government if it is of the opinion that, on account of grave emergency, the board is unable to discharge the functions and duties imposed on it under the provisions of the Act.

The guidelines/regulations issued by the SEBI may be grouped under primary and secondary markets. Mutual funds are also regulated by SEBI.

Objectives and Scope of SEBI Guidelines

The Capital Issues (Control) Act, 1947 which controlled the issue of capital was repealed on 29 May 1992. As a consequence, the issue of capital and pricing of issue by companies had become free of prior approval. However, with a view to ensure proper disclosure and investor protection, the Securities and Exchange Board of India has issued certain guidelines to be observed by companies making issues of the capital. The Union government empowered (27 October 1999) SEBI as the sole authority for regulating the issuance and transfer of shares of listed companies.

The guidelines broadly cover the requirements as to the first issue by new companies and existing private/closely held companies and also further issues of capital by other companies by way of shares, debentures and bonds. The guidelines will apply to all the issues of capital.

General Guidelines

Subscription list SEBI guidelines stipulate that the subscription list for public issues should be kept open for three working days and it should be mentioned in the prospectus. In the case of rights issue, it should not be kept open for more than sixty days. The gap between closure dates of various issues, e.g., rights issue to the Indian public, should not exceed thirty days. Any announcement of the closure of issue shall be made only after 90 per cent has been subscribed.

Companies are required to make their partly paid-up shares fully paid-up or forfeit the same, before making a public/rights issue.

Minimum Number of Shares and Application Money

- (i) In case of public issue at par, the minimum number of shares for which the application is to be made should be fixed at 200 shares of the face value of ₹ 10 each (29 October 1996).
- (ii) Where the issue is at a premium or comprises debentures, whether convertible or non-convertible, the amount payable in all, in respect of each instrument, (*i.e.*, on application, allotment and calls) by each applicant shall not be less than ₹ 5,000, irrespective of the size of the premium. It is subject to applications dealing with a multiple of tradeable lots.

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- (iii) The successful applicants will be issued share certificates/instruments for the eligible number of shares/instruments in tradeable lots, e.g., in case of shares of face value of ₹ 10 each, the tradeable lots shall be 100 shares.
- (iv) The minimum application money to be paid shall not be less than 25 per cent of the issue price. The minimum number of instruments for which an application has to be made shall in any case be not less than the marketable lot.

Oversubscription: The quantum of issue (rights or public issue) should not exceed the amount specified in the prospectus/letter of offer. No retention of oversubscription is permitted.

Compliance report: The lead managers have to file, within 45 days of the closure of an issue, a report in the prescribed form with a compliance certificate from the chartered accountants to the SEBI.

The Corporate Bond Market

The public issue segment of the corporate bond market in India, has remained insignificant instead of emerging as an alternative channel for raising resources when funding from the banking sector and the equity market becomes difficult. In recent years, large resources have been raised by way of debt from the private placement market. As against an annual average of ₹ 7,513 crore raised by way of public debt issues during 1990–91 to 1994–95, the resource mobilisation declined to an average of ₹ 5,469 crore during 1995–96 to 1999–2000 and further to an average of ₹ 2,899 crore during 2000–01 to 2006–07. However, private placement of debt increased from an average of ₹ 33,638 crore during 1995–96 to 1999–2000 to an average of ₹ 84,262 crore during 2000–01 to 2006–07. In 2007–08 as against ₹ 1,309 crore raised by way of public debt issues, resources raised from private placement market were quite large at ₹ 2,12,568 crore.

A well-developed bond market helps absorb shocks in a rapidly integrating global financial system. It reduces banks' exposure to credit and asset and liability mismatches which moderate the systemic risks. Further, the informational efficiency of corporate bond prices is at par with underlying stocks. Several factors, such as poor liquidity in the secondary market, narrow investor base and underdevelopment of securitisation products have hindered the growth of corporate debt market. Several measures have been initiated recently to develop the debt market. The corporate bond reporting and trading platforms have been operationalised at BSE, NSE and FIMMDA. A key factor, however, is the introduction of credit enhancement mechanisms like credit rating and bond insurance institutions.

Government of India Guidelines on Issue of Debentures (28 October 1980)

Object of issue: These guidelines apply only to the issue of secured debentures by public limited companies to the public. The object of the issue could be to raise

long-term funds to finance expansion/diversification or augment funds for working capital.

Quantum: The amount for project finance depends on the approval of the scheme by financial institutions. In the case of working capital, the debenture issue should not exceed 20 per cent of the gross current assets, loans and advances.

Debt-equity ratio: Debt-equity ratio is stipulated at 2 : 1 except in the case of capital intensive industries like fertilizers, petrochemicals, cement, paper and shipping.

Interest rate: Interest payable on debentures has been deregulated since 1991.

Maturity: Debentures are not redeemable before the expiry period of seven years.

Value: The face value of the debentures is ordinarily ` 100.

Listing: The debentures should be listed on a stock exchange.

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SEBI Guidelines For Debentures

Fully Convertible Debentures (FCD)

The SEBI restricts the conversion period to thirty-six months. Credit rating is required for all debentures. Conversion beyond thirty-six months is permissible only if the conversion is made optional with put and call options.

It may be noted that an option is merely an instrument that gives its owner, the right to buy or sell shares of a company within a specified period of time. Options are a derivative instrument which have beneficial impact all around. They stabilize share prices by reducing its volatility and provide a hedge for the investor against risks. They are now permitted to be issued.

Premium on conversion of debentures: The premium amount on conversion has to be predetermined and stated in the prospectus. A company is free to determine the rate of interest payable.

Debenture redemption reserve (DRR): In the case of non-convertible debentures, a Debenture Redemption Reserve (DRR) has to be created. A moratorium up to the date of commercial production is provided for the creation of DRR in respect of debentures raised for project finance. DRR may be created either in equal instalments or with higher amounts in the remaining period, if profits permit. Companies are allowed to distribute dividends out of the general reserves in certain years if the residual profits after transfer to DRR are inadequate to distribute reasonable dividend. DRR will be treated as a part of a general reserve, for consideration of bonus issue proposals and for price fixation related to post-tax return. In the case of new companies, distribution of dividend requires approval of the trustees to the issue and the lead institution. Debenture redemption can be taken up only after 50 per cent of the amount of debenture issue has been created. Withdrawal from DRR is permissible only after 10 per cent of the amount of

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debenture liability has been actually redeemed by the company. Dividends exceeding 20 per cent cannot be declared by existing companies without the prior permission of the lead institution or as per loan covenants, if the company does not comply with institutional conditions regarding interest and debt service coverage ratio. The company is free to redeem debentures in larger number of instalments. The first instalment starts from the fifth year instead of the seventh year.

Debenture Trustees

The names of the debenture trustees must be stated in the prospectus. The trust deed should be executed within six months of the closure of the issue.

The SEBI brought out regulations for debenture trustees in December 1993 making the registration of debenture trustees mandatory. The regulations, besides listing conditions for the grant of registration, also stipulate the obligations and responsibilities of debenture trustees as well as procedures for inspection by the SEBI and contains a Code of Conduct.

Conversion Option

Any conversion in part or whole of the debentures will be optional at the hands of the debenture holder if the conversion takes place at or after eighteen months from the date of allotment but before thirty-six months.

Non-Convertible Debentures (NCDS) and Partly Convertible Debentures (PCDS)

Debentures of less than eighteen months duration

If the maturity period of debentures is less than eighteen months, it is not necessary to create a charge or appoint a trustee or create DRR. If no charge is created on such debentures, they are unsecured and are treated as 'deposits.' The issuer has to ensure compliance with the Companies (Acceptance of Deposits) Rules, 1975. The offer document should disclose the details.

Prospectus of PCD/NCD

In the case of PCD, the premium amount at the time of conversion shall be pre-determined and stated in the prospectus.

Redemption amount, period of maturity, yield on redemption of PCD/NCD shall be indicated in the prospectus. The prospectus should indicate the discount on non-convertible portion of the PCD in case they are traded and the procedure for their purchase on spot trading basis must be disclosed in the prospectus.

Rollover of Non-convertible Portion

Rollover of non-convertible portion of PCD/NCD with or without change in interest rate can be done only on a positive consent and not on passive consent. It is compulsory for companies to give an option to those debenture holders who want

to withdraw and encash the debentures. Before rollover, the execution of fresh trust deed for non-convertible debentures or non-convertible portion of PCD is required. A company has to obtain credit rating six months prior to the date of redemption and should communicate it to the debenture holders.

A company desirous of rollover of its NCD or non-convertible portion of PCD, has to submit the letter of information containing credit rating, debenture holders' resolution, option for conversion and such other items the SEBI may prescribe from time to time, to the SEBI for vetting.

Disclosures for Issue of Debentures

The disclosures relating to the raising of debentures should include, among others: existing and future debt-equity ratios, servicing behaviour on existing debentures, payment of interest on due dates on term loans and debentures and finally certificate from a financial institution or bankers about their no-objection for a second or *pari passu* charge being created, in favour of the trustees to the proposed debenture issue.

Issue of Debt without SEBI Vetting or Acknowledgement

In addition to the earlier guidelines, circulars and clarifications, the SEBI issued guidelines through Clarification XIV on 1 March 1996. These guidelines enable companies listed on the stock exchange to issue debt instruments without being required to either submit the prospectus or letter of offer for vetting to the SEBI or to obtain an acknowledgement card from the SEBI in respect of the said issue of debt instruments. The guidelines exclude issues of the debt instruments along with any other security or when they are convertible into equity or carry warrants with an option to convert into equity. Issue of debt instruments to which those guidelines apply, requires the appointment of a merchant banker to manage the issue. The merchant banker has to ensure that the official document provides a true, correct and fair view of the affairs of the company, submits the draft of offer document to the SEBI six weeks before the issue, complies with observations received from the SEBI within three weeks of the receipt of such a draft and resubmit the offer document with the modifications to the SEBI. The Advisory Committee on Primary Markets (March 1997), suggested that in the case of rights issue at premium, the present requirement of the promoter's 'contribution' and its lock-in for two or three years should be removed.

Protection of Debenture Holder's Interest

Trustees to the debenture issue should be vested with requisite powers to protect the interest of debenture holders, including a right to appoint a nominee director on the board of the company in consultation with debenture holders.

The progress with respect to debentures raised for project finance/modernization/expansion/diversification/normal capital expenditure, is to be monitored by the leading institution/investment institution. With regard to debentures

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issued for working capital, the lead bank for the company should monitor, institutional debenture holders and trustees should obtain a certificate from the company auditors about the utilization of funds during the implementation period of the project.

In the case of debentures for working capital, a certificate has to be obtained at the end of the accounting year. Issues by companies belonging to the groups for replenishing funds or to acquire shareholding in other companies is not permitted.

The company issuing debentures has to file, with the SEBI, certificates from their bankers, that the assets on which security is to be created, are free from encumbrances and that necessary permission to mortgage the assets has been obtained or a 'No Objection Certificate' from the financial institution or bank for a second or *pari passu* charge has been obtained in cases where assets are encumbered. The security should be created within six months from the date of issue of debentures. If the company for any reason is not in a position to create a security within 12 months from the date of issue of debentures, a penalty interest rate of 2 per cent has to be paid to the debenture holders. If security is not created even after eighteen months, a meeting of debenture holders should be called within twenty-one days to explain the reasons and the date by which the security would be created.

Trustee to the debenture issue will supervise the implementation of the conditions, regarding creation of security for the debentures and regarding DRD.

Past Issues of FCD and PCD

In the case of FCDs and PCDs issued in the past, SEBI has laid down procedure where conversion was to be made at a price to be determined by the Controller of Capital Issues at a later date.

Issue of Shares

The SEBI guidelines have been devised to ensure proper disclosure and investor protection. The guidelines classify companies issuing shares on the basis of (a) number of years in commercial production, (b) track record and (c) nature and background of the promoter/entrepreneur/companies.

First Issue by a New Company

(a) Manufacturing companies (should be dividend paying): On 16 April 1996 and 12 August 1997, the SEBI issued guidelines in order to tighten the entry norms for companies accessing capital. Accordingly, a company should have a track record of dividend payment in the immediate preceding three years before going public. If a manufacturing company does not have such a track record, it can access the public issue market, provided its project has been appraised by a public financial institution or a scheduled commercial bank. Such an appraising entity is also participating in the project funding. The SEBI has decided not to vet offer documents of companies having track record of three years' dividend payment.

An unlisted company can freely price its securities, provided it has shown net profits in the immediately preceding three years.

The Advisory Committee on Primary Market (6 March 1997) set up by the SEBI, recommended that for accessing capital market, a company should have declared dividend in each of the three years and not after completion of three years to consider it as a genuine track record.

The SEBI revised on 18 May 1999, the eligibility norms for public issue with respect to criteria of actual payment of dividend. For listing, a company should have a track record of distributable profits for at least three out of the immediately preceding five years and a pre-issue networth of not less than ` 1 crore in three out of the preceding five years with a minimum networth to be met immediately in the preceding two years.

IPO Size and Pre-issue Networth

The entry norms for IPOs were tightened (15 June 2000) by requiring the IPOs of size up to five times the pre-issue networth would be allowed only if the company had a record of profitability and networth as specified in the guidelines. Companies without such a track record or the issue size beyond five times the pre-issue networth are allowed to make IPOs only through the book building route with 60 per cent of the issue to be allotted to qualified institutional QIBs.

Grading of IPO: Grading of IPOs was made mandatory in 2007.

Minimum Public Offer by IT, Media, Entertainment and Telecom Companies

Information Technology companies are permitted (17 August 1999) to make initial public offer of 10 per cent (reduced from 25 per cent) of the post-equity issue. Their public offer should be at least ` 50 crore and it should offer at least 20 lakh securities. Information Technology (IT) companies making IPO should have a track record of distributed profits in three out of five years in the IT business from out of IT activities (8 October 1999).

Companies in the media, entertainment and telecom sectors can make a minimum level of public offer of 10 per cent (reduced from 25 per cent on 7 April 2000) of post-equity issue. The size of the net offer to the public should not be less than ` 5 crore.

Infrastructure Companies

Infrastructure firms were exempted (7 September 1998) from making a minimum public offer of 25 per cent of its security, five shareholders per ` 1 lakh of offer and a minimum subscription of 90 per cent.

(b) Finance companies: Finance companies which have a minimum track record of two years of operation or have been granted registration as a non-banking finance company by the RBI or as an intermediary by the SEBI, are

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eligible to an issue of securities as per the guidelines issued through Clarification XII, dt. 29/9/95.

First Issue by New Company set up by an Existing Company

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A new company set up by an existing company with a five years track record of consistent profitability is free to price, provided the participation of the promoting company is not less than 50 per cent of the equity of the new company and the issue price is made uniform to all investors. The prospectus or offer document should contain justification for the issue price. The draft prospectus containing the disclosures will be vetted by the SEBI, before public issue. No private placement proof of promoter's share is permitted. Shares can be listed on any stock exchange or Over the Counter Exchange of India.

First Issue by Existing Private/Closely-held Companies

Existing unlisted companies going in for public issue for the first time.

- (i) Companies without a track record can price the issue at par only. An unlisted company can freely price its securities, provided it has shown net profits in the immediately preceding three years, subject to its fulfilling the existing disclosure requirements.
- (ii) Companies with a three years track record (two full years and one-half year of consistent profitability) or companies without a track record, but promoted by companies with a five years' track record are free to price the issue. They can list shares on a stock exchange.
- (iii) Not less than 20 per cent of equity (issued capital) should be offered to the public.
- (iv) Draft prospectus will be vetted by the SEBI to ensure adequacy of disclosure.
- (v) Pricing would be determined by the issuer and lead manager to the issue and would be subject to specific disclosure requirements about the net asset value of the company as per the latest audited balance sheet and justification for the issue price.

Public Issue by Existing Listed Companies

Existing listed companies are allowed to raise fresh capital by freely pricing their future issues. However, the price should be determined in consultation with the lead manager(s) to the issue. The draft prospectus will be vetted by the SEBI to ensure adequacy of disclosures. Banks are required to satisfy the criteria of any two years' profitability for issues above par. The prospectus or offer document should contain the net asset value of the company and justification for the price of the issue. The high and low prices for the last two years should be indicated in the offer document.

Companies with listing history less than six months can raise money through preferential allotment (2007).

Companies that wish to enhance their foreign shareholdings up to 51 per cent or more, as permissible under the relevant guidelines of the Government/ Reserve Bank of India can make issue at the price determined by the shareholders in a special resolution under Section 81(1) (A) of the Companies Act. This will also apply to the issue of shares to foreign investors by closely-held companies where there are no foreign shareholdings at present.

An unlisted company would be required to meet the entry norm of dividend payment, in the immediately preceding three years, before going public only if the post-issue networth becomes more than five times the pre-issue networth. The SEBI replaced (19 March 1999) the requirement of actual dividend payment in three out of preceding five years by the company's ability to pay dividend. Minimum pre-issue networth requirements for the companies were also laid down.

Uniform Entry Norms

As a measure of rationalization of existing guidelines, the SEBI has laid down only one set of disclosures and entry norms for all issues irrespective of the issue price. The different requirements for making issues at par and premium were merged to create a common set of requirements.

Promoters' contribution was made uniform at 20 per cent irrespective of the issue size.

Marketing Initial Public Offers through Secondary Market

On-line Securities Offer system was introduced by the SEBI to extend the benefits of on-line trading in the secondary market to the primary market. The new system reduces cost and time involved in a public issue process and does away with the blocking of funds of the investors.

Linking Issuer Company with Depository

All new IPOs have to be compulsorily traded in a dematerialized form and guidelines for public issues are modified to make admission to a depository for dematerialization of securities, a prerequisite for making public or rights issue or an offer for sale.

Rights Issues by Listed Companies without SEBI Vetting or Acknowledgement

The guidelines issued on 23 May 1995 dispense with the requirements to submit a draft letter of offer for vetting to obtain an acknowledgement card from the SEBI by companies listed on a recognized stock exchange to raise capital on a rights basis. The guidelines are not applicable to composite issues. Further, companies are prohibited from the rights issue of over ` 50 lakh (including premium) unless the Category-1 merchant banker has submitted the offer document to the SEBI. The salient features of the offer documents are stated below.

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Salient Features of Offer Documents

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I. General information

- (a) Name and address of registered office of the company.
- (b) Issue listed at name(s) of the stock exchanges.
- (c) Opening and closing dates of the issue.
- (d) Name and address of Lead Managers.
- (e) Name and address of the Trustees under Debenture Trust Deeds (in case of debenture issue).
- (f) Rating for the Debenture/Preference Shares, if any, obtained from CRISIL or any recognized rating agency.

II. Capital structure of the company

- (a) Issued, subscribed and paid-up capital
- (b) Size of present issue
- (c) Paid-up capital:
 - (i) after the present issue
 - (ii) after conversion of debentures (if applicable)
- (d)
 - (i) details of promoters holding (pre-issue and post-issue) and lock-in
 - (ii) pre-issue and post-issue shareholding pattern
 - (iii) promoter's intention to subscribe to their entire rights entitlement

III. Terms of the present issue

- (a) Authority for the issue, terms of payment and procedures, time schedule for allotment and issue of certificates
- (b) How to apply—availability of forms, letter of offer and mode of payment
- (c) Special tax benefits to shareholders under the Income Tax Act, if any

IV. Particulars of the issue

- (a) Object of the issue
- (b) Project cost
- (c) Means of financing (including contribution or promoters)

V. Company, management and project

- (a) History, main objects and present business of the company
- (b) Background of promoters, Managing Directors/Wholetime Directors and names of nominees of institutions, if any, on the Board of Directors including key management personnel
- (c) Location of the project
- (d) Plant and machinery, technology and process

- (e) Collaboration, performance guarantee, if any, or assistance in marketing by the collaborators
- (f) Infrastructure facilities for raw materials and utilities like water and electricity
- (g) Schedule of implementation of the project and progress made so far, giving details of land acquisition, execution of civil works, installation of plant and machinery, trial production, date of commercial production, if any
- (h) The products:
 - (i) Nature of the product(s) – consumer/industrial or end-users
 - (ii) Existing, licensed and installed capacity of the product, demand of the product existing and estimated in the coming years as estimated by a government authority or by any other reliable institution giving source of information
 - (iii) Approach to marketing and proposed marketing set-up. In case of company providing services, relevant information with regard to the nature/extent of service, etc., is to be furnished
 - (i) Future prospects—the expected year when the company would be able to earn net profit and declare dividend
- (j) Performance, *vis-a-vis* promises relating to the previous issue made, if any, during the preceding five years

NOTES**VI. Financial performance of the company for the last five years**

(Figures to be taken from the audited annual accounts in tabular form)

- (a) Balance Sheet Data, Equity Capital, Reserves (State Revaluation Reserve, the year of revaluation and its monetary effects on assets and borrowings)
- (b) Profit and Loss data, Sale, Gross profit, Net profit, Dividend paid, if any
- (c) Any change in accounting policies during the last three years and their effect on profits, and the reserves of the company
- (d) Stock market quotation of shares/debentures of the company, if any, (high/low price in each of the last three years and monthly high/low price during the last six months)
- (e) Information as required by the stock exchange regarding working results for the last but one month, before dating of the offer document and the last four weeks' closing price of the shares
- (f) Details of any pending litigations, defaults against the company, the group companies and the business relationship of these companies with the issuing company
- (g) Promise versus performance for the earlier public/rights issue of the company or group companies
- (h) Financial performance of the subsidiary company/group companies

- (i) Justification of premium
- (j) Risk factors and management perception of risk factors

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VII. Whether all Payment/Refunds, Debentures, Fixed Deposits, Interest on Fixed Deposits, Debenture Interest, Institutional dues have been paid up-to-date, if not, details of the arrears, if any, to be stated.

VIII. Following particulars with regard to the listed companies, under the same management, within the meaning of Section 370 (IB), which made any Capital Issue in the last three years.

- (a) Name of the company
- (b) Year of issue
- (c) Type of issue (rights)
- (d) Amount of issue
- (e) Date of closure of issue
- (f) Date of despatch of share/debenture certificates completed
- (g) Date of completion of the project, where object of the issue was financing a project.
- (h) Rate of dividend paid

IX. Management Perceptions of Risk Factors (e.g., Sensitivity to Foreign Exchange Rate Fluctuations, Difficulty in the Availability of Raw Materials or in Marketing of Products, Cost/Time Overrun).

Note: The term 'year' wherever used, means 'Financial Year.'

If the company does not receive any application money for at least 90 per cent of the issued amount, the entire subscription will be refunded to the applicants within 42 days from the date of closure of the issue. If there is a delay in the refund of application money by more than eight days after the company becomes liable to pay the amount (i.e., 42 days after closure of the issue), the company will pay an interest for the delayed period, at prescribed rates in subsections (2) and (2A) of Section 73 of the Companies Act, 1956.

No statement made in the offer document above should contravene any of the provisions of the Companies Act, 1956 and the rules made thereunder. It should be certified by the Directors of the company that all the legal requirements connected with the said issue and the guidelines, instructions issued by the SEBI, government and any other competent authority, have been duly complied with.

The merchant banker acting as the lead manager has to ensure that the letter of offer provides a true, correct and fair view of the state of affairs of the company; that the state of affairs are adequate for the investors to arrive at a well-informed decision. The merchant banker has to submit the draft letter of offer to the SEBI six weeks before its issue, incorporate comments received from the SEBI within three weeks of the receipt of the draft and submit a copy of the letter

of offer to the SEBI within two weeks of issue. He/she also has to submit a due diligence certificate to the SEBI. The provisions for these guidelines are in addition to the guidelines issued earlier.

Underwriting

Issuers have the option of deciding whether the issue is to be underwritten or not (10 October 1994). The number of underwriters registered with the SEBI as on 31 March 2000 was 42. If the issue is not underwritten and if the minimum subscription of 90 per cent of the offer to the public is not received, the entire amount received as subscription would have to be returned in full.

The number of underwriters should be decided by the issuer. The lead managers must satisfy themselves about the net worth of the underwriters and the outstanding commitments and disclose the same to the SEBI. The underwriting arrangements may be filed with the stock exchanges.

In 1999–2000, 18 issues were underwritten for ₹ 2,257 crore (seven issues for ₹ 227 crore in 1998–99) and 47 issues for ₹ 4,000 crore were not underwritten (25 issues for ₹ 4,791 crore in 1998–99). Of the total amount of ₹ 6,257 crore in 1999–2000, the underwritten amount constituted 36 per cent (4.5 per cent in 1998–99).

Minimum Subscription

A minimum requirement of 90 per cent subscription is also mandatory for each issue of capital and rights issue. If the company does not receive 90 per cent of the issued amount from public subscription plus accepted devolvement from underwriters within 60 days of the opening of the issue, the company should refund the amount of subscription. In case of disputed devolvement, if the above conditions are not met, the company should refund the subscription.

The Advisory Committee on Primary Market set up by the SEBI, recommended that a minimum requirement of 90 per cent subscription for public issues should continue. In the case of issues which are not underwritten or subscribed to the extent of 90 per cent, the promoters should be allowed to procure applications or bring their own applications after closure of issue, *i.e.*, the same rules should be applicable as in underwritten issues, 60 days after the closure. This would be subject to adequate disclosures in the documents.

Composite Issues

Composite issues consist of rights and public issues. The SEBI guidelines provide for issues to public by existing companies, priced differentially as compared to rights shareholders. Existing companies can resort to differential pricing of their shares. The price at which the shares are offered to public may differ from the price at which they are offered to the rights shareholders.

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NOTES**Reservations and Firm Allotment**

Under the Securities Contracts (Regulation) Rules, 1957, relating to listing requirements, 25 per cent of each class of the securities issued by a company should be offered to the public. The balance may be allotted on a firm allotment/reservation basis to various categories of investors. Such firm allotment/reservations should not exceed 75 per cent of the total issue amount (Clarification VIII, dated 11 October 1993). Firm allotments are not subject to any lock-in period (10 October 1994).

Reservation in Issue of Shares

- (i) Permanent employees (including working directors) of the company and in the case of a new company, the permanent employee of the promoting companies, the Maximum Permissible Allotment (MPA) is 10 per cent.
- (ii) The MPA is 10 per cent for the shareholders of the promoting companies in the case of a new company shareholders of a group of companies in the case of an existing company.
- (iii) Reservation up to a maximum of 20 per cent of the proposed total issue may be made for participation by the Indian mutual funds on a competitive basis, *i.e.*, in proportion to the shares applied for by such mutual funds. Lock-in period will not apply to their investments.
- (iv) Foreign Institutional Investors (including NRI & OCB), the MPA is 30 per cent (Union Budget 1997–98), according to the schemes of the RBI.
- (v) Indian and multilateral developmental financial institutions have an MPA of 20 per cent.

Firm Allotment

Firm allotment is allowed by the SEBI through a circular (11 October 1993) to four categories of investors namely Foreign Institutional Investors (FII) (including NRI and OCB), development Financial Institutions (FIs), Indian Mutual Funds and Permanent Regular Employees of the issue company. As per the SEBI directive, Indian mutual funds could apply for 20 per cent firm allotment of shares; development financial institutions another 20 per cent, foreign institutional investors 30 per cent and employees 10 per cent (limited to 200 shares of ₹ 10 each) of the total issues capital. The lead merchant banker is eligible to firm allotment for up to 5 per cent of the issue (29 September 1995).

In October 1994, the SEBI clarified that issuers can make firm allotments to scheduled banks in their public issue within the prescribed percentage for the category of development financial institutions.

The amounts allotted on the basis of firm allotment/reservation amounted to ₹ 202 crore in 1999–2000 (₹ 1,425 crore in 1998–99). Of the total capital raised through firm allotment during 1999–2000, NRIs got 37 per cent (23 per cent in

1998–99), promoters 48 per cent (41 per cent), employees 17 per cent (7 per cent), FIs 8 per cent (16 per cent) and MFs 6 per cent (6 per cent).

Financial Institutions

Removal of Ceiling for Firm/Reservation Allotment

The SEBI has removed the individual ceiling with respect to firm reservation basis, except a ceiling of 10 per cent applicable to employees as well as to the shareholders through Clarification XII (27 September 1995).

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Guidelines for Preferential Allotment

According to financial institutions, the guidelines laid down by the SEBI permit the issuing company to make preferential allotment to promoters, by complying with the provisions of the Companies Act. The ostensible purpose is to raise the stake of the promoters. The promoters can also acquire shares through purchase or open tender offers which are considerably expensive methods. From 1991–94, the RBI gave permission to 212 FERA companies to raise their equity stake to 51 per cent at highly concessional prices. FERA companies argued in 1991 that they were forced to disinvest up to 60 per cent of their shares at well below market price, and so should be allowed to raise their stake in the 1990s at prices higher than what they got when selling in the late 1970s. Besides, below-market preferential allotment was availed by Indian companies, the promoters of which enriched themselves. The preferential allotment was stopped by the government when there was a public outcry. It may be noted that the price of preferential shares has been as low as 10 per cent of the prevailing market price.

Preferential allotment to existing local or new promoters, foreign collaborators, parent companies, according to the guidelines issued by financial institutions (14 December 1993) can be made only on the approval of shareholders holding 90 per cent of the equity. The allotment should be at the market value of the shares, determined by the average value of the weekly high and low of the closing prices during the preceding six months or the average of the weekly high and low of the closing prices during the preceding two weeks; whichever is higher.

The provision for the allotment of shares on a preferential basis to promoters has been abused by some of the Indian associates of multinational companies as well as Indian promoters, to issue shares at a deeper discount. It is widely believed that promoters of Indian and foreign companies have enriched themselves by ₹ 5,000 crore during 1994 by allotting themselves shares and warrants (to be converted into equity) on a preferential basis at a heavy discount on market prices.

When financial institutions introduced guidelines to curb steep discounts, many promoters sought to bypass the norms by issuing warrants to themselves, instead of shares. This has amounted to circumvention because the warrants would be converted into shares at prices unrelated to the future date after which they are converted to shares and paid for. At the future date, the market prices are likely to be far higher than they were, on an average, over the six months prior to the board

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meeting approving the issue. The practice has been curbed by the guidelines issued by financial institutions at the end of July 1994.

The revised guidelines issued by the FIs basically fix the issue price of shares, on conversion of warrants at a 10 per cent premium, over the average of six months preceding the board meeting, approving the preferential allotment. The FIs also insist upon promoters seeking preferential allotment of warrants, paying an up-front fees of 5 per cent of the striking price, which has been kept unchanged at a 10 per cent premium on the average price of the preceding six months. The up-front fee would be forfeited by the company if the promoters fail to exercise the option to convert the warrants into equity shares within 18 months. The warrants are not transferable until conversion. Further, the lock-in period for shares acquired by the promoters on exercising warrants, is a minimum period of five years. The existing shareholdings of the promoters seeking preferential allotment will also be locked in for five years. In March 1996, the lock-in period provision for preferential allotment was reduced for all categories, except for the promoters.

On 5 June 1994, the Reserve Bank of India announced new guidelines for pricing preferential allotment of shares to foreign shareholders. The prices are fixed according to the guidelines for pricing preferential allotment of shares to foreign shareholders. The price, according to the guidelines, has to be determined on the basis of the average price of the shares, during the preceding six months. The average price has to be calculated on the basis of monthly average of the high and the low rates. As per the guidelines issued by the SEBI in August 1994, issues of capital by the listed companies by way of any financial instrument on a preferential basis to any select group of persons, will be at market-related prices.

The SEBI has, however, stipulated a five year lock-in period for shares, warrants and debentures issued preferentially. The lock-in period will also apply to foreign institutional investors and mutual funds (press release 4 August 1994).

On 1 March 1996, the lock-in period provision for preferential allotment was removed for all categories except for the promoters.

The SEBI stipulated (15 June 2000) a lock-in period of shares issued on preferential basis by listed companies to any person for a period of one year.

Issue of Shares through OTC Exchange of India (OTCEI)

- (a) Where a direct public issue is made through the OTCEI, without the sponsor taking any shares, the normal guidelines for disclosure and investor protection shall apply.
- (b) Where the shares of a company have been taken by the sponsor, such shares may be offered to the public at a later date at such a price as the sponsor may deem fit, in accordance with the regulations of the OTCEI, subject to specified conditions.

Free Pricing of Issues

The guidelines for capital issues, issued by the Securities and Exchange Board of India (SEBI) in June 1992, have opened the capital market to free pricing of issues. Issue pricing is done by companies themselves, in consultation with the merchant bankers. If the premium is too low, the issue gets oversubscribed and if the premium is too high, it is bound to be undersubscribed and hence, fail. The merchant bankers, apart from taking into account the earnings per share, book value and the average market price for two or three years, have to take into account the future prospectus of the company and assess whether the market can absorb the premium on issue. As far as SEBI is concerned, it has laid down guidelines and made the merchant banker responsible for vetting the prospectus, to ensuring that the investor is informed of the justification for the price and stating the net asset value. It is not going to tinker with the price. An existing listed company and a new company (set up by an existing company), with a five years track record, an existing private/closely held company and an existing unlisted company going in for public issue for the first time with two and a half years track record of constant profitability can freely price the issue, subject to specific disclosure requirements about the net asset value (as per the latest audited balance sheet).

In April 1994, by a notification, issuers were allowed to maintain a price band of 20 per cent in the offer document submitted to the SEBI. The final offer document will, however, have only the price that falls within this band. According to the SEBI notification issued in May 1995, rights issues would be vetted by lead managers and not by the SEBI.

Pricing of the issue is a part of the pre-issue management. The premium has to be decided after taking into account the net asset value, profit earning capacity and the market price. Justification of the price has to be stated and included in the prospectus.

Equity shares can be sold to existing shareholders at par or at a premium. The existing shareholders are offered the right to subscribe to new shares, in proportion to the number of shares they already hold. Section 81 of the Companies Act stipulates that a company can increase its subscribed capital any time after the expiry of two years or one year from the first allotment of shares and such further issue of shares must be offered to the existing shareholders, in proportion to the shares held.

At times, right-cum-public issues are also made. Of the total new capital issues in 1995–96, rights issues accounted for 3–5.7 per cent in terms of value. Rights issues of convertible debentures are more popular. They accounted for 47.2 per cent of the total amount raised from debentures. In the case of equity shares, rights accounted for 28.6 per cent of the total equity raised in 1995–96. In 1995–96, 267 companies made rights issues for ` 5,842.5 crore. Rights issues were used to be priced slightly below the market price to compensate the shareholders. However, since the advent of free pricing from 1992, rights issues

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are made at a premium. Sometimes, the premium is not warranted by any factor that is normally used in valuing shares. Earlier, such premium was fixed as per the guidelines of the Controller of Capital Issues. Since the adoption of free pricing and the abolition of the office of the Controller of Capital Issues, there have been a spate of rights issues at premium.

In the case of rights-cum-public issues, it must be ensured that the public offer does not dilute the book value of shares which accrues to the existing shareholders after the close of the rights issue. Existing shareholders have a better claim to a company's net worth than the new shareholders. To ensure that, the price of the public portion of a rights-cum-public issue should generally be higher than the book value or price paid by existing shareholders.

Registration of Members of Stock Exchange

Government of India: Stockbrokers and Sub-brokers Rules, 1992

Under the SEBI Act, the Central government issued a notification on 20 August 1992, laying down rules relating to stockbroker and sub-brokers.

Definition of Stockbroker

The rules define a stockbroker as a member of the stock exchange and the sub-broker as any person who acts on behalf of the stockbroker as an agent or otherwise, for assisting the investors in buying, selling or dealing in securities through such brokers.

Conditions for grant of certificate to stockbrokers: The rules stipulate that registration with the SEBI is necessary for acting as a broker or a sub-broker. The conditions for grant of a certificate or registration to act as stockbroker are that the person:

- (a) holds the membership of a stock exchange;
- (b) shall abide by the rules and regulations and by-laws of the stock exchange of which he is a member;
- (c) shall obtain prior permission from the SEBI, to continue trading in securities in case of any change in the status and constitution;
- (d) shall pay the amount of fees for registration; and
- (e) shall take adequate steps for redressal of grievances of the investors within one month of the date of receipt of complaint and keep the SEBI informed about the number, nature and other particulars of the complaints received from such investors.

Conditions for grant of certificate to sub-brokers: The conditions for the grant of a certificate to 3a sub-broker are that the person:

- (a) is authorized in writing by a stockbroker, being a member of a stock exchange for affiliating himself in buying, selling or dealing in securities;
- (b) shall pay the fees;

- (c) shall take adequate steps for the redressal of grievances of the investors, within one month of the date of the receipt of their complaint and keep the SEBI informed about the number, nature and other particulars of the complaints received; and
- (d) shall obtain prior permission from the SEBI to trade in securities in case of any change in the status and constitution.

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SEBI: Stockbrokers and Sub-Brokers Regulations, 1992

The stockbrokers and sub-brokers regulations were issued by the SEBI through a notification on 23 October 1992 with the prior approval of the Central government.

The regulations specify the procedure for registration of stockbrokers and sub-brokers. The total number of registered brokers was 9,192 as on 31 March 2000; and sub-brokers, 5,657.

Registration of Stockbrokers

The application for the grant of a certificate has to be made in Form A through the stock exchange, of which he is a member. The application must be forwarded by the exchange, within 30 days to the SEBI. The SEBI may require the applicant to furnish further information or clarification regarding the dealings in the securities and matters connected. The SEBI may also require personal representation.

While considering the application, the SEBI takes into account all matters relating to buying, selling or dealing in securities. It also takes into consideration the fact, whether the stockbroker is eligible to be admitted as a member of the stock exchange, has the necessary infrastructure like adequate office space, equipment and workforce effectively discharge his activities, past experience in securities business and is subjected to any disciplinary proceedings under the rules, regulations and by-laws of the stock exchange with respect to his business as a stockbroker, involving himself or any of his partners, directors or employees. On being granted a certificate in Form D, the stockbroker has to abide by the code of conduct. The code of conduct lays down general rules, duty to the investors and towards dealing with the other stockbrokers.

General Rules

A stockbroker is expected to maintain high standards of integrity, promptitude and fairness in conducting his business. He is expected to exercise due skill, care, diligence and comply with statutory requirements and not indulge in manipulation and malpractices.

Duty to the Investor

A stockbroker shall execute orders at best available market price and not refuse to deal with small investors. He should promptly inform his clients about the

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execution or non-execution of an order and make payment for sale and delivery of the securities purchased. A contract note should be issued promptly. He is expected to maintain confidentiality about his clients' investments. Stockbrokers should not encourage sales or purchases of securities or furnish quotations, information and advice to earn brokerage and commission. Stockbrokers are not expected to deal with clients who are in default with other stockbrokers. Stockbrokers should also disclose to the clients as to whether he is acting as a principal or a broker and avoid conflicts of interest. Investment advice should not be given unless required on the basis of information given by the client about his financial situation, security holdings and investment objectives. Stockbrokers should render fair, prompt and competent services to their clients.

Duties towards other Stockbrokers

A stockbroker should cooperate with other brokers in comparing unmatched transactions, replacing documents, declaring bad delivery, protection of client's interests and settlement of transactions. A stockbroker should not advertise his business and induce through unfair means, clients from other brokers. Finally, a stockbroker should not neglect or fail or refuse to submit the required returns to the SEBI and stock exchange and not make false or misleading statements on any such returns.

Registration Fees

Every stockbroker shall pay a registration fee of ` 5,000 for each financial year, when the annual turnover does not exceed ` 1 crore; where the turnover exceeds ` 1 crore, during any financial year, ` 5,000 plus 1/100 or 1 per cent of the turnover in excess of ` 1 crore for each financial year. After the expiry of five years, from the date of initial registration, he shall pay a sum of ` 5,000 for a block of five years, commencing from the sixth financial year, after the grant of initial registration to keep his registration in the future.

General Obligations and Responsibilities

- (i) Every stockbroker should keep and maintain the following books of accounts, records and documents: (a) Register of transaction (Sauda Book); (b) clients, ledger; (c) general ledger; (d) journals; (e) cash book; (f) bank pass book; (g) documents, register of shares and securities received and delivered; (h) members contract book, showing details of all the contracts entered by him with the other members of the same exchange for counterfoils of duplicates, or memos of confirmation issued to such other members; (i) counterfoils or duplicates of contract notes issued to the clients; (j) written consent of the clients with respect to the contracts entered as principals; (k) margin deposit book; (l) register of accounts of sub-brokers, and, (m) an agreement with the sub-broker specifying the scope of authority and responsibilities of stockbrokers and each sub-broker.

- (ii) The stockbroker should inform the SEBI, the place where the books of accounts, records and documents are maintained and kept.
- (iii) Stockbrokers should furnish with the SEBI after the closure of each accounting period a copy of the audit report, balance sheet and profit and loss accounts. The books of accounts, records and documents should be preserved for a period of five years.

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Inspection of Accounts, Records and Documents by SEBI

Inspection of accounts, records and documents may be undertaken by the SEBI to ensure that they are maintained in the manner required, and provisions of the SEBI Act, rules and regulations and the SE(R) Act and the rules made thereunder are complied with, investigation into the complaints received from the investors, other stockbrokers, sub-brokers or any person bearing on the activities of the stockbroker and investigate *suo moto* in the interest of securities business or investors' interest into the affairs of the stockbrokers. The SEBI can also appoint a qualified auditor to investigate into the books of account or affairs of the stockbroker.

The inspection may be undertaken after giving reasonable notice time or without notice, if the investors or public interest requires. The stockbroker has to cooperate by producing all the records and giving access to the premises. The SEBI communicates the findings of the inspection and gives the stockbroker an opportunity of being heard before any action is taken.

Default

A stockbroker who fails to comply with any of the conditions of the registration, contravenes any of the provisions of the SEBI Act, rules or regulations, contravenes the provisions of the SE(R) Act or the rules made thereunder, contravenes the rules, regulations of the stock exchange, is liable to suspension of registration after an enquiry for a specified period of cancellation of registration.

Registration of Sub-Brokers

An application in Form B for registration to the SEBI, accompanied by a recommendation letter from a stockbroker with whom he is affiliated, along with two references including one from the banker, should be submitted to the stock exchange of which the stockbroker, with whom he is to be affiliated, is a member. The stock exchange has to verify the information and certify that the applicant is eligible for registration. The stock exchange should forward the application within thirty days in the case of an individual. The applicant should be twenty-one years of age, should not be convicted of fraud or dishonesty and should have passed the 12th standard or an equivalent examination. If the SEBI is satisfied, the sub-broker is eligible for registration, a certificate in Form E is made and the stock exchange is informed.

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Fees

The sub-broker has to pay a fee of ₹ 1,000 for each financial year for an initial period of five years. After the expiry of five years, the sub-broker should pay a fee of ₹ 500 for each financial year, as long as the certificate remains in force.

The sub-broker should abide by the code of conduct. He should maintain high standards of integrity, promptitude and fairness in the conduct of investment business and act with due skill, care and diligence.

Duty to the Investor

With regard to the investor, the sub-broker should execute orders at the best market price and promptly finalize the transactions. Purchase or sale notes for all transactions entered by him with his clients, should be issued promptly. Scrip-wise split purchase or sale notes and, similarly, bills and receipts showing brokerage separately have to be issued. He can split the contract notes issued by the affiliated brokers client-wise or scrip-wise into different denominations. A sub-broker should not match the purchase and sale orders of his clients. They should be routed through the member broker with whom the sub-broker is affiliated.

He should not commit breach of trust by disclosing confidential information about his clients. He should not encourage sales or purchases to earn brokerage and commission. A sub-broker is not expected to deal with defaulting clients. He should disclose to his clients that he is acting as an agent and should avoid conflicts of interest. Investment advice should not be given, unless found suitable on the basis of information given by the client about his financial situation, security holdings and investment objectives. Sub-brokers should render fair, prompt and competent services to their clients.

Duties towards Stockbrokers

A sub-broker should cooperate with his broker in comparing unmatched transactions, replacing documents declared as bad deliveries, protecting clients' interests and settlement of his transactions with his broker. A legal agreement specifying the rights and obligations of the sub-broker and the principal broker should be executed. A sub-broker should not advertise his business and induce through unfair means, clients from other brokers. Finally, a sub-broker shall not neglect or fail or refuse to submit the returns to the SEBI or the stock exchange and not make false or misleading statements on any such returns.

Check Your Progress

4. Who does the SEBI board consist of?
5. When was the Capital Issues (Control) Act repealed?
6. How does SEBI classify companies issuing shares?

9.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The money or credit market is the centre for dealings in monetary assets of short-term nature generally below one year.
2. With a view to protect investors' interest and orderly development of the capital market, Securities and Exchange Board of India (SEBI) regulates the capital market and intermediaries.
3. Finance firms such as commercial banks provide loans, business inventory financing and indirect consumer loans.
4. The SEBI board consists of a Chairman, two members from the Government of India, the ministries of Law and Finance, one member from the RBI and two other members.
5. The Capital Issues (Control) Act, 1947 which controlled the issue of capital was repealed on 29 May 1992.
6. The guidelines classify companies issuing shares on the basis of (a) number of years in commercial production, (b) track record and (c) nature and background of the promoter/entrepreneur/companies.

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9.5 SUMMARY

- The financial system consists of the money market and the capital market as found elsewhere in the world.
- The money or credit market is the centre for dealings in monetary assets of short-term nature generally below one year.
- The money market has organized and unorganized components. The organized credit market is dominated by commercial banks. The other major players are the Reserve Bank of India, Life Insurance Corporation, General Insurance Corporation, Unit Trust of India, Securities Trading Corporation of India Ltd and Discount and Finance House of India.
- The capital market consists of primary and secondary markets. The primary market deals with the issue of new instruments by the corporate sector such as equity shares, preference shares and debentures.
- The secondary market consists of 23 stock exchanges, including the National Stock Exchange, the Over-the-counter Exchange of India (OTCEI) and Interconnected Stock Exchange of India Ltd (ISEIL) where existing instruments including negotiable debts are traded.
- A perfect capital market is only a concept, a benchmark for evaluating the operations of a capital market which has no taxes, transaction costs,

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regulations, has perfectly divisible assets, existence of a number of buyers or sellers and free access to information.

- Finance firms such as commercial banks provide loans, business inventory financing and indirect consumer loans. These organizations get their funds by issuing bonds and other obligations.
- The functions of financial institutions, such as stock exchanges, commodity markets, futures, currency, and options exchanges encompass creating and providing ownership for financial claims, being responsible for maintaining liquidity in the market and managing price change risks.
- The Securities and Exchange Board Act of 1992 provides for the establishment of a board to protect the interests of investors in securities and to promote the development and regulation of the securities market.
- SEBI guidelines stipulate that the subscription list for public issues should be kept open for three working days and it should be mentioned in the prospectus.
- Firm allotment is allowed by the SEBI through a circular (11 October 1993) to four categories of investors namely Foreign Institutional Investors (FII) (including NRI and OCB), development Financial Institutions (FIs), Indian Mutual Funds and Permanent Regular Employees of the issue company.
- The guidelines for capital issues, issued by the Securities and Exchange Board of India in June 1992, have opened the capital market to free pricing of issues.
- Inspection of accounts, records and documents may be undertaken by the SEBI to ensure that they are maintained in the manner required, and provisions of the SEBI Act, rules and regulations and the SE(R) Act and the rules made thereunder are complied with, investigation into the complaints received from the investors, other stockbrokers, sub-brokers or any person bearing on the activities of the stockbroker and investigate *suo moto* in the interest of securities business or investors' interest into the affairs of the stockbrokers.

9.6 KEY WORDS

- **Capital Market:** It is the part of a financial system concerned with raising capital by dealing in shares, bonds, and other long-term investments.
- **Money Market:** It refers to a section of the financial market where financial instruments with high liquidity and short-term maturities are traded.
- **Perfect Capital Market:** It is a market in which there are never any arbitrage opportunities.
- **SEBI:** It is the most important regulatory body of the securities market in the Republic of India.

9.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the instruments of the money market?
2. What does the capital market consist of?
3. Write a short-note on perfect capital markets.

Long Answer Questions

1. Describe the functions of the money market.
2. Examine the objectives and functions of the Securities and Exchange Board of India.

9.8 FURTHER READINGS

- Datt, R.K.P.M. Sundaram. 2001. *Indian Economy*. New Delhi: S. Chand & Company Ltd.
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UNIT 10 PUBLIC FINANCE

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Structure

- 10.0 Introduction
- 10.1 Objectives
- 10.2 Public Debt
- 10.3 Fiscal Deficit
- 10.4 Review of Monetary Policy of RBI
- 10.5 Centre and State Financial Relations
- 10.6 Answers to Check Your Progress Questions
- 10.7 Summary
- 10.8 Key Words
- 10.9 Self Assessment Questions and Exercises
- 10.10 Further Readings

10.0 INTRODUCTION

Public finance studies the role of the government in the economy. It is the definitive branch of economics which assesses the government revenue and government expenditure of the public authorities and the adjustment of one or the other to achieve desirable effects and avoid undesirable ones. Public finance is a subject which has the distinction of intimate interaction between theory and practice. As such it acquires a meaning and usefulness only in the context of institutional framework of the economy with reference to which it is being studied. The theoretical concepts and policy applications in public finance feed upon and grow out of each other. No single theoretical model can adequately fit in the framework of every economy since its institutional framework is a thing unique to itself. It is important, therefore, that the discussion of public finance should be in the context of a single economy.

Recent years have witnessed a heated debate on several theoretical and policy issues covering several segments of public finance, including the role of fiscal policy. Pleas are being made for a thorough restructuring of its various theoretical and policy premises and the framework within which these should be conducted. Exponential growth and transformation in global financial system and worldwide meltdown caused by it have fuelled rethinking on the role of fiscal policy with special focus on economic stability and growth—both in developed and developing countries. India, like the rest of the world, has also been deeply affected by these developments. This unit discusses different issues in public finance such as public debt, fiscal deficit, centre-state relations and the RBI monetary policy.

10.1 OBJECTIVES

After going through this unit, you will be able to:

- Differentiate between public debt and private debt
- Describe the recent trends in public debt in India
- Describe the monetary policy of the RBI in the pre and post reform period
- Examine centre-state relations in terms of federal finance

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10.2 PUBLIC DEBT

The government of a country finances its expenditure from its income. The income of the government consists of what is called public revenue and public debt. In its wider sense, the term 'public revenue' includes all kinds of income. Consequently, it includes also the money that a government borrows. The amount borrowed by the government during any given year constitutes the income of that year. However, since debt has to be repaid to the creditors from whom it is borrowed, it does not constitute the income of the government from the point of the view of the long period. Thus, the main difference between the two is that public revenue consists of the money revenue or income which the government is not obliged to return to the people from whom it is obtained while public debt carries with it the obligation on the part of the government to repay the loan amount together with interest to the creditors from whom it has been borrowed.

Thus, in a broad sense, public debt may be called 'revenue' of the state. Just as the taxes levied and collected in any given year constitute the income of the government, in the same way loans raised or debt incurred and received in that year also constitute the income of the government of that year. However, the vital difference between the public debt and the other traditional sources of public revenue (taxes, fees, etc.) is that while the former has to be repaid with interest, the latter are not. Taxes are collected from the public without any promise or commitment on the part of the government to provide the taxpayers any service, much less the commitment of paying them back to the taxpayers, but public loans or debt are taken by the government from the banks, institutions and individuals on the explicit understanding given in writing that these shall be repaid on maturity while interest shall be paid regularly, half-yearly or yearly as stipulated in the loan agreement.

The necessity of repaying the loans and various consequences of the different methods of redeeming a loan necessitate a separate study of the subject of public debt.

Differences between Private Debt and Public Debt

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In the matter of public borrowing, the government is placed in almost a similar position as is a private borrower. The relationship between the government and the holders of the government bonds is the same as that between a private borrower and a private lender. The government is barely a government in all its characteristics in such transactions. Like a private borrower, the government may also borrow either for unproductive consumption or for investment purposes. The government will also have to pay interest on such borrowings. However, the dissimilarities between the two kinds of debt are quite glaring. The following are the main differences between the private and public debt:

- In times of emergency, like war or economic crisis, the state may force the people and/or institutions in the country to lend funds to it. No private individual or institution can, however, force or compel the other private individuals or institutions to lend.
- In the abnormal circumstances, the state can repudiate the payment of loans taken by it from the public while the private individual can under no circumstance refuse payment of loans to another private individual without inviting legal action. However, normally the state will only in very rare and exceptional circumstances take resort to repudiation of loan because such an act on its part will damage its prestige beyond repair.
- Public debt is generally spent for productive purposes whereas private debt may be spent both for productive as well as for unproductive purposes.
- The state usually repays public debt by taxing the people. The creditors also make their contribution to the extent they also pay taxes in this task of repayment of public debt. In other words, the burden of public debt is also borne by the creditors of the government. As against this, the burden of private debt is never borne by the creditors. In other words, we can say that a private person has to repay his/her debt either out of personal earnings or out of his/her accumulated assets or by borrowing from other sources. While the government can at least partially shift the burden of payment of public debt on the shoulders of the individual creditors in the country in the case of internally held debt.
- The state can unilaterally reduce the rate of interest payable on public loans but a private economic unit is not in a position to do so. Private borrowers have to pay the rate of interest which they have contracted to pay to the lenders.
- The government may take loans from the public for a very long period while a private person can get loans only for a relatively short period of time. In fact, the public debt may consist of government bonds which have infinite or no maturity period.

- The government may borrow both from the internal and external sources. In other words, it not only borrows from others; technically it can also borrow from itself. When the government covers the budget deficit through the printing of paper notes, it amounts to taking loans from itself. However, a private person can borrow only from external sources.
- The proceeds of public debt are generally spent to promote the welfare of the society, including the creditors. For instance, when the government spends the loan proceeds on development schemes, it benefits almost all the sections of the community. Even the creditors are also benefited through this developmental expenditure. On the other hand, the private debt is not spent in the interest of creditors because it is exclusively spent to finance the individual or private project.
- Being large in amount, public debt significantly affects the production and distribution of wealth and income in the country while a private debt, being small in amount, produces no such effects.
- Since the credit of the government is generally high, it can borrow at lower interest rates than is possible for the private individuals. We can trust a government more easily than a private individual because the government loan is perfectly credit-risk free.

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Causes for the Increase in Public Debt

The size of public debt has increased tremendously in modern times. There is hardly any government today which has not contracted loans both from abroad and in the country from its people. Following are the important causes for the extraordinary increase in public debt in modern times.

- 1. Abandonment of the *laissez-faire*, *laissez-passer* policy:** Modern governments have abandoned the policy of *laissez-faire* according to which they indulged in the minimum amount of economic activities in the community. The 19th century philosophy was that the government which governed the least and consequently spent the least was the best. Nowadays, governments actively participate in the economic affairs according to the requirements of the people. The present-day state is a welfare state. Consequently, it resorts to economic planning under which it undertakes the execution of several development projects in order to raise the living standards of people. In order to implement the economic plans it has to borrow funds frequently on a large scale from the public.

Thus, government takes recourse to public debt for development purposes. Even the governments in advanced countries' have to undertake mass scale construction of public works like roads, railways, irrigation works, power-houses, etc., for accelerating the economic growth of their countries. The less developed countries interested in the optimum utilization of their

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economic resources find public debt a very useful device to finance the various development projects.

- 2. Unpopularity of taxation:** People generally do not like to pay taxes to the government. Taxation, whether old or new, has always been unpopular with the public. The citizens generally oppose the imposition of new taxes and enhancement of the old rates of taxation. To get over this public opposition, the government adopts the easier method of resorting to public debt.
- 3. Facing natural calamities:** Sometimes, the government raises loans in order to face natural calamities, such as, floods, famines, earthquakes, etc. For example, in India, the government of Rajasthan has been spending a substantial amount on the famine relief works compelling it to draw a large overdraft on the Reserve Bank of India. Such cases of natural calamities lead to a sudden spurt in the government expenditure. Thus, the government would be committed to incur a much larger expenditure and would, therefore, run into a sizeable public debt.
- 4. Waging of wars:** When a country is engaged in war, it has to borrow heavily from the public. Modern warfare is so costly that the normal income of the state raised through taxation falls substantially short of the actual war expenditure. Besides, taxation beyond certain limits has disastrous consequences on production, and thus interferes with the most important objective during a war, namely, the winning of war. Moreover, a public loan is a better and easier method of collecting revenue than taxation. Governments, therefore, borrow extensively from individuals and institutions toward war financing.
- 5. Covering of temporary budget deficit:** Sometimes, the government does not consider it appropriate to meet its budget deficit by resorting to additional taxation. In such a situation, the government resorts to temporary borrowing from public.
- 6. Fighting the depression:** During the great depression of the 1930s, the long-practised traditional monetary techniques of raising the economy from the depth of depression failed. Fiscal policy was then devised as a way out to deal with the problem. Depression does not mean that the public has no money to spend. Money is there but due to lack of entrepreneurship, the money remains unutilized. Profit expectations being low, nobody is willing to invest his money. At such a juncture, the government can utilize this money by raising borrowings from the public and utilize these borrowings on its own to raise the level of aggregate effective demand in the economy. On the other hand, the private enterprise may be willing but not able to enhance production and thereby to raise output and employment due to lack of funds. At such times, the government may borrow from the banks and release the borrowed funds often supplementing the private enterprise. Either by

ensuring circulation of new money or by activating the idle resources in the economy by raising loans, the government may be able to lift the depressed economy and place it on the road to recovery and lead to prosperity.

- 7. Controlling inflation:** By raising public debt, the government can withdraw a large amount of money from the public and prevent prices from rising. Since the monetary policy of the central bank alone has not been very successful, fiscal policy of which the public debt constitutes an important part, has been attaining greater importance ever since World War I.
- 8. Financing economic development:** An underdeveloped country is always faced with the shortage of funds. Taxation is resented if it is heavily imposed on the people because the taxable capacity of the people is low. However, the need for finance is imperative in order to take the economy out of the vicious circle of poverty. In such a situation, public loans are the only way out for the government.

Recent Trends in Public Debt

There is no doubt that public debt in India has grown rather rapidly since 1980s. During the 1980s the combined debt of the central government and the state government grew at the rate of 18% per annum, as against the GDP growth rate of 14% (both at current prices). As a result the public debt to GDP ratio increased from 50% in 1980-81 to 75% in 1990-1991. During this period i.e. 1980-90, increase in internal debt was faster than external public debt. Between 1980-81 and 1990-91, the internal debt as percent of GDP grew from 22.7% to 28.8% whereas the external debt as percent of GDP declined from 8.3% to 5.9%. Then 1990-91 onwards internal debt as percent of GDP started falling till 1997-98 and reached 25.7%, thereafter it increased to its highest level of 41.4% in 2003-04 and again it started falling to reach 36.4% in 2009-10. As a result of the concerted efforts to restore fiscal balance through tax reforms, expenditure management, institutional reforms and financial sector reforms in the first half of the 1990s, there was significant reduction in the magnitude of fiscal deficit and the proportion of debt relative to GDP during the period 1991 to 1997. However, during the period 1997 to 2003, there was a reversal in the trend of fiscal consolidation, and the cumulative impact of industrial slowdown, fifth pay commission award, and a lower than expected revenue buoyancy culminated in fiscal deterioration. On the other hand if we see the trend in the external debt as a percent GDP, it has declined throughout the last three decades and reached to its minimum of 1.7% in the year 2003-04. This shows that the share of internal public debt in the total public debt has increased compared to external public debt throughout the last three decades. Although the share of external public debt in the total public debt has decline, it is still a major cause of concern for the increasing public debt as the pressure created by the debt service on balance of payment with respect to a countries' external public debt account leads to decline in the foreign exchange reserves of the country. The total external public debt of the country grew from ₹ 11,298 crore in 80-81 to

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₹ 1,34,083 crore in 2009-10. As far as internal debt is concerned, the central government's outstanding internal debt rose from ₹ 30,864 crore in 1980-81 to ₹ 23,49,148 crore in 2009-10. The interest payment on the public debt is the major component of government's non-plan expenditure and during the last three decades interest payment on internal as well as external debt as a proportion of GDP has increased from 1.9% in 1980-81 to 3.3% in 2009-10. The gross interest obligations with respect to the centre's internal debt have become rather high during the course of the last three decades.

Check Your Progress

1. What is public revenue?
2. What is the vital difference between public debt and other traditional sources of public revenue?

10.3 FISCAL DEFICIT

A fiscal deficit occurs when a government's total expenditures exceed the revenue that it generates, excluding money from borrowings. Deficit differs from debt, which is an accumulation of yearly deficits. Some regard a fiscal deficit as a positive since it helps nations come out of recession. Others believe that a government should avoid deficits in favour of a balanced budget policy.

Let us discuss different concepts related to the fiscal deficit. The following break-up of GOI budget enables us to define (and therefore estimate) a few concepts of deficit, namely:

- Deficit on Revenue Account (RD)
- Deficit on Capital Account (CD)
- Budgetary Deficit (BD)
- Fiscal Deficit (or Gross Fiscal Deficit) (FD) or (GFD)
- Net Fiscal Deficit (NFD)
- Primary Deficit (PD) or (GPD)
- Net Primary Deficit (NPD)

1. Deficit on Revenue Account (RD)

The excess of expenditure on revenue account over receipts on revenue account measures Revenue Deficit. From Table 10.1, it would be:

$$\text{Item IV} - \text{Item I}$$

Table 10.1 Alternative Measures of Deficit

Public Finance

(` in crores)

	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
1	2	3	4	5	6	7
I. Revenue Receipts	4,34,387	5,41,864	5,40,259	5,72,811	7,83,833	7,89,892
(a) Tax Revenue (net)	3,51,182	4,39,547	4,43,319	4,56,536	5,63,685	6,64,457
(b) Non-tax Revenue	83,205	1,02,317	96,940	1,16,275	2,20,149	1,25,435
(i) Interest	22,524	21,060	20,717	21,756	19,728	19,578
(ii) Non-interest	58,151	78,534	73,429	91,378	1,97,665	1,03,684
(iii) Grants	2,530	2,723	2,794	3,141	2,756	2,173
II. Capital Receipts	1,44,482	1,97,978	2,99,863	4,53,063	4,47,743	4,47,836
(a) Recoveries	5,893	5,100	6,139	8,613	9,001	15,920
(b) Borrowings, other than 91-day <i>ad hoc</i> Tr. Bills	1,24,096	1,33,678	2,51,384	4,38,774	4,05,459	3,90,782
(c) Other Capital Receipts (net)	13,959	20,405	41,774	-18,905	10,539	1,134
(d) Sale of Public Assets	534	38,795	566	24,581	22,744	40,000
III. Total Receipts	5,78,869	7,39,842	8,39,935	10,25,883	12,30,576	12,37,728
IV. Expenditure on Revenue A/c	5,14,609	5,94,433	7,93,798	9,11,809	10,53,678	10,97,162
(a) Interest Payments	1,50,272	1,71,030	1,92,204	2,13,093	2,40,757	2,67,986
(b) Non-interest Expenditure	3,64,337	4,23,403	6,01,594	6,98,716	8,12,921	8,29,176
V. Expenditure on Capital A/c	68,778	1,18,238	90,158	1,12,678	1,62,898	1,60,567
(a) Loans and Advances	8,542	-1,220	12,663	16,116	42,515	28,640
(b) Capital Outlay	60,236	1,19,458	77,495	96,562	1,20,383	1,31,927
VI. Total Expenditure	5,83,387	7,12,671	8,83,956	10,24,487	12,16,576	12,57,729
VII. Borrowings through 91-day <i>Ad hoc</i> T. Bills and Drawing						
Down of Cash Balances	4,517	-27,171	43,834	-1,386	-15,000	20,000
1. Revenue Deficit (IV - I)	80,222	52,569	2,53,539	3,38,998	2,69,844	3,07,270
2. Deficit on Capital A/c (V - II)						
	(-75,704)	(-79,740)	(-2,09,705)	(-3,40,385)	(-2,84,845)	(-2,87,269)
3. Budgetary Deficit (VI - III)						
= VII = (row 1 + row 2)	4,517	(-27,171)	43,834	(-1,386)	-15,000	20,000
4. Fiscal Deficit [VI - {I + II(a) + II(d)}] = II(b) + II(c) + VII						
	1,42,572	1,26,912	3,36,992	4,18,483	4,00,998	4,11,916
5. Net Fiscal Deficit [FD - V(a)]	1,34,030	1,28,132	3,24,329	4,02,367	3,58,483	3,83,276

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6. Primary Deficit							
(a) FD – IV(a) + I(b)(i)	14,824	23,058	1,65,505	2,27,146	1,79,969	1,63,508	
(b) FD – IV(a) – 7,700	–44,118	1,44,788	2,05,390	1,60,241	1,43,930		
7. Net Primary Deficit [PD – V(a)]							
(a) FD – IV(a) + I(b)(i) – V(a)							
	6,282	21,838	1,52,842	2,11,030	1,37,454	1,34,868	
(b) FD – IV(a) – V(a)							
	–1,62,420	–42,898	1,32,125	1,89,274	1,17,726	1,15,290	

Receipts on revenue account include both tax and non-tax revenue as also grants. Tax revenue is net of states' share as also net of 'Assignment of UT Taxes to Local Bodies'. Note that receipts of UT taxes normally exceed the assignments, and the excess forms part of the Receipts on Revenue Account. Non-tax revenue includes interest receipts, dividends and profits, and non-tax revenue receipts of UTs. Grants include grants from abroad also.

Expenditure on revenue account includes both Plan and Non-Plan components. Thus, the Plan component includes Central Plan and Central Assistance for state and UT Plans. Non-Plan expenditure includes interest payments, defence expenditure on revenue account, subsidies, debt relief to farmers, postal deficit, police, pensions, other general services, social services, economic services, non-Plan revenue grants to States and UTs, expenditure of UTs without legislature, and grants to foreign governments.

2. Deficit on Capital Account (CD)

The excess of capital disbursements over capital receipts measures the Capital Deficit. Plan capital disbursements include those on Central Plan and Assistance for state and UT plans. Non-Plan capital disbursements include defence expenditure on capital account; other non-Plan capital outlay; loans to public enterprises, states and UT Governments, foreign governments and others; and non-Plan capital expenditure of UTs without legislature. The item of capital receipts has already been discussed above. It would be recalled that this item includes 'recoveries' of loans extended by the Centre itself, but only 'net' receipts of loans raised by it. From Table 10.1, we have:

$$CD = \text{Item V} - \text{Item II}$$

Note that receipts on account of sale of 91-day *ad hoc* treasury bills and drawing down of cash balances do not form a part of capital receipts. However, net receipts on account of sale of remaining varieties of treasury bills and sales proceeds of Government assets are included in capital receipts.

3. Budgetary Deficit (BD)

It is the sum total of RD and CD. From Table 10.1,

$$BD = (IV - I) + (V - II) = (IV + V) - (I + II) = VI - III$$

Note that BD is also exactly equal to item VII, that is, it is that portion of Government expenditure which is financed through the sale of 91-day *ad hoc* treasury bills and drawing down of cash balances.

It should be noted that in economic literature, and to a certain extent by international institutions, the term Budgetary Deficit is used to represent 'Fiscal Deficit' (FD) discussed below. FD is a wider concept while BD, as used in Indian official documents, is a narrower concept.

What is the justification for having a definition of BD which is at variance with its internationally accepted version? Officially, this justification is derived from the argument that budgetary deficit should not measure just a transfer of purchasing power from the private to the public sector. Instead, it should measure a net addition in 'high-powered money' (H) which, in turn, causes an increase in aggregate purchasing power in the hands of the economy. It should, therefore, reflect the expected effect of government expenditure in the form of an aggregate demand and inflationary pressure in the country. However, the measure of BD, as adopted in India, does not meet this criterion. It is because borrowings taken from RBI (except through the sale of 91-day *ad hoc* treasury bills) are excluded from it even when, in effect, such borrowings also add to the supply of money and credit in the economy.

It may be noted in passing that high-powered money is currency in the hands of the public and cash balances of banks including their balances with the RBI.

4. Fiscal Deficit (FD)

Fiscal deficit may also be called Gross Fiscal Deficit (GFD). It measures that portion of Government expenditure which is financed by borrowings (that is, *all borrowings including those through 91-day ad hoc treasury bills*) and drawing down of cash balances. It should be noted that in India, borrowings are net amounts (that is, gross borrowings *less* repayments). Similarly, loans extended by GOI are included on the expenditure side of capital account while 'recoveries' are included on the receipts side. Therefore, the amount of loans and advances by GOI is also reduced to a net figure. From Table 10.1,

$$\begin{aligned} \text{FD} &= [\text{VI} - \{\text{I} + \text{II(a)} + \text{II(d)}\}] \\ &= \text{II(b)} + \text{II(c)} + \text{VII} \end{aligned}$$

In other words, FD is (Total Expenditure *less* [Revenue Receipts plus Recoveries plus Sale of Public Assets]). It is also equal to the sum of three items, namely, (i) borrowings, other than through 91-day *ad hoc* treasury bills, (ii) sale of public assets, and (iii) BD.

It is often stated that FD measures an addition to the liabilities of GOI (whether backed by acquisition of some assets or not). This we should remember, is true only if the item 'drawing down of cash balances' is zero. Mostly, it is a small

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item and, therefore, by and large, the above-mentioned statement may be accepted in practical decision-making.

5. Net Fiscal Deficit (NFD)

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This measure of deficit is obtained when FD is reduced by ‘Loans and Advances’ component [V(a) of ‘Expenditure on Capital Account’]. In other words, this measure considers the fact that some payments by the Government are not part of ‘spending away’, but for acquisition of assets. However, this reasoning is not carried to its logical conclusion. While assets acquired through giving loans to others are accounted for, those acquired through ‘capital outlay’ [a part of item V(b)] are ignored.

6. Primary Deficit (PD)

This measure is also referred to as Gross Primary Deficit (GPD). Measures of deficit described above (except CD) include payments and receipts of interest. These transactions, however, reflect a consequence of past actions of the government, namely, loans taken and given in years prior to the one under consideration. Exclusion of interest transactions, therefore, enables us to see the way the government is *currently* conducting its financial affairs. Accordingly, PD is defined as

FD *less net* interest payments, (that is, *less* interest payments *plus* interest receipts), so that

$$\begin{aligned} \text{PD} &= \text{FD} - [\text{IV(a)} - \text{I(b)(i)}] \\ &= \text{FD} - \text{IV(a)} + \text{I(b)(i)} \end{aligned} \quad (\text{a})$$

However, in GOI budgetary documents, interest receipts [item I(b)(i)] are ignored so as to get a *smaller* measure of PD.

That is,

$$\text{PD} = \text{FD} - \text{IV(a)} \quad (\text{b})$$

7. Net Primary Deficit (NPD)

This measure of deficit is obtained by subtracting ‘Loans and Advances’ [Item V(a)] from Net Fiscal Deficit. It is also equal to FD *less* interest payments *plus* interest receipts *less* loans and advances. Thus,

$$\text{NPD} = \text{PD} - \text{V} \quad (\text{a})$$

Note that corresponding to two measures of PD, we get two measures of NPD, so that

$$\text{NPD} = \text{FD} - \text{IV(a)} + \text{I(b)(i)} - \text{V(a)} \quad (\text{a})$$

and

$$\text{NPD} = \text{FD} - \text{IV(a)} - \text{V(a)} \quad (\text{b})$$

This brings us to those concepts of deficit which cannot be estimated from the information given in Table 10.1 and has to be made available by the government directly.

8. Monetised Deficit (MD)

Monetised deficit is defined as an increase in net RBI credit to Central government. The rationale for this measure of deficit flows from the inflationary impact which a budgetary deficit exerts on the economy. Our Budgetary Deficit (BD) discussed above is not able to meet this test. The Chakravarty Committee recommended that in addition to existing measure of BD (namely, borrowings through 91-day *ad hoc* treasury bills and drawing down of cash balances), it should include **all** other borrowings from the RBI by the government. Since borrowings from RBI directly add to high-powered money, therefore, this measure is termed Monetised Deficit. It is obvious that **MD is only a part of FD**. Also it should be noted that even MD is not a perfect measure of the inflationary impact of the budget. Loans from banking sector also add to the liquidity and inflationary forces in the economy.

9. Public Sector Borrowing Requirements (PSBR)

It may be termed consolidated Public Sector Deficit, and represents net claims on (that is *net use of*) the resources of the economy by the entire public sector. It is the most comprehensive measure of deficit and covers all government entities.

In brief, $PSBR = (\text{Total Expenditure} - \text{Revenue Receipts})$ for all government entities. It also equals their (New Borrowings *less* Repayments *less* Drawing Down of Cash Balances).

Note that, here, the term ‘expenditure’ includes wages of public employees, expenditure on goods and services, fixed capital formation, interest on debt, transfer payments and subsidies. However, it **excludes** amortization payments on government debt and accumulation of financial assets. Similarly, revenue includes taxes, fees, fines, rates, user charges, interest on public assets, transfers, operating surplus of public enterprises and sale of public assets. It, however, excludes drawing down of cash balances.

This measure raises the problem as to which economic units should be counted as part of the government sector. Also it is not a measure of the resource cost of the economy which includes the repercussive effects including that of inflation.

10. Structural Deficit (SD)

When the borrowing requirements of the public sector (PSBR) is adjusted (that is, reduced) for occasional or temporary measures for reducing deficit and raising resources, it is termed Structural Deficit (SD). It is a measure of deficit which is expected to persist unless *long term corrective measures* are adopted by the authorities. For example, if the government raises resources by ‘sale of government

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assets' and through 'amnesty schemes', PSBR should be adjusted for (reduced by) these amounts to arrive at SD.

11. Operational Deficit (OD)

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PSBR adjusted (that is, reduced) for inflationary price rise gives us Operational Deficit (OD). Obviously, for arriving at OD, choice of an appropriate price index is of great relevance. However, it is very difficult to select an ideal price index. Another problem arises from the fact that while indirect taxes add to the revenue receipts of the government, they are also inflationary in nature. Similarly, many PSUs included in the estimation of PSBR may resort to raising of user charges. This act simultaneously adds to both the revenue of the government sector and the inflationary forces, and thereby clouds the true significance of this measure of deficit.

Problems of Budget Deficit in India

Over the past 15 years, India's general government deficits have exceeded 5 per cent in every year except in 2007–08. After a successful consolidation between 2003 and 2008 under the Fiscal Responsibility and Budget Management Act, the deficit again widened during the global financial crisis. The Thirteenth Finance Commission laid out a consolidation plan in 2010 which aimed at reducing the deficit to 5½ per cent of GDP in five years. However, achieving this target has proved elusive. In 2012, new plans for consolidation were announced. These plans focused on lowering expenditure and on controlling the cost of India's fuel and fertilizer subsidies, but achieving long-run fiscal consolidation will be challenging.

The initial years of India's planned development strategy were characterized by a conservative fiscal policy whereby deficits were kept under control. The tax system was geared to transfer resources from the private sector to fund the large public sector driven industrialization process and also cover social welfare schemes. However, growth was anaemic and the system was prone to inefficiencies. In the 1980s, some attempts were made to reform particular sectors. But the public debt increased, as did the fiscal deficit. India's balance of payments crisis of 1991 led to economic liberalization. The reform of the tax system commenced. The fiscal deficit was brought under control. When the deficit and debt situation again threatened to go out of control in the early 2000s, fiscal discipline legislations were instituted. The deficit was brought under control and by 2007-08 a benign macro-fiscal situation with high growth and moderate inflation prevailed. During the global financial crisis fiscal policy responded with counter-cyclical measures including tax cuts and increases in expenditures. The post-crisis recovery of the Indian economy is witnessing a correction of the fiscal policy path towards a regime of prudence. In the future, the focus would probably be on bringing in new tax reforms and better targeting of social expenditures.

After a brief impact of the global economic slowdown in 2008-09, Indian economy recovered quickly recording 8.4 per cent GDP growth in 2009-10 and 9.3 per cent GDP growth in 2010-11. The recovery, however, was short lived as growth rate slowed down substantially in the following year, 2011-12 to 6.2 per cent. Fiscal expansionary response which continued since 2008-09 to arrest the growth decline resulted in high fiscal deficits. The continued Euro Zone crisis and gloomy economic trends in major economies contributed adversely, impacting India's exports negatively. This along with the elevated levels of crude prices and high levels of gold imports led to the widening of trade gap and Current Account Deficit. Macroeconomic analysis of India during the years 2010-11 and 2011-12, therefore, showed a trend of rising current account deficit, sticky inflation, falling savings rates, falling investments and even consumption. The uncertainty in global economy along with the monetary policy tightening measures led to a perceptible negative impact on economic growth. As a result of these factors, the growth is estimated to come down to a decade low of 5 per cent of GDP, as per Central Statistics Office's (CSO) advance estimates. Last time sub 6 per cent growth was seen in 2002-03, when the growth in GDP was registered at 4 per cent.

The widening trade gap, falling investment and difficult economic situation, both domestically and abroad, have added to the negative outlook on the Indian economy. The rigid inflationary conditions and consequent tightening measures on monetary policy along with negative sentiment on investments and savings have had a deep impact on industrial growth. Discouraging trends in economic growth called for immediate corrective measures and appropriate policy response. Public debate centred around the fact that high fiscal deficit tends to heighten inflation, reduces room for monetary policy actions, and dampens private investment. The sustained high levels of fiscal deficit though required as a countercyclical measure to spur growth, has also caused diverse forms of macroeconomic imbalances, which could not be overlooked and immediate corrective measures were called for to contain the likely growth in fiscal deficit during 2012-13 and onwards.

Mid-year course correction with suitable policy response became imminent in the emerging scenario. Fiscal consolidation by way of regulating deficits and cutting expenditure to create positive business environment was immediate need of the hour. Government accordingly appointed Kelkar Committee in August 2012 to suggest 'Roadmap for Fiscal Consolidation' within one month's time period. Kelkar Committee held series of meetings with Ministry of Finance, concerned line ministries and Planning Commission to finalize its report within the given timeframe. Deliberating on various issues facing the economy, Kelkar committee suggested a slew of measures to contain the rising trend of fiscal deficit. The committee observed that deficit financing through domestic sources tends to be inflationary. At the same time, twin deficits hypothesis implies that, given a certain level of private savings, an increase in fiscal deficit will have to be balanced by either a reduction in private investment or an increase in the current account deficit. The Indian economy has been witnessing both.

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The fiscal stress in the ‘do-nothing’ scenario as per Kelkar Committee report was fast approaching unsustainable levels. On revenue side, slower pace of economic growth implied shortfall in both direct taxes—both corporation and income tax—due to lower profits and incomes. Similarly, slower pace of economic growth meant shortfall on custom duty, being directly linked to imports and excise duty due to slower pace growth in production. Another matter of concern related to expected shortfall in Non-tax revenue by at least ` 30,000 crore on account of lower realization from 2G spectrum following court litigation and poor response to auctions. It was estimated by the Committee that the revenue collections in the current year, Tax and Non-tax put together will take a hit by at least ` 60,000 crore from the budgeted targets in BE 2012-13. Similarly, international crude prices remained at high levels in the range of US \$ 110 to 115 per barrel peaking to above US \$ 120 per barrel for some time. As India imports bulk of its crude requirements and the pricing of petroleum products by oil marketing companies for the purpose of calculating under-recoveries are benchmarked to the international prices, there was a significant increase in the estimated under-recovery of Oil Marketing Companies (OMCs). In tandem with high crude price, prices of most of the petroleum products in the international market went up sharply, and fertilizer bill ballooned due to rising Urea prices. Therefore, it was estimated that the subsidy expenditure would rise by about ` 70,000 crore. Accordingly, it was estimated that unless immediate corrective measures are taken the deficit will be well above 6.1 per cent of GDP.

The net effect would be ‘crowding-out’ of private sector financing for investment due to large gross borrowing requirement. In an extremely fragile world market financing of this magnitude would be creating huge risks for macroeconomic and external stability. Against this scenario and aided by Kelkar Committee recommendations, government undertook the task of meeting the challenge. As a first credible step towards fiscal consolidation, the fiscal deficit target was revised from 5.1 per cent to 5.3 per cent for the current year. As per the roadmap of fiscal consolidation laid down by the government, the fiscal deficit in 2013-14 has been projected at 4.8 per cent, to be reduced by 0.6 per cent every year to achieve 3.0 per cent target by the end of the plan period, viz. 2016-17. In order to achieve the target for Disinvestment, committee of secretaries was constituted in the Ministry of Finance. Similarly, efforts were made to mop up revenues both tax and non-tax to contain the fiscal deficit within the projected targets. However, shortfall in the customs duty on indirect side and non-realization of targeted revenues from Spectrum sale on the Non-tax side had to be factored in.

The case of India illustrates the challenges of consolidating the fiscal position when growth is relatively strong. Fiscal vulnerabilities are masked by high growth. In the past years, the debt-to-GDP ratio has fallen as nominal output growth exceeded the pace of debt accumulation. However, several papers show that it is less costly to embark on fiscal adjustment in a supportive macroeconomic environment. Fiscal multipliers tend to be larger during downturns and fiscal

consolidation would involve disproportionately higher costs (see Corsetti et al., 2010; Baum et al., 2012; Baunsgaard et al., 2013; and Blanchard and Leigh, 2013). Therefore, consolidation during good times can help, as can engaging in simultaneous structural reforms. Delaying fiscal correction may lead to an increase of risk premiums as market sentiment deteriorates. High borrowing costs can crowd out important spending and derail growth. In the near term, there is an uncertainty about the trade-off between fiscal consolidation and growth. Therefore, a crucial question is how to achieve consolidation while minimizing the negative growth effects of raising revenues or controlling spending.

Check Your Progress

3. Why do some regard fiscal deficit as a positive?
4. How is the revenue deficit measured?
5. What is monetised deficit?

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10.4 REVIEW OF MONETARY POLICY OF RBI

The monetary policy pursued by the Reserve Bank of India during the past six decades clearly reveals the dynamic role which the Reserve Bank of India has played in the planned economic growth with stability of the economy. The monetary policy of the Reserve Bank has been marked by flexibility to suit the changing situation of the economy. The Reserve Bank of India has employed the instruments of general and selective credit control to contain the inflationary pressures which have haunted the economy during the planning era spanning well over five decades. The policy of selective credit restraint which generally dominated the scene was not, however, rigidly applied. In fact, in the midst of the restrictionist monetary policy, the Reserve Bank of India introduced the patches of effective credit liberalization where the circumstances warranted such liberalization from time to time. The financing of the priority sectors of the economy on a significant scale would never have been possible without the liberal refinance facilities provided by the Reserve Bank of India.

The experience of the operation of selective credit controls shows that while these control measures had largely succeeded in achieving their objective and had a salutary effect in regulating the flow of bank credit in favour of the concerned commodities and areas, these were at the same time subject to certain severe limitations, especially in the setting of an overall monetary expansion making it possible for the borrowers to take recourse to non-banking sources of finance. This underlines the necessity of maintaining harmony between the monetary and fiscal policies. Thus the Reserve Bank of India's monetary and credit policy, in its long-term aspect, continued basically to be tuned to the needs of planned economic development with preferential treatment to the special sectors, like the small scale industries, cooperatives, defence supplies and exports. In the short-term,

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adjustments in the cost and availability of credit were made from time to time to suit the requirements of the particular situations.

During the two decades of the post-economic reforms period, the most distinguishing feature of the Indian monetary policy has been its rapid transformation in style, structure and substance. During 1990–2010, the RBI had made sincere efforts to promote economic growth, control inflation and bring down the interest rates. During the two decades between 1991 and 2010, the prime lending rate declined by about nine percentage points, the cash reserve ratio (CRR) was slashed by a hefty 10 per cent, the statutory liquidity ratio (SLR) was reduced from 37.5 per cent to 25 per cent, the repo rate was reduced from 9 per cent to 4.75 per cent and the reverse repo rate was reduced from 6 per cent to 3.25 per cent; both these were, however, subsequently raised twice each time by 0.25 per cent taking them to 5.25 per cent and 3.75 per cent respectively while the bank rate was reduced 14 times by as much as six percentage points from 12 per cent to 6 per cent easing the overall liquidity in the system in order to accelerate the economic growth.

During the post-economic reforms period of two decades, the bank rate was reduced from the all-time high of 12 per cent on 9 October 1991 to 6 per cent on 29 April 2003 where it stands at present. The cash reserve ratio, on the other was reduced from 15 per cent to 5 per cent on 23 January 2009. As inflation raged the economy, the RBI in order to suck the excess liquidity from the system took frequent recourse to raise the cash reserve ratio. Consequently, the CRR had been raised in phases of 0.25 per cent each eight times from 5 per cent as on 11 September 2004 to 7 per cent on 4 August 2007; it had, however, been subsequently reduced to 6 per cent and has stayed at this rate. It was raised again until it reached the peak of 9 per cent on 30 August 2009. Thereafter, in pursuance of following the easy money policy, it was reduced in five steps from 9 per cent to 5 per cent. As if absorbing the excess liquidity from the system was not enough to control inflation, the RBI also made credit costlier by simultaneously raising the repo rate from 5 per cent as on 2 October 2004 to 7.75 per cent on 30 March 2007; it was subsequently raised to 9 per cent but was reduced in six steps eventually to 4.75 per cent. In short, in less than three years the repo rate was hiked by more than 50 per cent in seven steps of 25 basis points. During 2006–2007, in a single year it was raised five times.

The reduction in the cash reserve ratio from a hefty 15 per cent to the current rate of 6 per cent and in the bank rate from 12 per cent to 6 per cent in the post-economic reforms era has been an essential part of the financial reforms process. During this period, the bank rate had been reactivated, making it a reference rate to which refinance and deposit rates of banks were linked. The subsequent hike in the cash reserve ratio from 4.5 per cent on 14 June 2003 to 9 per cent on 8 August 2008 and to 5.75 per cent on 29 January 2010 and further to 6 per cent on 19 April 2010 has, however, made the RBI recede further from

its earlier declaration to bring down the cash reserve ratio to 3 per cent in the medium term.

Consequent upon these measures, the availability of liquidity in the system was substantially increased while it was also rendered cheaper through the reduction in the borrowing rates. During the post-economic reforms period, the selective credit control was also scrapped opening the floodgates of liberalization in RBI's monetary and credit policy. Several steps were also taken to deepen and broaden the money and capital markets as well as to strengthen the banking sector in the country.

The extent to which the central bank's monetary and credit policy can make its impact felt on the general price level depends on the extent of availability and the cost of obtaining funds from the alternative non-banking sources for hoarding purposes. In this context, the impact of the fiscal operations on the overall monetary expansion has to be borne in mind, especially in a period of large outlays on defence and development. It is, therefore, essential to ensure that both the fiscal and monetary policies act in such a way so as not to add to the pressure of aggregate monetary demand and thereby aggravate the imbalance between the overall demand and supply.

Moreover, in evaluating the overall success of the Reserve Bank of India's monetary policy, it should also be borne in mind that the Reserve Bank can at best—provided the fiscal operations of the government do not run counter to the set goals of the monetary policy pursued by the Reserve Bank of India—control only those forces which exert their pressure on the general price level from the monetary side. The Reserve Bank of India has nothing within its power to directly control the non-monetary factors which push up the general price level and cause instability in the economy. Consequently, the continuation of inflationary pressures in the economy in the face of pursuing a selective credit-squeeze monetary policy pursued by the Reserve Bank of India is not at all sufficient ground to infer the failure of the monetary policy of the Reserve Bank of India to contain inflation and promote economic growth in the economy.

Operating within the overall framework of a mixed economy wedded to development planning in a democratic system, the monetary policy of the Reserve Bank of India, despite its shortcomings, has operated with a fair amount of success. The Reserve Bank of India has played the useful role of an ever careful watchdog over the affairs of the money and banking system in the economy making the system play a productive role in the planned economic development of the country. The monetary policy pursued by the Reserve Bank of India over the period of six decades has kept on moving back and forth to facilitate planned growth of the economy.

The setting up of the Deposit Insurance and Credit Guarantee Corporation (DICGC), which started functioning in January 1962, constitutes an important

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landmark in the banking sphere in the country, in as much as in future, in periods of financial crises the banks will not be faced with the mad rush of frightened panicky depositors impatient to withdraw their money from the banks. With the establishment of the Industrial Development Bank of India (IDBI), the Regional Rural Banks (RRBs) and the National Bank for Agricultural and Rural Development (NABARD) through the initiative of the Reserve Bank of India, it has now become possible for it to extend the term credit for the planned industrial and agricultural development of the country. The establishment of the Small Industries Development Bank of India (SIDBI) has ensured that the development of the small and medium industries in the country will be simultaneously promoted along with that of the large industries. The Reserve Bank of India has succeeded in consolidating the banking system through arranging the mergers and amalgamations of the non-viable weak banking units with the strong ones to the advantage of all concerned. In short, the Reserve Bank of India has played and will continue to play the much-needed dynamic role of a true central bank in the country in every sense of the term.

10.5 CENTRE AND STATE FINANCIAL RELATIONS

Indian federal financial set up (including inter-governmental financial arrangements) has been prescribed in a great detail in our Constitution which came into force in 1950. Since then, the Constitutional provisions have undergone two further significant revisions. A brief description of these three stages is as follows.

Stage I

After independence, Indian Constitution came into existence in 1950. Its structure was closely patterned along the lines of the Government of India Act of 1935 which itself provided for a multi-layered (or multi-tiered) governmental set up for our country. The Constitution provided, on an obligatory basis, a two-tiered government, namely,

- (i) the Central (Federal/Union) Government (or Government of India) for the country as a whole; and
- (ii) the state level governments with their respective territorial jurisdictions. The states themselves were of three types, that is,
 - (a) Part A states, namely, pre-Independence British Provinces with Princely States merged with them;
 - (b) Part B states, formed by merging together groups of erstwhile Princely States; and
 - (c) Part C states, namely, erstwhile Chief Commissioner's Provinces.

The governmental structure at state level was restructured in 1956 as follows:

- (i) Part A and Part B states were renamed as 'states'; and
- (ii) Part C states were renamed as union territories.

It is noteworthy that in both Government of India Act, 1935 and our Constitution, it was not mandatory to have governments at sub-state/UT level. Even then, by using the enabling provisions, both the Centre and the states had constituted a variety of local bodies (LBs). The Centre had constituted Port Trusts and Cantonment Boards etc, while states had constituted, within their respective territorial jurisdictions, a variety of municipal bodies and assigned them functions and resources out of the State List.

The allocation of subjects and functions between the Centre and states was as per three Lists, namely, the Union List, the State List and the Concurrent List. There was no separate List for local bodies.

Stage II

The 73rd and 74th Constitutional Amendments in June 1993 initiated the next stage of Centre-state financial relations. With some exceptions, these Amendments make the creation of local bodies, with a pre-determined framework of the subjects to be handled by them, a constitutional obligation on the part of the states. The nomenclature of these bodies is indicative of the extent of urbanisation of the areas served by them. The subjects to be handled by these bodies are listed in Schedule XI and Schedule XII of the Constitution for rural and urban level bodies respectively. However, the Amendments do not provide for a separate allocation of resources for the local bodies. And, therefore, state governments transfer a part of their own resources to the local bodies within their respective territorial jurisdictions. In other words, it means the following.

- (a) A state may wholly assign some of its taxes, duties, tolls and fees to the local bodies.
- (b) It may share the revenue of some/all taxes, duties, tolls and fees with them.
- (c) It may give grants/loans to them.

In addition, the 73rd and 74th Constitutional Amendments also provided for each State to constitute a State Finance Commission every five years. The job of a SFC is to:

- study the financial position of the local bodies;
- recommend those principles on the basis of which the taxes, duties, tolls and fees are to be transferred to or shared with the local bodies are to be selected;
- recommend those principles on the basis of which the state should give grants to local bodies;
- recommend those principles on the basis of which the resources transferred from states to local bodies should be distributed between the latter;
- make recommendations for improving the financial position of the local bodies;

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- make recommendations on matters referred to it by the governor in the interest of sound finance of the local bodies.

Stage III

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Federal finance in India entered its third stage with the 80th Constitutional Amendment (in June 2000). Its relevant details would be taken up at appropriate places later in this Book. Later, another significant change took place with 88th Amendment of the Constitution in 2004. With this amendment, the Centre specifically acquired the right to levy service tax (which till then it could levy only by virtue of having residual taxation powers). However, as of now, its collection and appropriation may be in the hands of both the Centre and states in accordance with the law passed by Parliament.

Allocation of Functions/Resources

The Constitution of India came into force in 1950. It followed more or less the pattern laid down in the Government of India Act of 1935. With the objective of ensuring administrative and financial efficiency, it split the functions and financial powers of the Government into three parts, namely, Central, State and Concurrent. It also provided for a variety of inter-governmental resource transfers. Consequently, the Centre was assigned resources and functions having national or interstate base while the states were assigned resources and functions which had local and regional character.

The detailed division of functions and resources is given in the Seventh Schedule to the Constitution of India. It contains three Lists, namely, List I or Union List, List II or State List, and List III or Concurrent List.

List I: Union List

Tax Revenue

The Union List contains 100 entries with the following sources of tax revenue for the Central Government:

1. Taxes on income other than agricultural income (entry 82);
2. Duties of customs including export duties (entry 83);
3. Duties of excise on tobacco and other goods manufactured or produced in India except (a) alcoholic liquors for human consumption, and (b) opium, Indian hemp and other narcotic drugs and narcotics, but including medicinal and toilet preparations containing alcohol or any substance included in this sub paragraph (entry 84);
4. Corporation tax (entry 85);
5. Taxes on the capital value of the assets exclusive of agricultural land, of individuals and companies; taxes on the capital of companies (entry 86);
6. Estate duty in respect of property other than agricultural land (entry 87);

7. Duties in respect of succession to property other than agricultural land (entry 88);
8. Terminal taxes on goods or passengers carried by railways, sea or air; taxes on railway fares and freights (entry 89);
9. Taxes other than stamp duties on transactions in stock exchanges and future markets (entry 90);
10. Rates of stamp duty in respect of bills of exchange, cheques, promissory notes, bills of lading, letters of credit, policies of insurance, transfer of shares, debentures, proxies and receipts (entry 91);
11. Taxes on sale or purchase of newspapers and on advertisements published therein, and advertisements broadcast by radio and television (entry 92);
12. Taxes on sale or purchase of goods other than newspapers where such sale or purchase takes place in the course of interstate trade or commerce (entry 92 A);
13. Taxes on interstate consignments of goods for trade or commerce (entry 92 B);
14. Taxes on services (entry 92-C)
15. Fees in respect of any of the matters in this List, but not including fees taken in any Court (entry 96);
16. Fees taken in Supreme Court (entry 77).
17. Any other tax not mentioned in State List or Concurrent List (entry 97).

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Non-tax Revenue

The *non-tax* resources for the Union Government include the following:

1. **Borrowings, both internal and external.** Under Article 292 of the Constitution, the Government of India can borrow on the security of the Consolidated Fund of India, subject to any limits which Parliament may prescribe.
2. **Income from various government undertakings and monopolies.** These include income from currency and mint, Reserve Bank of India, railways, posts and telegraphs and other commercial and non-commercial undertakings, including income from lotteries organized by the Central Government.
3. **Incidental receipts.** This is the income accruing to the Government of India on account of the exercise of its sovereign rights and performance of functions connected with or arising out of these rights. This category includes, for example, income from government property, income or property accruing from lapse or escheat, war indemnities, income from cultivation, manufacture and sale for export of opium, and so on.

List II: State List

List II of the Seventh Schedule covers the functions and the financial resources of the states with 66 entries.

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Tax Revenue

List II contains the following sources of tax revenue for the state governments:

1. Land revenue (entry 45);
2. Taxes on agricultural income (entry 46);
3. Duties in respect of succession to agricultural land (entry 47);
4. Estate duty in respect of agricultural land (entry 48);
5. Taxes on lands and buildings (entry 49);
6. Taxes on mineral rights subject to any limitations imposed by Parliament by law relating to mineral development (entry 50);
7. Duties of excise on the following goods manufactured or produced in the state and countervailing duties at the same or lower rates on similar goods manufactured or produced elsewhere in India: (a) alcoholic liquors for human consumption, and (b) opium, Indian hemp and other narcotic drugs and narcotics, but not including medicinal and toilet preparations containing alcohol or any substance included in this sub paragraph (entry 51);
8. Taxes on the entry of goods into a local area for consumption, use or sale therein (entry 52);
9. Taxes on the consumption and sale of electricity (entry 53);
10. Taxes on the sale or purchase of goods other than newspapers excluding interstate sale and consignment (entry 54);
11. Taxes on advertisements other than advertisements published in the newspapers and advertisements broadcast by radio or television (entry 55);
12. Taxes on goods and passengers carried by road or on inland waterways (entry 56);
13. Taxes on vehicles for use on roads (entry 57);
14. Taxes on animals and boats (entry 58);
15. Tolls (entry 59);
16. Taxes on professions, trades, callings and employments (entry 60);
17. Capitation taxes (entry 61);
18. Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling (entry 62);
19. Rates of stamp duty in respect of documents other than those subject to stamp duty by the Government of India (entry 63);

20. Fees in respect of any of the matters in the State List, but excluding court fees (entry 66);
21. Fees taken in all courts except Supreme Court (entry 65);
22. Share in some specified Union Taxes (before 80th Amendment). and currently in all 'divisible taxes' of the Centre.

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Non-tax Revenue

The *non-tax* revenues of the states include the following:

1. **Borrowings.** The state governments are authorised to borrow under Article 293, upon the security of their respective Consolidated Funds, but **only from within the country**, including loans from the Government of India. A state legislature may impose limits within which that state can borrow or give guarantees. Furthermore, if any debt of a state taken from or guaranteed by GOI is fully or partially outstanding, then that state government can borrow further only with the permission of the Central Government and subject to such conditions which the Central Government may deem fit to impose.
2. **Income from undertakings** owned fully or partly by the state government.
3. **Income from public property** owned by the state government.
4. **Royalty** from mines, forests, treasure trove etc.
5. **Grants in aid** from the Central Government.
6. **Other grants** from the Central Government.

List III: Concurrent List

This List contains those subjects on which both the Centre and states can make laws. This List does not contain any tax item, so that the Centre and states are prevented from taxing the same tax base. In this List, the non-tax receipts are incidental to governmental activities. It is also noteworthy that if a law passed by a state clashes with a law passed by the Centre, then the Central law has the precedence.

In addition to this, the Centre also enjoys residual powers. It means that if there is no specific mention of a tax base either in the Union List or in the State List, then the Centre has the right to tax such a base. It is by using this right that the Centre started taxing several services.

With the 88th Amendment of the Constitution and addition of Entry 92-C in the Union List, the Centre got an explicit right to levy service tax. However, the Amendment also provides for collecting and appropriating of service tax *both* by the Centre and states as provided by the Parliament by law.

Salient Features of the Indian system

The allocation of financial resources between the Centre and states contains some important features which must be kept in mind for an objective assessment of the

issues and problems faced in the working of the federal financial system in our country.

1. Levels of Government

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Before the 73rd and 74th Amendments of the Constitution, our Constitution provided for *only two levels* of government, namely, at the Centre and at the state levels. There was no specified allocation of functions and resources for local bodies. However, a local government could be constituted by a state within its own territorial jurisdiction by assigning some functions and resources (out of its own sphere) to that body and pertaining to the area for which that local body was constituted. For this reason, even within the same state, different local bodies could have different composition of functions and resources. There was no assured uniformity in this matter even between similar local bodies.

This situation underwent a basic change with the 73rd and 74th Amendments (year 1992, w.e.f. 1993) of the Constitution. With these amendments, the states have come under a Constitutional obligation to create a variety of local bodies, corresponding to population size, both for rural and urban areas. These bodies may be known by several alternative names. Thus, the rural bodies may be referred to as 'panchayats' (and gram sabhas.) and urban bodies as 'municipalities' (also as nagar panchayats, municipal councils, and municipal corporations, etc.). The Amendments also apply to the Union Territories (both with and without a Legislative Assembly) but they do not apply to some specified areas in the North-East where they have a different variety of LBs. However, these amendments may be extended to these areas as well after a due legal procedure. The functions assigned to rural bodies are listed in Schedule XI and those assigned to urban bodies are listed in Schedule XII. These functions pertain to social, economic, educational and cultural uplift and consolidation. But the local bodies still continue to be creatures of states which determine their jurisdictions and assign subjects and resources to them out of the State List.

Union Territories. In the case of a union territory, the functions and financial heads of the state government remain with the Centre. Its budgetary receipts and disbursements form a part of the Central Government Budget.

2. No Overlapping of Tax Levy (Non-concurrency of Taxation)

There is absolutely no overlapping of the *taxation powers* of the Centre and states (though there may be some overlapping of state and local taxation but without an overlapping of geographical areas covered by them). The Constitution ensures that a given tax base is not taxed by two governments. Accordingly, tax bases (of similar subjects) have been precisely defined and allocated between the Centre and states. For example:

- The Centre can tax non-agricultural incomes, but the power to tax agricultural incomes rests with the states.

- The Centre can impose estate and succession duties, but only on properties other than agricultural lands.
- There is a clear cut division of excise duties between the Centre and states.
- The states can tax advertisements, but not when they appear in newspapers or on radio and television.
- The states can tax goods and passengers carried by roads and inland waterways, but air, sea and rail traffic is for the Centre to tax.

However, the 88th Amendment allowed concurrency of collection and appropriation of taxes on services. In other words, while service tax can be levied only by the Centre, it may be collected and appropriated in accordance with law made by Parliament to this effect.

3. Residuary Powers

Entry 97 of the Union List empowers the Centre to levy a tax which is not mentioned in either the Union List or the Concurrent List. The Centre started levying service tax under this provision. With 88th Amendment, service tax has been specifically listed in the Union List (with a new entry at 92-C). However, entry 97 of the Union List is still there which means that the Centre can still levy those taxes which are not mentioned in the Union List or the Concurrent List.

4. Tax Rental

Article 252 provides that two or more states may vacate a particular tax field in favour of the Centre, which in turn may collect a corresponding tax and return the net proceeds to the states concerned. As an example, till 80th Amendment of the Constitution, the Centre was levying Additional Duties of Excise in Lieu of Sales Tax on sugar, textiles and tobacco and returning the net proceeds to the states. With 80th Amendment, this arrangement ceased to exist. But the enabling provision is still there and may be invoked in having a similar arrangement with respect to some other taxes. [Note that on the above-mentioned items, the states could levy sales tax and not excise duties, while the Centre could levy excise duties and not sales tax].

5. Constraints

The Constitution imposes certain constraints on taxation powers of both the Centre and states for ensuring healthy Centre state and interstate financial relations. For example, a state can impose taxes assigned to it only within its territorial jurisdiction. There is also an exemption from taxation by states in respect of water and electricity in certain cases. The Centre cannot tax the income or property of a state, but its trade or other similar activities can be taxed. A state cannot tax the property of the Central Government. A state can tax the sale, distribution or consumption of electricity but not when it is purchased by the Centre or the Railways.

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6. Actual Levying, Collection and Appropriation of Tax Proceeds

In India, actual levying and collection of taxes, however, follows the dictates of administrative and financial efficiency, while the allocation of proceeds follows, as we shall see, the relative needs of various Governments. On this basis, the tax revenue of the country as a whole may be divided into the following six categories:

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(A) *The First Category*

The first category is of those taxes which may be levied, collected and retained by the Central Government. Till the 80th Amendment, all taxes mentioned in the Union List with the following exceptions belonged to this category, namely:

- Income tax *had to be* shared with the state governments;
- the Central Government was *permitted* to share the Union Excise Duties with the states;
- net proceeds of taxes mentioned in category B (Article 269) below were wholly assigned to the states, and
- the net proceeds of taxes levied under 'tax rental arrangement' (Article 252) had to be distributed between states.

However, following 80th and 88th Amendments, all taxes and duties mentioned in the Union List, except the duties and taxes referred to in Articles 268, 268(A) [that is, service tax] and 269, surcharge on taxes and duties, and any cess levied by Parliament for specific purposes, are compulsorily shared with the states. In addition, service tax may be collected and appropriated by both the Centre and states in accordance with the law made by Parliament.

(B) *The Second Category*

The second category comprises those taxes which are levied and collected by the Central Government but are wholly assigned to the states.

(a) **Provision under Article 269:** *Before 80th Amendment*, this Article listed the following taxes in this category, namely:

- (i) duties in respect of succession to property other than agricultural land;
- (ii) estate duty in respect of property other than agricultural land;
- (iii) terminal taxes on goods and passengers carried by railways, sea or air;
- (iv) taxes on railway fares and freights;
- (v) taxes other than stamp duties on transactions in stock exchanges and future markets;
- (vi) taxes on the sale or purchase of newspapers and on advertisements published therein;
- (vii) taxes on the sale or purchase of goods other than newspapers where such sale or purchase takes place in the course of interstate trade or commerce;

- (viii) taxes on the consignment of goods in the course of interstate trade or commerce.

However, *consequent to 80th Amendment*, this Article lists only taxes on inter-state sale or purchase of goods (other than newspapers) and taxes on the inter-state consignment of goods. And further appropriate changes are expected in the wake of adoption of VAT variety of GST at all India level in 2012–13 (or later).

- (b) Provision under Article 252:** The states can also vacate certain tax fields in favour of the Centre under Article 252. The Centre would then levy and collect corresponding taxes [such as excise duties in lieu of sales tax] and transfer back their net proceeds to the states as recommended by the Finance Commission. *Till 80th Amendment*, the Centre was levying Additional Duties of Excise in lieu of Sales Tax on tobacco, sugar and textiles. These duties were in the nature of **tax rental** arrangements and their net proceeds were wholly assigned to the states.

However, consequent to 80th Amendment, this arrangement has come to an end. But Article 252 can still be used to make a similar arrangement with respect to taxation of some other items (such as tax on agricultural incomes).

- (c) The Third Category:** The third category is of those taxes which are levied and collected by the Union Government but which are shared with the states either on a mandatory or a permissible basis. Before 80th amendment, income tax and Union Excise duties (excluding surcharges on them) fell under this category. However, as noted above, with the 80th and 88th Amendments, all taxes and duties mentioned in the Union List except the duties and taxes referred to in Articles 268, 268(A) and 269, surcharge on taxes and duties, and any cess levied by the Parliament for specific purposes, are compulsorily shared with the states.
- (d) In the Fourth Category:** In the fourth category are those taxes which are levied by the Union but collected and retained by the states. The underlying idea is to ensure uniformity of taxes which are of interstate importance. According to Article 268, this category consists of stamp duties and excise duties on medicinal and toilet preparations.
- (e) The Fifth Category:** The fifth category is of those taxes which are levied, collected and retained by the states. These taxes are those which are mentioned in the State List. However, the states may assign some of these taxes to the local bodies within their territorial jurisdiction.
- (f) The 88th Amendment:** The 88th Amendment of the Constitution introduced another category where the Centre levies a tax, but the collection and appropriation may be by both the Centre and the states. Currently, only service tax levied by the Centre falls in this category.

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7. Financial Imbalance

Our Constitution envisages a strong Centre with an ever-widening ‘vertical fiscal imbalance’ in its favour. While the resource-needs of states have an inherent long term tendency to increase, their revenue heads, with some exceptions, are characterised by insufficient buoyancy and elasticity. This makes them perpetually suffer from the problem of resource-deficiency.

The Constitution seeks a solution of the problem of vertical fiscal imbalance through a system of resource transfers from the Centre to the states in the form of tax-sharing, grants and loans. However, even though well-conceived, the system of resource transfers suffers from several drawbacks mainly because its performance is ultimately determined by the integrity and expertise of the decision-makers. For example, the system of grants does not adequately reward a state for its fiscal prudence. Instead, it rewards a state for its fiscal laxity. Both grants and loans have failed to help in reducing inter-state socio-economic disparities. In addition, there has been a recurring problem of unsustainable indebtedness of states to the Centre. Note that the new arrangement whereby the collections of small savings are lent to the states through the medium of the National Small Savings Fund amounts to only an accounting modification. In essence, the indebtedness of the states to the Centre and the NSSF put together continues to be unsustainable.

8. System of Resource Transfers

In view of a recognized inadequacy of revenue resources of the states, our Constitution provides for transfer of resources from the Centre to the states in the form of *tax sharing, grants in aid and loans*.

Ours is a vast country with a serious and worsening problem of *inter-regional economic disparities*, an important contributory factor being the poor financial discipline on the part of the states themselves. But our Constitution does not specifically provide that transfers from the Centre to states should be directed towards removing or reducing *regional disparities*. Successive Finance Commissions also paid insufficient attention to this problem. The main responsibility of tackling this problem through use of resource transfers was believed to be that of the Planning Commission.

Check Your Progress

6. What instruments has the RBI employed over the years to control inflation?
7. Give any three job responsibilities of the State Finance Commission.
8. Name the lists present in the Seventh Schedule to the Indian Constitution.
9. How can resources be transferred from the Centre to the State as per the Indian Constitution?

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10.6 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Public revenue consists of the money revenue or income which the government is not obliged to return to the people from whom it is obtained.
2. The vital difference between the public debt and the other traditional sources of public revenue (taxes, fees, etc.) is that while the former has to be repaid with interest, the latter are not.
3. Some regard a fiscal deficit as a positive since it helps nations come out of recession.
4. The excess of expenditure on revenue account over receipts on revenue account measures revenue deficit.
5. Monetised deficit is defined as an increase in net RBI credit to Central government.
6. The Reserve Bank of India has employed the instruments of general and selective credit control to contain the inflationary pressures which have haunted the economy during the planning era spanning well over five decades.
7. The responsibilities of the State Finance Commission are:
 - Study the financial position of the local bodies.
 - Recommend those principles on the basis of which the taxes, duties, tolls and fees are to be transferred to or shared with the local bodies are to be selected.
 - Recommend those principles on the basis of which the state should give grants to local bodies.
8. The Lists present in the Seventh Schedule to the Indian Constitution are:
 - List I or Union List
 - List II or State List
 - List III or Concurrent List
9. Resources can be transferred from the centre to the state as per Indian Constitution in the form of tax, grants and loans.

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10.7 SUMMARY

- The government of a country finances its expenditure from its income. The income of the government consists of what is called public revenue and public debt. In its wider sense, the term 'public revenue' includes all kinds of income. Consequently, it includes also the money that a government borrows.

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- The relationship between the government and the holders of the government bonds is the same as that between a private borrower and a private lender. The government is barely a government in all its characteristics in such transactions.
- Public debt is generally spent for productive purposes whereas private debt may be spent both for productive as well as for unproductive purposes.
- A fiscal deficit occurs when a government's total expenditures exceed the revenue that it generates, excluding money from borrowings.
- The excess of capital disbursements over capital receipts measures the Capital Deficit. Plan capital disbursements include those on Central Plan and Assistance for state and UT plans.
- Over the past 15 years, India's general government deficits have exceeded 5 per cent in every year except in 2007–08.
- The monetary policy pursued by the Reserve Bank of India during the past six decades clearly reveals the dynamic role which the Reserve Bank of India has played in the planned economic growth with stability of the economy.
- The monetary policy of the Reserve Bank has been marked by flexibility to suit the changing situation of the economy.
- The Reserve Bank of India has employed the instruments of general and selective credit control to contain the inflationary pressures which have haunted the economy during the planning era spanning well over five decades. The policy of selective credit restraint which generally dominated the scene was not, however, rigidly applied.
- The union-state financial relations include three stages. In the first stage, the previously divided states were again divided and some were named states and others as union territories.
- The 73rd and 74th Constitutional Amendments initiated in the stage II make the creation of local bodies, with a pre-determined framework of the subjects to be handled by them. The Amendments also provided for each state to constitute a State Finance Commission every five years.
- The Federal Finance in India entered the third stage with 80th Constitutional Amendments.
- The Constitution of India came into force in 1950. The division of its functions and resources is given in the Seventh Schedule. It contains three lists, namely List I (Union List), List II (State List) and List III (Concurrent List).

10.8 KEY WORDS

- **Public Revenue:** It consists of the money revenue or income which the government is not obliged to return to the people from whom it is obtained.
- **Public Debt:** It carries with it the obligation on the part of the government to repay the loan amount together with interest to the creditors from whom it has been borrowed.
- **Capital Deficit:** A deficit in the capital account means money is flowing out of the country, and it suggests the nation is increasing its ownership of foreign assets.
- **Residuary Power:** It refers to power that is retained by the government after other powers were distributed to other authorities in the course of elections or by the process of delegation.
- **Levy:** It means to impose a tax, fee or fine.

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10.9 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. State the difference between public revenue and public debt.
2. What is fiscal deficit?
3. Write a short note on budget deficit.
4. Name and explain the List I and II given in the Seventh Schedule of the Indian Constitution.

Long Answer Questions

1. Examine the causes for the increase in public debt.
2. Describe the monetary policy followed by the RBI in the pre and post reform period.
3. Explain the different stages of the Indian federal financial set-up.
4. Discuss the problems of budget deficit in India.

10.10 FURTHER READINGS

NOTES

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BLOCK - IV
EXTERNAL SECTOR

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UNIT 11 EXTERNAL SECTOR

Structure

- 11.0 Introduction
- 11.1 Objectives
- 11.2 Importance of Trade Policy
 - 11.2.1 Trade Philosophy
 - 11.2.2 Framework of Trade
 - 11.2.3 Structural Changes in India's Foreign Trade Policy
- 11.3 Trade Policy in the Pre Reform Period
 - 11.3.1 Alexander Committee Recommendations
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 - 11.3.3 Trade Strategies in the Sixth Plan
 - 11.3.4 Trade Strategies in the Seventh Plan
- 11.4 Trade Policy in the Post Reform Period
 - 11.4.1 Thrust on Export Promotion
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 - 11.4.3 Provisions and Implications of the Trade Policies
- 11.5 The Exim Policy, 2009–14
 - 11.5.1 Aims and Objectives
 - 11.5.2 Major Changes in the Foreign Trade Policy, 2009–14
 - 11.5.3 Highlights of the Foreign Trade Policy, 2009–14
- 11.6 The Eleventh Plan
- 11.7 Answers to Check Your Progress Questions
- 11.8 Summary
- 11.9 Key Words
- 11.10 Self Assessment Questions and Exercises
- 11.11 Further Readings

11.0 INTRODUCTION

The trade policy is an important adjunct of the foreign exchange policy. Trade, aid, and exchange policies are concepts related to economic relations. International trade is basically a reflection, first of the structure and trends in domestic production and second, the structure and trends in world production. But more importantly, factors such as international political forces, regional affinities, and socio-economic factors play a vital role in deciding the pattern of aid and trade. In a developing country like India, trade depends on aid and the composition and direction of trade are dictated by aid flows to some extent. Aid is essential from the perspective of inadequate growth of exports and increased demand for imports.

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The new trade policy, in operation since April 2009, has ushered in sweeping changes in the existing trade scenario of the country; it embodies elements that are working to alter the very functioning of the economy for good. For a thorough understanding of such a historic policy change, we need to describe and discuss its features and critically evaluate the same. With respect to this, you will study the historical perspective of the trade policies and how they have affected the formulation of the EXIM Policy.

The prime focus of India's exports and economic policies has been on developing and maintaining a certain degree of coherence and consistency. Increase in exports is undoubtedly the primary aim but importing goods for speeding up the process of development in the country also needs to be taken into consideration. The current scenario calls for an integrated approach towards expanding and developing India's foreign trade.

11.1 OBJECTIVES

After going through this unit, you will be able to:

- Explain the importance of the foreign trade policy
- Describe the structural changes in India's foreign trade policy
- Understand the historical perspectives of trade policies
- Understand the implications of trade policy on exports and imports
- Understand the significant developments and regulations of the foreign trade policy
- Understand the importance of export promotion
- Understand the EXIM Policy 2009–14 and its objectives and features

11.2 IMPORTANCE OF TRADE POLICY

A country's trade policy refers to the set of policies which govern the external sector of its economy. In a country like India, trade policy is one of the many economic instruments which is used to suit the requirements of economic growth. The main objectives of India's trade policy have been to promote exports and restrict the level of imports to the level of foreign exchange available to the government. During the middle of the Second Plan, the importance of exports in the context of developmental planning was first recognized.

The role of foreign trade in the national economy can be adjudged by the proportion of foreign trade to national income. As a proportion of national income, exports were about 8 per cent in 1951–52 which fell to 4.4 per cent in 1971–72 but rose again to around 8 per cent in the 1970s and 1980s due to faster growth of exports. Imports as a percentage of national income have also declined from

10.7 per cent in 1951-52 to 4.9 per cent in 1971-72 but stood at 9–10 per cent in the 1970s.

In 1993-94, exports as a percentage of national income stood at 8.7 per cent while the corresponding percentage for imports was 9.1 per cent. This data signifies that, first, now India is less dependent on the world economy than it was in the earlier decades. From the year 1951-1990, world trade grew at a faster rate than that of India's trade. The declining share in world trade is a common phenomenon for all developing countries which implies thereby that world trade has only benefited the developed countries and not others.

11.2.1 Trade Philosophy

First, the export philosophy was designed with a view to conserve the limited supplies of some essential commodities for domestic consumption and hence their exports were restricted. Second, export of certain goods which are of strategic importance like defence goods are prohibited. Third, exports to certain countries like South Africa and East Africa are not permitted for political reasons. India has aimed at the promotion of exports, keeping in view the limitations so that sufficient foreign exchange is available to pay for the requisite imports and also for facilitating the servicing of foreign debt and for building a buffer stock of reserves.

Import policy is an adjunct to the export policy and both are broadly coordinated so as to keep the receipts and payments in balance. While the export policy aims at the promotion of exports, the import policy encourages import substitution so that there is minimum withdrawal of foreign exchange reserves.

Import controls aim at restricting unwanted import of goods to conserve the limited foreign exchange reserves. Of the imports permitted, capital goods that are not produced at home, and raw materials are prioritized. Of the rest, priority among imports is assigned to food grains, scarce consumer goods like oils, sugar, etc., or to agricultural inputs like fertilizers. A substantial chunk of our import bill is accounted for by crude oil and petroleum, imports of which cannot be dispensed due to inadequate supplies here. Import controls are widespread in India and both tariff and non-tariff barriers are used to control imports. A licence is required for any item of export or import unless it is specifically permitted under the 'Open General Licence' category of items.

11.2.2 Framework of Trade

Before independence, India had trade surpluses and there was regular gold inflow into the account to pay for the surplus. But almost the whole of trade was concentrated in the hands of British companies, and foreign shipping lines facilitated British colonial interests rather than Indian interests. But during the war period, India accumulated huge sterling balances due to the surplus on trade account and war supplies to the United Kingdom. The war-time controls on trade were regularized later by passing The Import and Export (Control) Act of 1947 as

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‘Controlled’ trade became the order of the day in the post-war period. Protection granted to the Indian companies necessitated a wide network of controls on trade. With the inception of planning in 1951, the trade policy had shifted its emphasis from a positive trade balance to the immediate needs of development according to the priorities of the plan. Both imports and exports were low during 1951–56, due to the prevailing trade controls. But some export promotion councils and commodity boards were set up, export quotas were increased, and the export policy in general was liberalized. During the Second Plan 1956–61, in addition to export promotion, import substitution was also pursued. Import restrictions were tightened and a policy of imports on a deferred payment basis was initiated and an institutional framework for exports was strengthened by setting up of a Foreign Trade Board in 1957 which was later replaced by the Board of Trade in 1962. Nineteen Export Councils with an apex body federation of the export organizations and seven Commodity Boards were set up. Seven Development Councils were also organized to promote the export of heavy and light electrical, leather goods, art silk, drugs, and some non-traditional items.

During the Third Plan period (1961–66), the export promotion programme was further strengthened in terms of the institutional structure, incentives, and other policy measures. The Mudaliar Committee (1965) recommended that a selective approach should be adopted in respect of export incentives, fixation of minimum and maximum prices, quality controls, inspection, etc., designed to promote exports as a long-term strategy.

The institutional support to export promotion was strengthened during the tenure of the Fourth to Sixth Plan period. The Trade Development Authority (TDA) was set up to help the medium and small-scale entrepreneurs to develop their export potential. Package assistance was provided to them by TDA, starting with market information and extending up to the execution of export orders. Similar assistance was provided to small scale entrepreneurs by the State Trading Corporation of India Ltd. (STC) under a single window. It should be noted here that STC and MMTC are canalizing agencies for a number of import and export items and have been entrusted with export promotion activities.

11.2.3 Structural Changes in India’s Foreign Trade Policy

The structural changes as made in the trade policy of India since Independence can be accounted for by the following factors:

- (a) Change of hands from foreign nationals to Indian nationals in respect of the export houses, industrial houses, and companies.
- (b) British and foreign shipping were replaced by Indian shipping lines. The importance of foreign shippers has declined in India’s trade.
- (c) Banking and insurance have been taken over by Indian hands and have since been nationalized in the interest of the country.

- (d) Industrialization in the country and the diversification of our industrial base has led to diversification in the trade pattern. Despite the importance of agriculture in our economy, growth of industrialization in the post-war period had brought about some structural changes in the trade pattern, both in exports and imports.

NOTES**Check Your Progress**

1. Highlight the importance of a trade policy in perspective of the Indian economy.
2. List the limitations imposed on exports.

11.3 TRADE POLICY IN THE PRE REFORM PERIOD

Let us examine the recommendations of various committees on trade in the pre reform period.

11.3.1 Alexander Committee Recommendations

Some changes were introduced in India's trade policy as a result of the recommendations of the Alexander Committee (1976). The major recommendations of the Committee were as follows:

1. In view of the changing domestic environment, the framework of trade policy should be more development-oriented rather than control-oriented as in the past. It is necessary to remove excessive controls which characterize the import policy in order to speed up the process of industrial development and for maximizing the utilization of capacity.
2. Import goods should be classified into three broad categories, (i) raw materials and components, consumables, stores and spares, (ii) capital goods and equipment; and (iii) consumer goods. The banned list should consist of the items which are either indigenously available or are not essential for domestic requirements.
3. Tariffs should be used as a control mechanism rather than using the import licensing system. In order to remove the uncertainties which are associated with annual policy changes, the import-export policy should be announced on a three- year basis.

In line with these recommendations, the import policy since then has been substantially liberalized. So far as exports are concerned, the basic thrust remains towards export promotion subject to the restrictions which might have to be imposed in order to take care of the domestic requirements. In line with the changes in the import policy, the export of many items was withdrawn and only 57 items

remained canalized through various government organizations. In order to ensure proper unit value realization, minimum export prices were stipulated for a number of items.

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11.3.2 Tandon Committee Recommendations

The national export strategy as recommended by the Tandon Committee (January 1981) aimed at an annual growth rate of 11 per cent and India's share in world trade at 1 per cent. A series of measures were adopted since 1980–81 to promote exports. A few of the important measures can be outlined as follows:

- (a) Set up of an EXIM Bank to provide all export credit facilities under one window in March 1981.
- (b) Free Trade Zone facilities to all 100 per cent export-oriented firms and greater fiscal concessions for 100 per cent export-oriented units and for export in general.
- (c) Export production to be excluded for consideration of provisions of the MRTP Act, for MNCs, and for assessing the licensed capacity and excess production.
- (d) Liberal import of inputs for export promotion and supply of domestic inputs at international prices to exporters and actual users.
- (e) Favourable treatment to the import of high technology for export-oriented units, electronic goods, computers, etc.
- (f) Ceiling of foreign private investment of 40 per cent to be relaxed for export units and liberalization of such rules pertaining to foreign participation in the Indian industry.

11.3.3 Trade Strategies in the Sixth Plan

Trade policies need continuous monitoring and adjustments in line with domestic and international changes. The Sixth Plan indicated the factors which ought to be taken into account while preparing the medium-term import strategy. These factors can be explained as follows:

- (a) The import policy has to be selectively liberal in order to best utilize the increasing foreign exchange reserves. The case for such relaxation rests on three arguments, (i) to transform a part of the foreign exchange reserves into resources for development, (ii) to allow cheaper imports to stimulate competitive exports and reduce the production costs in the domestic economy, and (iii) to provide an element of competition in certain sectors of the industrial system where efficiency may be suffering due to excessive protection.
- (b) The main thrust of the import policy will be to meet the requirements of the priority industries as well as the export-oriented units.

- (c) Import needs of the units where 'on-availability' of critical import inputs happens to be the cause of low utilization of capacity should be met.
- (d) There is a strong case to reduce the investment cost of new industries and, therefore, tariff rates applicable to imported capital goods and machinery should be selectively reduced.
- (e) Where the total domestic requirements are not that high so as to make the establishment of an industry on an adequate scale an economically viable proposition, it would be better to import the items rather than producing them domestically. The pursuit of this policy will result not only in the better utilization of the existing foreign exchange reserves but also reduce the domestic resource costs.
- (f) There must be a well-thought out programme for meeting contingencies related to essential mass consumption items.
- (g) There should be a ban on non-essential consumer goods and those items, the importation of which might adversely affect the growth of domestic industries, especially the small-scale units.

The Sixth Plan envisaged that both import substitution and export promotion would have to be accorded equal importance in view of the large deficits as projected in the balance of payments. The major policy elements as advocated were as follows:

- (i) The envisaged investment allocations during the period of the Plan should result in a considerable degree of import substitution in industries such as steel, cement, fertilizers, crude oil and machinery, and equipment. However, the policy for import substitution will have to be selective. The choice of sectors for import substitution should depend on the long-term comparative advantage. Even though it may be necessary, in respect of the basic and strategic sectors of the economy, for the government itself to make such a choice, it should be possible for the rest of the economy to leave the choice to be made on the basis of the criteria of rate of return.
- (ii) While following the policy of import substitution, it would be necessary to ensure that import substitution should not in any way adversely affect export promotion activities. Policies directed towards import substitution should result in higher profitability for production in the home market, and therefore, unless some remedial action is taken, there will be a pull towards the domestic market and away from export markets.
- (iii) With respect to invisibles, incentives are to be provided for encouraging inward remittances. Efforts will also have to be made to invite investments from people of Indian origin who are now residing abroad. There is scope for expanding earnings from shipping, insurance, and banking. The trade policy will have to be devised in a way which would allow for such opportunities to be quickly availed.

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- (iv) In the past, the policy with regard to borrowings in the international capital market was basically guided by the aim to keep the country's indebtedness within limits and to maintain the ability of debt-servicing. It is now considered desirable to make selective use of the international capital market. This is especially for the purpose of financing projects that have high rates of return and also the capacity of generating exportable surplus.
- (v) In view of the resource constraints, it is necessary to limit the budgetary export assistance to the minimum. However, even with improvements in the import regime and other policy framework including the price policy, it might still be necessary to limit budgetary export assistance to the minimum. Even with improvements in the import regime and other policy framework elements including the price policy, it might still be considered necessary to provide some budgetary support in order to ensure that the export performance is not adversely affected.
- (vi) The task of achieving a real growth rate of 9 per cent p.a. in exports will be easier if the domestic inflation rate is kept under control. The highest growth rate in exports in the recent times was recorded during the two years when the rate of inflation in India was much lower than that of the rest of the world. The economic policy measures will, therefore, have to be directed towards the maintenance of the domestic price level which will have a beneficial effect on India's international competitiveness.

11.3.4 Trade Strategies in the Seventh Plan

The Seventh Plan started with the projections of 7 per cent growth in the volume of exports and 5.8 per cent growth in imports. The export growth of the projected range is expected to be achieved by concentrating on the 'thrust' industries which have a demonstrable and lasting comparative advantage. Some of these lead industries have rates of growth of exports higher than that of GDP growth. Such commodities, viz., engineering goods, chemicals, garments, gem and jewellery, etc., account for nearly half the increase in the exports projected in the Plan. The export of other products may not keep pace with the growth of GDP as in case of traditional products such as tea, jute, cotton, oil cakes, etc., and some non-traditional products like metallic ore. In view of the sound financial state of the country, during 1992-94, foreign investment flowed into this country with greater ease than in respect of other developing countries. During the Seventh Plan period, the emphasis was on promoting exports and in particular export of services to bridge the deficit in current account. One of the areas of concentration has been the promotion of turnkey projects, civil construction works, capital goods on deferred payments, and consultancy in technological and managerial services.

11.4 TRADE POLICY IN THE POST REFORM PERIOD

The trade policy which was in operation during the period July–August 1991, brought about sweeping changes in the trade scenario of the country. It embodied elements that worked to alter the very functioning of the economy for good. The formulation of the foreign trade policy with an objective to use it as an economic and foreign policy tool reflected the change in the perception towards the external sector and its role in the overall strategy of development.

In order to make the trade policy competitive and holistic, numerous committees were set up during the 1970s and 1980s which reviewed the existing policy and recommended many changes. From amongst these committee reports, there were two reports that were found to be of consequence, namely the Committee on Import and Export Policies and Procedures which was chaired by P.C. Alexander in 1978 and the Committee on Trade Policies which was chaired by Abid Hussain in 1984. The Alexander Committee's recommendations were centred on reducing the control mechanisms and shifting the emphasis to the expansion of trade. The Abid Hussain Committee, on the other hand, focused on the coordination and integration of the trade policies with the economic policies and a phased reduction in protectionism. The Committee also called for the policies to be implemented on a sustained basis in order to establish continuity and long-term export planning. Keeping in view these recommendations, a long-term strategy for export planning was developed by implementing the import–export policy for the period 1985–88. The focal points of this policy were decided to be boosting exports and import substitution. Following this policy, two more such policies were introduced, both for a span of three years each, which was followed by the EXIM Policy, 1992–1997 that was implemented for a period of five years.

The trade policy changes in the post 1991 period and sought to minimize the role of quantitative restrictions and substantially reduced the tariff rates on the lines as suggested by the Tax Reforms Committee (Chairman: Raja J. Chelliah). The developments in India's trade policy during this period needs to be viewed in conjunction with policy reforms initiated in other spheres of the economy. The devaluation of the rupee in July 1991 and the transaction to the market-based exchange rate regime deserve mention in this regard. These measures were aimed at enhancing the price competitiveness of exports. The policies governing foreign investment and foreign collaboration have also undergone significant changes and have a bearing on trade performance. Apart from unilateral measures, the liberalization of India's trade policies also reflects the multilateral commitments of the country to the World Trade Organization (WTO). A number of factors made this new policy radically different from all the earlier policies.

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11.4.1 Thrust on Export Promotion

The thrust on export promotion is clearly discernible from the Export-Import Policy. The policy introduced various forms of incentives for exporters. While such incentives existed during the earlier years, the EXIM Policy of 1985–88 aimed at striking a balance between export promotion and import substitution with marginal preference for the latter. The ‘Import Export Pass Book’ scheme was introduced in 1985, as per the recommendation of the Abid Hussain Committee.

Export promotion received further emphasis under the EXIM Policies for the periods 1992–97 and 1997–2002. Exporters are eligible for income tax rebate on their export earnings. Special incentives have been extended to units as set up in export processing zone (EPZs), electronic hardware parks, etc. Such special benefits have been extended to the export oriented units (EOUs) too. Merchant exporters have been made eligible to special facilities. The measures also include the favoured access to import on capital goods [under the Export Promotion Capital Goods (EPCG) Scheme] and restricted imports [under the Special Import Licence (SIL)].

11.4.2 India’s Trade Policy vis-à-vis Other Developing Countries

Trade policy reforms in India need to be seen in the light of similar efforts made in a large number of developing countries since the 1980s. A comparison of reduction in domestic protection by various developing countries vis-à-vis India, based on certain documents of the WTO, shows that the progress in trade liberalization in India has been more pronounced than that in many other similarly-paced countries. During the mid-1990s, the import weighted an average tariff rate in India at 20 per cent which was considerably lower than that in countries such as Pakistan (50 per cent) or Nigeria (24 per cent) and comparable with countries such as Sri Lanka (20 per cent) or Thailand (17 per cent). The peak tariff rate in India (45 per cent) is much lower than most of the developing countries including Thailand (200 per cent), Malaysia (145 per cent), and Pakistan (70 per cent). In terms of tariff binding commitments, the coverage of items under the bound rates was much higher for India than most of the East Asian and South Asian countries. Table 11.1 illustrates this in the present scenario as follows:

Table 11.1 Direction of India’s Exports (Percentage Share)

Region	2002-03	2003-04	2004-05	2005-06	2006-07*
Europe	24.17	24.54	23.55	24.16	22.89
EU Countries (27)	22.55	22.74	21.85	22.53	21.26
Other WE Countries	1.58	1.73	1.65	1.58	1.57
East Europe	0.04	0.07	0.05	0.05	0.06
Africa	4.65	4.82	5.05	5.27	6.63
Southern Africa	1.21	1.24	1.51	1.88	2.23
West Africa	2.02	1.99	1.98	1.84	1.91
Central Africa	0.22	0.24	0.19	0.16	0.16

East Africa	1.20	1.35	1.37	1.39	2.33
America	24.45	20.97	20.10	20.72	19.23
North America	21.99	19.19	17.52	17.82	15.85
Latin America	2.46	1.78	2.58	2.90	3.38
Asia	44.39	47.60	49.50	48.38	49.78
East Asia	1.15	1.10	1.03	0.97	1.18
ASEAN	8.76	9.12	10.09	10.10	9.95
WANA	14.28	15.95	17.04	16.19	18.22
NE Asia	14.92	14.70	15.83	15.74	15.31
South Asia	5.28	6.73	5.51	5.38	5.12
CIS & Baltics	1.75	1.63	1.31	1.21	1.17
CARs Countries	0.16	0.24	0.21	0.16	0.15
Other CIS Countries	1.59	1.39	1.10	1.05	1.02
Unspecified Region	0.59	0.44	0.49	0.24	0.27
Total	100.00	100.00	100.00	100.00	100.00

External Sector

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Note: *Figures are provisional.

Source: DGCI&S

The non-tariff measures are an integral part of the trade policy of the majority of developing countries including India as they are in many other industrialized countries. As compared to many other developing countries, quantitative restrictions such as price control in respect of exports/imports, direct subsidy to export/import-substituting sectors, etc., are less pronounced in India.

Table 11.2 highlights the performance of merchandise exports and its broad components in the spheres of agriculture and allied products and manufactured goods, during the period 2002–2007 as follows:

Table 11.2 *Composition of Exports During the Tenth Plan*

Commodity Group	2002-03		2003-04		2004-05		2005-06		2006-07*		CAGR
	% Share	% Growth	% Share	% Growth	% Share	% Growth	% Share	% Growth	% Share	% Growth	
Agri and Allied Products	12.73	13.71	11.8	12.27	10.14	12.5	9.91	20.52	9.91	22.53	16.22
Ores and Minerals	3.78	58.12	3.71	18.67	6.08	114.4	5.98	21.36	5.57	14.11	40.99
Manufactured Goods	76.33	20.62	75.95	20.5	72.7	25.24	70.38	19.48	65.51	14.05	19.92
Petroleum Products	4.89	21.58	5.59	38.5	8.37	95.87	11.29	66.53	14.569	59.39	54.32
Others	2.27	1.15	2.95	57.39	2.71	20.28	2.44	11.15	4.29	115.43	35.60
Total	100	20.29	100	21.1	100	30.85	100	23.41	100	22.54	23.58

Note: *Figures are provisional.

Source: DGCI&S.

Since the unit deals with the EXIM Policy of India in the historical perspective, we will study the changes as a result of this policy from the period 1980-2000 (see Table 11.3).

NOTES*Table 11.3 Composition of Exports from the Period 1980 to 2000*

	Growth Rates*		Percentage Share	
	1980-81 to 1991-92	1992-93 to 1999-00	1980-81 to 1991-92	1991-92 to 1999-00
1. Agricultural and Allied Products	3.3	8.1	24.2	18.3
2. Manufactured Goods	10.1	10.6	62.0	76.6
3. Total Exports	7.4	10.1	100.00	1000.00

*Annual average.

Source: DGCI &S

11.4.3 Provisions and Implications of the Trade Policies

The provisions that have been incorporated in the trade policy aim at strengthening the export-profile of the country. They make a radical departure from the past system of controlled-trade by giving a strong market-orientation to the trading in imports and exports. Even the task of equating the outgo of foreign exchange for imports and the incoming foreign exchange on account of exports has been left to be accomplished by a market-based self-balancing mechanism. Some of the highlights during this period have been described in the subsequent paragraphs.

Priority for exports

The policy is all set to make exports a kingpin in the new strategy of managing the balance of payments (BOP) and thereby influencing the growth of the economy. This is in total contrast to the strategy of import substitution which has so far dominated the scene. Imports will, from now onwards, be dependent upon the availability of foreign exchange earned largely from exports.

Increasing export items

Besides providing for the expansion of the existing traditional and non-traditional export-products, the government identified many new items of exports. For example, it was for the first time that great emphasis had been laid on agro-based products as also those allied to agriculture, animal husbandry, floriculture, pisciculture, and sericulture. Another set of new products which are being given special attention belong to the service sector. These include consultancy, architecture, education, medical services, etc. In respect of these services, India has a tremendous comparative advantage over other countries. The reservation from SSI provisions for another fourteen items related to leather goods and toys,

etc., was meant to enable new investment and improvement of technology in these key export-oriented sectors. A medium-term export strategy was put on the anvil, besides the short term corrective measures. The objective was to raise the share of India in world exports to about 1 per cent in the period 2002–07. The strategy was directed to increase exports at about 11.9 per cent per annum by focusing on certain key export commodities. Twenty-five countries and 220 export commodities were identified for special focus.

Incentives and facilities

Towards this end, the policy provided for several measures for strengthening the incentives for exports and for raising the profitability of export-business. Opportunities were provided to the exporters to earn more by allowing them to sell the foreign exchange as earned by them at a higher market rate rather than a lower official rate. In the first EXIM Scrip Scheme (1991), exporters could sell 30 per cent of their foreign exchange at the market rate. Another system in this perspective called the Partial Convertible Rupee System Scheme replaced the EXIM Scrip Scheme, and allowed free sale to the extent of 60 per cent of the foreign exchange. The scheme of fully convertible rupee on trade account was introduced in March 1993 which permitted the exporter to sell 100 per cent of the foreign exchange earned from merchandise/commodities trade. Under the present scheme, fully convertible rupee on current account (in operation since March 1994), exporters can sell the entire foreign exchange earned on trade account as well as on invisible account (i.e. services). While such schemes benefit all exporters, those who export goods with low import-intensity gain the most from such schemes. In other words, such schemes provide strong motivation for the export of goods with low import-intensity. Through the policy of liberalization, the government also provided a favourable framework for enterprises to flourish in the export-sector.

Limiting imports

In respect of imports, the trade policy aimed at limiting them to the availability of foreign exchange, earned largely through exports. All imports have to be financed through the purchase of foreign exchange at the market rate. Imports have been linked with and limited to the availability of foreign exchange at the market rate. As a result of this, provisions were made in the trade policy to compress imports. Efforts were made to curtail the import of non-essential and low-priority items such as cereals and cereal preparations. The production of import substitutes of certain commodities like pulses, edible oils, petroleum, etc. was also emphasized on. Provisions were made to ensure that the inventories or stocks of imported inputs were to be kept to the minimum necessary limit for domestic production. The devaluation of the Indian rupee in July 1991 led to the compressing of imports as imports became expensive in terms of rupees.

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Market-oriented trade

Trade was proposed to be conducted in terms of market prices, and its profitability was to be determined by the market-related gains and losses. This was the natural outcome of dismantling of a number of controls and easing restrictions on imports and exports of the country.

Reduction in import-licensing

Deregulation of the economy refers to the elimination of a substantial volume of import licensing. This involves reduction in the extent of licensing and in the number and types of licenses to a degree, that it can be described as virtually doing away with the system itself. Almost all items, except a few categories under the advance licensing system made it easy to import without seeking permission/licenses from the government.

Simplification of procedures

Another aspect of marketization of the trading activities is the easing of rules and reduction in the paper work as required for dealing with the government. This was done in several directions and in several ways with the perspective of removing to the maximum possible extent the bureaucratic hurdles in the conduct of private business.

Self-balancing mechanism

Along with the marketization of trade, the policy also featured other decisions of the government in respect of foreign exchange that provided an equilibrating system whereby payments (for imports) and receipts (from exports) were equated. This mechanism helps in the avoidance of BOP deficits.

11.5 THE EXIM POLICY, 2009–14

In pursuance of its liberalization programme launched in 1991 with the introduction of the New Industrial Policy and other economic trade reforms, the government extended the validity of the Policy from three years to five years with the announcement of the five-year long Export—Import Policy, on 31 March 1992, coinciding with the Eighth Five Year Plan (1992–97). The basic objective of a five-year policy was two fold. It reflects the priorities for development of the economy as set out in the five year plans. The third five-year EXIM Policy (2002–07) which coincided with the Tenth Five Year Plan, and which was valid up to March 2007, was terminated mid-length and replaced with the Foreign Trade Policy with effect from August 2004 up to 31 March 2009 on the assumption of power by the UPA Government. The current Foreign Trade Policy (2009–14) in force is effective from 1 April 2009 up to 31 March 2014.

11.5.1 Aims and Objectives

The country witnessed a robust growth in exports in the last five years mainly on account of the twin objectives, set out in the first Foreign Trade Policy 2004–09, namely (i) to double the country's percentage share of global merchandise trade within five years, and (ii) use trade expansion as an effective instrument of economic growth and employment generation. The exports in the last five years registered more than two-fold increase from USD 63 billion in 2003-04 to USD 168 billion in 2008-09, thereby increasing our share in global merchandise trade to 1.45 per cent in 2008 from 0.83 per cent in 2003 (WTO estimates). Our share of global commercial services exports too rose from 1.4 per cent to 2.8 per cent during the same period. On the employment front, nearly 14 million jobs were created directly or indirectly as a result of augmented exports during the period.

The year 2009, however, witnessed one of the most severe global recessions in the post-war period which affected almost all the countries and hitting all the major economic indicators of industrial production, trade, capital flows, unemployment, per capita investment and consumption. Consequently, the WTO and the IMF have estimated a projected global trade decline by 9 per cent and over 11 per cent in volume terms. India has not been an exception to the unprecedented economic slow-down faced by the entire world.

To arrest and reverse the declining trend of exports and to provide additional support especially to those sectors which have been hit badly by recession in the developed world, and also to double our share in global trade by 2020, the current Foreign Trade Policy 2009 –14 has come up with short term and long-term objectives. The short-term objective of the Policy is to achieve an annual export growth of 15 per cent with an annual export target of USD 200 billion by March 2011, while for the remaining three years, i.e. up to 2014 the annual export growth of 25 per cent per annum has been envisaged. Besides, it is expected to double our exports of goods and services by 2014. The long-term objective of the Policy is to double India's share in global trade by 2020.

To meet these objectives of achieving the projected target, a mix of the following policy measures would be adopted by the government:

- Fiscal incentives
- Institutional changes
- Procedural rationalization
- Enhanced market access across the world and diversification of export markets
- Improvement in infrastructure related to exports
- Bringing down transaction costs
- Providing full refund of all indirect taxes and levies

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- Goods and Services Tax (GST) to rebate all indirect taxes and levies on exports

11.5.2 Major Changes in the Foreign Trade Policy, 2009–14

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- DEPB (Duty Entitlement Pass Book) Scheme to continue up to December 2010.
- Income tax benefits under Section 10(A) for IT industry and under Section 10(B) for 100 per cent EoUs extended till 31 March 2011.
- Enhanced insurance coverage and exposure for exports through ECGC schemes ensured till 31 March 2010.
- Interest subvention scheme to continue.
- 15 per cent value addition stipulated on imported inputs under Advance Authorization to encourage value addition in manufactured exports.
- Enhancement of incentive rates for exports to emerging markets of Africa, Latin America, Oceania and CIS countries. Duty credit scrips for FMS increased from 2.5 per cent to 3 per cent and for FPS from 1.25 per cent to 2 per cent.
- Additional resources made available under the MDA and MAI schemes.
- Six or more 'Made in India' shows to be organized across the world every year to promote Brand India.
- For the first time EPCG at Zero Duty introduced for certain sectors (engineering and electronic products, basic chemicals and pharmaceuticals, apparels and textiles, plastics, handicrafts, chemicals and allied products and leather and leather products) to facilitate technology upgradation for exporters to be globally competitive.
- Status holders to import capital goods duty free (through Duty Credit Scrips equivalent to 1 per cent of their FOB value of exports in previous year) of specified product groups.
- Additional focused support and incentives to units in 'Towns of Export Excellence' for upgradation of export infrastructure.
- Encouragement to production and export of 'green products' through measures such as phased manufacturing programme for green vehicles, zero-duty EPCG scheme, and incentives for exports.
- Setting up of the Directorate of Trade Remedy Measures to facilitate MSMEs in availing their rights through trade remedy instruments under the WTO framework.
- Reduction in the transaction cost and institutional bottlenecks.
- Time-bound implementation of e-trade projects.
- EDI to be extended to additional ports/locations.

- Inter Ministerial Committee to serve as a single window mechanism for resolution of trade-related grievances.

11.5.3 Highlights of the Foreign Trade Policy, 2009–14

Let us look at the highlights of the foreign trade policy 2009-2014.

1. Higher support for market and product diversification

- Twenty-six new markets have been added under the Focus Market Scheme. These include sixteen new markets in Latin America and ten in Asia-Oceania.
- The incentive available under the Focus Market Scheme (FMS) and the Focus Product Scheme (FPS) raised from 2.5 – 3 per cent and from 1.25 –2 per cent respectively.
- A large number of products from various sectors have been included for benefits under the FPS. These include engineering products (agricultural machinery, parts of trailers, sewing machines, hand tools, garden tools, musical instruments, clocks and watches, railway locomotives, etc.), plastic (value-added products), jute and sisal products, technical textiles, green technology products (windmills, wind turbines, electric-operated vehicles, etc.), project goods, vegetable textiles and certain electronic items.
- The Market Linked Focus Product Scheme (MLFPS) has been greatly expanded by inclusion of products classified under as many as 153 ITC (HS) Codes at 4-digit level. Some major products include pharmaceuticals, synthetic textile fabrics, value-added rubber products, value-added plastic goods, textile made-ups, knitted and crocheted fabrics, glass products, certain iron and steel products and certain articles of aluminium, among others. Benefits to these products will be provided, if exports are made to thirteen identified markets (Algeria, Egypt, Kenya, Nigeria, South Africa, Tanzania, Brazil, Mexico, Ukraine, Vietnam, Cambodia, Australia and New Zealand).
- MLFPS benefits are also extended for export to additional new markets for certain products. These products include auto components, motor cars, bicycle and its parts and apparels, among others.
- A common simplified application form has been introduced for taking benefits under FPS, FMS, MLFPS and VKGUY.
- Higher allocation for Market Development Assistance (MDA) and Market Access Initiative (MAI) schemes is being provided.

2. Technological upgradation

- To aid technological upgradation of our export sector, the EPCG Scheme at Zero Duty has been introduced. This Scheme will be available for engineering and electronic products, basic chemicals and pharmaceuticals,

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apparels and textiles, plastics, handicrafts, chemicals and allied products and leather and leather products (subject to exclusions of current beneficiaries under the Technological Upgradation Fund Schemes (TUFS), administered by the Ministry of Textiles and beneficiaries of the Status Holder Incentive Scheme in that particular year). The Scheme shall be in operation till 31 March 2011.

3. Towns of export excellence

- Jaipur, Srinagar and Anantnag have been recognized as 'Towns of Export Excellence' for handicrafts; Kanpur, Dewas and Ambur have been recognized as 'Towns of Export Excellence' for leather products; and Malihabad for horticultural products.

4. EPCG scheme relaxations

- To increase the life of existing plant and machinery, export obligation on import of spares, moulds, etc. under the EPCG Scheme, has been reduced to 50 per cent of the normal specific export obligation.
- Taking into account the decline in exports, the facility of Re-fixation of Annual Average Export Obligation for a particular financial year in which there is decline in exports from the country, has been extended for the five-year policy period 2009 –14.

5. Support for green products and products from the North East

- The Focus Product Scheme benefit extended for export of 'green products'; and for exports of some products originating from the North East.

6. Status holders

- To accelerate exports and encourage technological upgradation, additional duty credit scrips shall be given to status holders at the rate of 1 per cent of the FOB value of past exports. The duty credit scrips can be used for procurement of capital goods with Actual User condition. This facility shall be available for sectors of leather (excluding finished leather), textiles and jute, handicrafts, engineering (excluding iron and steel and non-ferrous metals in primary and intermediate forms, automobiles and two-wheelers, nuclear reactors and parts, and ships, boats and floating structures), plastics and basic chemicals (excluding pharma products) [subject to exclusions of current beneficiaries under Technological Upgradation Fund Schemes (TUFS)]. This facility shall be available till 31 March 2011.
- Transferability for the duty credit scrips being issued to status holders under VKGUY Scheme has been permitted. This is subject to the condition that transfer would be only to status holders and scrips would be utilized for the procurement of cold chain equipment only.

7. Stability/continuity of the Foreign Trade Policy

- To impart stability to the Policy regime, Duty Entitlement Passbook (DEPB) Scheme is extended beyond 31 December 2009 till 31 December 2010.
- Interest subvention of 2 per cent for pre-shipment credit for seven specified sectors has been extended till 31 March 2010 in the Budget 2009-10.
- Income tax exemption to 100 per cent EOUs and to STPI units under Section 10B and 10A of the Income Tax Act, has been extended for the financial year 2010-11 in the Budget 2009-10.
- The Adjustment Assistance Scheme initiated in December 2008, to provide enhanced ECGC cover at 95 per cent to the adversely affected sectors, is continued till March 2010.

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8. Sector-specific initiatives

(i) Marine sector

- Fisheries have been included in the sectors which are exempted from maintenance of average EO under the EPCG Scheme, subject to the condition that fishing trawlers, boats, ships and other similar items shall not be allowed to be imported under this provision. This would provide a fillip to the marine sector which has been affected by the present downturn in exports.
- Additional flexibility under the Target Plus Scheme (TPS)/Duty Free Certificate of Entitlement (DFCE) Scheme for status holders has been given to the marine sector.

(ii) Gems and jewellery sector

- To neutralize duty incidence on gold jewellery exports, it has now been decided to allow duty drawbacks on such exports.
- In an endeavour to make India an international trading hub in diamonds, it is planned to establish 'Diamond Bourse(s)'.
- A new facility to allow import on consignment basis of cut and polished diamonds for the purpose of grading/certification purposes has been introduced.
- To promote the export of gems and jewellery, the value limits of personal carriage have been increased from US\$ 2 million to US\$ 5 million in case of participation in overseas exhibitions. The limit in case of personal carriage, as samples, for export promotion tours, has also been increased from US\$ 0.1 million to US\$ 1 million.

(iii) Agriculture sector

- To reduce transaction and handling costs, a single window system to facilitate export of perishable agricultural produce has been introduced. The system

will involve creation of multi-functional nodal agencies to be accredited by the APEDA.

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(iv) Leather sector

- Leather sector shall be allowed re-export of unsold imported raw hides and skins and semi-finished leather from public bonded warehouses, subject to payment of 50 per cent of the applicable export duty.
- Enhancement of FPS rate to 2 per cent would also significantly benefit the leather sector.

(v) Tea

- Minimum value addition under advance authorization scheme for export of tea has been reduced from the existing 100 – 50 per cent.
- DTA sale limit of instant tea by EOU units has been increased from the existing 30 – 50 per cent.
- Export of tea has been covered under the VKGUY Scheme benefits.

(vi) Pharmaceutical sector

- The export obligation period for advance authorizations issued with 6-APA as input has been increased from the existing six months to thirty-six months, as is available for other products.
- The pharma sector extensively covered under the MLFPS for countries in Africa and Latin America; some countries in Oceania and Far East.

(vii) Handloom sector

- To simplify claims under FPS, the requirement of ‘Handloom Mark’ for availing benefits under FPS has been removed.

9. EOUs

- EOUs have been allowed to sell products manufactured by them in DTA upto a limit of 90 per cent instead of the existing 75 per cent, without changing the criteria of ‘similar goods’, within the overall entitlement of 50 per cent for DTA sale.
- To provide clarity to the customs field formations, DOR shall issue a clarification to enable procurement of spares beyond 5 per cent by granite sector EOUs.
- EOUs will now be allowed to procure finished goods for consolidation along with their manufactured goods, subject to certain safeguards.
- During this period of downturn, the Board of Approvals (BOA) to consider, extension of block period by one year for calculation of the net foreign exchange earning of EOUs.
- The EOUs will now be allowed CENVAT credit facility for the component of SAD and Education Cess on DTA sale.

10. Thrust to value-added manufacturing

- To encourage value-added manufactured export, a minimum 15 per cent value addition on imported inputs under the Advance Authorization Scheme has now been prescribed.
- Coverage of project exports and a large number of manufactured goods under the FPS and the MLFPS.

11. DEPB

- The DEPB rate shall also include factoring of custom duty component on fuel where fuel is allowed as a consumable in standard input-output norms.

12. Flexibility provided to exporters

- Payment of customs duty for Export Obligation (EO) shortfall under Advance Authorization/DFIA/EPCG Authorization has been allowed by way of debit of duty credit scrips. Earlier, the payment was allowed in cash only.
- Import of restricted items, as replenishment, shall now be allowed against transferred DFIA's, in line with the erstwhile DFRC scheme.
- Time limit of sixty days for re-import of exported gems and jewellery items, for participation in exhibitions has been extended to ninety days in case of USA.
- Transit loss claims received from private approved insurance companies in India will now be allowed for EO fulfilment under the export promotion schemes. At present, the facility has been limited to public sector general insurance companies only.

13. Waiver of incentives recovery on RBI specific write-off

- In cases, where the RBI specifically writes off the export proceeds realization, the incentives under the FTP shall now not be recovered from the exporters subject to certain conditions.

14. Simplification of procedures

- To facilitate duty-free import of samples by exporters, the number of samples/pieces has been increased from the existing 15 – 50. Customs clearance of such samples shall be based on declarations given by the importers with regard to the limit of value and quantity of samples.
- To allow exemption for up to two stages from payment of excise duty in lieu of refund, in case of supply to an advance authorization holder (against invalidation letter) by the domestic intermediate manufacturer. It would allow exemption for supplies made to a manufacturer, if such manufacturer in turn supplies the products to an ultimate exporter. At present, exemption is allowed up to one stage only.

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- Greater flexibility has been permitted to allow conversion of shipping bills from one export promotion scheme to another scheme. Customs shall now permit this conversion within three months, instead of the present limited period of only one month.
- To reduce transaction costs, dispatch of imported goods directly from the port to the site has been allowed under the Advance Authorization Scheme for deemed supplies. At present, the duty-free imported goods could be taken only to the manufacturing unit of the authorization holder or its supporting manufacturer.
- Disposal of manufacturing wastes/scrap will now be allowed after payment of applicable excise duty, even before fulfilment of export obligation under the Advance Authorization and EPCG Scheme.
- Regional authorities have now been authorized to issue licence for import of sports weapons by 'renowned shooters', on the basis of NOC from the Ministry of Sports and Youth Affairs. Hence, there will be no need to approach the DGFT (Hqrs.) in such cases.
- The procedure for issue of Free Sale Certificate has been simplified and the validity of the certificate has been increased from 1 – 2 years. This will solve the problems faced by the medical devices industry.
- Automobile industry, having their own R&D establishment, would be allowed free import of reference fuels (petrol and diesel), up to a maximum of 5 KL per annum, which are not manufactured in India.
- Acceding to the demand of trade and industry, the application and redemption forms under EPCG scheme have been simplified.

15. Reduction of transaction costs

- No fee shall now be charged for granting incentives under the schemes. Further, for all other authorizations/licence applications, the maximum applicable fee is being reduced to ` 100,000 from the existing ` 1,50,000 (for manual applications) and ` 50,000 from the existing ` 75,000 (for EDI applications).
- To further EDI initiatives, export promotion councils/commodity boards have been advised to issue RCMC through a Web-based online system.
- Electronic message exchange between customs and DGFT in respect of incentive schemes have become operational by 31 December 2009. This will obviate the need for verification of scrips by customs facilitating faster clearances.
- For EDI ports, with effect from December 2009, double verification of shipping bills by customs for any of the DGFT schemes shall be dispensed with.

- In cases, where the earlier authorization has been cancelled and a new authorization has been issued in lieu of the earlier authorization, application fee paid already for the cancelled authorization will now be adjusted against the application fee for the new authorization subject to payment of minimum fee of ₹ 200.
- An inter-ministerial committee will be formed to redress/resolve problems/issues of exporters.
- An updated compilation of Standard Input Output Norms (SION) and ITC (HS) Classification of Export and Import Items has been published.

16. Directorate of ‘Trade Remedy Measures’

- To enable support to Indian industry and exporters, especially the MSMEs, in availing their rights through trade remedy instruments, a ‘Directorate of Trade Remedy Measures’ shall be set up.

11.6 THE ELEVENTH PLAN

A vigorous strategy for promoting exports must be an important part of our strategy for managing the balance of payments in the years ahead. An enhanced target of US \$160 billion was fixed for 2007-08 (the first year of the Eleventh Plan), indicating a growth rate of 26.6 per cent.

On an average, the exports are projected to grow at a rate of about 20 per cent or more during the Eleventh Five Year Plan period in the current US dollar terms.

To achieve this target, it is necessary to achieve the general conditions that would promote rapid growth in the economy, including the development of efficient infrastructure services. Of these, reliable power supply is perhaps the most important factor, especially if we have to strengthen the competitive capacity of our middle and small-size enterprises. In addition to this, it is necessary to ensure the following:

- Promoting the production and export of commercial crops and agri-based processed products.
- Facilitating the provision of critical specialized infrastructure necessary for promoting the export of various commodities including agricultural and marine where necessary.
- Expansion and modernization of the infrastructure and quality control mechanisms through the upgradation of technology and greater use of IT.
- Strengthening various institutions involved in consultancy, design, human resource development, and the information services needed for export promotion. This is especially important for exploiting the export potential of medium and small-scale exporters.

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- Strengthening the institutions by providing general support services to the exporters.

The following areas have been included that would receive special attention during the Eleventh Plan:

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- (i) Simplification of the beginning of procedures
- (ii) Streamlining of documentary requirements
- (iii) Accelerated implementation of EDI initiatives
- (iv) Fuller neutralization of taxes
- (v) Improving infrastructure facilities to meet international standards
- (vi) Initiating necessary institutional and structural changes

Check Your Progress

3. What was the policy concerning imports during the period 1980–2000?
4. What is deregulation of the economy?
5. What mechanism was introduced to avoid BOP deficits?
6. What are the prime objectives of the EXIM Policy, 2009–14?

11.7 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. In India, trade policy is one of the many economic instruments which is used to suit the requirements of economic growth. The objectives of India's trade policy stem from the requirement to promote exports and restrict the level of imports to the level of foreign exchange available to the government.
2. The following are some of the limitations imposed on exports:
 - (i) The export philosophy was designed with a view to conserve the limited supplies of some essential commodities for domestic consumption and hence their exports were restricted.
 - (ii) Export of certain goods which are of strategic importance like defence goods are prohibited.
 - (iii) Exports to certain countries like South Africa and East Africa are not permitted for political reasons.
3. The trade policy during the period of 1980–2000 aimed at limiting imports to the availability of foreign exchange, earned largely through exports. All imports were to be financed through the purchase of foreign exchange at the market rate. As a result of this, provisions were made in the trade policy to compress imports.

4. Deregulation of the economy refers to the elimination of a substantial volume of import licensing. This involves reduction in the extent of licensing and in the number and types of licenses to a degree, that it can be described as virtually doing away with the system itself.
5. A self-balancing mechanism was introduced which can be described as an equilibrating system whereby payments (for imports) and receipts (from exports) were equated. This mechanism helps in the avoidance of BOP deficits.
6. To arrest and reverse the declining trend of exports, the current Foreign Trade Policy 2009–14 has come up with short term and long-term objectives. The short-term objective of the Policy is to achieve an annual export growth of 15 per cent with an annual export target of USD 200 billion by March 2011. The long-term objective of the Policy is to double India's share in global trade by 2020.

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11.8 SUMMARY

- A country's trade policy refers to the set of policies which govern the external sector of its economy.
- In a country like India, trade policy is one of the many economic instruments which is used to suit the requirements of economic growth.
- The main objectives of India's trade policy have been to promote exports and restrict the level of imports to the level of foreign exchange available to the government.
- Import controls aim at restricting unwanted import of goods to conserve the limited foreign exchange reserves.
- Both imports and exports were low during 1951–56, due to the prevailing trade controls. But some export promotion councils and commodity boards were set up, export quotas were increased, and the export policy in general was liberalized.
- The trade policy which was in operation during the period July–August 1991, brought about sweeping changes in the trade scenario of the country.
- It embodied elements that worked to alter the very functioning of the economy for good.
- The formulation of the foreign trade policy with an objective to use it as an economic and foreign policy tool reflected the change in the perception towards the external sector and its role in the overall strategy of development.
- In pursuance of its liberalization programme launched in 1991 with the introduction of the New Industrial Policy and other economic trade reforms, the government extended the validity of the Policy from three years to five

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years with the announcement of the five-year long Export—Import Policy, on 31 March 1992, coinciding with the Eighth Five Year Plan (1992–97).

- The country witnessed a robust growth in exports in the last five years mainly on account of the twin objectives, set out in the first Foreign Trade Policy 2004–09, namely (i) to double the country’s percentage share of global merchandise trade within five years, and (ii) use trade expansion as an effective instrument of economic growth and employment generation.
- A vigorous strategy for promoting exports must be an important part of our strategy for managing the balance of payments in the years ahead. An enhanced target of US \$160 billion was fixed for 2007-08 (the first year of the Eleventh Plan), indicating a growth rate of 26.6 per cent.

11.9 KEY WORDS

- **Trade Policy:** It means the set of policies which govern the external sector of its economy.
- **Import Controls:** They refer to controls that aim at restricting unwanted import of goods to conserve the limited foreign exchange reserves.
- **Deregulation:** The elimination of a substantial volume of import licensing is known as deregulation.
- **EXIM Policy:** It refers to the export import policy of a government.
- **World Trade Organization:** It is the only global international organization dealing with the rules of trade between nations.

11.10 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the recommendations of the Abid Hussain Committee?
2. What are the structural changes in India’s trade policy?
3. Highlight the importance of import controls.
4. What have been the provisions of the Eleventh Plan with respect to export promotion?
5. How were the provisions concerning export promotion in the Seventh Plan different from those of the Sixth Plan?
6. What was the objective of the medium-term export strategy?
7. List the features of the New Economic Policy of India.
8. List the objectives of the EXIM Policy, 2009–2014.

9. Explain in brief the reforms initiated in the gems and jewellery sector.

External Sector

Long Answer Questions

1. What have been the focal points of the trade policies over the years? Explain in detail with respect to the Sixth, Seventh, and the Eighth Plans.
2. Write in detail about the procedural simplifications as advocated in the EXIM Policy, 2009–14.
3. Describe in brief the highlights of the EXIM Policy, 2009–14.

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11.11 FURTHER READINGS

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UNIT 12 EXCHANGE RATE

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Structure

- 12.0 Introduction
- 12.1 Objectives
- 12.2 Meaning and Concepts
 - 12.2.1 Exchange Rate Policy
- 12.3 Foreign Exchange Management Act
- 12.4 Answers to Check Your Progress Questions
- 12.5 Summary
- 12.6 Key Words
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- 12.8 Further Readings

12.0 INTRODUCTION

Every sovereign nation has its own currency. Theoretically the monetary unit of a country can be exchanged with any other currency of any other country. Most of the international financial transactions involve an exchange of one currency for another. The ratio in which they are exchanged, or prices in terms of each other are known as 'exchange rates'.

When countries trade with each other, they require money-flows. Foreign exchange markets provide the mechanism for exchanging different monetary units for each other. If the currency is widely accepted as in the case of US \$, it can pay in its own currency. Sometimes, nationals of one country may prefer to hold financial assets in a foreign country or denominated in a foreign currency because:

- Domestic currency may be subject to variable and high inflation, rendering it a poor store of value;
- Foreign currency balance may reduce risks;
- Foreign currency assets help hedge anticipated foreign currency liabilities.

Actually, the efficiency of the international financial system and its degree of integration with individual sovereign financial systems depends, to a large extent, on how cheaply and quickly, foreign exchange transactions can be effected. This unit will discuss various aspects of the exchange rate, as well as the Foreign Exchange Management Act in India.

12.1 OBJECTIVES

After going through this unit, you will be able to:

- Define exchange rate

- Discuss the different types of exchange rate policies
- Describe the Foreign Exchange Management Act in detail

12.2 MEANING AND CONCEPTS

Exchange rate refers to the rate at which two currencies can be bought or sold. Most of the exchange transactions take place via banks or brokers who form the wholesale core of the exchange market. The role played by central banks in the exchange markets are based on the policy objectives and rules formulated by the respective governments. The main purpose of such intervention is to control or, at least, influence the exchange rate. Central bank buys foreign exchange when the exchange rate is low and sells the same when it is sufficiently high. The rules that govern the buying and selling in the interbank market are referred to as exchange rate regimes. They include fixed exchange rates *vis-à-vis* gold, a single currency and basket currencies. Fixing the price of gold in terms of a nation's 'currency' was widely practised by most countries before the First World War. The US government which converted dollar into gold at fixed rate abandoned the practice in 1972.

India has followed varied types of exchange rate over the years. Since Independence, the exchange rate system in India has transitioned from a fixed exchange rate regime where the Indian rupee was pegged to the pound sterling on account of historic links with Britain to a basket-peg during the 1970s and 1980s and eventually to the present form of market-determined exchange rate regime since March 1993. How the exchange rate system in India evolved is discussed below:

- **Par Value System (1947-1971):** Just after independence, India followed the par value system of the IMF whereby the rupee's external par value was fixed at 4.15 grains of fine gold.
- **Pegged Regime (1971-1992):** India pegged its currency to the US dollar (from August 1971 to December 1991) and to the pound sterling (from December 1971 to September 1975).
- **The Period Since 1991:** A two-step downward adjustment of 18-19 per cent in the exchange rate of the Indian rupee was made on July 1 and 3, 1991.
- **Liberalised Exchange Rate Management System:** The Finance Minister announced the liberalised exchange rate management system (LERMS) in the Budget for 1992- 93. This system introduced partial convertibility of rupee. Under this system, a dual exchange rate was fixed under which 40 per cent of foreign exchange earnings were to be surrendered at the official exchange rate while the remaining 60 per cent were to be converted at a market-determined rate.

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Let us now discuss the different types of exchange rate in the next section.

12.2.1 Exchange Rate Policy

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Let us discuss the different types of exchange rate policies that a government can take.

Fixed Exchange Rate vis-à-vis One Currency

Under a fixed exchange rate regime/the government guarantees a constant price for a particular other currency, called the official parity and the central bank intervenes by buying and selling whenever the exchange rate deviates from a stated percentage from the fixed (constant) rate. This system was adopted, under the Bretton-Woods Agreement in 1945 which tied together the world's major currencies for a considerable period of time.

The fixed exchange rates work as long as the countries maintain their competitiveness by following similar economic policies. The exchange rate is driven up and down by the balance of supply and demand. In the 1950-60s, currency demand and supply were driven mainly by the trade-gap, since capital flows were restricted by technology and capital controls. Market pressure on currency was more or less in the right direction. But, the absence of coordination led to the breaking down of the fixed rate system. Bretton-Woods agreement contemplated the correction of structural misalignment without laying down the distinction between a structural problem and a temporary problem. Parity adjustments were not forthcoming because devaluation was equated with national humiliation and revaluation hurt exports. There are some countries which still maintain fixed exchange rates with narrow intervention bands relative to one currency. In 2007, 83 countries adopted floating regimes (including 48 managed floats and 35 independent floats), 82 countries soft pegs and 23 countries hard pegs. Among the 82 countries following soft pegs, 49 countries are pegged to a single currency, while six countries follow exchange rate bands, including horizontal band (Hungary, Cyprus, Denmark, Slovak Republic and Tonga) and crawling band (Costa Rica).

Fixed Exchange Rate vis-à-vis a Basket

A target parity for a basket of currencies was adopted by some countries after 1972. Some countries chose special drawing rights, some Euro-currency unit (ECU) while others chose a basket of their choice. European Monetary System (EMS) is built around a basket of all EU currencies called European Currency Unit (ECU). The composition of the basket is revised every five years or whenever a weight changes by more than 5 per cent. Weights depend on the level of each member state's GNP and international trade.

Some Latin American countries have adopted a crawling peg system where the official parity is revised frequently. Inflation and balance of payments data are built into a formula to revise the rate.

Flexible Exchange Rates

While 86 per cent of developing countries had some type of pegged exchange rate (to a single currency or basket) in the mid-1970s, at the end of 1996, less than half did the same. They shifted to more flexible arrangements. One-third of the developing countries in 1997 had independent floating rates, though some of them engage in 'dirty floating rates' to guide exchange rates on the sly. Flexible exchange rates are believed to make it easier for an economy to adjust to external shocks, such as rise in the oil price which widens a country's trade deficit. Flexible exchange rates free the monetary policy to pursue domestic objectives such as price stability rather than use it to keep the exchange rate on target, through changes in interest rates. On the other hand, the disadvantage of flexible exchange rates is their volatility and they can be grossly misaligned. Trade can be hindered and the economy thrown out of gear.

Exchange Rate Peg

A pre-crisis feature common to Mexico (1994) and the Asian economies (1996) was the existence of an exchange rate peg or anchor. Several exchange rates in East Asia were pegged to the US dollar. Wide swings in the dollar/yen exchange rate from mid-1995 contributed to the build-up in the crisis through shifts in international competitiveness that proved to be unsustainable. The associated losses in competitiveness in countries with dollar pegged currencies contributed to their export slowdown in 1996-97 and wider external imbalances.

The exchange rate peg is very difficult to defend against speculative attacks when a country's financial system is weak. The required interest rate increases to shore up the exchange rate, have a severe negative impact on the financial system and may even cause a crisis in that sector.

This type of exchange rate arrangement also causes distortions in the financial system. The peg is considered an implicit guarantee that there will be no change in the value of currency encouraging financial and business sectors to incur excessive exchange risk by borrowing foreign currencies. Further, investors know that convertibility is limited by a country's reserves and the ability to borrow abroad. When the sustainability of the exchange rate arrangement becomes doubtful a country will attract mainly short-term, speculative capital flows.

The appreciation of the real exchange rate, growing short-term external debt, declining real estate prices, decreasing external competitiveness, large current account deficits and weak financial systems characterized by inadequate supervision and regulation, coupled with political difficulties in the political environment led to speculative attacks on the countries, currencies. When it became difficult to defend currency parities by running down reserves and raising interest rates, drastic devaluations were effected. Stock markets also plummeted in Mexico and Asia.

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International Liquidity

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Exchange rates affect competitiveness of exports and liquidity. Liquidity refers to the means available for settlement of international transactions. Liquidity includes holdings of gold, foreign exchange, special drawing rights (SDRs) and reserve positions in the International Monetary Fund. At the end of June 2000, India's foreign exchange reserves consisted of gold (US \$2,948 million), SDRs (US \$8 million), foreign currency assets (US \$33,774 million) which together amounted to US \$36,730 million. The reserve position in the Fund was US \$653 million. Exchange reserve in 2006 exceeded US \$150 billion.

A country's exchange arrangements and the pace of its adjustment to external imbalances have an important bearing on the expected size and volatility of payment imbalances which influence the demand for reserves. The demand is also influenced by the access to international capital markets. On the other hand, the supply of reserves depends primarily on the financial policies of the reserve currency countries, the state of international capital markets and the supply of IMF reserve assets. The share of reserves held in dollar denominated assets constitute 60 per cent of international reserves. The other major reserve currencies are Deutsche mark, Japanese yen and pound sterling. International financial markets have come to occupy the centre stage in the provision of liquidity and financing the adjustment process.

The International Monetary Fund was set up in 1946 to manage the system of fixed exchange rates by making short-term liquidity available for meeting balance of payment deficits. Fund's resources consist of members subscriptions (SDR 212 billion or US \$290 billion) and arrangement to borrow (SDR 34 billion). India's quota is SDR 4,158 million which constitutes 1.96 per cent of total quotas of members. Members are provided liquidity on unconditional and conditional basis. Unconditional liquidity is provided in the form of reserve assets that can be used for balance of payments financing, while conditional liquidity takes the form of credit that is subject to conditions. Unconditional liquidity takes the form of allocation of SDRs and reserve positions in the Fund which are claims corresponding to resources that countries have made available to the IMF.

Credit to members is extended for varying periods up to 10 years and subject to different degrees of conditionality. The credit must support a programme aimed at establishing or maintaining enduring stability of the member's currency at a realistic exchange rate. For these borrowings, the Fund negotiates a stabilization programme with the member's country aimed at ultimately correcting its deficit.

By the middle of the 1970s, the need for funds was much larger and the loan capacity of IMF was found inadequate. The needs of developing countries were financed by private international capital markets and the banks lent without proper monitoring. When the debt crisis broke out, the character of international financial and monetary system changed. The role of IMF which was limited initially

became prominent after the debt crisis. Banks were unwilling to negotiate rescheduling arrangements unless the country concerned had agreed to a stabilization programme (exchange rate devaluation, interest rate increase, changes in pricing policy fiscal changes and credit ceilings). IMF programmes and policies have exacted a high social and economic cost from debtor nations. It was envisaged when the Fund was designed that the burden of adjustment to balance of payments imbalances would be shared between deficit and surplus countries alike. Such symmetry in adjustment responsibility was not forthcoming in practice. A country whose currency is high in demand should be declared scarce by the Fund. This would allow members to introduce restrictions directed solely against that member. The scarce currency clause was never invoked. Empirically, it is found that IMF programmes make little significant difference to the balance of payments overall, the current account, inflation and fiscal position. The high burden of social safety nets in economies which have simultaneously undertaken structural adjustment has led to deterioration in their fiscal position.

The ERM crises of 1992-93, the Mexican crises of 1994-95, the Asian crisis of 1997 and the Russian and Brazilian crises of 1998 have demonstrated the limitations in containing them and in securing an equitable distribution of the burden of adjustment. Adequate resources are not available with the conditionality clause to correct for temporary disequilibria in members' balance of payments without posing a threat to global financial stability. The lack of jurisdiction of the IMF over financial flows and the inadequate emphasis on financial stability in Fund programmes and conditionality to face the problems associated with market failures, the political economy in the voting process for authorizing IMF support to crisis-affected countries and the moral hazard of private sector bailouts in acting as lender of last resort have been met with several initiatives to approach the problem outside the envisaged role of the IMF since the international institutional framework is incapable of resolving the burden of crisis on domestic safety nets to mitigate the welfare losses of market failures.

Check Your Progress

1. What is the exchange rate?
2. What system introduced the partial convertibility of the rupee?
3. When was the IMF set up?

12.3 FOREIGN EXCHANGE MANAGEMENT ACT

The Foreign Exchange Regulation Act, 1973 was replaced by the Foreign Exchange Management Act or FEMA with effect from 1 June 2000. The FEMA consolidated and amended the law relating to the foreign exchange with the objectives of facilitating external trade and payments and of promoting the orderly development

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and maintenance of foreign exchange market in India. The FEMA is consistent with full current account convertibility and contains provisions for progressive liberalization of capital account transactions.

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The FEMA is more transparent in its application as it lays down the areas requiring specific permission of the Reserve Bank/Government of India on acquisition/holding of foreign exchange. In the remaining cases, funds can be remitted and assets/liabilities can be incurred in accordance with the specific provisions laid down in the Act. Foreign exchange transactions have been classified in two categories: capital account, which alters the assets or liabilities outside India of persons resident in India or alters the assets or liabilities in India of persons resident outside India (for instance, transactions in property and investments and lending and borrowing money) and current account transactions.

The FEMA provides powers to the Reserve Bank for specifying, in consultation with the Central government, the classes of permissible capital account transactions and limits to which exchange is admissible for such transactions. The Exchange Earners' Foreign Currency (EEFC) and Resident Foreign Currency (RFC) account holders are freely permitted to use the funds held in these accounts for payment of all permissible current account transactions. Rules made by the Central government under this Act permit remittances for all current transactions through authorized dealers (ADs) without any monetary/percentage ceiling except for certain prohibited transactions (eight items, like lotteries, banned magazines, football pools) and transactions which require approval from the Central government (11 items, irrespective of the amount) or the Reserve Bank (16 items, wherein the remittance sought exceeds the indicative limits such as business trip (US \$25,000), basic travel quota (BTQ), gift, donation, employment and emigration (US \$5,000)).

The Act gives full freedom to a person resident in India, who was earlier resident outside India, to hold/own/transfer any foreign security/immovable property situated outside India and acquired when he/she was resident there.

The regulations under FEMA for foreign investment in India and Indian investments abroad are also comprehensive, transparent and permit Indian companies engaged in certain specified sectors to acquire shares of foreign companies, engaged in similar activities by share swap or exchange through the issuance of ADRs/GDRs up to certain specified limits.

FEMA is a civil law unlike FERA. The contraventions of the Act provide for arrest only in exceptional cases. There is no presumption of *mens rea* under FEMA, that is, the burden of proof will be on the enforcement agency and not on the person in question. The Act provides for powers of adjudicating officers at par with Income Tax authorities, with an Appellate Tribunal, which would hear appeals against the orders of the adjudicating authority. Further, unlike FERA, FEMA does not apply to Indian citizens resident outside India.

Exchange Rates and the IMF

Exchange Rate

Under the agreement with the International Monetary Fund (IMF), members have an obligation with the Fund and with each other to ensure orderly exchange arrangements and to promote a stable system of exchange rates. Members are free to apply the exchange arrangements of their choice, except that they may not maintain a value for their currency in terms of gold. Members have to inform the Fund of the exchange arrangements they wish to apply for and of any subsequent changes in them. The exchange arrangements could take the following forms:

- fluctuating or fixed exchange rate in terms of other currencies or the special drawing rights or some other basket of currencies
- cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members
- a new arrangement was adopted in 1975 under which the exchange value of the rupee was determined with reference to the daily exchange rate movements of a selected number of countries who are India's major trading partners, also known as basket of currencies.

The selection of the currency units and the weights to be assigned to them was left to the discretion of the bank. The pound sterling, however, continued as the currency of intervention. The bank has maintained the rupee value of the basket currencies within a band. The basket-link has helped to moderate the variation in the rupee rates. To discourage speculation, the actual composition of the basket has not been disclosed.

Effective from 1 March 1992, the US dollar replaced pound sterling as the intervention currency under the Liberalized Exchange Rate Management System (LERMS). Under LERMS all foreign exchange receipts on current account transactions (exports and remittances) were required to be surrendered to the Authorized Dealers (ADs) in full as hitherto. The rate of exchange for these transactions was the free market rate quoted by the ADs except for 40 per cent of the proceeds which would be based on the official rate. The ADs had to surrender, to the RBI, 40 per cent of their purchase of foreign currencies representing current account receipts at the official rate of exchange announced by the RBI. They were free to retain the balance of 60 per cent of foreign exchange being sold in the free market for permissible transactions. Implicit in the dual exchange rate system was a tax on exports as only 60 per cent of the export proceeds could be converted at the market rate and the rest only at a much lower official rate. Further, continuance of the system could have led to distortions in resource-allocation since some imports were financed by relatively subsidized official rate of exchange.

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Check Your Progress

4. What act did the Foreign Exchange Management Act replace?
5. What powers do FEMA provide to the RBI?

12.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The exchange rate refers to the rate at which two currencies can be bought or sold.
2. The Finance Minister announced the liberalised exchange rate management system (LERMS) in the Budget for 1992- 93. This system introduced partial convertibility of the rupee.
3. The International Monetary Fund was set up in 1946 to manage the system of fixed exchange rates by making short-term liquidity available for meeting balance of payment deficits.
4. The Foreign Exchange Regulation Act, 1973 was replaced by the Foreign Exchange Management Act with effect from 1 June 2000.
5. The FEMA provides powers to the Reserve Bank of India for specifying, in consultation with the Central government, the classes of permissible capital account transactions and limits to which exchange is admissible for such transactions.

12.5 SUMMARY

- Exchange rate refers to the rate at which two currencies can be bought or sold.
- Most of the exchange transactions take place via banks or brokers who form the wholesale core of the exchange market.
- Since Independence, the exchange rate system in India has transitioned from a fixed exchange rate regime where the Indian rupee was pegged to the pound sterling on account of historic links with Britain to a basket-peg during the 1970s and 1980s and eventually to the present form of market-determined exchange rate regime since March 1993.
- Under a fixed exchange rate regime/the government guarantees a constant price for a particular other currency, called the official parity and the central bank intervenes by buying and selling whenever the exchange rate deviates from a stated percentage from the fixed (constant) rate.

- Flexible exchange rates are believed to make it easier for an economy to adjust to external shocks, such as rise in the oil price which widens a country's trade deficit.
- Exchange rates affect competitiveness of exports and liquidity. Liquidity includes holdings of gold, foreign exchange, special drawing rights (SDRs) and reserve positions in the International Monetary Fund.
- The Foreign Exchange Regulation Act, 1973 was replaced by the Foreign Exchange Management Act with effect from 1 June 2000.
- The FEMA consolidated and amended the law relating to the foreign exchange with the objectives of facilitating external trade and payments and of promoting the orderly development and maintenance of foreign exchange market in India.
- Effective from 1 March 1992, the US dollar replaced pound sterling as the intervention currency under the Liberalized Exchange Rate Management System (LERMS).

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12.6 KEY WORDS

- **Liquidity:** It refers to the availability of liquid assets to a market or company.
- **Fixed Exchange Rate:** It is a regime applied by a country whereby the government or central bank ties the official exchange rate to another country's currency or the price of gold.
- **Flexible Exchange Rate:** It is a monetary system that allows the exchange rate to be determined by supply and demand.
- **Bretton Woods:** It refers to the international monetary arrangement, agreed upon by the allied nations in 1944 in Bretton Woods, US, that created the IMF and the World Bank and that set up a system of fixed exchange rates with the us dollar as the international reserve currency.
- **Central Bank:** It is a national bank that provides financial and banking services for its country's government and commercial banking system, as well as implementing the government's monetary policy and issuing currency.

12.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. How does exchange rate affect the competitiveness of exports?
2. Write a short-note on the exchange rate obligations of IMF members?

Long Answer Questions

1. Examine the different types of exchange rate policies.
2. Describe the Foreign Exchange Management Act in detail.

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UNIT 13 EXCHANGE DEBT

Structure

- 13.0 Introduction
- 13.1 Objectives
- 13.2 Meaning and Importance of External Debt
- 13.3 External Debt in India
- 13.4 Answers to Check Your Progress Questions
- 13.5 Summary
- 13.6 Key Words
- 13.7 Self Assessment Questions And Exercises
- 13.8 Further Readings

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13.0 INTRODUCTION

In the 18th and 19th centuries, the government, under the influence of *laissez faire* philosophy, which was reflected in economic liberalism, restricted its activities to its minimum unavoidable essential duties of providing protection and security to the citizens. Consequently, the activities of the state were limited to performing only the essential functions of protecting the community against external aggressions and internal disorders by spending on the defence and maintenance of law and order. These functions were considered essential for the preservation of the community. However, with the passage of time, with an enormous increase in the responsibilities of the state and also with the development of enlightened views on public finance, the governments in order to supplement their traditional financial resources started borrowing from individuals and institutions within the country and also from outside the country. Although borrowing as a source of financing certain government activities has not been unknown in the developed countries, the necessity of the public borrowing by the government is imperative in the case of less developed countries where the taxable capacity of the people is low. In modern times, public debt is as popular in the developed countries as it is in the less developed countries.

In modern times, borrowing by the government has become a normal method of government finance along with other sources of public finance like taxes, fees, etc. In all countries of the world, public debt has shown the tendency of increasing rapidly. In fact, the debt burden, particularly external debt burden, of the world's less developed countries has grown phenomenally and quite disproportionately to the debt servicing capacity of these poor countries. At present, the external debt burden of the third world countries has crossed the staggering figure of over \$2,000 billion mark and in the case of several individual developing countries of Latin America and Africa, the annual debt servicing burden of payment exceeds or

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nearly equals their total export earnings. For such unfortunate countries, there is little hope that in any foreseeable future they will be in a position to pay off their foreign debt. In fact, the external debt burden of the Third World countries has been mounting up year after year adding to the grave economic plight of these poor countries. These countries are in the never-ending external debt trap from which these countries find it almost impossible to come out. With each passing year, world's developing countries are sliding deeper in debt.

We find a significant difference in the composition of debt of the developed and developing countries. For example, the total public borrowings of the less developed countries may generally comprise the borrowings made from abroad while in a developed country these mainly consist of the borrowings raised internally from the local authorities, institutions and individuals. It is on account of this significant difference in the composition of public debt that the American economists, including Taylor, have emphasized the internal debt for their country. In India, however, the economists emphasize the external debt. However, both internal debt as well as external debt are the essential and important components of public debt. In this unit, we will stick to discussing the external debt in India.

13.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the meaning and importance of external debt
- Describe the external debt of India

13.2 MEANING AND IMPORTANCE OF EXTERNAL DEBT

The government of a country can go to any national and/or international capital market and borrow funds from there. Internal debt is contracted by the government from the individuals and institutions within the country. On the contrary, external debt is taken by the government from the individuals, institutions and/or governments of foreign countries. For instance, under the British rule, the government of India used to take (i) rupee loans which were taken by the government from the people of the country, and (ii) sterling loans which were raised in the London money market. At present, the government of India has profusely borrowed from international financial institutions like the World Bank, the International Development Association, friendly foreign governments and from international capital markets.

There is a general feeling that an internal debt is better than an external debt. Many people denounce the resort to external loans on the part of the government on political grounds by arguing that a foreign loan may carry with it foreign control

of the country's economy. The main objection to an external loan seems to be based on the misconception that it involves a drain of wealth from the country. When loans are taken from the foreigners, the country has to pay annually a heavy sum of money by way of payment of interest on these loans. This results in the remittance of huge funds to foreign countries. Consequently, a large chunk of country's limited foreign exchange earnings from exports become non-available for the country's economic development. Moreover, an external debt can also pose a danger to the economic and political independence of the country. On the other hand, if we borrow money in the home market, there is no drain of the scarce national resources and the wealth remains in the country.

A country cannot, however, be rendered bankrupt by an internally held debt because it only causes the redistribution of wealth within the country while an external debt, if not used productively with care, may cause great hardship to the nation by increasing her debt burden beyond her debt repaying capacity. For example, for most of world's underdeveloped countries, the external debt servicing burden absorbs a major part of their total foreign exchange earnings through their limited exports. At present, the servicing of India's external debt accounts for over 22 per cent of the country's total export earnings while for many other developing countries, the debt-service ratio is much higher.

Burden of External Public Debt

The incidence of external public debt can be discussed under the following headings:

1. **Direct money burden:** In the case of external public borrowing, the debtor country has to pay to the creditor country every year huge sums of money by way of payment of interest on loans. After the maturity of debt, the principal amount of loan has also to be paid to the foreign country in the foreign exchange. In order to earn this foreign exchange, the country has to make exports. Such exports for which the country receives no payment from the foreign country are known as 'unrequited exports' and represent the direct money burden of an external public debt on the nation. Today, the developing countries are caught in the external debt trap and the debt-service ratio of many of these debtor countries is very high, standing above 50 per cent, while the debt-export ratio has been well above the 300 per cent level. In case of India, the debt-service ratio is around 30 per cent while the debt-export ratio is around 225 per cent.
2. **Indirect money burden:** Sometimes, the debtor country has to pay interest in terms of the goods and services to the creditor country. In other words, the debtor country has to export goods and services on a large scale to the creditor country. This inevitably results in a rise in the prices of these goods and services in the country. As a consequence, there is a steep fall in the economic welfare of the community. This fall in community's welfare shows the indirect money burden of the external public debt.

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3. Direct real burden: The government very often imposes new taxes on the people to pay the external debt. Ordinarily, the burden of these taxes falls more heavily on the poor sections than on the rich sections of the society. This shows the direct real burden of the external public debt.

4. Indirect real burden: As we know, the government imposes taxes on the people to pay the external debt as a consequence of which the capacity of the people to work and to save declines. Ultimately, this decline in peoples' capacities produces unfavourable effects on production. It shows the indirect real burden of an external public debt. Apart from all this, an external public debt is also fraught with the danger of the debtor nation becoming a political hegemony of the creditor nation.

Check Your Progress

1. How is internal debt contracted?
2. List one way in which the government tries to pay off the external debt.

13.3 EXTERNAL DEBT IN INDIA

The external debt of India is the total debt the country owes to foreign creditors, complemented by internal debt owed to domestic lenders. The debtors can be the Union government, state governments, corporations or citizens of India. The debt includes money owed to private commercial banks, foreign governments, or international financial institutions such as the International Monetary Fund (IMF) and the World Bank. The debt figures are published quarterly, with a lag of one quarter. Statistics for the first two quarters of the calendar year are compiled and published by the RBI. The government also publishes an annual status report on the debt which contains detailed statistical analysis of the country's external debt position. Let us look at the recent external debt statistics in India.

At end-March 2018, India's external debt witnessed an increase of 12.4 per cent over its level at end-March 2017, primarily on account of an increase in commercial borrowings, short-term debt and non-resident Indian (NRI) deposits. The increase in the magnitude of external debt was partly due to valuation loss resulting from the depreciation of the US dollar against major currencies. The external debt to GDP ratio stood at 20.5 per cent at end-March 2018, higher than its level of 20.0 per cent at end-March 2017.

Table 13.1 Composition of India's External Debt

Exchange Debt

Sl. No.	Components	External Debt outstanding at end of (US\$ million)				Absolute Variation (US\$ million)		Percentage Variation	
		March 2017 PR	June 2017 PR	Sept. 2017 PR	Dec. 2017 QE	Dec. 2017 over March 2017 (6-3)	Dec. 2017 over Sept 2017 (6-5)	Dec. 2017 over March 2017	Dec. 2017 over Sept 2017
1	2	3	4	5	6	7	8	9	10
1	Multilateral	54,501 (11.6)	55,508 (11.4)	55,550 (11.2)	56,021 (10.9)	1,520	471	2.8	0.8
2	Bilateral	23,227 (4.9)	23,118 (4.8)	23,061 (4.7)	23,371 (4.6)	144	310	0.6	1.3
3	IMF	5,410 (1.1)	5,535 (1.1)	5,622 (1.1)	5,666 (1.1)	256	44	4.7	0.8
4	Export Credit	9,608 (2.0)	9,764 (2.0)	9,616 (1.9)	9,390 (1.8)	-218	2,369	-2.3	24.6
5	Commercial Borrowings	1,72,846 (36.6)	1,83,437 (37.8)	1,89,904 (38.3)	1,96,861 (38.3)	24,015	6,957	13.9	3.7
6	NRI Deposits	1,16,867 (24.8)	1,18,246 (24.3)	1,18,020 (23.8)	1,23,315 (24.0)	6,448	5,295	5.5	4.5
7	Rupee Debt	1,228 (0.3)	1,213 (0.2)	1,203 (0.2)	1,205 (0.2)	-23	2	-1.9	0.2
8	Long-term Debt (1to7)	3,83,687 (81.3)	3,96,821 (81.7)	4,02,976 (81.3)	4,15,829 (81.0)	32,142	12,853	8.4	3.2
9	Short-term Debt	88,124 (18.7)	88,982 (18.3)	92,824 (18.7)	97,609 (19.0)	9485	4785	10.8	5.2
10	Total External Debt (8+9)	4,71,811	4,85,803	4,95,800	5,13,438	41,627	17,638	8.8	3.6

PR: Partially Revised. QE: Quick Estimates.
 Figures in parenthesis indicate their respective percentages to total external debt.

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Major highlights pertaining to India's external debt at end-March 2018 are presented below:

- At end-March 2018, India's external debt was placed at US\$ 529.7 billion, recording an increase of US\$ 58.4 billion over its level at end-March 2017.
- Valuation loss due to the depreciation of the US dollar vis-à-vis major currencies (viz., euro, SDR, Japanese yen and pound sterling) was placed at US\$ 5.2 billion. Excluding the valuation effect, the increase in external debt would have been US\$ 53.1 billion instead of US\$ 58.4 billion at end-March 2018 over end-March 2017.
- Commercial borrowings continued to be the largest component of external debt with a share of 38.2 per cent, followed by NRI deposits (23.8 per cent) and short-term trade credit (19.0 per cent).

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- At end-March 2018, long-term debt (with original maturity of above one year) was placed at US\$ 427.5 billion, recording an increase of US\$ 44.3 billion over its level at end-March 2017.
- The share of long-term debt (original maturity) in total external debt at end-March 2018 was 80.7 per cent, lower than its level of 81.3 per cent at end-March 2017.
- The share of short-term debt (with original maturity of up to one year) in total external debt increased to 19.3 per cent at end-March 2018 from 18.7 per cent at end-March 2017. The ratio of short-term debt (original maturity) to foreign exchange reserves increased to 24.1 per cent at end-March 2018 (23.8 per cent at end-March 2017).
- Short-term debt on a residual maturity basis (i.e., debt obligations that include long-term debt by original maturity falling due over the next twelve months and short-term debt by original maturity) constituted 42.0 per cent of total external debt at end-March 2018 (41.6 per cent at end-March 2017) and stood at 52.3 per cent of foreign exchange reserves (53.0 per cent at end-March 2017).
- US dollar denominated debt continued to be the largest component of India's external debt with a share of 49.5 per cent at end-March 2018, followed by the Indian rupee (35.8 per cent), SDR (5.5 per cent), Japanese yen (4.8 per cent) and euro (3.4 per cent).
- The borrower-wise classification shows that the outstanding debt of both government and non-government sectors increased at end-March 2018.
- Debt service payments declined to 7.5 per cent of current receipts at end-March 2018 as compared with 8.3 per cent at end-March 2017.

Government and Non-Government External Debt

Government (Sovereign) external debt was at US\$ 108.9 billion at end-December 2017 while non-Government debt was at US\$ 404.5 billion. The share of Government debt in total external debt increased to 21.2 per cent at end-December 2017 from 19.4 per cent at end-March 2017. The ratio of Government debt to GDP has fallen from 4.8 per cent at end-March 2012 to 3.9 per cent at end-March 2017. The increase in 'Other Government External Debt' in recent years reflects the increasing level of foreign portfolio investment in government securities.

Check Your Progress

3. Who are the debtors of external debt in India?
4. What is the government and non-government external debt in India?

13.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Internal debt is contracted by the government from the individuals and institutions within the country.
2. The government very often imposes new taxes on the people to pay the external debt.
3. The debtors of the external debt in India can be the Union government, state governments, corporations or citizens of India.
4. Government (Sovereign) external debt was at US\$ 108.9 billion at end-December 2017 while non-Government debt was at US\$ 404.5 billion.

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13.5 SUMMARY

- The government of a country can go to any national and/or international capital market and borrow funds from there.
- Internal debt is contracted by the government from the individuals and institutions within the country. On the contrary, external debt is taken by the government from the individuals, institutions and/or governments of foreign countries.
- There is a general feeling that an internal debt is better than an external debt. The main objection to an external loan seems to be based on the misconception that it involves a drain of wealth from the country.
- In the case of external public borrowing, the debtor country has to pay to the creditor country every year huge sums of money by way of payment of interest on loans.
- The government very often imposes new taxes on the people to pay the external debt. Ordinarily, the burden of these taxes falls more heavily on the poor sections than on the rich sections of the society.
- The external debt of India is the total debt the country owes to foreign creditors, complemented by internal debt owed to domestic lenders.
- The debtors can be the Union government, state governments, corporations or citizens of India.
- The debt includes money owed to private commercial banks, foreign governments, or international financial institutions such as the International Monetary Fund (IMF) and the World Bank.

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- Government (Sovereign) external debt was at US\$ 108.9 billion at end-December 2017 while non-Government debt was at US\$ 404.5 billion.
- The ratio of Government debt to GDP has fallen from 4.8 per cent at end-March 2012 to 3.9 per cent at end-March 2017.

13.6 KEY WORDS

- **Laissez Faire:** It is the policy of leaving things to take their own course, without interfering.
- **External Debt:** It is the portion of a country's debt that was borrowed from foreign lenders including commercial banks, governments or international financial institutions.
- **Internal Debt:** It is the part of the total government debt in a country that is owed to lenders within the country.

13.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Define external debt.
2. Differentiate between internal and external debt.

Long Answer Questions

1. Examine how external public debt is a burden.
2. Discuss the external debt of India.

13.8 FURTHER READINGS

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UNIT 14 FOREIGN DIRECT INVESTMENT AND MULTINATIONAL CORPORATIONS

Structure

- 14.0 Introduction
- 14.1 Objectives
- 14.2 Foreign Direct Investment
- 14.3 Multinational Corporations In India
- 14.4 Answers to Check Your Progress Questions
- 14.5 Summary
- 14.6 Key Words
- 14.7 Self Assessment Questions and Exercises
- 14.8 Further Readings

14.0 INTRODUCTION

In the previous unit, you learnt about external debt. In the final unit of the book, the discussion will turn towards foreign direct investment and multinational corporations in India.

Foreign direct investment or FDI is an investment in the form of a controlling ownership in a business in one country by an entity based in another country. It is thus distinguished from a foreign portfolio investment by a notion of direct control. Since liberalization policies of 1991, the Indian economy has been geared to attract foreign investment so as to achieve the economic objectives of growth and creating employment. India today has become one of the most attractive destinations of foreign direct investment. In 2017, India attracted almost \$62 billion worth of FDI. The unit will also discuss Multinational Corporations in India. A Multinational Company or MNCs is an enterprise that operates in several countries but it is managed from one (home) country. In today's globalized world, MNCs have come to dominate the world economy. We will discuss several aspects related to MNCs in India.

14.1 OBJECTIVES

After going through this unit, you will be able to:

- Define Foreign Direct Investment and Multinational Corporations
- Examine the benefit and drawbacks of FDI

- Describe the economic, political and cultural consequences of MNCs in a society

14.2 FOREIGN DIRECT INVESTMENT

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Foreign direct investment or FDI plays a significant role in the growth and economic development of a nation. FDI is a source of capital, managerial skill and technical knowledge.

Economies across the world are globalizing and the major force shaping globalization is the growth of foreign direct investment. It has been playing a pivotal role, through the Multinational Corporations (MNCs), in bringing together the national economies and building an integrated international production system so as to enhance the competitiveness and economic performances of host and home countries. Considering the potential benefits of foreign direct investment for economic development and growth, governments strive to create a favourable climate to attract FDI, by establishing an enabling framework, knowing, however, that other factors (such as market size, growth and macroeconomic stability) carry the principal weight in investors' locational decisions. Governments have done so through the liberalization of their national FDI regimes by reducing or eliminating restrictive measures on entry and establishment, local ownership and control requirements, discriminatory operational conditions and screening or authorization procedures. Many have adopted or agreed to general standards of treatment—including national treatment, most-favoured-nation and fair and equitable treatment, and treatment according to international law — and provided specific guarantees in key areas such as the transfer of funds, expropriation and dispute settlement. These trends, which are part of a broader liberalization process that encompasses all types of international transactions, are in turn an extension of the general tendency to pursue market-oriented policies, as a means to achieve greater economic efficiency. During the past few decades, international trade and foreign direct investment have been the two most important activities that are integrating the world economy.

With the increase in the mobility of factors of production across countries, FDI has become an integral part of a firm's strategy to expand international business. FDI is the largest source of external finance for developing countries. At present, inward stock of FDI amounts to about one-third of the developing countries' GDP, compared to merely 10 per cent in 1980.

FDI in recent years has become a global commodity and especially the developing countries are in the race to attract more FDI. Empirical evidence reveals that to attract foreign investment, a large number of countries have introduced drastic reforms in their economic, fiscal, industrial, and political structure since 1991. Some of the key reforms introduced by these countries in FDI laws and regulatory framework include opening of industries previously closed to FDI, streamlining or abolition of approval procedures, provision of incentives and

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establishment of specialized liberalized schemes. Another development in the desire of government to facilitate FDI flows is reflected in a dramatic increase in the number of bilateral investment treaties (BITs) for the protection and promotion of investment. Besides, the pattern of BITs has also changed considerably from intra-developed and developed-developing to intra-developing and developing underdeveloped countries as a partner.

The net FDI inflows to developing countries increased from an annual average of US \$5 billion in 1970–79 to US \$13 billion in 1980–85, to US \$25 billion during 1985–90.

Global FDI inflows registered an increase of 141 per cent from US \$638 billion in 2003 to US \$1538 billion in 2007. Developed countries continue to remain the major destination of FDI inflows with a global share of 65 per cent, followed by developing countries with 28 per cent and transition economies with 7 per cent in 2007. The rapid increase in the reforms initiatives taken by nations the world over has led to faster growth in the global FDI than world trade and world output.

FDI plays a crucial role in the development process of host economies. It also has a significant role in enhancing exports of the host country. It is estimated that the sales from foreign-owned facilities are about double the value of world trade. FDI not only serves as a source of capital inflow into host economies, but also helps to enhance the competitiveness of the domestic economy through transferring technology, strengthening infrastructure, raising productivity, and generating new employment opportunities.

FDI has often been viewed as a threat by host countries due to the capacity of transnational investing firms to influence economic and political affairs. Many developing countries often fear FDI as a modern form of economic colonialism and exploitation, similar to their previous unpleasant experiences with colonial powers.

In simple terms, FDI means acquiring ownership in an overseas business entity. It is the movement of capital across national frontiers, which gives an investor control over the assets acquired. FDI occurs when an investor based in one country (the home country) acquires an asset in another country (the host country) with the intent to manage it. It is the management dimension that distinguishes FDI from portfolio investment in foreign stocks and other financial instruments. Conceptually, a firm becomes a multinational corporation (MNC) by way of FDI as its operations extend to multiple countries.

Determinants of FDI

A firm, while selecting countries as investment destinations must evaluate the country on the following factors:

- **Resource base:** Availability of raw material, complementary factors of production, physical infrastructure, availability of skilled workforce, and availability of business-related services.

- **Market conditions:** Economic and political climate, taxation policies, incentives, trade policy, market size, market growth, regional integration, cost of capital input, wage rate, cost of logistics.

Benefits of FDI

The benefits that accrue to the host country from FDI include the following:

- **Access to superior technology:** Foreign firms bring superior technology to the host countries while investing. The extent of benefits depends upon the technology spill over to other firms based in the host country.
- **Increased competition:** The investing foreign firm increases industry output, resulting in overall reduction in domestic prices, improved product or services quality, and greater availability. This intensifies competition in host economies, resulting in net improvement in consumer welfare.
- **Increase in domestic investment:** It is found that capital inflows in the form of FDI increase domestic investment so as to survive and effectively respond to the increased competition.
- **Bridging host countries' foreign exchange gaps:** In most developing countries, the levels of domestic savings are often insufficient to support the capital accumulation to achieve growth targets. Besides, the level of foreign exchange may be insufficient to purchase imported inputs. Under such situations, the FDI helps in making available foreign exchange for imports.

Drawbacks of FDI

In most countries, public opinion towards foreign enterprises is not very favourable and FDI is feared due to its impact on domestic firms, the economy, and culture. The major drawbacks of FDI are as follows:

- **Market monopoly:** Multinational corporations are far more advanced than domestic companies, owing to their large size and financial power. In some sectors, this has led to MNC monopolies, thus impeding the entry of domestic enterprises and harming consumers. An MNC's ability to operate at a large scale and invest heavily in marketing and advertising and R & D activities differentiate their products and makes entry of new firms far more difficult as they are unable to make similar investments in R & D and marketing strategies.
- **Crowding-out and unemployment effects:** FDI tends to discourage entry and stimulates exit of domestic entrepreneurs, often termed as the crowding-out effect. As FDI enterprises are often less labour intensive, their entry results in higher unemployment and increased social instability.
- **Technology dependence:** MNCs often function in a way that does not result in technology-sharing or technology-transfer, thereby making local firms technologically dependent or technologically less self-reliant.

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- **Profit outflow:** Foreign investors import their inputs and use the host country as a processing base, with little value-added earnings in the host country. A large proportion of their profits may be repatriated.
- **Corruption:** Large foreign investors often bribe government officials and distort market forces.
- **National security:** With MNCs holding a dominant position in sensitive industries, such as telecommunications, and the supply of core equipment and software for the information technology (IT) industry, there is a danger that the strategic interests of the host country may be compromised.

According to the *Financial Times*, in 2017, India overtook China and the US as the top destination for the Foreign Direct Investment. In first half of the 2015, India attracted investment of \$31 billion compared to \$28 billion and \$27 billion of China and the US respectively. FDI inflows in India increased to USD 60 billion in 2016-17 indicating that the government's effort to improve ease of doing business and relaxation in FDI norms is yielding results. In the next fiscal, foreign direct investment in India had increased to USD 61.96 billion.

Check Your Progress

1. What is FDI a source of?
2. Why has FDI become an integral part of a firm's strategy to expand international business?
3. Why is FDI often viewed as a threat by host countries?

14.3 MULTINATIONAL CORPORATIONS IN INDIA

The emergence of the multinational private corporation as a powerful agent of world social and economic change has been a signal development of the post-War era. Its evolution has been regarded with mixed feelings by the host countries.

A multinational corporation is an enterprise which owns or controls producing facilities in more than one country such as factories, mines, oil refineries, distribution channels, etc. The United Nations defined multinational corporations as 'enterprises which control assets—factories, mines, sales offices and the like—in two or more countries'. According to another definition, a multi-company is one with sales above \$100 million with operations in at least six countries and with subsidiaries accounting for at least 20 per cent of its assets.

Multinational Corporations account for one-fifth of the world's output, excluding socialist economies. Their production in recent years has been growing at the rate of 10 per cent a year, nearly twice the growth rate of the world output and half as much as the world trade. According to one report in 2016, out of the top 100 economies in the world, 31 were countries and 69 were multinational companies. Therefore, multinationals are gigantic in size.

Most of the multinationals enjoy predominantly oligopolistic market positions and are characterised by the importance of new technologies, special skills or product differentiation and heavy advertising which sustain their oligopolistic nature by making the entry of competitors more difficult.

Almost every large enterprise has foreign involvement of some kind. Whatever its home, it will send agents to other nations, establish representative offices abroad, import foreign materials, export some products, license foreign firms to use its patents or know-how, employ foreign nationals, have foreign stockholders, borrow money from foreign banks and even have foreign nationals on its board of directors. None of these, however, would make an enterprise multinational because none would require a substantial direct investment in foreign assets nor entail a responsibility for managing organizations of people in alien societies. Only when an enterprise confronts the problems of designing, producing, marketing and financing its products within foreign nations does it become truly multinational.

A domestic corporation may become multinational by establishing foreign branches, by operating wholly or partially owned subsidiaries in other countries or by entering into joint ventures with enterprises in other countries.

It is interesting to note the concentration of multinational corporations in certain fields of industries. Taking the USA as the leader of such enterprise, we find that 85 per cent of US investment is concentrated in the following industries: vehicles, chemicals, mechanical and electrical engineering.

If we take the multinationals as a whole, we find that they have established almost complete domination on such industries as rubber tyres, oil, tobacco, pharmaceuticals and motor vehicles.

Concentration in Specific Areas

The geographical distribution of multinational corporations shows an interesting pattern. If we consider the distribution by the origin of enterprise, we find that in 1966, about 55 per cent of the multinationals were of US origin, 20 per cent of British origin, while about 25 per cent were of European or Japanese origin.

Multinational operations by private business corporations are comparatively recent in the history of man. The companies of merchant traders in medieval Venice and the English, Dutch and French trading companies of the 17th and 18th centuries were forerunners, but not true prototypes of today's multinational corporation. They were essentially trading rather than manufacturing organizations, with comparatively little fixed investment. And they operated mainly within the colonial territories rather than under the jurisdiction of foreign sovereign states.

Historical Background

During the 19th century, foreign investment flowed extensively from Western Europe to the underdeveloped areas of Asia, Africa and the Americas. In this age of empire building, Victorian Britain was the great capital exporter, followed by

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France, Germany and the Netherlands. Little of this capital flow was direct investment outside imperial boundaries.

The first substantial multinational corporate investment came in the mining and petroleum industries during the initial years of the 20th century. A wide geographical separation existed between the great mineral deposits of the world and the consuming markets in the USA and Western Europe. Hence large oil companies like British Petroleum and Standard Oil and mineral corporations like International Nickel were among the first true multinationals. Coca-Cola, Singer, Woolworth were early American multinationals.

Multinational corporate investment spread further in the years after World War I, spurred by rising barriers to international trade and led by burgeoning automobile and associated industries. After the Second World War, multinationals flowered as American firms invested heavily abroad in a wide variety of manufacturing and merchandising operations.

American corporations led the world trend towards business multinationalism. The great size and wealth of the US economy generated capital for investment. Companies were attracted by the relatively higher foreign rates of return on investment. American capital outflow took the form of corporate direct investment because of the superior organization of American capital markets and the larger capabilities of American managers. American corporate investment abroad is concentrated in the hands of the largest firms. Of a total investment of \$65 billion at the end of 1968, 500 largest American corporations had invested more than \$50 billion.

Direct investment in foreign manufacturing facilities is an alternative to exporting home-made products. Why have manufacturers endure the harder tasks and larger risks of foreign operations instead of shipping their products abroad? Evidently, direct investment appeared to be more profitable.

The second reason for direct foreign investment is that entrepreneurs confront foreign barriers to their exports. Nationalistic sentiments led most nations to build their own industrial capabilities. By raising barriers against imports of manufactured products, they induced foreign as well as local firms to establish domestic industries. Large number of American corporations became multinationals simply to maintain or expand markets in Canada or in E.E.C. that could not be as profitably served by exports.

Third, business firms also multinationalise because their presence as a producer in a foreign nation enables them to adapt their products to local demands more effectively. Another reason for direct foreign investment is that the anti-trust laws and keen competition at home tended to restrict the expansion of dynamic American business, channelling corporate attention to opportunities abroad.

Organizational Forms

A multinational business corporation may adopt one of the two basic organizational forms—(i) a world corporation form in which domestic and foreign operations are merged or (ii) an international division form in which foreign business is done in separate national divisions, apart from domestic operations.

Multinational corporations plough back their profits on a significant scale. This removes, to some extent, the basis of the charge that they indulge in economic drain. But some countries also feel that ploughing back of profits is not a good solution because it increases the foreign stake in a country's economy and polity.

American corporate investment in developing countries has been gradually shifting from an earlier emphasis on the mining, extractive and raw material industries towards diversified manufacturing and merchandising operations. One important consequence has been a great increase in American exports of technological and managerial skills and knowledge to the recipient country. This shift will serve to reduce the charge of foreign exploitation.

The potential contribution of multinationals to the development of poorer countries is large. Its realization depends mainly on the development of stable governments in those countries and their actions to encourage private investment. Any developing country that offers political stability, respect for contracts, financial responsibility and equitable taxation will attract investment, foreign and domestic. The remarkable evolution of such regions as Hong Kong and Taiwan testify to this truth.

Private business investment is superior to governmental aid as an instrument of development because it combines transfer of managerial and technical assistance with that of capital. General dissatisfaction with bilateral governmental aid makes it important to expand the flow of business investment. While measures to limit or to insure against risks will help to enlarge this flow, they will not remove the root causes of international tensions. The foreign subsidiary of the American corporation will still be charged with "exploitation" of local resources and making too much profit. When it pays higher than prevailing wages and benefits to its employees, their higher living standards will provoke envy and resentment amongst others.

The political and social effects of multinational corporations in developing countries are not as clear as their economic effects. The process of development is inherently unsettling to a society. By producing shifts in the distribution of income and wealth and by redistributing economic power among social classes, development creates political stresses. Often these tensions can be relieved by peaceful political reforms; not infrequently they are followed by more or less violent upheavals. Indeed, being an agent of change, the foreign corporation is seen in the developing country as a threat to privileged positions in the traditional society. However, some leading development economists have counselled Latin American

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countries that their best interests would be served by compelling foreign firms to sell affiliates to local owners or to the government. They argue that the foreign affiliates stunt the growth of local enterprise. While nationalistic pride may be bolstered by such a policy, its cost in slower development appears to be high.

The cultural consequences of American corporate penetration in the developing countries can be plainly seen in the ready acceptance by natives of soft drinks, packaged foods, automobiles, electrical appliances and much of the paraphernalia of American life. At a more fundamental level, it is likely that the status and value systems, the social attitudes and behavioural patterns, the arts and the essential cultural foundations of many of these countries will also undergo profound changes. These should ultimately reduce barriers of communication between peoples and lay a common basis for a stable world order.

Multinational corporations are carriers of new values and ideas that threaten the old ways, which have served the people of developing countries well. A multinational corporation introduces 'the idea of meritocracy instead of aristocracy, of rewarding talent instead of status, of distinguishing people by ability instead of by colour or sex'.

Fear of 'loss of control' of their national destinies because of massive foreign private investment has caused many developing countries to enact laws for screening such investment in the future. The case for home country controls is not necessarily based on charges of 'abuses' or 'exploitations' by multinationals. The case for home country controls over multinational business enterprises is based on the reality that the goals of the multinational firms and the goals of host country are not identical.

A developing country should lay emphasis on exporting manufactures. This view reflects the vision that a modern country needs industry and that the small domestic markets of most developing countries will impose high costs unless industrial products are exported. Developing countries complain frequently that multinational firms usually prohibit exports by their foreign subsidiaries. For example, in the 1960s in India, 43 per cent of all written collaboration agreements between Indian firms and foreign firms from 1961 to 1964 contained clauses restricting exports.

Much of the hatred against American multinationals is based on a mistaken identification of the American multinational corporations with the imperialistic enterprises of former colonial powers. The initial experience with foreign corporations of most host countries in the developing regions of the world was with the imperial monopolies of Britain, France, Holland and Spain. These early companies were the 'chosen instruments' of their governments. They followed the flags of the mother countries into their colonies to mine and harvest natural resources and to sell manufactured goods at high profit margins. It was natural that these early multinational corporations were regarded as instruments of imperialism by the colonial peoples. These attitudes have been carried over to the more recent American multinational corporations, which are viewed as an instrument of "neo

colonialism” and probably as an agent of CIA. But the US does not treat its enterprises as “chosen instruments” of national policy.

Multinationals operate in India in two ways: (i) through branches established in the country and (ii) through Indian companies which are subsidiaries of foreign companies, which hold more than 50 per cent of the paid-up equity capital.

In 1977, there were 482 branches of multinationals operating in India. Of these, 319 were branches of UK-based companies. The US-based companies had the second largest number of branches – 88; Japanese, W. German, Swiss, French and Canadian companies came next, with 21, 12, 11, 8 and 7 respectively. After India’s liberalisation and globalisation policies in 1991, the number of MNCs operating in India skyrocketed. As Foreign Direct Investment can be made in almost any sector in India, the numbers of MNCs in India have grown to over 5,800 in 2017.

In 1973, the United Nations took note of the growing size of the multinationals and recommended an in-depth study of the rise of multinationals and its impact on trade and development of other countries. A group of eminent persons led by Mr L.K. Jha submitted a report on the subject in 1974. Important points made in the report are as follows:

1. International corporations are organizations largely beyond the control of any single government;
2. Their overall goal is worldwide profits without regard for what is best for an individual country;
3. The interests of the country where a subsidiary is established for the development of export markets are subjected to the market interests of the parent company;
4. Parent companies do not make the most modern technology available to their subsidiaries; and
5. International corporations prevent the growth of locally owned enterprises by aggressive and unfair competition.

Criticism of Multinationals

To begin with, there is hardly any reason to justify the term multinational because in most cases only nationals of one country serve on the governing body or board. They operate in several countries and may have employees from many nations, but most policy and investment decisions as well as control are from one centre. It is also pointed out that multinationals do not regard themselves obligated to the interests of the region in which they are located. They neglect the training of the local people for the top management position.

Second, there is also an inherent danger that at the time of crisis, these corporations are capable of diverting vast sums of money from one area to another, which could bring about the collapse of the economic system.

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Third, the technology that multinational corporations transfer was invented in an environment where capital was abundant and labour was scarce. The reverse is true for the Third World countries which are long on labour and short on capital. So the technology is not appropriate for the developing countries.

Fourth, Raul Prebisch and Hans Singer speak of the 'enclave' effect of foreign investment in that the multinational tycoons never become part of the internal economic structure of the less developed countries.

Fifth, worse than the economic dominance is the cultural devastation of host countries. Operations of these multinationals strike a resounding similarity to the ways of the old imperialists which imposed their own culture on the colonies. They create a small nucleus of parallel culture in the host countries through payment of considerably higher salaries and perks to the local staff, thereby alienating them from the mainstream.

Sixth, a French critic has said that governments cannot stop inflation partly because they no longer can control huge multinational tycoons whose search for profits and creation of consumer demands are at the base of the problems.

A President of General Motors declared, "What is good for General Motors is good for America". But what is good for America may not be good for the host country.

Regulation of Multinationals

Foreign companies which undertake business activities in India or invest in Indian businesses need to comply with certain Indian laws. For example, at the time of making an investment in India or setting up an Indian office, the foreign company needs to comply with the Foreign Exchange Management Act (FEMA). FEMA also requires foreign companies in India to comply with certain procedural and filing requirements on a periodic basis when they conduct operations in India. Similarly, if the company sells products or services in India and has an office in India, it will have to comply with Indian tax laws. Similarly, it will be required to comply with local regulations if it has an office (such as a Shops and Establishment Registration).

Understanding the definition of foreign company under Companies Act, 2013

A foreign company is a company which is incorporated outside India but having its place of business (including a share transfer or an office registered with a regulatory authority) in India. Under the Companies Act 2013, a foreign company means any company or body corporate incorporated outside India which has a place of business in India, either of its own or if it conducts business through an agent, physically / electronically or any other manner. However, all foreign companies are not required to comply with the Companies Act, it is only applicable to foreign companies where 50% or more of the paid-up share capital (calculated by including

preference shares) is held by Indian entities. Foreign companies must comply with the provisions of the Companies Act, 2013 in respect to the business as if it were a company incorporated in India.

Government Policy

The policy of the government is to ensure that operations of foreign companies as also those of indigenous concerns conform to the overall socio-economic policy of the country and their activities, including their size of operations are regulated within the policy guidelines announced by the government from time to time.

Indian Joint Ventures Abroad

Indian joint ventures abroad have shown encouraging performance in relation to the twin policy objectives of extending co-operation to developing countries and creating opportunities for this country in exports of capital goods, technology and know-how.

The ventures have been contributing to the progress of import substitution and industrialisation in the developing countries where they are primarily located. In the process, they have resulted also in increased exports of technology-intensive products from India. Even in terms of commercial profitability, the performance of the joint ventures has shown improvement. The total profits they earned doubled between 1974–75 and 1976–77. Also the losses have declined during the period.

In 1978, there were a total of 329 joint venture proposals from Indian entrepreneurs. The proposals involve projects in as many as 48 countries.

The trend towards higher investment indicates that Indian entrepreneurs have now started embarking upon some ambitious and well-planned projects as are capable of yielding handsome returns after a few years. Such projects also speak volumes for India's technological capability and competence.

A region-wise analysis of the ventures in production discloses a marked preference by Indian entrepreneurs to invest in the neighbouring countries of South-East Asia especially in ASEAN countries. They had invested ` 1518.2 lakh in actual Indian equity in 47 units in South-East Asia. The figures are in comparison to ` 23.9 lakh in five units in South Asia, ` 30 lakh in eight units in West Asia, ` 687.5 lakh in 19 unit in Africa and ` 68.3 lakh in 13 units in Europe and America.

In South-East Asia, in the 1970s India had as many as 26 joint ventures (actual and projected) in Malaysia alone, followed by Indonesia (7), Thailand (5), Singapore (4), the Philippines (3) and Fiji (1). In South Asia there are three Indian joint ventures in Sri Lanka and one each in Nepal and Afghanistan. Elsewhere the position is as follows: West Asia: Iran (2), UAE (4), Oman (2). Africa: Kenya (6), Mauritius (7), Nigeria (5) and Uganda (1). Europe and America: France (1), UK (4), West Germany (1), Canada (2) and the USA (5).

After liberalisation, the magnitude and quality of foreign investment by Indian companies have gone up substantially. There has also been a perceptible shift in

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Overseas Investment Destination (OID) from the year 2000 onwards. While in the first half of 2017, overseas investments were directed to resource rich countries such as Australia, UAE, and Sudan, in the latter half, OID was channeled into countries providing higher tax benefits such as Mauritius, Singapore, British Virgin Islands, and the Netherlands. Indian firms invest in foreign shores primarily through Mergers and Acquisition (M&A) transactions. With rising M&A activity, companies will get direct access to newer and more extensive markets, and better technologies, which would enable them to increase their customer base and achieve a global reach. India has emerged as one of the strongest performers in the deal-street across the world in mergers and acquisitions. M&A deal volume in India increased 14 per cent to 1,022 transactions, worth US\$ 46.8 billion, in 2017.

According to the data provided by Reserve Bank of India (RBI), India's outward Foreign Direct Investment (OFDI) in equity, loan and guaranteed issue stood at US\$ 784.28 million in the month of February 2018 as against US\$ 866 million in January 2018 and US\$ 1.35 billion in February 2017.

The Relevance of Swadeshi

According to Eichenberg in his lecture on 2 February 2000 on liberal international relations theory, the promotion of free trade and the institution of democratic principles is the key to peace. In late 1991, with the transfer of the Indian Parliament into the hands of political and economic reformers, India began its quest towards liberalization despite much opposition. The reform implemented liberal trade in the largest democracy in the world.

Since India's independence from British control in 1947, Indian foreign policy can be characterized as fairly isolationist. During the Cold War period, India retained a policy of nonalignment, which was uncommitted to either the West or the East and stuck to 'swadeshi' ideology.

Swadeshi, which simply means 'India first,' is an extremely nationalistic ideology that promotes self-sufficiency. Just under a decade ago, Indian foreign policy has taken important measures towards liberalization. Under PM Narasimha Rao India has faced important reforms in its domestic and foreign economic policy. Under the administration of Rao, major changes in banking, interest rates and the ability to fully convert rupees (India's currency) in trade transactions took place. However, towards the end of 1991, Rao took the most important step by opening India's doors to foreign investment. The new government tried to restructure the 'ever-proliferating bureaucracy' and the 'license raj'. This reshaping broke the barriers, which allowed foreigners to step into the Indian markets. Such barriers included series of permits and licenses granted only by members of the Indian Parliament or high-ranking bureaucrats. These complicated and inefficient policies turned away potential foreign investors and, therefore, severely affected the Indian economy.

Rao also implemented revolutionary changes as part of the reform plan. According to the Asian Survey by Nalini Kant Jha, Rao limited the equity participation to 40 per cent and removed the provision for the necessity of local control of industry. India also removed restrictions on foreign trade, which significantly inflated the export growth and notably reduced customs duties and tariffs on imports.

The policy reforms in 1991 allowed India to step into a new era, an era of liberalization. Firstly, India's democracy is much different than the government of any other developing in existence today. Political parties and public activists play a major role in the development and sustenance of governmental political and economic policies. Amartya Sen in his work entitled, *India: Economic Development and Social Opportunity* says, 'The democratic framework of the Indian polity permits this exercise (of public influence) in ways that are not open in many other developing economies.' As a result, the constituents of the democratic state continue to be the major political actors in India's international relations.

Secondly, India's new economic policy of a liberal trade is leading the country to forge stronger and better relations with western nations, such as the US. Before the initiation of this new liberal era, the Indo-US relations have been quite unpleasant due to the nonalignment policy of India during the Cold War Era and the swadeshi temperament of the Indian Parliament during that time.

When Rao took office in 1991, he tried to recuperate the relationship through liberal ideology. He planned to improve the trade relations between the two largest democracies of the world and, as a result, turn the existing tension into mutually beneficial alliance.

During the 1990s, there was a continual increase of foreign investment in India by many nations. Foreign interests in India increased exponentially and, as a result, India moved far away from its swadeshi years to an age of global interdependency. However, the reforms of 1991 were not been widely accepted by all Indians. Much opposition was mainly led by the Bharatiya Janata Party (BJP) and the Left parties. The BJP and the Left claimed that India was moving towards the wrong direction. According to them, the country is moving towards a mirage of liberalism only to realize that their developing nation is being exploited by neo-imperialism. The BJP and other swadeshi advocates claimed that the 'common man' of India began to suffer due to increased prices in agricultural and food products and decreased wages due to outside competition. However, when the BJP came to power, they also undertook many reforms to welcome foreign investment and FDI.

According to Eichenberg's lecture on neo-imperialism on 23 February 2000, there are two net results of the theory, which are:

- The limitation on domestic sovereignty
- Underdevelopment as a result of increased dependency on the global economy

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The reform of 1991 did not result in either of these two. During the last two decades, as India has extended its hands to numerous and diverse foreign investors, they are not extensively dependent on a single trading partner. As a result, India could not, as Sen puts it, become an 'economic prisoner in the international world of open exchange.' Thus, domestic sovereignty remains strong as the existence of multiple international trading partners remain. Moreover, these trading partners will continue to remain because of the huge market for all goods and services that exists in India due to its increasingly large middle class. Hence, a high influx of foreign investment from numerous diverse investors will not lead to underdevelopment, but, on the contrary, lead to strong development of the nation's economy.

As against the beliefs of the supporters of the swadeshi ideology, India is not affected by liberalization, but is, in fact, the state's best option. The Indian economy is being continually strengthened by the new domestic and foreign economic policies of the central government by allowing foreign investment to enter the Indian market. This has further strengthened the global importance and international recognition of the country. Consequently, India's relations with the US, Europe and the Far East have begun to improve through increased interdependency, ideational similarities and global interests in the state, thereby leading to a more peaceful international environment.

Check Your Progress

4. How does the United Nations define multinational corporations?
5. What are the two basic organizational forms of an MNC?
6. What is a foreign company according to the Company's Act, 2013?

14.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. FDI is a source of capital, managerial skill and technical knowledge.
2. With the increase in the mobility of factors of production across countries, FDI has become an integral part of a firm's strategy to expand international business.
3. FDI has often been viewed as a threat by host countries due to the capacity of transnational investing firms to influence economic and political affairs
4. The United Nations defined multinational corporations as 'enterprises which control assets—factories, mines, sales offices and the like—in two or more countries'.
5. A multinational business corporation may adopt one of the two basic organizational forms—(i) a world corporation form in which domestic and

foreign operations are merged or (ii) an international division form in which foreign business is done in separate national divisions, apart from domestic operations.

6. A foreign company is a company which is incorporated outside India but having its place of business (including a share transfer or an office registered with a regulatory authority) in India.

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14.5 SUMMARY

- Foreign direct investment or FDI plays a significant role in the growth and economic development of a nation.
- Economies across the world are globalizing and the major force shaping globalization is the growth of foreign direct investment.
- FDI has been playing a pivotal role in bringing together the national economies and building an integrated international production system so as to enhance the competitiveness and economic performances of host and home countries.
- FDI in recent years has become a global commodity and especially the developing countries are in the race to attract more FDI.
- Empirical evidence reveals that to attract foreign investment, a large number of countries have introduced drastic reforms in their economic, fiscal, industrial, and political structure since 1991.
- FDI plays a crucial role in the development process of host economies. It also has a significant role in enhancing exports of the host country.
- Many developing countries often fear FDI as a modern form of economic colonialism and exploitation, similar to their previous unpleasant experiences with colonial powers.
- Foreign firms bring superior technology to the host countries while investing.
- Multinational corporations are far more advanced than domestic companies, owing to their large size and financial power. In some sectors, this has led to MNC monopolies, thus impeding the entry of domestic enterprises and harming consumers.
- FDI inflows in India increased to USD 60 billion in 2016-17 indicating that the government's effort to improve ease of doing business and relaxation in FDI norms is yielding results.
- The emergence of the multinational private corporation as a powerful agent of world social and economic change has been a signal development of the post-war era.

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- A multinational corporation is an enterprise which owns or controls producing facilities in more than one country such as factories, mines, oil refineries, distribution channels, etc.
- The political and social effects of multinational corporations in developing countries are not as clear as their economic effects. The process of development is inherently unsettling to a society. By producing shifts in the distribution of income and wealth and by redistributing economic power among social classes, development creates political stresses.
- After liberalisation, the magnitude and quality of foreign investment by Indian companies have gone up substantially.
- There has also been a perceptible shift in overseas investment destination (OID) from the year 2000 onwards.
- As against the beliefs of the supporters of the swadeshi ideology, India is not affected by liberalization, but is, in fact, the state's best option.
- The Indian economy is being continually strengthened by the new domestic and foreign economic policies of the central government by allowing foreign investment to enter the Indian market.

14.6 KEY WORDS

- **Swadeshi:** The buying or favouring of goods made in India over goods manufactured abroad.
- **Foreign Direct Investment:** It is investment in the form of a controlling ownership in a business in one country by an entity based in another country.
- **Joint Ventures:** They are commercial enterprises undertaken jointly by two or more parties which otherwise retain their distinct identities.
- **Monopoly:** It refers to the exclusive possession or control of the supply of or trade in a commodity or service.
- **Enclave:** It means a place or group that is different in character from those surrounding it.
- **Subsidiary:** It means a company controlled by a holding company.

14.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the determinants of foreign direct investment?

2. What are the reforms that countries have introduced to attract FDI since the 1990s?
3. How are multinational companies regulated in India?

Long Answer Questions

1. Discuss the benefits and drawbacks of foreign direct investment.
2. Describe the economic, political and cultural effects of multinational corporations on a society?
3. Examine the relevance of swadeshi thinking in India in the era of globalization.

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