INDIAN ECONOMIC DEVELOPMENT POLICY

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SYLLABUS

Indian Economic Development Policy

Objectives:

Objective of this course is to acquaint students of the Indian Economy, present and future of Indian Economics, and how the Indian Economy is influencing the business environment in India context.

Sr. No.	Content
1	Industrial Sector in Pre-reform Period, Industrial Sector in Post-reform Period, Issues and Problems of Public Sector
2	**Sectoral performance II:** Role of Infrastructure in economic development, Indian Financial System: Money Market and Monetary Policy, Capital Market in India and Working of SEBI
3	**Sectoral performance III:** Foreign Trade and Balance of Payment, Role of Foreign Capital-FDI and Multinational Corporations
4	Fiscal Federalism in India, Government Finance : Union and States, 12th and 13th Finance Commissions
5	**Governance of the Economy:** Implementation of Economic Policies, Parallel Economy, Role of Bureaucracy and Delivery Mechanism in Implementation of Economic Policies, Implementation of Economic Policies: Role of Panchayat and Pressure Groups

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Unit 1: Industrial Sector in Pre-Reform Period

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1.2 The Role of Industrialisation
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Objective

After reading this Unit students will be able to:

- Discuss the Industrial Sector in Pre-Reform Period
- Explain the role of Industrialisation.

Introduction

The term 'pre-reform period' in Indian context means that the process of industrial policy reform started in 1970s. During the 1970s and 1980s, automatic capacity expansions were permitted and a few industries were delicensed in 1975. Moreover, systematic deregulation began in earnest in the mid-1980s. One major change was taxation reforms which primarily related to the conversion of multi-point excise duties into a Modified Value-Added Tax (MODVAT) in all sectors except petroleum products, textiles and tobacco. However, this liberalisation was trivial and hence the intensive industrial policy reforms were launched when the New Industrial Policy (NIP) statement of 1991 introduced. This policy announced reforms in regulations governing foreign investment, licensing, small-scale sector industries, monopoly, and in public sector enterprises. The economic reforms of 1990s were unprecedented in their scope and magnitude. Therefore, the period before 1991 is known as 'pre-reform period' and after 1991 is termed as 'post-reform period'. However, the discussion with regard to the industrial sector will have an emphasis on its performance during 1980s only.

1.1 Industrial Sector in Pre-Reform Period

The direction of industrial development in India made an early start with the introduction of the Statement of Industrial Policy, 1945, the Industrial Policy Resolution of 1948, the enactment of the Industries (Development and Regulation) Act, 1951, the First and Second Five Year Plan documents, and the Industrial Policy Resolution of 1956. These were efforts of organised thinking. It may be noted that the 1945 Statement of Industrial Policy is remarkable as a precursor of all the thinking that became enshrined in the key industrial policy resolutions after independence.

The concept of industrial licensing was also included in this statement. At this point of time, special emphasis was laid on the development of steel, heavy engineering, machine tools and heavy chemicals industries in the economy. The active participation of the Government in the setting up of certain important industries was also mooted in this industrial policy. A significant continuity is observed in thinking between pre-independence and post-independence Government as reflected in the Industrial Policy Resolutions of 1948 and 1956. The dominant view in development economics during 1950s and 1960s was that the Government had to play an important role and it should undertake activities that would compensate for market failure. The low growth of the economy persisted during 1970s. A succession of Five Year Plans set forth a large number of economic policies controlling and directing

private economic activity and guiding public sector enterprises that absorbed a high and increasing fraction of investment. According to Rakesh Mohon (1992), the Second Five Year Plan and even later Plans had been increasingly concerned with the allocation of public resources and much less with indications and policies to direct the whole economy in desired directions. P.C. Mahalanobis influenced the plans heavily. His economic model ignored foreign trade and assumed that domestic investment was limited by the domestic ability to produce capital goods. In this model, the key elements were import substitution, predominance of the public sector and promotion of heavy industry. With the passage of time, these policies combined with industrial licensing system and extensive bureaucratic control over production, import and export, capital issues, foreign exchange, allocation of raw materials, price and allocation of credit served to eliminate competition within the domestic market and to generate a highly inefficient and restrictive production system. It was clear by the late 1970s and early 1980s that the pervasive regulation and controls over private economic activity by the Government had effects opposite to those intended and had inhibited economic efficiency and industrial growth in the country. Thus, from that time onwards, the idea of bringing in industrial policy reforms in the Indian economy was in the air. In 1984, to "rationalise" controls became the declared objective.

Industrial Sector in Pre-Reform Period

In the pre-reform period, the industrial sector in India fared quite impressively in the 1980s in terms of growth of output/value added, compared to the earlier decades. There has been much discussion in recent literature on the pattern of growth in the 1980s and the factors behind the improved growth performance. With the introduction of some major policy reforms in 1985, the re-orientation of industrial and trade policies initiated in the mid-1970s received a fillip. Let us see whether the growth performance in the second half of the 1980s was superior to that in the first half of the period.

Pattern of Industrial Growth : If we look at average annual growth rates in Gross Value Added (GVA) for the entire economy, the agricultural sector and the different subsectors of the industrial sector for the 1970s, 1980s and the two halves of the 1980s, we find that there was appreciable increase in the growth rate in the 1980s in all sectors/sub-sectors for which comparable figures are available. We find from comparison of the two halves of the 1980s that with the exception of registered manufacturing, other sectors/ sub-sectors fared better in the second half. Moreover, the unregistered manufacturing sub-sector improved its growth rate considerably from 4.1 to 7.5% per annum and this improvement alone is responsible for the observed increase in the growth rate of the manufacturing sector from 6.2 to 7.8%. It may be noted that the share of industry increased substantially over the 15-year period (1950-51 to 1965-66), from 12.8 to 19.1%. However, the increase was marginal over the subsequent 15-year period (1965-66 to 1980-81) from 19.1 to 20.8%. We see that the structural change in favour of industry again gained momentum in 1980s. Industry, on the other hand, accounted for a little more than one quarter (25.1 %) of total GDP at the end of that decade.

1.2 The Role of Industrialisation

Industrialisation has a major role to play in the economic development of the underdeveloped countries. The gap in per capita incomes between the developed and underdeveloped countries is largely reflected in the disparity in the structure of their economies; the former are largely industrial economies, while in the latter production is confined predominantly to agriculture. Table 1 clearly reveals the positive relationship between per capita income and the share of manufacturing output (industry including construction). Undoubtedly, some countries have achieved relatively high per capita incomes by virtue of their fortunate natural resource endowments.

Notes Petroleum exporting countries like Saudi-Arabia, Kuwait, and UAR have achieved higher per capita income by exploiting the strong advantage that they enjoy in international trade. But these countries are a rather special case.

The pattern of 'growth through trade' in primary commodities was, however, realised in the nineteenth century when industrialization was closely linked with international trade, because(a) countries previously isolated by high transport costs as well as other barriers came to specialize, and (b) economic

development through trade was diffused in outlying areas because the pattern of advance in the rising industrial countries happened to be such as to cause a rapidly growing demand for crude products of the soils which those areas were well-fitted to supply. This traditional pattern of growth through trade is out of place now. As rising levels of per capita consumption have gradually transformed the composition of demand for goods and services and as technological changes have resulted in the more economic use of new materials or the creation of synthetic substitutes, the growth of import demand of the advanced countries for most primary products has lost the momentum of the earlier period and, currently, it lags behind the growth in their domestic incomes and output. The volume of exports from the underdeveloped countries expanded at a rate of 3.6 per cent per annum while the exports from the developed countries rose at the rate of 6.2 per cent. This export lag is accompanied by a deterioration in their terms of trade. Thus in view of unfavourable trends in world trade of primary commodities, industrialisation is the only effective answer to the problems of under-developed countries. They can no longer depend upon trade for their development; they have to activise dynamic elements within their economies.

Table 1 : Percentage Industrial Distribution of Gross Domestic Product and Per Capita Income (2009)

Country	Per capita income in U.S. Dollar (2008)	Industrial origin of Domestic Product at factor cost (Percentages)		
		Agriculture	Industry	Services
U.S.A.*	46,436	1.3*	20.8*	77.3*
Belgium	44,429	.8*	23.1*	76.1*
U.K.*	35,164	.7*	23.7*	75.1*
Japan	39,726	1.4*	29.3*	69.3*
China	3,744	10.3	46.3	43.4
India	1,134	17.1	28.2	54.6

Source : World Bank, **World Development Indicators,** 2010 *2008

Besides the limitation of 'trade gap', these countries are facing a relentless increase of population combined with a likelihood of diminishing returns in agriculture which is instrumental in creating the trap of poverty. The essential precondition for development (and to break this vicious circle) is an all-round rise in low productivity occupations to high productivity occupations. In general, the net value of output per person is higher in industry than in agriculture. In industry, the scope for internal as well as external economies is greater than in other sectors and certainly greater than in agriculture. As industrialisation proceeds, economies of scale and inter-industrial linkages (complementarity) become more pronounced. It also leads to the creation of economic surplus in the hands of industrial producers for further investment.

The Pattern of Industrialisation

While there is now almost universal agreement on the importance of industrialisation, there is still much debate regarding the proper pattern of industrial development. Historically, industrial development has proceeded in three stages. In the first stage, industry is concerned with the processing of primary products : "Milling grain, extracting oil, tanning leather, spinning vegetable fibres, preparing limber and smelting ores." The second stage comprises the transformation of materials making bread and confectionery, footwear, metal goods, cloth, furniture and paper. The third stage consists of the manufacture of machines and other capital equipments to be used not for the direct satisfaction of any immediate want but in order to facilitate the future process of production. Hoffmann

classified all industrial output into two categories, consumer goods and capital goods output and classified various stages in terms of the ratio of consumer goods output to that of capital goods output. "In stage I the consumer goods industries are of overwhelming importance, their net output being on the average five times as large as that of capital goods industries." This ratio is 2.5 : 1 in the second stage and falls to 1 : 1 in the third stage and still lower in the fourth stage. Both these types of classifications emphasise the increasing role of the capital goods industries in the economy as industrial development takes place.

Though the general development of industry itself has proceeded from consumer goods to the capital goods, there are many variations of this pattern, both in terms of time taken to attain later stages and in terms of relative importance of each of the stages. Similarly, underdeveloped countries may also evolve a different pattern of industrialisation suitable to their economic conditions. It has been suggested that the pattern of industrialisation in under-developed countries should be guided primarily by considerations arising from the relative scarcity of capital. Since labour is relatively plentiful and capital scarce, the development of labour-intensive consumer goods seems quite legitimate. However, the basic premise of this approach is inappropriate. The problem is not how to economise the use of capital (this has to be done as an inevitable condition) but how to increase its supply. Since most underdeveloped countries do not produce these goods at home, the only alternative to increasing their supplies is through imports. This depends upon the rate of growth in exports of primary commodities and manufactured goods. As it has been pointed above, the countries are facing an "export lag" in their exports of primary commodities. Consequently, primary commodity exports do not seem to be a reliable source of foreign exchange earning in order to increase the import of capital goods.

Did u know? Soviet pattern of industrialisation involves a straight jump from the first to the third stage while British pattern is that of a gradual evolution.

Industrial Pattern and the Five-Year Plans

The Government of India launched the process of industrialisation as conscious and deliberate policy of economic growth in early fifties. The Government recognised the significant contribution industrialisation could make to the development process, "as a base for the growth of the primary sector, as a catalytic agent for the development of infrastructure, as a stimulant to generation of technologies through R & D effort . . . and as a growth multiplier."

Industries and the Second Plan (1956-61)

The Second Five-Year Plan programme for industrialisation was based on the Industrial Policy Resolution of 1956 which envisaged a big expansion of the public sector. A base of heavy industry was sought to be created. The actual investment in the public sector on organised industry was ₹ 870 crores. Private sector investment was ₹ 675 crores during the Second Plan period—more than envisaged in the Plan. Similarly, investment in village and small industries was ₹ 265 crores (in both public and private sectors). Taken together, total investment in industries was ₹ 1,810 crores, i.e., 27 percent of the total investment during the Second Plan.

The industrial pattern sought to be developed during the Second Plan was conceived in terms of the following priorities :

(i) increased production of iron and steel and of heavy engineering and machine building industries;

(ii) expansion of capacity in respect of other development commodities and producer goods such as aluminium, cement, chemical pulp, dyestuffs and phosphatic fertilisers, and of essential drugs.

(iii) modernisation and re-equipment of important national industries which have already come into existence such as jute and cotton textiles and sugar;

(iv) fuller utilisation of existing installed capacity in industries where there are gaps between capacity and production; and

(v) expansion of capacity of consumer goods keeping in view the requirements of common production programmes and the productions targets for the decentralised sector of industry.

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During the Second Plan a major task in industry was the building up of three steel plants in the public sector : Rourkela Steel Plant in Orissa, Bhilai Steel Plant in Madhya Pradesh and Durgapur Steel Plant in West Bengal. The other programmes of industrial development include manufacture of electrical equipment, expansion of Hindustan Machine Tools, expansion of Sindri Fertilizer factory and the establishment of a fertilizer plant at Nangil further expansion of Hindustan Shipyard and Chittranjan Locomotive factory.

The Second Plan witnessed a major diversification of the industrial spectrum. It strengthened further programmes of development in respect of oil exploration and coal and made a beginning with the development atomic energy.

Most of the investments in the Second Plan were heavy and basic industries. There was also rapid expansion of machine-building industries for use in agriculture are transport and for such industries as chemicals, textiles, Jute, cement, tea, sugar, flour and oil mills, paper, mining, etc. Good progress was also recorded in modernisation and equipment of important industries such as jute, cotton textiles and sugar. Quite a number of new industrial items e.g., industrial boilers, milling machines, tractors, motor cycles, scooters, etc., were also produced in large quantity.

In the sphere of village and small industries substantial progress was recorded. About 60 industrial estates comprising 1,000 small factories were set up. The period also witnessed the rise of a vigorous class of small entrepreneurs. In a number of items such as machine tools, sewing machines, electric motors, fans, bicycles, hand tools, etc. production increased from 25 to 50 per cent during the five-year period. Khadi, handloom and powerloom cloth production increased from 1,610 million metres to 2,150 million metres.

Industries and the Third Plan (1961-66)

With the base created in the first two Plans, the Third Plan called for the **maximum rate of investment** *to* (a) strengthen industry, power and transport and (b) hasten the process of industrial and technological change.

The overall financial outlay in organised industries and mining during the Third Plan period was ₹ 3,000 crores out of which the outlay in the public sector was about ₹ 1,700 crores and that in the private sector ₹ 1.300 crores.

The key role in industrial development programme was for the public sector. The aim was to make the economy self-sustaining in producers' goods industries such as steel, machine building, etc., so that the quantum of external assistance needed could be curtailed to a very low level. An overall target of 7 per cent increase in industrial production was envisaged in the Plan.

Except for the year 1965-66, industrial output increased steadily at the rate of 7.6 percent per annum. The achievement was lower than the average of 14 per cent per annum visualised in the plan. Although the increase in the output of producer and basic industries was higher than the growth in the general index of production, yet it was much lower than the target set out in the Third Plan.

Despite the overall under-achievement of targets of Third Plan reflected the first stage of a decade or more intensive development leading to a self-reliant and self-generating economy. Engineering industries like automobiles, cotton textile machinery, diesel engines, electric transformers and machine tools, advanced according to set-targets as did industries such as petroleum products, heavy chemicals, cement etc. Mining and extractive indusries also showed considerable progress. It was during this period that a fairly sound base for future industrial growth was laid through the completion of projects of the HEC for manufacture of machinery and equipment for steel plants, the MAMC for the production of mining equipment and Bharat Heavy Electrical for power generation and transmission equipment.

Industries and the Fourth Plan (1969-74)

The Fourth Plan intended to complete industrial projects undertaken in the Third Plan. It also aimed to enlarge capacities in export promotion and import substitution industries.

During the Fourth Plan, the actual outlay on organised industry was of the order of ₹ 2,700 crores in the public sector. Thus, the financial investment was short of the targets set out in the Fourth Plan. Nearly three-fourths of the total investment was in the core sector, viz., iron and steel, non-ferrous

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metals, fertilisers, petroleum and petro-chemicals, coal and iron ore.

The performance in industry was far short of even the modest targets set out in the Fourth Plan. On an average, the growth rate in industry was around 5 per cent which was much below targeted growth rate of 8 per cent envisaged in the Plan.

Industries in the Fifth Plan (1974-78)

Programmes of industrial development in the Fifth Plan were formulated keeping in view the objectives of self-reliance and growth with social justice. The Plan proposed to lay emphasis on the following :

(i) Rapid growth of core sector industries by giving high priority to steel, non-ferrous metals, fertilisers, mineral oils, coal and machine building.

(ii) Development of industries which promise a rapid diversification and growth of exports.

(iii) Enlarging the production of industries supplying mass consumption goods, viz., cloth, edible oils and vanaspati, sugar, drugs, bicycles.

(iv) Restraint on the production of inessential goods, except for exports.

(v) Development of small industries by reserving 124 items exclusively for them and by initiating an intensive programme for the development of ancillary industries as feeder industries to large-scale units.

Against the targeted annual growth rate of 8.1 per cent in the industrial sector, the actual annual industrial growth rate was of the order of 5.3 per cent during 1974-75 to 1977-78—much below the target.

Industries in the Sixth Plan (1980-85)

The Sixth Plan (1980-85) intended to work within the overall developmental strategy particularly with regard to the objectives of structural diversification, modernisation and self-reliance. The other elements of policy included the following :

(a) To meet foreign exchange requirements, export of engineering goods and industrial products, as also project exports would be stepped up.

(b) A judicious blend of permitting import of contemporary technology and promoting the development of indigenous know-how through domestic research and development.

(c) New strategies for development of backward regions would be devised. The thrust would be to implement a new model of development which would prevent concentration of industry in existing metropolitan areas.

A review of the progress of the industrial growth during the Sixth Plan reveals that as against the target of 7% growth in industrial productions, the growth rate achieved, however, was only 5.5 per cent. This was lower than the trend growth rate of 6 percent witnessed in the earlier three decades.

Industries in the Seventh Plan (1985-90)

In consonance with the guiding principles of the Seventh Plan, viz., to achieve growth with social justice, and improving productivity, the objectives of the development programmes in the industrial sector were :

(i) to ensure adequate supply of wage goods and consumer articles of mass consumption at reasonable prices and of acceptable quality;

(ii) to maximise the utilisation of the existing facilities through restructuring, improved productivity and upgradation of technology;

(iii) to concentrate on development of industries with large domestic market and export potential to emerge as world leaders in them;

(iv) to usher in 'sunrise' industries with high growth potential and relevance to our needs; and

(v) to evolve an integrated policy towards self-reliance in strategic fields and opening up of avenues for employment of skilled and trained manpower.

The Seventh Plan provided for an investment of ₹ 19,710 crores in large and medium industries and ₹ 2,750 crores for the development of village and small industries. Total investment in the industrial sector would thus be of the order of ₹ 22,460 crores or 12.5% of the total Plan outlay. The annual target growth rate was 8 per cent.

The main elements of the Seventh Plan industrial strategy were :

(i) Rapid removal of infrastructural constraints, by placing greater emphasis on additional availability of power through more efficient use of existing capacity as well as the establishment of new power stations including super thermal and nuclear plants.

(ii) Encouragement of modernization and technological upgradation in industries like textiles and sugar where a large number of units were set up in the early part of the 20th century.

(iii) Specific targets of productivity for major industries like steel, fertilizers, non-ferrous metals, petro-chemicals, paper and cement were to be set for the Plan.

(iv) Export production was to be made an integral part of production in the domestic economy. A special effort was to be made in selected industries in which the country has comparative advantage and has reached a degree of industrial maturity.

(v) Encouragement of 'sunrise' industries such as telecommunications, computers, micro-electronics, ceramic composites and bio-technology. Industries were to be encouraged to adopt technologies like fibre optics, lasers, robotics etc. for enhancing productivity and quality.

(vi) Location of industries near the small district towns which were not industrialized so far would be promoted with a view to removing regional disparities and encouraging dispersal of industries.

(vii) About 30 per cent of industries—large and medium—had already installed pollution control system. The Seventh Plan intended to enlarge the coverage of this programme as also to strengthen it.

A review of the progress of the Seventh Plan reveals that the annual growth rate of the industrial sector including mining, manufacturing and electricity generation during the Seventh Plan period was 8.5% which though marginally lower than targeted 8.7% was much higher than the 5.5% achieved during the Sixth Plan.

Industries in the Eighth Plan (1992-97)

The Eighth Plan was formulated under a new environment when a number of reforms in industrial, fiscal, trade and foreign investment policies were introduced in the economy —commonly called as economic liberalisation. In the context of the new Industrial Policy of July 1991, the role of the public and private sector was reviewed. In the initial phase of planned development the public played a pioneering role but its principal weakness extremely poor performance and its inability to general adequate resources for sustaining the growth process. During this period, the private sector has come of age has developed considerable entrepreneurial, manage technological, financial and marketing strengths. Thus, private sector should henceforth play a greater role in process of development. This new approach is consist with the general philosophy of placing greater reliance competitiveness of industries and efficiency of operation. Future growth would, therefore, be more in those sector where the country has comparative cost advantage.

Eighth Plan allocated a total investment of ₹ 38,083 crores for industry and mineral production (at 1991-92 prices). A review of the progress of actual outlay reveals that at current prices, ₹ 40,759 crores were spent, but measured at 1991 -92 prices, this worked out to be ₹ 31,39 crores. In other words, actual investment worked out to about 82 per cent of planned investment. There therefore, a serious shortfall of the order of 18 per cent.

Industries during the Ninth Plan (1997-2002), Tenth Plan (2002-07) and onward

Ninth Plan targeted a growth rate of 8 per cent for industry, but realized growth rate was only 5.0 per cent which was even lower than the growth rate of 7.3 per cent realised in the Eighth Plan. In this way, it may be stated that the Ninth Plan was a failure. As against the target of 5.9 per cent for

mining, the realised growth rate was barely 2.5 per cent. Similarly, achievement in manufacturing was 5.3 per cent as against the target of 8.2 per cent and in electricity, the realised growth rate was 5.5 per cent as against the target of 9.3 per cent.

Ninth Plan allocated ₹ 69,972 crores for industry at 1996-97 prices, but the Tenth Plan reveals that the total allocation to industry in the public sector was ₹ 44,695 crores at 2001-02 prices. If we revalue the proposed allocation of the Ninth Plan of ₹ 69,972 at 1996-97 prices, it works out to be ₹ 88,730 crores at 2001-02 prices. Comparing it with the public sector outlay of ₹ 44,695 crores, it implies that actual outlay of the public sector was only 50.3 per cent of the proposed outlay. It was hoped that the private sector would fill the gap, but this did not happen.

Reviewing the internal and external factors for the slowdown during the Ninth Plan, the Tenth Plan states : "The industrial slowdown is widespread, covering all broad sectors, e.g. manufacturing, electricity and mining and all end-use based groups such as capital goods, intermediate goods and consumer goods (both durables and non-durables). The slowdown in domestic and global demand appeared to be a major factor constraining industrial growth. Another major reason has been the decline in investment, noticeably by the private sector."

The difficulties caused by internal factors were aggravated by the slow growth of the world economy, which resulted in a substantial slowdown in manufacturing exports. This implies that failure of the Ninth Plan in industry can be attributed to the fall in public sector investment which was not compensated by an upturn in private investment.

Self-Assessment

1. Choose the correct option:

(*i*) What was the Industrial Revolution?

(*a*) The industries set up after the French and American Revolutions

(*b*) The acceleration of technical and economic development that begun in Britain around 1750

(*c*) Where all the poorly paid industrial workers finally had enough and all stopped work at once around 5.30 in the afternoon

(*d*) None of These

(*ii*) What was the 'new' industry dominated by?

(*a*) Machinery and Manufacturing

(*b*) Farms and Animals

(*c*) Selling and Servicing

(*d*) None of these

(*iii*) Which statement is the best summary of the economy in 1750?

(*a*) Heavy manufacturing, lots of pollution

(*b*) Water powered factories, some pollution

(*c*) Based on agriculture, growing and selling produce

(*d*) None of these

(*iv*) Why do some historians dislike the term 'Industrial Revolution'?

(*a*) They feel 'revolution' means a dramatic change, but the real change was gradual and varied

(*b*) They hate using the word revolution if America or France are not involved

(*c*) They feel 'industrial' is incorrect, implying some sense of mechanised change, where the real change began much earlier

(*d*) None of these

(*v*) When and where was Britain described as 'the workshop of the world'?

(*a*) In 1750 when the Americans predicted the 'revolution' to come

(*b*) In 1800 at the Paris Industrial Conference

(*c*) In 1851 at the Great Exhibition

(*d*) None of these

1.3 Summary

- The direction of industrial development in India made an early start with the introduction of the Statement of Industrial Policy, 1945, the Industrial Policy Resolution of 1948, the enactment of the Industries (Development and Regulation) Act, 1951, the First and Second Five Year Plan documents, and the Industrial Policy Resolution of 1956.
- In the pre-reform period, the industrial sector in India fared quite impressively in the 1980s in terms of growth of output/value added, compared to the earlier decades.
- If we look at average annual growth rates in Gross Value Added (GVA) for the entire economy, the agricultural sector and the different subsectors of the industrial sector for the 1970s, 1980s and the two halves of the 1980s, we find that there was appreciable increase in the growth rate in the 1980s in all sectors/sub-sectors for which comparable figures are available.
- There are several opinions about the resurgence of growth in the 1980s but there are certain most common factors causing the improvement in the growth rate.
- Industrialisation has a major role to play in the economic development of the underdeveloped countries. The gap in per capita incomes between the developed and underdeveloped countries is largely reflected in the disparity in the structure of their economies; the former are largely industrial economies, while in the latter production is confined predominantly to agriculture.
- The industrial sector which possesses a relatively high marginal propensity to save and invest contributes significantly to the eventual achievement of a self-sustaining economy with continued high levels of investment and rapid rate of increase in income and industrial employment.
- In many cases, the diversion of underemployed rural labour to non-agricultural occupations is an urgent requirement for development.
- While there is now almost universal agreement on the importance of industrialisation, there is still much debate regarding the proper pattern of industrial development.
- Soviet pattern of industrialisation involves a straight jump from the first to the third stage while British pattern is that of a gradual evolution.
- The alternative to the increase of exports of primary products from under-developed countries would be to develop export promoting manufacturing industries.
- Before the rise of the modern industrial system Indian manufacturers had a world-wide market. Indian muslin and calicoes were in great demand the world over. Indian industries not only supplied all local wants but also enabled India to export its finished products.
- The British Government in India provided discriminating protection to some selected industries since 1923. This protection was accompanied by the most favoured nation clause for British goods.
- The Government of India launched the process of industrialisation as conscious and deliberate policy of economic growth in early fifties. The Government recognised the significant contribution industrialisation could make to the development process, "as a base for the growth of the primary sector, as a catalytic agent for the development of infrastructure, as a stimulant to generation of technologies through R & D effort... and as a growth multiplier."

1.4 Key–Words

1. Propensity : An inclination or natural tendency to behave in a particular way.
2. Industrialisation : Industrialization is a historical phase and experience. Industrialization is the overall change in circumstances accompanying a society's movement population and resources from farm production to manufacturing production and associated services.

1.5 Review Questions

1. Discuss the pre reform period in industrial sector.
2. What is meant by industrialization? Discuss the role of industrialization.

Answers: Self–Assessment

1. (*i*) (*b*) (*ii*) (*a*) (*iii*) (*c*) (*iv*) (*c*) (*v*) (*c*)

1.6 Further Readings

Books

1. Indian Economy; Gaurav Datt and Aswani Mahajan; S. Chand and Company LTD. Ram Nagar, New Delhi-110055.
2. The Indian Economy; S.K. Ray; Prentic, Hall of India Private Limited New Delhi - 110001.

Unit 2: Industrial Sector in Post-Reform Period

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Objectives

After reading this Unit students will be able to:

- Explain the Industrial sector in Post-Reform Period

Introduction

Liberalisation of industrial licensing and opening up industry to foreign investment, the amendment to the Monopolies and Restrictive Trade Practices (MRTP) Act and restricting the role of the public sector were some of the important policy changes made by the 1991 reforms of Industrial Policy. At the same time, a separate set of policy measures were introduced for the promotion and strengthening of Small-Scale Industries (SSIs) in August, 1991. The empirical studies have shown that the investment boom of the early 1990s led to a rapid increase in demand and in profits; improvements intechnology and efficiency probably added to this effect. Regarding the productivity front of the manufacturing sector, the empirical evidences reflect a fall in labour productivity and capital intensity in the post-reform period. The performance of the SSI sector in India shows that the sector is facing a tough challenge for its survival and growth in the period of globalisation. It is seen that the growth and contribution of the SSI has not been so impressive in the post-reform period. However, international and national policy changes have thrown open new opportunities and markets for the Indian SSI sector. The performance of industrial sector in the post-reform period can be discussed in the light of changes in the industrial policy made in 1991. Moreover, the assessment also includes discussion on structural changes in the industrial production and impact of liberalisation on profitability and productivity of the manufacturing sector. The Small-Scale Sector (SSI) has great potential and an importance place in the Indian economy; hence this sector shall be given special emphasis.

2.1 Industrial Sector in Post-Reform Period

The widespread regulation and controls over private economic activity by the Government had inhibited economic efficiency and growth clearly by the late 1970s and early 1980s. Thus, systematic deregulation was started in the mid-1980s. Moreover, taxation reform-mainly the conversion of multi-point excise duties into a modified value added tax (MODVAT) by 1990-also influenced industrial performance. It did so by reducing the taxation of inputs and the associated distortion. Further, the New Industrial Policy (NIP) statement of 1991 introduced reforms in regulations governing licensing, monopoly, foreign investment and small-scale sector industries and in the role of public sector enterprises. An important part of the NIP statement of 1991 was liberalisation of industrial licensing and opening up industry to foreign investment. Apart from this, the reforms process of the 1990s

amended the Monopolies and Restrictive Trade Practices (MRTP) Act. This eliminated the need for prior Government approval for new investment, capacity expansion and mergers by large firms. At the same time, the scope of Public Sector Units (PSUs) was restricted to the provision of infrastructure services. Complete privatization was introduced in the late 1990s, which made slow progress with the first major successful privatisation taking place in 2001. As a result of the above changes, a separate set of policy measures were introduced for the promotion and strengthening of Small-Scale Industries (SSIs) in August, 1991. We find that this new policy statement was a clear re-affirmation of the commitment of the Government towards the importance of this sector in economic growth objectives. In this policy, Government proposed to impart more vitality and growth impetus to the sector to enable it to contribute its mite fully to the economy, particularly in terms of growth of output, employment and exports. In the process, the sector was substantially delicensed and investment limits in plant and machinery were increased. On the whole, firms operating in the Indian market in the pre-reform period (before 1991) faced barriers to entry due to Government control over private investment. It was done through the licensing regulations, reservation of production for the public sector and lengthy and opaque procedures for approving Foreign Direct Investment (FDI). These were further subject to a maximum limit of 40% equity share in the business.

2.2 Small-Scale Industries in India

For defining Small-Scale Industries (SSIs), there is no single functional economic criterion. Specific circumstances have defined the SSIs in different countries. The SSI is a relative concept and has to be understood in the context of the stage of economic development attained and the political and social environments existing in the country concerned. In India, SSIs were not given so much importance during the British rule as is given today. Apparently, most countries define Small-Scale Industries or enterprises in terms of employment levels. Generally, SSIs are taken to be those units, which employ more than 5 but less than 50 or 100 workers. In India, investment ceilings are also used to define SSIs. This limit in 1950 was upto Rs. 0.5 million in fixed assets employing less that 50/100 persons with or without power. Later, from 1960 onwards, there are no conditions regarding employment but investment limit has been raised to keep up with inflation and hence to preserve the real value of investment limits. In 1999, the investment limit was fixed at Rs. 10 million.

Since independence, Small-Scale Industry (SSI) has been one of the major planks of India’s economic development strategy. The key elements of India’s policy for the support of small-scale industries have been small-scale industry reservations, fiscal concessions by way of lower excise duties, preferential allocation of and subsidisation of bank credit, extension of business services by the Government and preferential procurement by the Government. Thus, small-scale industry has been sought to be protected from the competition of large companies both through reservations as well as fiscal concessions. The rationale for protection of SSIs from the viewpoint of the SSIs is that distortions in the capital are much more important than those in the labour market. Moreover, in the land market, small enterprises could face greater regulatory hurdles in achieving appropriate access to land. Similarly, the SSIs make economical use of capital and absorb abundant labour supply which characterises an under developed economy. Recently, it is being asked if protection of SSIs still relevant. There has been vast growth of small units over the years. In the process, the Governmental structure for technical support of SSIs has become both obsolete and inadequate. Further, with the opening of the economy, the reservation policy has become counter productive. In addition to this, the fiscal concessions can also be operating so as to discourage growth into large units. Thus, a new approach for supporting small-scale industries has to be adopted in India.

Globalisation and Small Industry Units Performance in India : Because of its significant role in terms of output, exports and employment, SSI is important for India. There were 3.4 million small industry units at the end of March 2002 and accounted for more than 40% of gross value of output in the manufacturing sector, about 35% of total exports, and providing employment to over 19.2 million people. The employment in this sector is second only to agriculture. The cumulative impact of liberalisation and globalisation and recent developments is a remarkable transformation of the economic environment. Now, SSIs operate in an environment where it has no option but to compete or perish in the process. There are two ways to evaluate growth performance of small industry :

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1. To assess the change in small industry's relative contribution to GDP, exports and organised sector employment in the 1990s with that of the 1980s.
2. Comparison of the growth rates of units, employment, output and exports of small industry in the 1990s with that of the 1980s.

We observe that the growth of small industry in the transitional period of 1990s has come down not only in terms of units and employment but also output. The increasing competition in the globalisation period might have affected the growth of Indian SSIs adversely. It may be noted that the scenario during the two periods does not differ much, except for exports. It is true that the growth rates of units and employment have steadily come down but the growth rates of output and more importantly, exports have fluctuated.

It is seen that the share of small industry in national income increased in the protection period of the 1980s but declined considerably in the transitional period of the 1990s. To conclude, performance of the SSI sector in India does indicate that the sector is facing a tough challenge for its survival and growth in the period of globalisation. However, international and national policy changes have thrown open new opportunities and markets for the SSI sector in India. The Government and small industry must make efforts to imbibe technological dynamism to build upon the opportunities.

Review of Industrial Growth Under Planning— Structural Transformation

The progress of industrialisation during the last 50 years since 1951 has been a striking feature of Indian economic development. The process of industrialisation, launched as a conscious and deliberate policy under Industrial Policy Resolution of 1956 and vigorously implemented under the five year plans, involved heavy investments in building up capacity over a wide spectrum of industries. As a result, over the last nearly 50 years, industrial production went up by about five times, making India the tenth most industrial country of world. The industrial structure has been widely diversified covering broadly the entire range of consumer, intermediate and capital goods. The progress India has made in the field of industrialisation is clearly reflected in the commodity composition of India's foreign-trade in which the share of imports of manufactured goods has steadily declined; on the other hand, industrial products, particularly engineering goods have become a growing component of India's exports. Finally, the rapid stride in industrialisation has been accompanied by a corresponding growth in technological and managerial skills for efficient operation of the most sophisticated industries and also for planning, designing and construction of such industries.

Industrial Progress Since Independence

A major achievement in the industrial sector has been the diversification of India's capability. This indicates the growth of the industrial output in selected commodities. The figures show clearly the tremendous increase in production of some important goods in the country.

India has attained self-sufficiency in almost all consumer goods. Growth of capital goods production has been specially impressive. An impressive industrial capacity has been achieved in mining and metal industries, chemical and petrochemical industries, production, capital goods industries including sophisticated equipment for steel mills, fertiliser plants, chemicals etc. light, medium and heavy engineering industries and transportation industry, construction industries. Further, India can now sustain the future growth sectors of the economy primarily through domestic and only with marginal imports. Finally, the infrasture including R and D capability, consultancy and engineering services, project management services innovative capacity to improve and adapt technology have indeed shown an impressive record of progress.

Rate of Industrial Growth

Industrial growth, however, has not been since 1951. After a steady growth of about 8 pen cent the initial period of 14 years (1951 to 1965), there fluctuating trend since then—near stagnancy during 1968, and of 9.5 per cent during 1976-77, a high level percent in 1979-80. In the sixties (1961-70) the growth rate of industrial output was put at 5.5 per cent in the seventies (1971-80) the average growth rate about 4 per cent per annum. Even during 1980-81 growth rate of industrial production was 5.5 annum.

The basic fact was that the rate of industrial had been slowing down. During the 7th Plan (1985-90) growth rate had picked up to an average of over 8 per annum and in the Eighth Plan, it had declined to cent per annum.

During the Ninth Plan (1997-2001-02), industry growth slumped to 4.6 per cent per annum, but during 10th Plan (2001-02 to 2006-07), it picked up significant to 8.2 per cent per annum. This is a healthy development.

Growth of Infrastructure

The rapid pace of industrial growth and the development of productive capacity has been marked by remarkable, though still inadequate, expansion of infrastructural facilities in the country with expansion and modernisation of coal which is India's primary fuel source, by more than three-fold and notable success in the exploration of oil and gas both on and off-shore. The Sixth Plan summed up the success in infrastructure admirably. An efficient complex of refineries, pipelines, storage and distribution has been developed and India has entered the petrochemical age. A large infra-structure has been built to sustain this sub-continental economy- a network of irrigation, storage works and canals, hydro and thermal power generation, regional power grids, a largely electrified and dieselised railway system, national and state highways on which a rapidly growing road transport fleet can operate and telecommunications system covering most urban centres and linking India with the world. The development of modern industry as well as of agriculture has stimulated the growth of banking, insurance and commerce and required matching expansion and modernisation of ports, shipping and internal and external air services. The major beneficiaries of all these services, as pointed out all however, have been the wealthier sections of the population both in urban and rural areas.

Science and Technology

Significant progress has been recorded in the science and technology. India now ranks third in the respect of technological talent and manpower. The scientists and technologists are working in many and the frontiers of today's knowledge, as in agriculture industry, in the development of nuclear power and of space technology for communications and development. For further industrial and scientific' and with growing competence in adaptive research development, we need only a selective import of technology. The country has been able to train a cadre of technology manpower which can handle cement factories, chemicals fertiliser units, oil refineries, power houses, steel locomotive factories, engineering industries, etc. than a lakh and half degree and diploma holders are out by the technical institutions. Similarly in plant and sending brilliant young men and women training in top skills has helped to generate skilled many and thus reduce dependence on foreign technician experts. However, small and cottage industries, rural and activities have not received the research development support that they required.

Inadequacies of the Programme Industrialisation

Without under-estimating the achievements process of industrial expansion initiated during the plan era, it may be emphasised that much of the industry growth is only apparent and not real. Our reasons for are as under :

Firstly, the share of industry income in national in 1948-49 was 17 per cent. In 1996-97, it was around per cent—an increase of just 4 per cent in 50 years in terms of contribution of national product, manufacturing industry sector continues to be low. In of the developed nations, this share is between 30 per cent.

Secondly, the process of industrialisation has been able to make a dent on the problem of unemployment. The high capital intensity of public sector im generated a very small amount of employment, For employment absorbed only 2 per cent of the labour Professor Gunnar Mydral studied the spread effect industrialisation on employment and also its back effects in terms of unemployment on the traditional. After a careful examination of the situation, My observed : "The employment effects of industrialise cannot be expected to be very large for several decade ahead, that is, until the region is much more industrial. For a considerable time the net employment effects even be negative. This

dimension of the problem, as the wider consequences for labour utilisation outside the modern sector, is overlooked in the vision that sees industrialisation as the remedy for 'unemployment' and under-employment".

2.3 Pattern of Ownership of Industries

The Annual Survey of Industries has reclassified data about the ownership pattern of industries into three categories. In the non-corporate sector are included

Table : 4 Ownership of industries (2007-08)

	Factories	Productive Capital (₹ crores)	Employees ('000)	Net Value Added (₹ crores)	Wages Worker
1. Non-Corporate Sector	89,593	78,301	2,473	36,503	34
2. Corporate Sector	52,396	10,17,345	5,323	3,81,586	70
(a) Private	52,206	10,00,984	5,296	3,75,929	69
(b) Public	190	16,360	26	92,024	2,30
3. Others	4,394	66,437	400	63,501	1,29
Total (1+2+3)	1,46,385	11,62,085	8,198	4,81,592	62

Note :

1. Non-corporate sector comprises of individual proprietorship, Joint Hindu Undivided Families (HUF) and Partnership
2. Private corporate sector includes public and private limited companies
3. Others include Khadi & village industry, handloom, co-operative societies etc.

Source : Annual Survey of Industries (2007-08)

industrial units which are owned by individuals proprietorships, joint families (Hindu Undivided families -HUF) and partnerships. Secondly, the corporate sector is sub-divided into two sectors - (a) private corporate includes public and private limited companies; and (b) public corporate sector includes Government Departmental Enterprises and public corporations. There is third category 'others' comprising of khadi & village Industry. Handloom and co-operative societies running industrial units e.g. sugar mills run by co-operative societies in Maharashtra etc.

In terms of number of units, the non-corporate sector accounts of 63% of units, mostly in small industries sector referred to as the unorganized sector, but they employed 7.3% of productive capital, accounted for only 8.2% of value added, but provided employment to nearly 31% of industrial labour.

The corporate sector accounted for 91.3% of the productive capital, 90.4% of value added and provided employment to about 66% of industrial labour. Within the coiporate sector, the private sector accounted for 83.2% of productive capital and 78.4% of the value added and provided employment to about 62% of industrial labour. Along with this, the public sector provided 8% of productive capital with 12% of value added and provided employment to only 3.3% of total industrial labour of the order of 8.45 million.

Others were a minor category where contribution productive capital, value added and employment was insignificant.

Although public sector was relatively small comparison to the private sector, yet a noteworthy of the changing industrial pattern in the planning era in the is the growth of the public sector in a big way in the he and basic industries, the machine goods sector, engineers industries etc. which provided the industrial base of economy and thus created basic infrastructure of economy to enable the private sector to flourish later this sense, the role of public sector as the engine of growth is unique.

Interestingly, the wages per worker received 2004-05 reveal that they were lowest in non-corporate sector as ₹ 27,603. They were higher in 'others' as & Village Industries, Handlooms etc. as ₹ 50, 385 because the State fixed the wages, irrespective of the earned. In the corporate sector or the organized

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average wages per worker per annum was the highest ₹ 62,809. Within the Corporate sector, wages in the pull sector were the highest at ₹ 70,720 and the private at ₹ 58,966. Since the public sector is a pace sector improving the level of wages, it provides to lead the followed by to private sector.

Self-Assessment

1. Choose the correct option:

(*i*) India's central bank the Reserve Bank of India (RBI) in its April-June quarter monetary policy review left the key policy rates unchanged. Which of the following facts are not true with regards to this?

I. The repo rate remained unchanged at 8 percent while the reverse repo rate remained stable at 7 percent

II. Cash Reserve Ratio (CRR) - the amount of total deposits that banks are required to keep with the central bank - also remained unchanged at 5.25

III. The statutory liquidity ratio (SLR) - the percentage of total deposits that banks need to invest in the government bonds was changed to 23 percent from the erstwhile 24 percent

IV. RBI also cut its economic growth outlook for the fiscal year 2012-13 to 6.5 percent, from the earlier projection of 7.3 percent

(*a*) I & III (*b*) Only II (*c*) III & IV (*d*) Only IV

(*ii*) As per the a report by Ernst & Young and Event & Entertainment Management Association (EEMA), which interviewed CEOs of 32 Indian events and activation companies, the organised events and activation market in India is expected to grow by what percent over the next two years, powered by weddings, sports and higher spends on below-the-line promotional events?

(*a*) 50% (*b*) 55% (*c*) 53.33% (*d*) 46%

(*iii*) According to the quarterly report on 'Public debt management' prepared by the Department of Economic Affairs (DEA) under the Ministry of Finance, India's public debt rose by what per cent to 3752576 crore rupees during the first quarter (April-June) of fiscal year 2012?

(*a*) 4% (*b*) 4.9% (*c*) 5.6% (*d*) 7.1%

(*iv*) Exports from Special Economic Zones (SEZs) grew by what per cent to Rs 118321.56 crore during the first quarter (April-June) of the fiscal 2012-13?

(*a*) 51% (*b*) 57.5% (*c*) 64% (*d*) 73%

(*v*) The Union government on 30 July 2012 introduced national certification standards for organic textiles to boost the demand for organic textiles in major markets, including Europe and Japan. With respect to the above statement which of the following is not true?

I. The Indian Standards for Organic Textiles (ISOT) launched by Commerce, Industry and Textiles Minister Anand Sharma is to be included under the National Programme for Organic Productions (NPOP)

II. The NPOP includes norms for organic production and processing of agriculture crops along with certification standards

III. In 2011 India exported certified organic products to various countries in Europe, Asia and the US worth Rs 2000 crore

IV India with the introduction of the national certification standards thus took over the long-standing position of the Global Organic Textiles standards (GOTS), which are private standards prevailing in the organic textiles industry

(*a*) I & IV (*b*) II & III (*c*) Only IV (*d*) Only III

(*vi*) Where was the first cotton mill of India was established in 1857?

(*a*) Mysor (*b*) Madras (*c*) Surat (*d*) Bombay

2.4 Summary

- The widespread regulation and controls over private economic activity by the Government had inhibited economic efficiency and growth clearly by the late 1970s and early 1980s.
- From 1991, the process of organisational restructuring and the concomitant supportive changes in industrial policy aimed at creating a more competitive and challenging industrial environment are being undertaken.
- The impact of liberalisation on profitability and productivity of the manufacturing sector has not been clearly laid out.
- Largely due to price control and protection from insufficient domestic production capacity, the margins of joint sector companies held up much better.
- For defining Small-Scale Industries (SSIs), there is no single functional economic criterion. Specific circumstances have defined the SSIs in different countries.
- Small-Scale Industry (SSI) has been one of the major planks of India's economic development strategy. The key elements of India's policy for the support of small-scale industries have been small-scale industry reservations, fiscal concessions by way of lower excise duties, preferential allocation of and subsidisation of bank credit, extension of business services by the Government and preferential procurement by the Government.
- The progress of industrialisation during the last 50 years since 1951 has been a striking feature of Indian economic development.
- A major achievement in the industrial sector has been the diversification of India's capability.
- The development strategy adopted by the Indian planners consisted of accelerated industrialisation with base of heavy industry.
- There was yet another aspect to industrial strategy adopted by our planners. From the very beginning, the banners anticipated shortage of foreign exchange as a for the constraint to the development effort.
- One striking feature of the period of planning was that the structure of Indian industries had changed in favour of basic and capital goods sector. The study of structural transformation of the Indian industries reveals that there has a clear shift in favour of basic and capital goods sector.
- The rapid pace of industrial growth and the development of productive capacity has been marked by remarkable, though still inadequate, expansion of infrastructural facilities in the country with expansion.
- Significant progress has been recorded in the science and technology. India now ranks third in the respect of technological talent and manpower. In scientists and technologists are working in many the frontiers of today's knowledge, as in agriculture industry, in the development of nuclear power and of space technology for communications and development.
- Without under-estimating the achievement process of industrial expansion initiated during the plan era, it may be emphasised that much of the it growth is only apparent and not real.
- The Annual Survey of Industries has reclassified data about the ownership pattern of industries into three categories.
- In terms of number of units, the non-corporate sector accounts of 63% of units, mostly in small industries sector referred to as the unorganized sector, but they employed 7.3% of productive capital, accounted for only 8.2% of value added, but provided employment to nearly 31% of industrial labour.
- Others were a minor category where contribution productive capital, value added and employment was in insignificant.

2.5 Key–Words

1. Delicensing : To deprive of a license.
2. Employment : The state of being unemployed or not having a job; "unemployment is a serious social evil"; "the rate of unemployment is an indicator of the health of an economy".
3. Growth : Development from a lower or simpler to a higher or more complex form; evolution.
4. Labor market : The market in which workers compete for jobs and employers compete for workers Market, marketplace, market place - the world of commercial activity where goods and services are bought and sold; "without competition there would be no market"; "they were driven from the marketplace"

2.6 Review Questions

1. What is meant by pattern of ownership industries?
2. Write a short note on small scale industries in India.
3. Discuss the industrial sector in post-reform period.

Answers: Self–Assessment

1. (*i*) (*b*) (*ii*) (*a*) (*iii*) (*b*)
   (*iv*) (*c*) (*v*) (*d*) (*vi*) (*d*)

2.7 Further Readings

Books

1. Indian Economy; Gaurav Datt and Aswani Mahajan; S. Chand and Company LTD. Ram Nagar, New Delhi-110055.
2. The Indian Economy; S.K. Ray; Prentic, Hall of India Private Limited New Delhi - 110001.

Unit 3: Issues and Problems of Public Sector

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Objective

After reading this Unit students will be able to:

- Discuss about the Issues and Problems of Public Sector

Introduction

Prior to 1947, there was virtually no "Public sector" in the Indian economy. The only instances worthy of mention were the Railways, the Posts and Telegraphs, the Port Trusts, the Ordnance and Aircraft Factories and a few State managed undertakings like the government salt factories, quinine factories, etc. The idea that economic development should be promoted by the State actually managing industrial concerns did not take root in India before 1947, even though the concept of planning was very much discussed by Congress governments in the Indian provinces. However, in the post-independence period, the expansion of public sector was undertaken as an integral part of the 1956 Industrial Policy.

3.1 Issues of Public Sector

The Industrial Policy Resolution 1956 gave the public sector a strategic role in the Indian economy. For one thing, at the time of independence, the country was backward and underdeveloped — basically an agrarian economy with a weak industrial base, heavy unemployment, low level of savings and investment and near absence of infrastructural facilities, Indian economy needed a big push. This push could not come from the Indian private sector, which was starved of funds and of managerial ability and was incapable of undertaking risks involved in large long-gestation period investments. It was assumed at that time that only the Government intervention in a big planned way could accelerate agricultural and industrial production, expand employment opportunities, reduce poverty, etc. In other words, the public sector was thought of as the engine for self-reliant economic growth to develop a sound agricultural and industrial base, diversify the economy and overcome economic and social backwardness.

To this basic argument for the expansion of the public sector, the Government added additional reasons over time, e.g. :

(a) to accelerate the growth of the core sectors of the economy;

(b) to serve the equipment needs of strategically important sectors like Railways, Telecommunications, Nuclear Power, Defence, etc.

(c) to exert countervailing power on the operation of private monopolies and multinationals in selected areas;

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(d) to ensure easier availability of articles of mass consumption, to check prices of important articles etc. - the rationale behind setting up consumer-oriented industries;

(e) to protect employment, the Government was forced to take over sick industrial units.

In fact, over a period of time, the Government entered into many sectors for all types of good and bad reasons and in many cases for no reasons at all.

Central Government Enterprises

As on March 31, 2010, there were 217 Central Government undertakings, excluding banks, financial institutions and departmental undertakings like the Railways. Ports etc. The growth of investment in Central Government undertakings is shown in Table 1. It will be clear from the table that since 1951, the number of industrial and commercial undertakings of the Central Government had increased from 5 in 1950-51 to 239 units in 2005-2006 and the capital investment had increased from ₹ 29 crores to ₹ 5,79,920 crores on 31 st March 2010. The investment is in the form of equity capital and long term loans.

Total Investment in Public Sector

Central Government Public Sector Enterprises recorded a total investment of ₹ 4,21,089 crores in 2006-07. The State level Public enterprises accounted for ₹ 2,59,180 crores as on 31.3.2005. Besides them, departments like Railways, Posts and Telegraphs and other departments accounted for an investment of nearly ₹ 50,000 crores. If all these are included, then the total public sector investment in the entire country, in all kinds of enterprises (departmental and non-departmental), at the Centre, State and local level, would be around ₹ 7,30,269 crores.

Objectives of Public Sector

We conclude this section by broadly summarizing the objectives of setting up public enterprises in India :

(i) To promote rapid economic development through creation and expansion of infrastructure;

(ii) to generate financial resources for development;

(iii) to promote redistribution of income and wealth;

(iv) to create employment opportunities;

(v) to promote balanced regional growth;

(vi) to encourage the development of small scale and ancillary industries; and

(vii) to promote exports on the one side and import substitution, on the other.

The Issues of Public Sector

Some of the financial and accounting issues which have been the subject of public debate, for example external reporting and monitoring, are common to several parts of the public sector, and these are dealt with in this book. Some of these are conceptual issues, some practical. Some are related to external reporting and monitoring, others to internal financial control. But two general questions arise.

The first concerns how specific accounting and control problems should be tackled in a public sector context. Such problems arise because of the distinctive constitutional, economic and financial features of public sector bodies. These are bound to affect the way in which their operations are accounted for and controlled. Areas of special concern include, for example, the accounting treatment of capital equipment and the need to provide non-financial indicators to supplement financial data because of the non-profit basis of most parts of the public sector.

The second question, following naturally from the first, is how far should public sector practice relate to practice in the private sector and in what respects, if any, should it diverge? This question has been asked about most aspects of financial reporting, including the form of financial statements and the treatment of individual items in the accounts, such as capital asset valuation and depreciation. The question is also asked about internal financial and economic issues, such as the use of investment appraisal techniques and monitoring.

That such issues cannot be taken in isolation applies to almost all the main aspects of this book. For example, questions about the form of external financial statements cannot be separated from the nature and objectives of particular public sector operations and the fact that there are a variety of users for financial statements in the public sector, with different kinds of needs. Similarly, the relationship between auditing practices in the public and private sectors cannot be examined without looking at the different ways in which accountability is exercised for public sector institutions compared to the purposes and forms of accountability of private concerns.

In the area of financial reporting, for example, there is the question of how far there should be uniformity, and how much flexibility ought to be allowed between similar types of institutions. Another recurrent theme is the issue of how accounting rules should be developed, while on the use of external financial information the nature and rights of different user groups are not always clear. As for internal financial control, the pressure on resources has in most cases given rise to a call for improved systems for monitoring, not only internally but also for external disclosure and performance review. Finally, on a more personal level, the role and status of accountants within their organizations and in relation to the accountancy profession as a whole continues to be a matter of concern to many public sector accountants.

The public sector is both extremely diverse and, despite privatizations, extremely large. Even ignoring the large sums expended on transfer payments (such as pensions, welfare benefits and subsidies), the total expenditure of the public sector on employing people, goods and services in carrying out both trading and public service activities is enormous – about 40% of the gross domestic product. It gives an idea of the relative size of net public sector expenditure analysed in four ways. It can be seen that local authority expenditure amounts to more than a quarter of all public expenditure, and expenditure on health rather more than 10%. The nationalized industries, by contrast, make little overall demand on the public purse because, although the amounts they spend are large.

3.2 Problems of Public Sector

A number of charges are leveled against the public sector in India. Some are lopsided and some are genuine, to a certain extent.

Objective and Role

In the history of planning in the country, over the last six decades, there has been a definite shift in the assigned role of public enterprises in the country through various Five Year Plans from 'attaining the commanding heights' in the national economy and 'easing out private sector' to the 'opening up', 'liberalisation' and 'globalisation. It has been a perennial problem for the policy makers to set the role of the public sector in the Indian economy and it would continue to be so.

Secondly, the objectives of public sector have been defined and goals being set not very systematically in each case. Even the objectives at the macro level have been mixed-up with a number of propositions, sometimes contradictory in nature.

Extent and Coverage

Whether the public sector should extend to wide variety of economic activities or to be confined to a selected few only, is a very crucial decision of great magnitude.

Similarly, whether the economy of the country should be open to private sector or be confined only to the public sector monopoly or both should be given a competitive share in open market becomes another crucial political decision. The problem is consistently persisting in the Indian polity, more particularly from the recent past.

Organisation and Management

The organisation and management of the public sector enterprises has been on 'trial and error' ever since independence in the country. Initially, the enterprises were organised as departmental undertakings owing to their simplicity of operations and management.

Then came a time when the government company form was most prevalent. Following the developments in the international field, particularly in England, corporate form was adopted in India too.

And a host of corporation was created, both sectoral and multipurpose as well as development corporations. Lastly, joint ventures came on the scene again taking a cue from the development in the world.

The management has all along been a problem to tackle. In the first place, there has been a consistent dearth of managerial skills in the country, both at the initial stages as well in recent past.

The constitution of management boards is the other major problem, which merits attention most. Here, the government burdens the governing board with the civil servants, undermining the principle of autonomy of the enterprises. The management board tilts the balance of decision making on policy matters greatly in government favour and thus reducing the enterprise to, more or less, a department.

Personnel Administration

The personnel management of the public sector is beset with a plethora of problems which are mostly responsible for it's inefficient, uneconomic and below standards performance.

The recruitment to public enterprises is done by individual enterprises or by a central personnel agency for a group of enterprises in a given sector following general guidelines of the government in matters of reservations, etc.

The tendency to second the civil servants to top management is so rampant in the country that it negates the initiative of inbreeding and the insiders are disillusioned, not to talk of their disappointment and disinterestedness.

Remuneration or compensation to the employees is another area, which needs prompt attention. While compensation to top managers is usually high in most of the enterprises with innumerable perks and other amenities and benefits, it is progressively lower in the middle and lower level managements.

The performance appraisal in most of the public enterprises is done only as the annual recording of character rolls. These results in the low standards of performance and the efficiency of the enterprises go down progressively.

Financial Management

The prime requirement of majority of the enterprises is the sound and scientific financial management as they lack financial discipline, consciousness and professionalism.

The financial advisor has to play a crucially important role in the management of finances of the public sector enterprises.

Budgeting, the most crucial of all the segments of financial management, is not properly practised in the public enterprises in most cases.

A number of agencies are involved in the planning and control of financial management of public enterprises in the country, viz., Board of Management, Administrative Ministry, Ministry of Finance, Bureau of Public Enterprises, Planning Commission, Director General of Technical Development and Public Investment Board.

Workers' Participation in Management

With a view to ensure increased productivity for the larger benefit of the enterprise, the employees and the community, to give workers' better understanding of their role in the production process and to satisfy their demands for self-expression leading to better industrial relations, worker's participation in management (WPM) was launched.

The process of WPM involves four main steps, viz., information sharing, joint consultations, joint decision-making and self-management. The workers are involved at all these levels to take the decisions in the best interest of enterprise.

With regard to workers' participating at various levels including board level, it is beset with a number of problems relating to selection of employees to be represented on the Board of Management.

Autonomy and Accountability

'Autonomy' implies "freedom to act" and is related to "freedom in internal management".

Autonomy in the case of public enterprises does not imply 'full freedom' to act as desired by the individual enterprise management. The Public Enterprises are accountable to Parliament through the concerned minister and therefore cannot act freely.

At the same time the public enterprises should be accorded sufficient autonomy to run their operations on business lines. It facilitates quick decision-making and encourages initiative. Accountability of the public enterprises implies rendering of accounts to the public - the ultimate owner of these enterprises. According to S.S. Kher, "accountability involves measurement of top management. It must be remembered that the accountability that we are talking of, is accountability, which has a particular purpose - a demonstrably useful purpose. A distinction has to be drawn between accountability and control. Control is active function while accountability is a passive function. Control means directing, restraining, or stimulating an organisation or individual to a certain action. In fact, control facilitates accountability. An accountable individual or organisation has to possess control power to give true account.

3.2.1 Role of the Public Sector in India

After the attainment of independence and the advent of planning, there has been a progressive expansion in the scope of the public sector. The passage of Industrial Policy Resolution of 1956 and the adoption of the socialist pattern of society as our national goal further led to a deliberate enlargement of the role of public sector.

To understand the role of the public sector, we must have a comprehensive view of the entire public sector. We should include besides autonomous corporations, the departmental enterprises. While doing so, not only the enterprises owned and run by the Central Government be covered, but the enterprises run by the State Governments and local bodies should also be included.

It would not be appropriate to use any single measure to estimate the role of the public sector in the Indian economy, rather it would be desirable to use a few indicators, e.g., employment, investment, value of output, national income generated, savings, capital formation and capital stock.

Share of Public Sector in Employment

There are two important categories of public sector employment : (a) Government administration and defence and other government services like health, education, research and various activities to promote economic development; and (b) public sector proper, i.e., economic enterprises owned by the Centre, State and Local Government. The total number of workers employed in the public sector in 1971 was 111 lakhs, but by March 2006, their number grew to about 182 lakhs before falling to 180 lakhs in 2007. Since employment in the public sector is confined to the organised sector, public sector employs 65.9 per cent of the workers employed in organised sector of the Indian economy.

Share of the Public Sector in GDP

During the last five decades, the share of the public sector in gross domestic product (GDP) has shown a steady improvement. Measured at current prices, public sector accounted for 7.5 per cent of GDP in 1950-51, its share in 1993-1994 had risen to 23.6 per cent. However, it declined to 20.8 per cent in 2008-09. Public sector, therefore, accounts for about one-fourth of national output. This is largely due to a rapid expansion of the public sector enterprises.

There is a big increase in the share of public administration and defence from 4.5 per cent to 8.7 per cent between 1950-51 and 2007-08. The share of public sector enterprises, however, rose from 3 per cent in 1950-51 to 11.2 per cent in 2008-09. Despite this fact, the private sector still occupies a dominant position in the economy. There are some sectors such as agriculture and small-scale sector in which

the share of the state is almost zero. However, in insurance, defence equipment, indigenous crude oil production, etc., government ownership is cent per cent. Increasingly, industries of strategic and national importance are being brought under state ownership.

3.2.2 Causes for the Expansion of Public Enterprises

In a developing economy like India, some industries had to be brought within public ownership and control, for otherwise rapid growth of the economy was thought to be impossible. Nationalising some of the industrial, banking and insurance units and starting new units was expected to help in speeding up the rate of economic growth. Therefore, public enterprises became an essential part of the economic development programme of India. In this section, we shall study the need for or the rationable of public enterprises in the context of economic planning in India.

(i) **Rate of Economic Development and Public Enterprises :** The justification for public enterprises in India was based on the fact that the rate of economic development be planned by the government was much faster than could achieved by the private sector alone. In other words, the public sector was essential to realise the target of the high rate of development deliberately fixed by the government.

To fulfil this ambitious plan target, the government had to resort to compulsory saving through taxation. In the words of Professor Ramanadham, "Having gathered the resources, the government and other important policy making bodies like the Planning Commission are under the normal human temptation to use the funds under the government's own aegis and it appears to be an avoidable botheration for the administration to offer the money to private enterprises in the first instance and then go about instituting the necessary checks and balances for the sake of ensuring the safety and proper use of funds. Instead it appeals as preferable to Parliament as well as the administrative bodies to launch industrial enterprises in the public sector.

(ii) **Pattern of Resource Allocation and Public Enterprises :** In Professor Ramanadham's words, "The main reason for the expansion of the public sector lies in the pattern of resources allocation decided upon under the plans." In the Second Plan the emphasis was shifted to industries and mining, mainly basic and capital goods industries to be developed under the aegis of the public sector. Thus more resources for industrialisation were funnelled through the public sector. Under these circumstances, "It is inevitable. that the public sector must grow not only absolutely but also relatively to the private sector."

(iii) **Removal of Regional Disparities through Public Enterprises :** Another important reason for the extension of the public sector was the anxiety for balanced development in different parts of the country and to see that there were no serious regional disparities. Public enterprises of the Central Government were set up in those regions which were underdeveloped and where local resources were not adequate. Good examples are the setting up of the three steel plants at Bhilai, Rourkela and Durgapur and the Neyveli Project in Chennai which were meant to help industrialise the regions surrounding the projects. In certain cases, the State Governments were unable to raise adequate resources for development of their regions. The only alternative available was the setting up of projects by the Central Government or to start enterprises which were financed by the Centre.

(iv) **Sources of Funds for Economic Development :** Initially, state was an important source of funds for development. The surplus of government enterprises could be re-invested in the same industries or used for the establishment and expansion of other industries. It may be noted that private sector industries can also plough back whole or substantial amounts of their profits for expansion. However, profits in private enterprises are declared as dividends among shareholders. This would only create inequalities among people. But profits of public sector industries can be directly used for capital formation.

(v) **Socialistic Pattern of Society :** The socialistic pattern of society calls for extension of public sector in two ways. For one thing, production will have to be centrally planned as regards the type of goods to be produced, the volume of output and the timing of their production. It may be comparatively easy to achieve this through the public sector rather than through private

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sector. We may quote the Second Five-Year Plan here : "The adoption of the socialistic pattern of society as the national objective, as well as the need for planned and rapid development, require that all industries of basic and strategic importance, or in the nature of public utility services, should be in the public sector. Other industries which are essential and require investment on a scale which only the state, in present circumstances, could provide, have also to be in the public sector."

(vi) **Limitations and Abuses of the Private Sector :** The behaviour and attitude of the private sector itself was an important factor responsible for the expansion of the public sector in the country. When the Americans insisted on the Bokaro Project to be set up in the private sector, Mr. J.R.D. Tata openly confessed that the private sector was not in a position to mobilise resources to the tune of ₹ 700 crores. Thus, the private sector did not want to move into certain sectors or if it wanted to move in, it did not have the necessry resources. This was understandable but the private sector was unwilling to take even the normal risks of business. During the Second Plan period and later, many of the licences issued to the private sector for setting up fertiliser units were surrendered when the need for fertiliser production was paramount for the country to push an agricultural breakthrough. To give another example, the business recession of 1966-67 frightened the private sector cement industry from expansion, even though it had given an undertaking to the Government to expand. To safeguard the long-term prospects of the economy, the Government had to set up the Cement Corporation of India to boost the production of cement. The failure of the private sector drug industry to manufacture antibiotics and at the same, its tremendous exploitation of the consumers--to the extent of holding them to ransom--was responsible for the entry of the Government in drugs and pharmaceuticals industry.

3.2.3 Performance of Public Sector Undertakings

While the Government has been pushing ahead with more and more public sector undertakings, there has been considerable criticism about the poor performance and in some cases utter failure of government undertakings in the country. Some economists have argued that profit should not be used as a criterion for judging the performance of public enterprises According to them, public enterprises are guided by a variety of considerations in determining prices and it would not be appropriate to use profit as a criterion of their efficiency. This is particularly so in social utility services, like railways, posts and telegraphs, supply of water, electric energy, etc. The State should not raise the prices of these services, even though costs may have risen. Similarly, the public enterprises have a bulk of their investment in heavy and basic enterprises. Such enterprises have long gestation period and a part of the investment may be under construction. It would, therefore, be appropriate to calculate the rate of return on effective capital employed and thus not include the capital employed in undertakings under construction or in expansion or capital work-in-progress.

Did u know? *"The profitability" of the running concerns alone should be the index of their performance.*

Besides, the term 'profitability' should not always be used in a business or a pure commercial sense with reference to public enterprises which are not permitted to manipulate depreciation or other payments to show higher rate of return. Moreover, PSUs offer much better reward for labour in terms of wages and salaries and other perquisites in comparison with small and medium enterprises in the private sector. To judge their performance, an adjustment should, therefore, be made for a higher social rate of return. The concept of total surplus generated in the form of declared profits, retained profits and depreciation becomes more relevant in the case of private sector enterprises and not for PSUs. This is not to suggest that profitability should not be considered as an index of efficiency, but to emphasize that the problem should be viewed in a proper perspective.

Although profit maximisation (or in the case of public enterprises, the generation of surplus) may not be the sole criterion to judge their performance, yet it cannot be denied that it would be a folly to ignore it altogether. It has been aptly pointed out that profit maximisation may not be treated as a positive virtue but it may well be a 'good whip' to prevent the public enterprises from misbehaving. Thus the principle of profit maximisation has a negative virtue that it impels enterprises to reduce wastes of resources and inefficiency arising there from. From this point of view, the argument for generation of surplus by public enterprises to be used for economic development has a great force.

3.2.4 Shortcomings of the Public Sector

It would be unreasonable to argue that all is well in the public undertakings. There is much scope for improving the efficiency and working of public sector enterprises. The main points which merit consideration are :

(i) **Mounting losses :** A review of the working of public sector enterprises reveals that either the profits in them have been deplorably low or that they have been making losses. As compared with the performance of the Central Government, however, the State Governments are having perennial loss-makers like irrigation works, State Electricity Boards and State Road Transport. The biggest losses are made by SEBs. It is estimated that the losses incurred by SEBs rose from ₹ 4,117 crores in 1991-92 to ₹ 30,606 crores in 2005-06– these losses were incurred because power was supplied at a mere 240 paise per unit as against the production and distribution cost of 350 paise per unit.

(ii) **Political factors influence decision about location :** It has been noted that in many situations, political factors influence decisions about location of projects. Powerful ministers in the ruling party make promises about the future location of projects in a state irrespective of the results of the feasibility study about costs. This approach leads to a considerable wastage of capital resources. A classic instance of this political but irrational approach is the decision of the Central Government to break up the MIG aircraft project into two parts to be located in two separate states. These two locations--Nasik and Koraput—are over 900 *km* apart. This was done to satisfy two powerful political bosses from two states.

(iii) **Delays in completion and increase in costs of construction :** Many reports on the working of public sector projects have pointed out that many of the projects took longer time to complete than was initially envisaged. Not only that, the cost of the projects was also revised upwards. For instance, in the case of Trombay Fertilizer Project, it took 6-7 years to complete against the original estimate of 3 years. Most of the delay in construction time-schedule and increase in costs can be traced to poor and inadequate project planning. It is very necessary to prepare comprehensive construction plans so that the avoidable delays and increases in costs should not put additional burden on the scarce resources.

(iv) **Over-capitalisation :** Public sector projects are charged with over-capitalisation. In other words, the input-output ratio obtaining in many projects was unfavourable. The Study Team found several undertakings, viz., Heavy Engineering Corporation, Hindustan Aeronautics, Fertilizers Corporation (Trombay Projects), etc. over-capitalised. In this connection the Study Team mentioned: "The causes leading to over-capitalisation can be traced to inadequate planning, delays and avoidable expenditure during construction, surplus machine capacity, tied aid resulting in the compulsion to purchase imported equipment on a non-competitive basis, expensive turn-key contracts, bad location of projects and the provision of housing and other amenities on liberal scale."

(v) **Price Policy :** The pricing policies of the public sector undertakings are not guided solely by the profit maximisation principle, but are under the regulation and control of the Government. Most of the public enterprises produce products which serve as inputs for other sectors of the economy. It would be suicidal from the point of view of the overall growth of the economy if the prices of steel, oil, fertilisers or coal are fixed very high. The public sector has to keep in mind the social implications of its price policy. In this connection, it is important to remember that in many cases, under public pressure, prices are kept low even when costs and prices have been rising. This naturally affects commercial profitability.

(vi) **Use of manpower resources in excess of actual requirements :** It has been brought out that in most public enterprises, manpower is in excess of actual requirements. There is poor manpower planning and this is clearly reflected in the inadequate arrangements for training and education of workers. The unsatisfactory salary and wage rates and the absence of incentives to staff have resulted in the flight of personnel from the public sector to the private sector. The Sixth Pay Commission has Substantially raised the emoluments of executives and thus prevent their shift to private sector. It has been suggested that top position in a public sector undertaking should

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also be opened to its employees. Besides, professional and technical persons of an undertaking should be trained and induced into management.

The Government has been shedding the load of surplus workers in PSE. As a result of this policy, total number of employees in Central PSEs declined from 19.92 lakhs in 2001-02 to 16.14 lakhs in 2006-07—a reduction of 3.78 lakhs. This has reduced the wage cost of CPSEs.

(vii) Capacity utilisation : During 2005-06, out of 203 units, 103 units or 51 per cent of all manufacturing/producing units had recorded capacity utilisation of more than 75 per cent. On the other hand, 33 public sector enterprises operated in the capacity utilisation range of 50 to 75 per cent and 67 functioned below 50 per cent utilisation of rated capacity. This is certainly not an optimum situation. It is very necessary to find the causes of low capacity utilisation and thus remedy the situation by appropriate measures.

(viii) Inefficient management : Managerial effectiveness and efficiency are crucial factors in improving the overall performance of the public enterprises. For efficiency in business and industrial enterprises it is necessary that operational decisions are prompt. This necessitates a large measure of autonomy and flexibility of operations in the Government enterprises. Again, delegation of authority and elasticity in working are needed in a high degree. Within the enterprise itself the delegation of authority from the top management to lower levels is another essential condition for efficiency in operation. Every officer should know what he is required to do and what result he is expected to produce. Unfortunately, there has been general failure to define responsibilities and duties in public sector enterprises in India. Finally, the successful operation of public enterprises is dependent upon the availability of experienced persons to fill up top positions. Public enterprises are sarcastically referred to as 'colonies for bureaucrats'. In the initial stages, the officers of the ministry who provided funds for the projects also pre-empted the right of management. In this way they infused 'bureaucratic blood' in the system. An unfortunate practice has been to use bureaucrats as chairmen, managing directors and managers of public enterprises. Many of them are not really qualified to run industrial enterprises. The government has been progressively shifting to professionalised management in these enterprises. This is a healthy development.

In conclusion, it may be pointed out that the picture of the public sector generally painted by the Federation of Indian Chambers of Commerce and Industry, Forum of Free Enterprises and such other organisations is too black. It is equally true that all the public sector enterprises are not functioning efficiently. The competitiveness of the private and public sector projects should act as the motivating mechanism for improving efficiency in both the sectors.

Self-Assessment

1. Choose the correct option:

(*i*) Which is the most basic cause of an issue being placed on the policy of agenda?

(*a*) Increased public attention on a particular issue

(*b*) Knowledge that an existing problem can be ameliorated through

(*c*) Previous lack of attention to a known public need

(*d*) Public problems highlighted by the operation of a free market system.

(*ii*) Selling of state owned assets

(*a*) Deregulation (*b*) Privatisation

(*c*) Intergration (*d*) Nationalisation

(*iii*) Removal of government control over industries

(*a*) Privatisation (*b*) Adminstration

(*c*) Sequestration (*d*) Deregulation

(*iv*) A cost of privatisation

(*a*) Loss of income to the government (*b*) Loss of customer choice

(*c*) Reduction in shareholders (*d*) Loss of employment

3.3 Summary

- The Industrial Policy Resolution 1956 gave the public sector a strategic role in the Indian economy. For one thing, at the time of independence, the country was backward and underdeveloped — basically an agrarian economy with a weak industrial base, heavy unemployment, low level of savings and investment and near absence of infrastructural facilities, Indian economy needed a big push.
- The relationship between auditing practices in the public and private sectors cannot be examined without looking at the different ways in which accountability is exercised for public sector institutions compared to the purposes and forms of accountability of private concerns.
- In the area of financial reporting, for example, there is the question of how far there should be uniformity, and how much flexibility ought to be allowed between similar types of institutions.
- As for internal financial control, the pressure on resources has in most cases given rise to a call for improved systems for monitoring, not only internally but also for external disclosure and performance review.
- The public sector is both extremely diverse and, despite privatizations, extremely large. Even ignoring the large sums expended on transfer payments (such as pensions, welfare benefits and subsidies), the total expenditure of the public sector on employing people, goods and services in carrying out both trading and public service activities is enormous – about 40% of the gross domestic product.
- After the attainment of independence and the advent of planning, there has been a progressive expansion in the scope of the public sector. The passage of Industrial Policy Resolution of 1956 and the adoption of the socialist pattern of society as our national goal further led to a deliberate enlargement of the role of public sector.
- There are two important categories of public sector employment : (a) Government administration and defence and other government services like health, education, research and various activities to promote economic development; and (b) public sector proper, i.e., economic enterprises owned by the Centre, State and Local Government.
- Despite many criticisms against the public sector enterprises, there is no denying the fact that rapid industrialisation in the first three decades after independence was mainly due to the public sector.
- Most of the public sector enterprises have been started keeping in mind the requirements of the Indian economy, in the fields of production and distribution.
- Internal resources consist of depreciation and retained profits. With every five year plan, the public sector was able to mobilise larger internal resources. During the Seventh Plan internal resources of the order of 29,750 crores were generated.
- From every angle, the public sector has grown in importance and has come to occupy a prominent place in the Indian economy. What we have described above relates mostly to enterprises in the Central sector.
- In a developing economy like India, some industries had to be brought within public ownership and control, for otherwise rapid growth of the economy was thought to be impossible.
- The socialistic pattern of society calls for extension of public sector in two ways. For one thing, production will have to be centrally planned as regards the type of goods to be produced, the volume of output and the timing of their production.
- The behaviour and attitude of the private sector itself was an important factor responsible for the expansion of the public sector in the country. When the Americans insisted on the Bokaro Project to be set up in the private sector, Mr. J.R.D. Tata openly confessed that the private sector was not in a position to mobilise resources to the tune of ` 700 crores.
- In a number of cases, the Government was forced to take over a private sector industry or industrial units either in the interest of workers or to prevent excessive exploitation of consumers.

- While the Government has been pushing ahead with more and more public sector undertakings, there has been considerable criticism about the poor performance and in some cases utter failure of government undertakings in the country.
- It would, therefore, be appropriate to calculate the rate of return on effective capital employed and thus not include the capital employed in undertakings under construction or in expansion or capital work-in-progress.
- Although profit maximisation (or in the case of public enterprises, the generation of surplus) may not be the sole criterion to judge their performance, yet it cannot be denied that it would be a folly to ignore it altogether.
- While evaluating the performance of the public sector it is necessary to refer to the gains to the employees in the form of a steady improvement in their emoluments, provision for housing, medical care and educational facilities.
- It would be unreasonable to argue that all is well in the public undertakings. There is much scope for improving the efficiency and working of public sector enterprises.
- Many reports on the working of public sector projects have pointed out that many of the projects took longer time to complete than was initially envisaged.
- In most public sector enterprises, pricing policies are not rational. They have no declared price policy, except perhaps that they have some departmental directives and ad hoc piecemeal orders.
- It may be pointed out that the picture of the public sector generally painted by the Federation of Indian Chambers of Commerce and Industry, Forum of Free Enterprises and such other organisations is too black.
- To improve the performance of the public sector, the Government of India announced in July 1991 the new Industrial Policy.

3.4 Key-Words

1. Agrarian economy : An economy dominated by agricultural products; a pre-industrial economy.
2. Privatizations : It can have several meanings. Primarily, it is process of transferring ownership of a business, enterprise, agency, service or property to the private sector, either to a business that operates for a profit or to a non-profit organization. The term can also mean government outsourcing of services or functions to private firms, e.g. revenue collection, law enforcement, and prison management

3.5 Review Questions

1. What are the issues of public sector?
2. Discuss the problems of public sector.
3. Discuss the role of public sector.

Answers: Self–Assessment

1. (*i*) (*b*) (*ii*) (*b*) (*iii*) (*d*) (*iv*) (*d*)

3.6 Further Readings

Books

1. The Indian Economy; S.K. Ray; Prentic, Hall of India Private Limited New Delhi - 110001.
2. Indian Economy; Gaurav Datt and Aswani Mahajan; S. Chand and Company LTD. Ram Nagar, New Delhi-110055.

Notes

Unit 4: Sectoral Performance II: Role of Infrastructure in Economic Development

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Objectives

After reading this Unit students will be able to:

- Describe the Role of Infrastructure in Economic Development.

Introduction

Infrastructure is the basic physical and organisational structures needed for the operation of a society or enterprise, or the services and facilities necessary for an economy to function. The term typically refers to the technical structures that support a society, such as roads, water supply, sewers, electrical grids, telecommunications, and so forth. Viewed functionally, infrastructure facilitates the production of goods and services, and also for the distribution of finished products to markets, as well as basic social services such as schools and hospitals; for example, roads enable the transport of raw materials to a factory. Encompassing all things to all people is not a particularly useful way to define infrastructure, as it does not make clear investors, Governments, and citizens' ability to understand, advocate, and direct capital toward durable, networked assets with widespread societal benefits. Primary infrastructure components are generally monopolistic in nature and require large financial commitments for their development, repair, and replacement. Infrastructures facilitate economic productivity and promote a standard of living. Infrastructure can then be more concisely defined as the physical components of interrelated systems providing commodities and services essential to enable, sustain, or enhance societal living conditions.

4.1 Role of Infrastructure in Economic Development

The prosperity of a country depends directly upon the development of agriculture and industry. Agriculture production, however, requires irrigation, power, credit, transport facilities, etc. Industrial production requires not only machinery and equipment but also skilled mano-power, management, energy, banking and insurance facilities, marketing facilities, transport services which include railways, roads, and shipping, communication facilities, etc. All these facilities and services which help in industrial and agricultural production constitute collectively the infrastructure of an economy. The development and expansion of these facilities are an essential pre-condition for increasing agricultural and industrial production in a country. In the last 200 years or more industrial and agricultural revolutions in England and other countries were accompanied, by a revolution transport and

communications, the extensive use of cargo and later oil as source of energy, tremendous expansion in banking, insurance and other financial institution to finance production and trade, an explosion knowledge of science and technology, and so on.

Infrastructural facilities—often referred to economic and social overheads—consist of :

(a) Irrigation, including flood control and comman area development.

(b) Energy : coal, electricity, oil and non-conventional sources.

(c) Transport : Railways, roads, shipping and civilaviation.

(d) Communications : Posts and telegraphs, tele phones, telecommunications, etc.

(e) Banking, finance and insurance.

(f) Science and technology.

(g) Social overheads : health and hygiene and education

Growth of Infrastructure since Independence

Indian planners were fully aware of the link between infrastructural facilities and general economic development and, accordingly, they gave high priority the rapid expansion of these facilities right from the First plan itself. The plans have generally devoted over 50 per cent of the total plan outlay on infrastructure development. As a result, there has been phenomenal increase in infrastructural facilities.

For instance, coal production including lignites rose from 32 million tonnes to 566 million tonnes between 1951 and 2010. During the same period, power generation from public utilities, excluding power generation from captive and non-conventional power plants rose from 5 billion *kwh* in to 768 billion *kwh*; and production of petroleum crude rose from an insignificant 0.4 million tonnes to over 34 million tonnes. Likewise, there has been tremendous expansion in the other infrastructural facilities.

4.2 Energy

The most important single factor which can act as a constraint on economic growth of a country is the availability of energy. India is both a major energy producer and consumer. Currently, India ranks as the world's seventh largest energy producer and fifth largest energy consumer.

There is a direct correlation between the degree of economic growth, the size of per capita income and per capita consumption of energy. Table 2 based on World Development Report shows per capita income and per capita consumption of energy of six countries :

In Table 1, the first three countries are developing countries with low per capita incomes, while the next three are developed countries with high per capita incomes. The per capita consumption of energy in India in 2003 was 529 *kg* of oil equivalent (Kgoe) as compared to 1,484 in China. On the other hand, per capita consumption of energy was as much as 3,464 in England, 4,019 in Japan and 7,766 in U.S.A. Per capita consumption of energy in India was only 13 per cent of that in Japan, and only 6.8 per cent of that in the U.S.A. Although per capita commercial energy consumption in India has been steadily going up during the last 2 decades, it is still one of the lowest in the whole world (26 per cent of the world average of 1,750 kg).

Table 1 : Per capita income and per capita consumption of energy for selected countries

Country	Per capita income (in U.S. dollars) 2008(*ppp*)	Per capita consumption of energy (*kgs*. of oil equivalent)2007
India	2,930	529
China	6,010	1,484
U.K	36,240	3,464
Japan	35,190	4,019
U.S.A.	46,790	7,766

Source : World Development Report, 2009 and **World Development Indicators** (2010)

Notes

Sources of Energy

Broadly, there are two sources of energy, viz., commercial energy and non-commercial energy. Commercial energy, or more correctly, commercial sources of energy, consist of coal, petroleum and electricity. These sources are commercial in the sense that they command a price and the users have to pay for them. Commercial energy accounts for over 50 per cent of all energy consumption in India.

Non-commercial sources of energy - also known as traditional sources of energy - consist of firewood, vegetable wastes and dried dung. These are called non-commercial sources, as they are supposed to be free and command no price. Actually, the non-commercial sources such as firewood and dried dung have started commanding a price in urban areas and to some extent in rural areas as well. While commercial sources of energy are generally exhaustible—exception being, hydro-electric power—non-commercial sources of energy are renewable. More than 60 per cent of Indian households depend on traditional sources of energy for meeting their cooking and heating needs.

Availability of Primary Energy in India

There are three broad sources of primary commercial energy, viz., (a) coal and lignite; (b) oil and gas, and (c) electricity.

Coal and lignite : The total estimated resources of coal in India are placed now around 148,790 million tonnes, but the mineable reserves may amount to about 60,000 million tonnes. The total lignite reserves, found mostly at Neyveli in South Arcot district of Tamil Nadu, are placed at 3,300 million tonnes of which 1,900 million tonnes are in the proved category. Annual production of coal including lignite was around 566 million tonnes (2009-10). According to the present and future demand projections, the coal reserves in India would be just sufficient for about 130 years.

Oil and gas : According to the latest available estimates, net recoverable reserves of oil are placed around 550 million tonnes, and the net recoverable reserves of gas are put at about 500 billion cubic metres. Annual production of oil crude is around 34 million tonnes (2009-10). At the current rate of consumption, oil may last for only about 20 to 25 years.

Electric power : As regards electricity, there are hydro-electric power and thermal power. Thermal power is generated by the use of oil and gas and also by the use of nuclear energy. The official estimated annual energy potential from hydro-electric sources is placed around 90,000 MW; of this potential, about 18,000 MW has been developed. This implies that only 20 per cent of the hydro-potential has been utilised and 80 per cent still remains unharnessed, despite the inherent advantages and superiority of hydro power plants over thermal and nuclear plants.

Non-commercial Energy Resources in India

(i) **Fuelwood :** Fuelwood is essential for cooking and it is extensively used in our villages and towns. According to the Tenth Plan estimate, 65 per cent of total rural energy consumption is met from fuel wood. During 2001-02, fuel wood consumption was put at 223 million tonnes—180 million tonnes for household consumption and the balance 43 million tonnes for cottage industry, hotels, etc. If the present demand and supply conditions continue, there would be a veritable fuelwood famine. In fact, scientitsts anticipate that in the near future, fuelwood could be a greater constraint than the availability of foodgrains.

(ii) **Agricultural wastes :** Agricultural wastes such as straw are presently used as feed and fodder, roofing material, organic matter for compost making and as fuel for cooking purposes. There are no really reliable estimates of agricultural wastes, but according to one estimate the consumption of agricultural wastes for fuel purpose was put around 41 million tonnes for the year 1975-76 and it may be around 65 million tonnes now.

(iii) **Animal dung :** Dried dung of animals is extensively used as fuel in our rural areas (and also in towns). Out of the total estimated production of 324 million tonnes of animal dung, about 73 million tonnes are estimated to be burnt for energy purposes every year. This is more than the total fertiliser consumed in agricultural production in India. If this animal dung, which is a valuable organic manure, was used as fertiliser, food production could be increased considerably.

Notes

Non-conventional Sources of Energy in India

While the above sources of energy--both commercial and non-commercial--are known as conventional sources of energy, there are three other sources of energy which are commonly called as **non-conventional sources of energy**. They are : solar energy, wind energy and tidal power. Solar energy potential is almost unlimited in India, a tropical country. Likewise, wind energy is available in abundance, especially in coastal areas and in hilly regions, but both solar energy and wind energy are not so far utilisied in the absence of cost-effective technologies. However, in the context of acute shortage of conventional sources of energy, many countries are exploring the possibilities of using these non-conventional sources of energy. Accordingly, they would assume more significance in the years to come.

Trends in the Consumption of Commercial Energy

The sectoral pattern of consumption of commercial energy (i.e. coal including lignite, oil and gas and electric power) is given in Table 2.

The transport sector was the largest consumer of commercial energy (44%) in 1953-54. However, there has been a continuous fall in the share of the transport sector in the total commercial energy consumption. For instance, its share declined to 22 per cent in 2005-06. The industrial sector is now the largest consumer of commercial energy in the country.

During this period, the agricultural sector has, however, registered sharp increase in the consumption of commercial energy, i.e., from one per cent to 9 per cent.

Table 2 : Sectoral trends in commercial energy consumption

(in percentage)

	1953-54	**1970-71**	**2005-06**
Household sector	10	12	12
Agriculture	1	3	9
Industries	40	50	42
Transport	44	28	22
Others	5	7	15
	100	100	100

Source : Ninth Five Year Plan, Vol. II. Ch 6.

Table 3 brings out the percentage share of different fuels in commercial energy consumption.

Table 3 : Percentage share of different fuels in commercial energy consumption

(in percentage)

	1953-54	**1970-71**	**2005-06**
1. Coal	80	56	29
2. Oil and gas	17	35	54
3. Electricity	3	9	17
	100	100	100

Source : Same as for Table 1.

It is interesting observe that (a) the share of coal in the total commercial energy consumption has declined steadily over the years; and (b) the share of oil and electricity, however, has steadily increased.

These figures do not really reflect the real significance of coal. As these figures relate to final energy consumption, only the direct consumption of coal in industry, household sector, transport, etc., is

considered and the use of coal in power generation has been excluded. But it is important to remember that about 65 per cent of the total coal produced in India is used for thermal power generation.

Trends in the production of commercial energy since 1950-51

As energy is an essential input for economic development, the production and the consumption of commercial energy has increased steadily after the introduction of economic planning in 1950-51. Between 1951 and 2007, coal production had increased by nearly 14 times, crude oil production by 120 times and electricity (installed capacity) by over 106 times.

Table 4 : Growth of Commercial energy since 1950-51

	1950-51	1970-71	2009-10
Coal (*m*. tonnes)	33	76	566
Oil crude (*m*. tonnes)	0.3	7	33.7
Electricity*			
Installed Capacity (000MW)	2.3	16.3	188
Generation (billion *kwh*)	7	61	877.5

*(Utilities and non-utilities)

Source : Economic Survey, 2010-11

Rural Energy Crisis and Decentralised Energy

The conventional energy systems, based on fossil fuels such as oil crude and coal and electricity (rural electrification) have miserably failed to solve the rural energy crisis, in India. This may at any time, provoke "fuelwood riots" similar to the food riots of the late 1950's and early 1960's. The problem of rural energy supplies calls for a radically new approach known as the "decentralised energy" approach which seeks to supply energy from the locally available renewable sources like the cowdung and agro-wastes. In other words, attempt has to be made to supply commercial energy based on the traditional non-commercial energy forms.

Firewood is obviously the most important cooking fuel and will remain so for a long time. With the rise in the price of fossil fuel (of kerosene and of LPG) and their non-availability, people in urban areas have come to depend increasingly upon firewood. There is an acute shortage of firewood and consequent rise in the price of fuelwood. Contrary to the common belief, there is no shortage of land in India to produce even two to three times the fuelwood requirements. The Planning Commission Fuelwood Study Committee estimated that some 240 million tonnes of fuelwood (as against the present demand of 133 to 140 million tonnes) can be produced every year, through :

(a) **fuelwood on farm lands :** Growing trees farm lands as shelter belts, windbreaks, shade trees, fodder trees and fruit trees, all of which will produce' fuelwood;

(b) **fuelwood on wastelands :** Growing fuel-wood on nearly 80 million hectares of barren and waste lands including land along the country's roads, railway lines, canals etc.—even if 15 per cent of this vast tract of land is planted with fuelwood species, estimated yield would be 95 to 100 million tonnes per year; and

(c) **fuelwood degraded forests :** proper protection of degraded forests and afforestation through fuelwood trees can supply about 50 million tonnes of fuelwood per year.

Really speaking, therefore, the problem of fire-wood famine can be successfully tackled, if the Government is prepared to mobilise sufficient financial resources—about ₹ 800 to ₹ 1,000 crores a year—and is willing to change the present forest policy from timber production to the production of fuel and fodder. Such an effort is worth attempting since this would not only solve the acute problem of fuelwood in both rural and urban areas but also **help promote employment in a big way**, in planting, maintenance, in felling of trees, in processing of wood, etc. Moreover, it will have a favourable ecological effect through increase in tree cover, control of floods and of soil erosion and of promoting soil fertility.

Notes

To some extent, the Government has appreciated the need to encourage the fuelwood plantation programme and has promoted farm forestry and social forestry programmes since 1976. But by subsidising and encouraging richer and more affluent farmers to go for massive tree planting, the Government has turned wood into a lucrative economic commodity and has condemned the weaker sections in the rural areas to continue to experience acute fuelwood crunch. The correct alternative would be to involve the rural poor, especially the rural women, directly in the community forestry programmes and help them to produce more fuel and fodder and share these resources equally. This alternative is rather difficult for the bureaucrats to implement but sooner or later, the Government policy makers will have to try this method.

Biogas : The Planning Commission Working Group on Energy Policy stated enthusiastically, "Biogas plants constitute the most promising alternative energy technology in the household sector". The Government announced a series of subsidies and concessional bank loans for the construction of biogas plants in rural areas. Under the National Project for Biogas Development nearly 3.2 million biogas plants have been set up so far in the country; the current annual target is around 2 lakh biogas plants.

Notes The oil-energy crisis was also responsible for an explosion of interest in biogas plants in India during the 1970's.

The biogas plant has the double advantage of producing fuel as well as manure. The gas produced can be used for cooking and lighting and to carry out simple agricultural operations. It is estimated that there are 15 million households with the requisite number of cattle—4 to 5 heads of cattle are the minimum needed to feed a family size plant. The scheme has thus a large potential for developing local sources of energy supply and the Government introduced an ambitious and massive programme of installation of biogas plants.

The biogas programme did not have the success the Government anticipated. One basic reason for the poor performance is that no attempt was made to study carefully the cost-benefit of these plants to the users. More important than this factor, is the growing realisation that the biogas scheme would further accentuate the inequality between the energy-haves and the energy-havenots in the rural areas. For instance, it has been estimated that only about 10 per cent of rural households in India possess 4 to 5 heads of cattle and, therefore, the biogas plants would be useful only for richer farmers. Again, these richer farmers would use animal dung only for their own personal needs and deprive the poor of a fuel that does not have any price at present and has been freely available. To overcome these problems created by family biogas plants, the Government and some voluntary agencies have started promoting community plants which are relatively economical to set up and to operate. But there are problems of collection of manure and distribution of gas in fact, the cost of distribution to individual house-holds is quite high. Considering the caste, religious, and other social factors in our villages, the community biogas programme does not promise ot have much future.

Agricultural Wastes : With the increase in the production of foodgrains to around 200 to 210 million tonnes, residue from grain crops alone would come to about 335 million tonnes. With the use of improved and efficient technologies, it is possible to increase the scope of rice husks, cotton stalks, etc. as cooking fuels. Dr. Pathak of the Punjab Agricultural University studied the potential of agricultural wastes in a rich village in Ludhiana District and found that after all the fodder needs of the village were met, the energy potential of the remaining crop wastes and animal wastes was enough to meet all the energy requirments of the village and still leave a surplus. In a situation where supplies of conventional energy, and sources like firewood, are decreasing and since alternatives like kerosene are not within the reach of the rural poor, this increase in energy supplies in the form of agricultural wastes will benefit the society in general and the rural poor in particular.

The present national energy policy of the Government has been extremely lopsided, as it seeks to solve essentially the oil shortage on the one side and coal and power shortage, on the other. **The major consideration has been the energy needs of industry and transport and of the higher income groups in urban areas**. The national energy policy has virtually ignored the cooking energy needs of the poor people in urban and rural areas. The sporadic and half-hearted measures to promote solar cookers, biogas plants and recently fuelwood plantations have not solved the cooking energy crunch in any

significant way. The Centre for Science and Environment, an enlightened voluntary organisation, therefore, pleads for a national cooking energy policy : "If the Government wants to help meet the basic needs of our population without causing wholesale environmental destruction, an integrated national cooking energy policy is an imperative. If the Government fails to come up with an implementable policy or lacks the will to implement one, the results will be disastrous for the people and the environment."

Did u know? At present around 80 million tonnes out of a total estimated output of 450 to 500 million tonnes of agricultural wastes and residues are used as fuel for cooking purposes.

4.3 Power

Electric power, which is one form of energy, is an essential ingredient of economic development and, it is required for commercial and non-commercial uses. Commercial uses of power refer to the use of electric power in industry, agriculture and transport. Non-commercial uses include electric power required for domestic lighting, cooking, use of domestic mechanical gadgets like the refrigerators, air conditioners, etc. With rapid growth of population in India and with the increase in the use of modern gadgets in daily life, it is quite natural that the demand for electricity for domestic use should grow at a fast rate. Table 5 explains the pattern of utilisation of electric power produced and supplied by public power sector units or public utilities.

Table 5. Pattern of electricity consumption (utilities)

(per cent)

	1950-51	1970-71	2008-09
Industry	63	68	37.1
Agriculture	4	10	20.4
Railway traction	7	3	2.2
Public lighting and commercial	13	10	15.6
Domestic use	13	9	24.7
Total	**100**	**100**	**100**

Source : Economic Survey, 2009-10 CSO (2010) * Provisional.

A marked feature is the increasing use of electricity in agriculture. With programmes of rural electrification, the demand for power for lift irrigation and energisation of pumpsets has increased during recent years, from 4 per cent to 22 per cent. The establishment of new industries like iron and steel, machine tools, engineering, fertilisers, etc., and the expansion of capacity of consumer goods industries have led to considerable increase in the consumption of power in India. But it will be observed that the share of industry in the total utilisation of power has come down from 68 per cent in 1970-71 to 37.1 per cent in 2009-10. This does not mean that industrialisation has slowed down, nor does it imply that industrial units are shifting to other sources of fuel. Many large, industrial units have set up, in a big-way, their own captive power plants, instead of depending upon the inadequate and often undependable public utilities. It is estimated that non-utilities (the private sector power units) generated 109.7 billion *kwh* of power which was consumed by industries.

It may be observed that the consumption of power by domestic consumers has increased rapidly, However, consumption of electricity by railways and for public lighting as a proportion of total consumption has declined.

Sources of electric power

There are three main sources of generation of electric power, viz., hydel power thermal power, and nuclear power.

Notes

Table 6. Growth of Installed Plant Capacity in Public Utilities (in thousand MW)

Year	Hydro	Thermal	Nuclear	Total
1950-51	0.6(33)	1.1 (67)	--	1.7
1970-71	6.4 (43)	7.9 (59)	0.5(2)	14.7
2000-01	25.1 (25)	73.6 (72)	2.9 (3)	101.6
2008-09	36.9 (25)	107.0 (72)	4.1 (3)	148.0 (100)
2009-10	36.9(23.0)	118.0(74.0)	4.5(3.0)	159.4(100)

Note : Figures in brackets are percentage of total installer capacity.

Source : Economic Survey, 2010-11.

Hydel Power

Hydro-electric power is a renewable natural resource. In 1950-51 installed capacity of hydro-power was 560 MW but by 2009-10 it had increased to 36,900 MW; but in relative terms, it had declined from 33 per cent to 23 per cent. (This was because of the greater growth of thermal power since 1951)

Hydel power has several advantages :

(a) It is the most economical source of power

(b) There is no problem of pollution of atmosphere or disposal of waste in generation of hydel power; and

(c) Oil, coal and natural gas resources which can be used for producing electricity are in short supply and have implications in terms of high costs and exert greater pressure on foreign exchange resources; hydel power can easily replace them.

It has, however, been aruged that hydel projects take a long period of gestation as compared to thermal projects. This point was examined by the Power Economy Committee which after thorough investigation concluded that in case a hydro project is thoroughly examined and designed before implementation, the actual period of construction is nearly the same as that of a thermal project. This explains why the Power Commission in 1962 and Energy Survey of India Committee (1965) recommended that greater reliance be placed on hydro-projects. After the tremendous enthusiasm for hydro-electric projects during the First and the Second Plans, there was a slackening of emphasis of hydro schemes. This was an unwise step, and there was a need to reverse this trend. Emphasising this as a future directional change of policy, the Power Economy Committee (1971) stated : "Under the existing conditions in the country, the hydel schemes constitute the most economic source of electric production .... To control and reduce the cost at energy generation and supply in the country, to enable full utilisation of generating facilities already built up and to ensure that the limited capital allocations to the power supply industry go the farthest in meeting the country's estimated deficit, the bulk of the new generating capacity to be added during the 5th and 6th Plans should be derived from hydro sources."

In spite of these clear advantages claimed for hydro-power, and despite the fact that only one-fifth of hydro power has been harnessed in the country so far, the Government has been relying more on thermal power to relieve the power shortage in India.

During 1998-99, the Governemnt of India announced a policy on Hydro-Power Development with a view to exploiting the vast hydropower potential available in the country at a faster rate. Accordingly, action was initiated to add nearly 8800 MW hydel capacity in the Central Sector by 2004-2005.

Thermal Power

Thermal power which is generated by coal and oil has always been the major source of electric power in India. In absolute terms installed capacity of thermal power had increased from 1,150 MW in 1950-51 to 1,18,000 MW in 2009-10; and in relative terms the share of thermal power had increased from 67 per cent to 74 per cent during this period. Bulk of the thermal power is derived from coal and only a small fraction comes from oil. Both coal and oil are non-renewable and exhaustible resources. Low

grade coal and middlings available at collieries and washeries are used for the generation of electric power. Accordingly, thermal power generation plants are located near coal mines and washeries. With the increase in the international price of oil and consequently with the rise of domestic price of oil, the cost of generation of power through oil has shot up and the Fuel Policy Committee recommended the substitution of coal based technology in place of oil. While the use of oil for power generation is being discouraged, the success of its substitution by coal depends on the extent to which coal production can be augmented in the country.

Nuclear Power

Nuclear power is of recent origin and its supply accounts for only 3 per cent of the total installed capacity of electricity. The Planning Commission has stated clearly : "In relation to the total capacity of the power systems in India and their rates of growth, the contributions of nuclear power will remain relatively modest in the coming two decades." Attempts are, however, made to set up nuclear power stations in Tamil Nadu, Rajasthan, etc. Considering the relative failure of nuclear power plants in Russia and in other countries including India, nuclear energy is unlikely to make a significant contribution to power generation in the country.

Amidst increasing aversion of developed world, it is being said that the future of nuclear energy is now in developing countries. At present there are 19 nuclear power plants in the country, with a total installed capacity of 4000 megawatts. In the post Indo-US nuclear deal this capacity is expected to get enhanced to 60000 megawatts. Five new nuclear power parks have been planned including one in Jaita Pur, Maharashtra. Other nuclear parks have been planned in West Bengal, Gujarat, Andhra Pradesh and Tamilnadu. Each such park will have an installed capacity of 10000 megawatts.

There were 436 nuclear reactors in the world. US, Japan and France were producing 56.5 percent of global nuclear energy production, fulfilling 6.5 percent of energy requirements all over the world. It may be noted that US fulfils 19 percent of its electricity requirements from nuclear power, but for some time it is not establishing any new nuclear power plant. Even Japan is producing less energy from nuclear source. Major reason for the same is that its Kashiwazaki kariwa nuclear plant was closed down after earthquake in 2007. Many nuclear reactors have retired and they have not been replaced by new ones. Last year global production of nuclear power came down by 1.8 percent. Therefore it seems that government of India is extra enthusiastic about the feature of nuclear energy in India. Strong opposition to Jaitapur nuclear project is a signal to the future resistance, which nuclear plans are going to face in context to the international experiences.

Targets and Achievements

Table 9 shows how the targets of power generation were not reached in any of the plans completed so far. In every Five Year Plan there was a shortfall in achievement--15 per cent in the First Plan and as much as 50 per cent in the Fourth Plan The cumulative result of slackness in this basic area of planning is that power crisis threatens to choke the growth process of the Indian economy. In fact, it seriously damaged the targets of the Fourth and Fifth Plans. Accordingly, the Sixth Plan (1980-85) put maximum emphasis on power generation; even then, there was a shortfall of 28 per cent in the power generation target. The short-fall of 4 per cent during the Seventh Plan period was the lowest. The shortfall in the Ninth Plan was a hefty 53 per cent.

4.4 Transport System in India's Economic Development

Significance of Transport

If agriculture and industry are regarded as the body and the bones of the India economy, transport and communications constitute its nerves which help the circulation of men and materials. The transport system helps to broaden the market for goods and by doing so, it makes possible large-scale production through division of labour. It is also essential for the movement of raw materials, fuel, machinery etc., to the places of production. The more extensive and continuous the production in any branch of activity, the greater will be the need for transport facilities. Transport development helps to open up remote regions and resources for production. Regions may have abundant

agricultural, forest and mineral resources but they cannot be developed if they continue to be remote and inaccessible. By linking the backward regions with the relatively more advanced, transport development helps in the better and fuller utilisation of resources. Finally, expansion of transport facilities, in turn, helps industrialisation directly. The demand for locomotives, motor vehicles, ships etc. leads to the start of industries which specialise in the production of these goods. Expansion of transport is thus of fundamental importance for a developing country like India.

Transport and the Five Year Plans

Indian planners gave high priority to the development of transport, for in their opinion "an efficient and well developed system of transport and communications is vital to the success of a plan of economic development which lays stress on rapid industrialisation." Accordingly, the allocation on the transport sector was quite high during the first three plans, viz., between 25 and 28 per cent. The allocations in the next successive Plans on the transport sector declined gradually. The Eighth Plan outlay, for instance, was only 13 per cent of the total outlay. But the lower allocation in the last three plans does not mean that the transport sector had been fully developed.

There is the resource crunch on the one side and there is increasing importance given to energy and industrial sectors, on the other.

Growth of Transport System since 1951

Rail and road transport systems dominate but other forms of transport are also important within their specialised areas considering the size of the country and its geographical features. Table 13 shows that the transport sector has recorded a substantial growth since the introduction of economic planning in 1950-51. Railways have recorded a growth of 3 per cent per annum in freight originating tonnage, though the growth in route length was indeed low. The road network has expanded at an annual rate of 5 per cent while road transport fleet has increased by 7 per cent per annum in respect of goods vehicles. About 70 per cent of the Indian villages have been connected by a net work of rural roads and over 40 per cent of our villages are served by all weather roads. Shipping tonnage has increased by an impressive 11 per cent while coastal shipping could register only a meagre rise of 1.4 per cent. Airlines passenger traffic has risen smartly by 9 per cent per annum. The traffic handled by major ports has increased from 19 million tonnes to 562.7 million tonnes between 1951 and 2010, at an annual rate of over 5 per cent. The growth of the transport sector in general is indeed quite impressive and it reflects the enormous outlay allocated to the development of the transport system during the planning period.

Problems of Transport Development in India

Since 1950-51 transport systems have registered impressive progress but there are many bottlenecks, constraints and difficulties. Inadequacies and imbalances in transport threaten to constrain economic growth and the quality of life in urban as well as rural India.

(a) **Transport bottlenecks :** The capacity of the entire transportation system including the road network continues to fall short of demand for transportation. For instance, capacity constraints in railways have led to the movement of bulk commodities like coal, over long distances, by road, at high cost to the economy. The acute shortage of wagons had affected almost all industries in the country. The scarcity of coal experienced throughout the country with enough coal at the pit-heads, the piling up of stocks of cement with manufacturers but with the scarcity of cement everywhere, scarcity of fertilisers and foodgrains, and so on, were often due to shortage of railway facilities. The inefficiencies, the delays and the corruption prevalent in the railway staff had driven manufacturers to make use of the services of road transporters for the movement of their products. The railway bottlenecks have largely been now removed.

Even now 30 per cent of villages in our country still lack road connection. The road transport system is under heavy strain, with inadequacy of capacity and sub-standard infrastructure. This has led to excessive transit delays, fuel wastage and higher operating costs. Similar problems are to be met with in the case of shipping also.

Notes

Table 7 : Growth of the Transport System

			1950-51	1970-71	2005-06	2009-10
1.	*Railways* :	Route length ('000 *km*)	53,600	59,800	63,300	64000
		Freight Traffic originating (million tonnes)	93	196	680	888
2.	*Roads* :	Total length ('000 *km*)	400	915	2,713*	4,236**
		Surfaced	160	400	1,510*	2,090**
		No. of goods vehicles ('000)	82	343	4,782	NA
3.	*Shipping* :	Overseas shipping (million tonnes GRT)	0.2	2.2	7.0	9.7
	ports	traffic in m. tonnes	19	–	424	562.7
4.	*Civil Aviation* :	Number of passengers (lakhs)	–	26	318	569

Source : Tenth Five Year Plan, 1997-2002, Vol. II. and **Economic Survey,** 2009-2010, Tables S-27 etc. Ministry of Shipping Annual Report 2009-10. N.A-Not Available

* For the year 2003-04 ** For 2007-08

(b) **Poor planning of transport system :** In the formulation of transport plans, sufficient attention was not given to spatial and economic features which influence the pattern of transport demand in the country. For instance, population and economic activities tend to concentrate in major cities and towns. Massive volumes of traffic are concentrated in certain regions of the country and hence there is tremendous pressure on rail and road transport systems in the cities and certain regions. Alternative routes should be developed or there should be balanced development of regions.

There is bound to be substantial build up of transport demand in the years to come. Such increase in transport demand cannot be met always by expansion in transport services. Careful transport planning should include greater dispersal of industries, balanced regional development, generation of thermal power, development of other sources of energy, etc.

Another aspect of poor transport planning is that in the urban areas, lack of adequate mass transport, complete absence of demand management and policy distortions in the areas of fuel pricing and bank finance have resulted in an explosion of personalised transport comprising mainly of scooters and cars. This has contributed to high levels of pollution and alarming rates of accidents. On the other side, a large number of villages lack a reliable all-weather transport connection with nearby markets and towns.

Yet another aspect of poor transport planning in India is that North East and Jammu & Kashmir have not been adequately linked with the rest of the country and as a result, they have remained physically and emotionally isolated.

Finally, certain environment-friendly and socially cost effective means of transport like coastal shipping, inland water transport and non-mechanised transport have remained largely underdeveloped.

(c) **Rail-road coordination :** Rail and road transport are the dominant modes of transport in the country and they would continue to be so in the future too. However, the modal mix of transport has been continually shifting against the railways. For instance, in 1950-51, the road transport accounted for 11 per cent of the freight traffic and 26 per cent of the passenger traffic; but now, its share had increased to 60 and 80 per cent respectively. This continuing shift in favour of the road transport system is undesirable from economic as well as environment angles. A continuously mounting energy import bill is one of the direct consequences. The Seventh Plan argues in this connection : "Ideally, the Railways should have adequate capacity to clear all train and wagon load traffic for long and medium loads particularly for bulk commodities while the road transport would cater essentially for small lot, short haul traffic for which it is the more efficient mode."

(d) Overaged and obsolete assets : The transport infrastructure in India suffers from over-aged and obsolete assets. This is true of all modes of transport. For instance, in the case of Indian railways, about 25 per cent of the total route length, 80 per cent of the equipment in railway workshops and a large portion of the rolling stock have to be renewed and replaced. Nearly 80 per cent of the buses operated by the SRTUs, nearly half of the shipping tonnage and one-third of the aircraft of our airline corporations would come up for replacement. This problem of replacement has assumed enormous proportions and it is now generally realised that this cannot be done during a single plan.

(e) Technology Upgradation : Transport technology has a great influence on the productivity and safety of the transport sector. Modernisation of the transport system and the use of emerging technologies are essential elements of transport planning — these, however, should be based on the local needs and not imitation of those used in developed countries. Even though, every five year plan has talked about technology upgradation as a thrust area, the actual progress has been painfully slow : engine design, multi-axle vehicles, construction of roads, cargo handling equipment at the ports, navigational and communication facilities at the airports, modernisation of rolling stock and signalling system in the railways—all these continue to be primitive. Unless attention is given to these aspects, the productivity of operation and the quality of service, besides making the transport system more safe and reliable.

Despite impressive expansion over the years, the entire Indian transport network is characterised by many deficiencies and a major exercise in expansion of capacity and modernisation and technological upgradution is necessary. The Tenth Plan (2002-07) has proposed a comprehensive transport policy to tackle the above diverse problems facing the transport sector. The problems in the transport sector are so huge and the financial resources required are so vast—estimated at ₹ 2,00,00 crores—that transport plan programmes of the Tenth Plan are bound to be just paper plans and nothing more.

Growth of Indian Railways

The Indian Railways had modest beginnings in 1853 when the first railway train journeyed a distance of 22 miles between Bombay and Thana. From a modest beginning in 1853, the railway development was very rapid and by 1900 there were nearly 25,000 miles of railway line. Railway construction slackened and in next 50 years, only 10,000 miles of railway lines were added making up a total of a little more than 34,000 miles, of railway line in 1950.

Originally, the Railways were operated by private companies owned by Englishmen. The Government gave certain concessions such as free grant of land, guarantee of a minimum return on capital etc. There were criticisms and complaints against private ownership and management. In 1925, the Government of India took over the first railway company. Gradually, the other companies were also taken over; by 1950 the railways in the former princely States were also taken over by the Government of India.

The Indian railways have now become a unified State-enterprise. It is the country's biggest nationalised enterprise and one of the largest railway systems of the world with a capital base of about ₹ 58,000 crores, 63,000 route Kms, approximately 8,000 diesel and electric locomotives, 42,000 passenger coaches, 2,22.000 wagons and employing nearly 1.6 million staff. For long haul freight movement in the bulk and long distance passenger traffic, and for mass rapid transportation in suburban areas, railways occupy a unique position in the Indian economy.

Railway Development Under the Plans

As the Indian Railways constitute the largest transport agency intimately connected with the development of the national economy, the main objective of planning in Railways in the past was to expand railway traffic in such a way as to avoid bottlenecks in the production process and to ensure an efficient rail transport system. The total outlay on Railways in the first seven plans was ₹ 24,000 crores. Apart from the general objective of an efficient rail transport system, each Plan had a special objective, as for example,

Notes

(i) First Plan : rehabilitation and replacement of over-aged assets;

(ii) Second Plan : particular emphasis to prepare the Railways for carrying the traffic generated by the new steel plants and the increased production of coal;

(iii) Third Plan : Building up additional capacity so as to be ahead of the traffic demand and to prevent bottlenecks;

(iv) Fourth Plan to Seventh Plan : Modernisation of the system to improve efficiency of operations; and high priority to the development of freight terminals to facilitate the free and smooth movement of wagons; accelerate the conversion of steam locomotives to diesel and electric traction.

(v) Eighth and Ninth Plans : The main thrust was on capacity generation, man-power planning and energy conservation, safety, and customer satisfaction through reliable and better quality of services.

(vi) Tenth Plan : The Tenth Plan (2002-07) emphasized, as under previous plans, capacity expansion through modernization and technological upgradation of the railway system, improvement in quality of service, rationalization of tariff and improvement in safety and reliability of railway services.

During the first three years of the Tenth Plan, the Indian Railways were in a bad shape. But there was a spectacular increase in productivity in the last two years of the Tenth Plan which resulted in quantum expansion in capacity augmentation, increase in railway receipts, control of railway expenditure and huge surpluses.

Roads and Road Transport System in India

Importance of Road Transport for the Indian Economy

As compared to the railways, the road transport system has definite advantages :

(i) Motor transport as well as road construction have contributed significantly to the growth of the gross national product all over the world, but India has remained significantly backward in this regard. Besides, there is tremendous scope for creating employment through road construction and maintenance. Further, India needs increased road mileage, specially to open up the vast areas which cannot be reached except through roads.

(ii) Road transport is quicker, more convenient and more flexible. It is particularly good for short distance travel as well as for movement of goods. Motor vehicles can easily collect passengers and goods from anywhere and take them to wherever they want to be dropped. Door-to-door collection and delivery are possible in the case of road transport. But in the case of railways, the lines are fixed and the railways do not have the flexibility of the roadways. Passengers and goods will have to be taken to the railway station.

(iii) Roads are a necessary complement to railways. India is a country of villages and it is only roads which can connect villages; Railways can connect towns. The railway stations will have to be properly served by a network of feeder roads. Only through these roads the railways can receive their passengers and goods. If railways are essential for the movement of goods and people for long distances, road transport is essential for such movement for short distances. Roads and railways are, therefore, not competitive but are complementary.

(iv) Road transport is of particular advantage to the farmers. Good roads help the farmers to move their produce, particularly the perishable products, like vegetables, quickly to the mandis and towns. Only by developing the road system, the farmer can be assured of a steady market for his products. This assumes great importance in the context ot the green revolution. Besides, good roads reduce the strain on the draught animals During the monsoon season, it may be impossible for the villagers to move out of their villages unless there are good roads. In this connection, it is important to recognise that it is the road system which brings the villagers into contact with the towns and the new ideas and the new system which emanate from the towns.

(v) Roads are highly significant for the defence of the country. We have explained earlier that in a vast country like India, it is necessary that the troops should be moved quickly from one place

to another in times of emergency. The railways are useful here. But more important than the railways is the road transport. Now-a-days the army has to move its troops, its tank and armoured cars, its field guns, and so on. For the movement of these, roads are essential. The great importance given to the construction of border roads to facilitate the movement of troops for the protection of the northern borders against the Chinese aggression is an example of the great importance of roads in the defence of the country.

The Seventh Plan (1985-90) brings out the importance of roads as follows : "Since the country's economy is still largely agrarian in character and the settlement pattern is rural-oriented, roads constitute a critical element of the transportation infrastructure. Road construction and maintenance generate sizeable employment opportunities, a factor that has assumed considerable importance with demographic expansion and the growth of the labour force. Better roads also achieve fuel economy and improve the overall productivity of the road transport sector. Road development will thus continue to play an important role in the Seventh Plan."

Rail-Road Co-Ordination

Railways and roads are complementary to each other much more than other modes of transport and are mutually helpful. The road system links up the cultivators with the local market and the nearest railway station. The Railways, on the other hand, provide the connecting links between the area of production and the consumers at a distance and between the manufacturers in the town and the cultivators in the village. The Railways cannot collect for transport enough produce, unless there are good and sufficient roads. At the same time, even the best of roads cannot place the producers of agricultural produce, iron and steel, cement, coal and other bulky commodities in touch with the final consumers. Road and railways are thus complementary. However, they have become competitive everywhere. In India, too, such a competition has been taking place. In the last three decades or more, there has been an effort to eliminate competition and bring about co-ordination between the two transport services.

The Natural Superiority of Road Transport

The bus and lorry companies can out-compete the railways in attracting passengers as well as goods traffic. Motor transport can provide certain services which the railways can never provide—as for instance, door-to-door collection and delivery, highly flexible time table, speedy transport, etc. These advantages of road transport have made this form of transport very popular among the mercantile community, "particularly for less than wagon load consignments." According to David Hughes, "Road delivery has in many instances halved our cost and slashed delivery time. Yet there is also another potent advantage of road over rail delivery and that is the absence of pilferage. No loss, no ill-will and no unduly expensive method of packing is involved." According to Hughes, "road transport companies are taking up as much as 80 to 90 per cent of the small parcel traffic in South India." While the transport of goods by rail is full of complaints such as denial of wagon facilities, long delays in booking, the unconsciously long time taken in transportation, loss through pilferage, and so on, transport of goods by road is speedier, suffers less from pilferage and has the advantage of direct delivery from door to door.

Protection of Railways Against Road Competition

In the 1930s a number of committees went into question of competition between railways and road transport. One important suggestion was that the railway should improve their services and face road competition effectively. For instance, the Railways should run show trains, make time table adjustments, provide cheap return tickets, season tickets, etc. In the matter of goods transport, the Railways should introduce express goods trains, more expeditious handling of goods, simplification of clerical formalities, door-to-door collection and delivery services, etc. Most of these suggestions have been implemented by the Indian Railways.

The Motor Vehicles Act of 1939 made it compulsory for all motor vehicles to get licence and made them observe specified conditions with regard to maintenance of vehicles, avoidance of over-crowding, speed, etc. The Act of 1939 imposed restrictions on the free transport of goods. Permits were valid for

particular regions and special permission had to be taken for plying beyond the region of origin. The object of the Motor Vehicles Act was to protect the Railways from the unhealthy competition of motor transport.

In 1945, the Government of India issued to the State Governments "A Code of Principles and Practices" for the regulation of road transport. This Code sought the free carriage of all goods other than those of perishable or fragile nature to a distance of only 75 miles and that beyond this distance permits should only be issued if the Railways were not able to handle the traffic.

It is thus clear that throughout the Government has been seeking to control road transport with the object of protecting the railways. This was given clear expression to by Masani Committee : "In respect of railways and roads, the principle of rail-road co-ordination was accepted long ago, but in the opinion of the Committee it has not been fairly applied and has been working in a one-sided way so as to restrict road transport."

Should Railways be protected against Road Transport ?

The Government has always protected the interests of railways against the competition of motor transport. Important reasons for this attitude are :

(i) Railways are the predominant system of land transport and they are a vital factor in respect of Central finance.

(ii) Without effective co-ordination, there would be wasteful duplication with adverse effects on Central finances.

(iii) Railways are publicly owned, managed and controlled; Road transport should also be publicly controlled.

(iv) There are two obligations on the railways which do not apply to the roads, viz., (a) obligation to carry everything that is offered, and (b) prohibition of undue preference and prejudice.

(v) The railway rates are based on the principle what the traffic can bear' and not on maximisation of profit.

(vi) The railways carry two types of goods, viz., high rate traffic and low-rate traffic. The low-rate traffic consists of cheap raw materials such as coal, cement, mineral ores, fertilisers, etc., which are important for industrial and agricultural production. The railways make up their loss on such traffic through profit on high rate traffic. If road traffic is allowed to take away the cream of traffic, then the inevitable result will be the pushing up of the freight rates on lower-rate goods. This will adversely affect industrial development of the country, and will also have serious repercussions on regional development as well as exports.

(vii) Above all, the railways have to serve certain vital and national needs even at a loss. This is so when they have to open up strategic lines and give special travel concessions for social and national purposes.

Water Transport in India

There are two kinds of water transport—inland water transport or river transport and coastal or marine transport.

Inland Water Transport (IWT)

Inland water transport (IWT) comprising a variety of rivers, canals, backwaters, creeks etc. is the cheapest mode for certain kinds of traffic, both over long and short levels, provided the points of origin and destination are located on water front and no transhipment of goods is involved. Besides, IWT is one of the most efficient modes of transport from the point of view of energy consumption. Unlike in other modes of transport, there is practically no investment needed. IWT is also a labour intensive mode of transport and benefits weaker sections of the community. The only requirement is navigable water.

At one time, river and canal transport played an important part in the transport system of the country but since the middle of the last century inland water transport suffered because of the emphasis

placed on railway transport and the diversion of river water for irrigation purposes. As a result, inland water transport (IWT) forms a small part of the total transport network of the country. Out of a total freight traffic of about 550 million tonnes by all modes of surface transport, IWT carries about 17 million tonnes—which is only 0.15 per cent of domestic transportation and there are opportunities for considerable growth.

Inland river transport is important in Assam West Bengal and Bihar. Out of the 25 lakhs tonnes of traffic between Assam and Calcutta, river transport accounts for half and the Railways and road transport account for the rest. Inland transport is highly important in Kerala where rivers and backwaters are used for transporting goods and people. Inland transport is also of some importance in Orissa, Andhra and Tamil Nadu.

Total navigable waterways comprising a variety of rivers, canals, backwaters, etc extend to 14,500 *kms* of which only about 5,200 *kms* of major rivers and 488 *kms*. of canals are suitable for operation of mechanise crafts. Even where waterways are available, the potential has not been fully exploited on account of various constraints.

Thrust Areas and Strategy in the Tenth Plan

(i) Development of IWT in the regions where enjoys natural advantages.

(ii) Improvement in productivity of assets, throu modernisation and upgradation of technology.

(iii) Building up of trained and skilled manpower for IWT operations.

In order to achieve these objectives, the Ninth Plan is adopting the following measures :

(a) Two national waterways — Ganga and Brahmaputra — are being developed. These would include dredging and conservacy works to attain and maintain adequate depth and width of channels, providing adequate navigation aids and setting up integrated terminals to enable nevigation throughout the year and 24-hour navigation on selected stretches.

(b) Modernisation of IWT vessels and replacement of overaged ones, development of specific vessels to meet the requirement of different types of cargo to suit different waterways.

(c) Private entrepreneurs will continue to be given interest subsidy for acquisition of better designed vessels and improved country crafts. Private participation would also be encouraged in setting up of terminals.

Indian Shipping

Before Independence, Indian shipping companies did not succeed because of severe competition from foreign shipping companies and lack of support by the foreign rulers in india. It was only the Scindia Steam Navigation Company which could face foreign competition. At the time of India's Independence, there were only 42 ships with less than 1,00,000 tonnes of GRT gross registered tonnage). It was only after Independence that Indian shipping became predominant in India's coastal trade and got some share in foreign trade. Indian ships carried only 2 per cent of the volume of India's diverseas trade.

Civil Aviation in India

Air transport has a significant role to play. It offers saving in time that cannot be matched by surface transport over long distances. Air transport helps optimise technological, managerial and administrative skills in a resource scarce economy.

In 1950, the Air Transport Enquiry Committee known as Rajadhyaksha Committee, was appointed. The Committee recommended the integration of all companies into four companies so as to remove cut-throat competition and secure scientific and zonal distribution of work. But since the private companies did not voluntarily integrate, the Government had to nationlise civil aviation on three grounds :

(a) Nationalisation would raise operational efficiency;

(b) it would result in better organisation of civil aviation and would enable the Government to get trained technicians, pilots, etc.; and

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(c) it would reduce duplication of services, wastage of flying hours and thus would reduce costs and losses.

In 1953 the Parliament passed the Air Transport Corporation Act under which the Indian Airlines Corporation was to run internal services and Air India International was to run external services. Since nationalisation, improvements in all directions have taken place. New aerodromes have been constructed. Both internal and external services have been extended.

Airports

There are a number of agencies which are involved in providing civil aviation services in India. While Air India, Indian Airlines and Vayudoot provide air services, International Airports Authority of India (IAAI) and Director General of Civil Aviation (DGCA) provide infrastructural facilities. IAAI looks after the development of the four international airports; DGCA is responsible for maintenance and development of civil aerodromes, civil enclaves and aeronautical communication stations.

There has been rapid growth in air travel due to acceleration in economic activity in recent years. The Planning Commission anticipated air traffic to grow at the rate of 18 percent per annum. But during the Tenth Plan period, the actual growth rate was between 24 to 28 percent. As a result, airlines have been facing infrastructure constraints due to limited landing slots, inadequate parking bays and congestion during peak hours. Moreover, there is considerable suppressed demand for domestic air travel because many regional domestic airports have not been upgraded. The 11th Plan has given high priority for provision of infrastructural facilities at a much faster pace.

The Government of India has selected two joint venture companies (JVCs) to modernize, upgrade and operate Delhi and Mumbai airports. This step to restructure and modernize the Mumbai and Delhi airports through the joint venture route has been taken despite stringent opposition from the left parties. It has been estimated that capital invested to the extent of nearly ₹ 7,960 crores and ₹ 6,130 crores would be required for Delhi and Mumbai airports. The Government has decided, in principle, to modernize Chennai Airport through JV route. It may also be mentioned here that construction work at greenfield airports of international standards at Bangalore and Hyderabad has already commenced. The two airports are expected to be operational in 2008. "In principle" approvals have already been given to construct greenfield airports of international standards in Goa, Ahmedabad and Trivandrum.

Five Year Plans and Civil Aviation

The Seventh, Eighth and Ninth Plans have kept certain important considerations while planning for investment in civil aviation. In the first place, they have planned for rationalisation of air services and of tank structure. Secondly, some of the tourist routes served the domestic services were showing heavy losses incating the need to strengthen tourist promotion and development programmes. Thirdly, indiscriminate pansion of air services had resulted in increasing haul operations and raising fuel consumption. Fourth Vayudoot services have been integrated with the service of Indian Airlines and are operated as feeders to the non service centres of Indian Airlines. Finally, the Seven Plan emphasised the need to set up a separate organisation for running helicopter services to meet the requirement of helicopters by ONGC for air transport support for the operations.

The five year Plans included specific programmes for the different agencies providing civil aviation devices in India. The programme for Indian Airlines included acquisition of aircraft, modernisation of work shop facilities, etc. The programme for Air India included acquisition of additional aircraft, increased capacity for freight traffic, strengthening of workshop training facilities, etc. The programme of IAAI include completion of international terminal phase II at Bombay international phase I at Delhi and Madras domestic terminal complex. DGCA programme included instation of flight safety equipments such as air route surveillance radar etc.

The Communication System in India

The communication system comprises posts and telegraphs, telecommunication systems, broadcasting, television and information services. By providing necessary information about the markets and also

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supplying necessary motivation, the communication system helps to bring buyers and sellers together effectively and helps to accelerate the growth of the economy. Accordingly, the modern communication system has become an integral part of the development process.

Postal System in India

Since 1950-51, the postal network has been expanded throughout the country, and in recent years, with special emphasis on the rural, hilly and remote tribal areas. With more than 1.5 lakh post offices, the postal network in India is the largest in the whole world. The long term objective of the Department of Postal Services of the Government of India is to locate a post office within three Kms of every village and to provide the facility of a letter box in every village with a population of over 500. At present, it is estimated that there are approximately 1,10,000 Gram Panchayat villages which do not have a post office. The Postal Department seeks to provide basic postal services on a contractual basis by utilising the existing infrastructure of Panchayats in these areas. This scheme—known as the Panchayat Sanchar Sewa Scheme,—has been recently introduced by the Government and it has the twin advantage of (a) providing postal services to needy areas with less Government expenditure and (b) generating employment opportunities in such areas.

Indian Telegraphs

Indian telegraphs is one of the oldest Government-owned public utility organisations in the world. The number of telegraph offices has increased from 8,200 in 1951 to over 30,000 now. The phonogram service for sending and receiving telegram by telephone, telex service to send and receive printed message directly from one centre to another, the tremendous expansion of telephone facilities and direct trunk dialling—all these facilities are available to the general public

Telecommunications

Telecommunication is a vital input for global competition and for India's success in the international markets. It is important not only because of its role in bringing the benefits of communication to every corner of India but also in serving the new policy objectives of improving the global competitiveness of the Indian economy and stimulating and attracting foreign direct investment.

There has been a phenomenal growth in the telecommunication sector after 1995. The telecommunications network of the public sector (BSNL and MTNL) is one of the largest telecommunication network in Asia with a capacity of 50 million lines and over 40 million working connections comprising 35,510 telephone exchanges in the country (by end - December 2002). The annual growth rate of providing new telephone connections has been increasing steadily from about 10 percent in 1988-89 to 30 per cent in 1999-2000 and 17 per cent during 2001-02. The number of new telephone connections provided during 2003-04 alone was 22 million which was equal to the total number of phones installed as of 1999.

There has been a shift in importance towards the private sector and towards wireless telephony with fall ing tariff rates for cellur phones, there has also been a phenomenal increase in the number of cellular subscribers. At the time of independence, there were only two phones per ten thousand of population. By the year 2009, there were more than four phone connections per 10 persons. Today a customer, who wishes to own a phone can get the same in minutes. Prior to advent of mobility companies, it used to take 8 to 15 years to get a phones connection. By March 2009, there were nearly 43 crores telephone connections, out of which around 90 percent were mobile connections. **Cellular telephony has become the most preferred mode of communication among the Indian public, as capital costs of mobile telephony are lower.** Today an ordinary worker can an is affording a mobile phone. Today a mobile in the hand of a Plumber, Carpenter, Electrician, Autorikshaw drive is a common feature.

From the data provided in table 19, we can make a review of the growth of infrastructure investment in the post-reform period.

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4.5 Urban Infrastructure

Urban infrastructure includes water supply and sanitation which are important basic needs for improvement of the quality of life and enhancement of the productive efficiency of citizens. Generally, State Governments and Union Administrations, with financial and technical assistance from the Central Government, have planned and executed various schemes for providing drinking water and sanitation. The Government of India launched the National Water Supply and Sanitation Programme in the First Plan itself with an outlay of ₹ 49 crores (which was 1.5 per cent of the total Plan outlay) at that time; and this outlay had increased to ₹ 16,700 crores in the Eighth Plan (3.8 per cent of the total outlay).

With steady increase in urban population on account of rapid industrialisation, natural growth of population and migration from rural areas, the magnitude of the water supply and sanitation problem in our bulging cities and towns is assuming a critical dimension in the background of depleting ground water resources, environmental pollution, poor water supply and sanitation in slum areas and non-availability of proximate sources of water supply. In spite of the enormity of the problem, the Government of India has set bold targets of covering 100 per cent of the drinking water requirements of the urban population and 75 per cent of their sanitation needs.

Most urban infrastructure services are provided by Municipal Corporations and Municipalities who fund their requirements largely by loans and grants from Central and State Governments. In order to supplement the efforts of urban development, the Government of India has depended upon the following agencies :

(a) Life Insurance Corporation of India (LIC) which invests in urban infrastructure projects — like water supply, drainage, housing, power and transport— as a part of its statutory requirements;

(b) The Housing and Development Corporation Ltd. (HUDCO) is given the task of financing urban infrastructure. HUDCO provides infrastructure loans to State Urban Finance Corporations, Water Supply and Sewerage Boards, Municipal Corporations, Improvement Trusts, etc; and

(c) The Infrastructure Leasing and Finance Services Ltd which also finances urban infrastructure projects.

Many states in India are now inviting private sector participation in the provision of infrastructure services on a more cost - effective basis—e.g., contracting out the management of urban services such as construction and maintenance of toilets, garbage collection and disposal, solid waste conversion and maintenance water supply systems, etc, BOT franchises and provision of services through voluntary organisation community organisations and common interest group.

Urban Transport

Another important problem of our cities, particularly in our metropolitan cities is the extreme inadequate of public transport facilities, as a result of which number of personalised vehicles has increased rapidly urban areas in the last few decades. In many cities, vehicle population has reached alarming proportions relation to the road and network available. With his density of population, and scarcity of land, there almost no scope for accommodating more vehicles are meet the growing demand for transport. Besides, contract of energy consumption in order to check dangerous growing urban pollution point out to the need for increase in public transport and rail-based transport.

Metro Rail

Metro rail projects in Delhi and some of metropolitan cities have started gaining momentum. The approvals and commissioning of metro routes in NCR Delhi, Mumbai, Banglore, Chennai, Kolkata, etc. given in Table 8.

Notes

Table 8 : Metro Rail Project Approved by the Government of India

Project	Length (*km*)	Commissioning schedule range	Cost (₹ Crores)
		National Capital Region	
Delhi MRTS Phase I	65.1	3/2004 to 11/2006	10,57
Delhi MRTS Phase II	54.7	6/2008 to 6/2010	11,68
Extension of Delhi Metro to Gurgaon	14.5	3/2010	1,58
Extension of Delhi Metro to NOIDA	7.0	11/2009	8
Central Secretariat at Badarpur	20.2	9/2010	4,02
Metro Link (Dwarka Sector-9 to Sector-21)	2.8	9/2010	32
Airport metro Express Link	22.7	9/2010	3,82
Total for Delhi & NCR	187.0		32,9
	Metro rail project other than Nation capital Region		
Banglore Metro	42.3	9/2012	8,18
Kolkata East-West Metro Corridor	14.7	1/2015	4,8
Chennai Metro	45	2014-15	14,6
Mumbai Metro Line-1	11.1	10/2010	23
Mumbai Metro Line-2	31.9		7,6
Total outside NCT	145		37,6
Grand total (NCT + outside NCT)	331.8		70,5

Source : Ministry of Urban Development, 2010.

Science and Technology

Science and Technology are ideas and the means with which man seeks to change his environment. While science represents "accumulation of knowledge", technology represents "refinement in tools". Over the last two hundred years or so, science and technology have helped to improve the quality of human life. For rapid economic progress, the application of science and technology (S and T) to agriculture, industry, transport and to all other economic and non-economic activities has become essential. S and T are changing in other countries like USA, Russia, Germany, Japan etc., and new knowledge and new technologies are being used in every line of production and these countries have experienced tremendous economic progress. The recent progress in agriculture and the green revolution it has ushered in has demonstrated to our people the promise of fulfilling the basic human needs and improving the quality of life of our people.

Nehru and S & T

Jawaharlal Nehru believed in the spread of scientific temper. He was responsible for the setting up of a chain of national laboratories devoted to basic and applied research, develop indigenous technology and processes and help industrial enterprises in solving their technological problems. The Council of Scientific and Industrial Research (CSIR) as well as the Department of Atomic Energy were set up. The Indian Council of Agricultural Research (ICAR) was strengthened. Then came the Department of Electronics, Department of Space Technology, the Indian Space Research Organisation (ISRO) etc., In 1958 the Science Policy Resolution was adopted to provide positive incentives for the development and utilisation of S and T in nation building activities. The major aims of this policy were :

(i) to foster, promote and sustain by appropriate means the cultivation in science and scientific research in all its aspects-pure, applied and educational;

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(ii) to ensure an adequate supply within the country of research scientists of higher quality and recognise their work as an important component of the strength of the nation; and

(iii) to encourage and initiate with all possible speed programmes for the training of scientific and technical personnel on a scale adequate to fulfil the country's needs in regard to science and education, agriculture, industry and defence; and

(iv) to ensure for the people of the country all the benefits that can accrue from the acquisition and application of scientific knowledge.

This 1958 Resolution gave explicit recognition to the importance of research and development in the economic growth of India.

4.6 Private Investment in Infrastructure: Outlook and Prospects

The Government of India has increasingly realised that infrastructure need not be a public sector monopoly. In the past, the responsibility for providing infrastructure services was vested with the Government— the reasons being : heavy capital investments, long gestation periods, externalities, high risks and low rates of return on investment. The infrastructure under government ownership and management has, however, proved thoroughly inefficient and corrupt. The demand for infrastructure facilities and services has always outpaced supply; besides, the quality of the existing supply is extremely poor. The consequent shortfalls in capacity and inefficiencies in infrastructure facilities are patent in the increasingly congested roads, chronic transport bottlenecks, frequent power failures and load shedding, long waiting lists for installation of telephones and shortage of drinking water. The widening gap between demand and supply of infrastructure and the extremely poor quality of the existing supply raises important questions concerning the sustainability of economic growth of the country in the coming years.

In order to sustain an annual GDP growth rate of 7 per cent, it is imperative to accelerate the rate of investment in infrastructure. According to the Finance Ministry's Expert Group on Commercialisation of Infrastructure Projects (June 1996) the total infrastructure investment requirements would be about ₹ 40,000 crores to ₹ 45,000 crores during 1996-2001 and another ₹ 75,000 crores during the next 5 years (2001- 06). This order of massive investment requirements is clearly beyond the capacity of the Government. The financial resources available to the Government are very limited. At the same time, public debt and other government liabilities are increasing by leaps and bounds. Accordingly, the creation of quality infrastructure will need the infusion of private capital, both domestic and foreign. At the same time, technological and organisational innovations have made it possible for the private sector to enter the infrastructure.

Since 1991, Government strategy attaches high priority to the development of efficient infrastructure and towards creating an enabling environment for private participation in the infrastructure sector. Besides, public-private partnership can also encourage better risk sharing, accountability, cost recovery and management of infrastructure. Some of the important steps in this direction are :

(a) The Government set up the Infrastructure Development Finance Company in January 1997, under the Indian Companies Act, with an authorised capital of ₹ 5,000 crores.

(b) The Government has announced a tax holiday to companies developing, maintaining and operating infrastructure facilities, such as roads, bridges, new airports, ports and railway projects and also those dealing with water supply, sanitation and sewerage projects.

(c) The Government has permitted income tax exemption on dividend, interest or long term capital gains earned by funds or companies set up to develop, maintain and operate an infrastructure facility.

(d) The Government has raised the corpus of the National Highways Authority of India Ltd (NHAI) by ₹ 200 crores to enable it to leverage funds from the domestic and international capital markets.

(e) The Government has enhanced tax rebate limits for investments in shares and debentures offered by infrastructure companies; this is to channelise domestic savings into such investments.

Infrastructure investments are, by their very nature, long gestation activities. If private participation has to be encouraged to enter the infrastructure, there is the need to develop domestic capital markets which will make funds available for long periods through long term debt instruments. The Asian Development Bank (ADB) has provided a loan of $ 300 million for the Public Sector Infrastructure Facility (PSIF) in order to support private sector infrastructure projects through the development of the long-term debt market. The money will be borrowed by ICICI, IFCI and SCICI for onlending to infrastructure companies through long term debt instruments — viz., bonds and debentures, for a minimum of 15 year maturity.

In many developed and developing countries, contractual savings in the form of pension and provident funds are being tapped for infrastructure financing, since these savings are long term in nature and could act as a source of funds for debt instruments with long term maturities. The Government will have to introduce appropriate reforms in public provident funds, pension funds and insurance companies so that the private sector can have access to these funds for infrastructure development.

The Government of India has announced various measures to attract foreign investment in infrastructure.

For instance, the Government has allowed automatic approval for foreign equity participation upto 74 per cent in key infrastructure industries such as electricity generation and transmission, non-conventional energy generation and distribution, and construction activities in the area of roads, bridges, railbeds, ports and harbours.

In recent years, the Government has undertaken many sector-specific reform measures. For instance, telecom projects are to be treated as infrastructure and are to receive all the fiscal concessions available for infrastructure projects — like tax holiday and concessional project import duty. The Government of India has promulgated an ordinance to facilitate private investments in the transmission of electricity, as distinct from generation and distribution of electricity. The Government has also announced guidelines for private investment in highway development through the Build-Operate-Transfer (BOT) route - these would provide more financial concessions and also facilitate the preparation of detailed feasibility reports, clearance for the right of way of land, relocation of utility services resettlement and relocation of the affected establishments, environmental clearance and equity participation in the highway sector. Similar guidelines have been given for private participation in ports.

The Expert Group on Commercialisation of Infrastructure Projects has also recommended the setting up of an autonomous regulatory body for each infrastructure sector on the lines of SEBI to ensure fair competition among public and private operators, protect consumer interests, particularly the needs of vulnerable and weaker sections, ensure public safety, environmental sustainability, etc.

What will be the future role of public sector enterprises in the field of infrastructure, after the entry of the private sector ? The public sector enterprises will continue to shoulder the major burden of providing critical infrastructure services but public sector reforms would be necessary to broad-base their management, to upgrade their technology, to improve their performance and quality of services and to generate adequate investible resources through rationalisation of service charges and better recovery of costs.

Public Private Partnership and Infrastructure

Given the need of mega infrastructure required, public sector cannot cope with the need of the hour. Though the Government has been emphasizing the importance of infrastructure for the development of the economy, we witness a cut back in the investment by the government in the infrastructure, both at the central and state level. In the last few years, public private partnership in the infrastructure sector is gaining importance.

Economic Survey 2009-10, underlines the importance of PPP projects and says, "PPPs offer a number of advantages in terms of leveraging public capital to attract private capital and undertake a larger number of infrastructure projects, introducing private-sector expertise and cost-reducing technologies as well as bringing in efficiencies in operation and maintenance. Hence, more than their fiscal implications, PPPs are tools to fulfill the basic obligations of Governments to provide better

infrastructure services (with large externalities), by increasing the accountability of the private sector as a service provider."

But it is not an automatic or easy task. Economic Survey further says, "A key pre-requisite is to lay down a policy, legal and regulatory framework that assures a fair return for investors, protects the interests of users, especially the poor, and assures quality supply at reasonable cost. For this purpose, it is important that issues related to the adopted, procurement strategies and templates to be employed and mechanisms for financial structuring to be considered, are clearly outlined ab initio at the level of the sponsoring agencies, including State Governments."

Sector wise description of PPP both at state and central level projects is given in Table 9.

Table 9 : Sector-wise PPP project

Sector	Number	Below ₹ 250 crore	Between ₹ 251 to 500 crore	More than ₹ 500 crore	Value of contacts (in crore)
Airports	5	0	303	18,808	19,111
Energy	24	734	2,669	13,708	17,111
Ports	43	1,066	2,440	62,993	66,499
Roads	271	8,689	32,862	60,454	102,005
Urban Development	73	2,753	2,404	10,132	15,288
Other sectors	34	1,613	905	1,644	4,162

Economic Survey, 2009-10

Infrastructure in the 11th Plan : An Overview

The Planning Commission has openly accepted the fact that lack of infrastructure is a major constraint in India's economic performance. The development of rural infrastructure is a high priority in the 11th Plan with critical targets for irrigation, rural road connectivity, rural drinking water etc. There are huge gaps in general infrastructure encompassing power, roads, railways, ports, airports, telecommunications and the 11th Plan has proposed to address these vigorously. The 11th Plan, for instance, will raise total expenditure on infrastructure to 9.0 percent of GDP as against 4.5 percent in the Tenth Plan. Consistent with the above projection, the investment in physical infrastructure alone during the Eleventh Five Year Plan has been estimated to about ₹ 2,002 thousand crores (at 2006-07 prices) which is equivalent to about US $ 500 billion. Of this amount, the share of the Central government is estimated to be 37 percent, of the state governments to be about 33 percent and that of the private sector to be 30 percent. Obviously, the Government has adopted the strategy of public private partnership in the infrastructure structure.

The power sector is critical for industrial growth and the real problem is the distribution system, which in the hands of State Governments. Top priority should therefore, be given, to improve the performance distribution companies.

Finally, PPPs have become the preferred mode construction and operation of infrastructure service such as highways, airports, ports etc. They offer significant advantages in attracting private capital in construction of public infrastructures as well as in improving efficiencies in the provision of services to users.

During recent years, the UPA Government at the Centre has adopted such an approach in the construction of roads, ports, airports and in railways. Naturally, the people would expect state governments too to adopt similarly transparent approach to ensure that the projects succeed.

However, public private partnership can some times run into controversy if the private sector partner seen to have received unduly favourable treatment. In essential that the general public is convinced that PPP are in the public interest. This can be done by ensure that :

(a) the terms of concession agreements are transparent and protective of public interest; and

(b) there is robust competition in bidding for the project so that least cost options are chosen.

Notes

Self -Assessment

1. Choose the correct option:

(*i*) The Keynesian theory of employment provides the solution of?

(*a*) Frictional unemployment (*b*) Disguised unemployment

(*c*) Cyclical unemployment (*d*) Seasonal unemployment

(*ii*) The concept of disinvestment was introduced by?

(*a*) Friedman (*b*) Kaldor

(*c*) Keynes (*d*) Myrdal

(*iii*) Full employment is a situation when?

(*a*) Cyclical unemployment is zero (*b*) Frictional unemployment is zero

(*c*) Seasonal unemployment is zero (*d*) Disguised unemployment is zero

(*iv*) The coal production including lignites rose from 32 million tones to ---------between 1951 and 2010:

(*a*) 566 million tones (*b*) 400 million tones

(*c*) 800 million tones (*d*) None of these

4.7 Summary

- The prosperity of a country depends directly upon the development of agriculture and industry. Agriculture production, however, requires irrigation, power, credit, transport facilities, etc.
- In the last 200 years or more industrial and agricultural revolutions in England and other countries were accompanied, by a revolution transport and communications, the extensive use of cargo and later oil as source of energy, tremendous expansion in banking, insurance and other financial institute to finance production and trade, an explosion knowledge of science and technology, and so on.
- Indian planners were fully aware of the link between infrastructural facilities and general economic development and, accordingly, they gave high priority the rapid expansion of these facilities right from the First plan itself.
- The most important single factor which can act as a constraint on economic growth of a country is the availability of energy. India is both a major energy producer and consumer. Currently, India ranks as the world's seventh largest energy producer and fifth largest energy consumer.
- Broadly, there are two sources of energy, viz., commercial energy and non-commercial energy. Commercial energy, or more correctly, commercial sources of energy, consist of coal, petroleum and electricity.
- The Government has also launched a scheme for utilisation of agricultural biomass available at Taluka level for decentralised power generation to meet the power requirements of the people locally.
- The Government of India has announced various policy measures to encourage direct foreign investments and collaborations. NRIs particularly are taking up projects such as wind, farms and solar plants in the states of Andhra Pradesh, Gujarat, Karnataka, Madhya Pradesh and Kerala, totalling an aggregate capacity of 450 MW.
- National Bio-Fuel Board is being set up to promote the use of bio-fuels. The short term target is to encourage *jatropa farming*, suitable adoption of vehicle engines to use bio-fuels along with minimal oil and target bio-fuel consumption to 20 percent by the end of the 12th Plan (i.e. by the Year 2017).
- Electric power, which is one form of energy, is an essential ingredient of economic development and, it is required for commercial and non-commercial uses. Commercial uses of power refer to the use of electric power in industry, agriculture and transport.

Notes

- It may be observed that the consumption of power by domestic consumers has increased rapidly, However, consumption of electricity by railways and for public lighting as a proportion of total consumption has declined.
- Power development during the last 50 years has been significant. The total installed generating capacity from all sources — utilities and non-utilities—had increased from 2,300 MW in 1950 to 1,43,800 MW by 2005-06.
- The Government of Orissa was the first to initiate reform of the State power sector with substantial restructuring of SEB to make the operation of the sector more efficient and financially viable.
- In India, as in all developing countries, power generation and distribution have been a government monopoly.
- Ever since the Narasimha Rao Government announced its new power policy for private power, this country has witnessed one of the most acrimonious debates on various aspects of the policy.
- If agriculture and industry are regarded as the body and the bones of the India economy, transport and communications constitute its nerves which helf the circulation of men and materials. The transport system helps to broaden the market for goods and by doing so, it makes possible large-scale production through division of labour.
- Indian planners gave high priority to the development of transport, for in their opinion "an efficient and well developed system of transport and communications is vital to the success of a plan of economic development which lays stress on rapid industrialisation."
- Rail and road transport systems dominate but other forms of transport are also important within their specialised areas considering the size of the country and its geographical features.
- Since 1950-51 transport systems have registered impressive progress but there are many bottlenecks, constraints and difficulties. Inadequacies and imbalances in transport threaten to constrain economic growth and the quality of life in urban as well well as rural India.
- Despite impressive expansion over the years, the entire Indian transport network is characterised by many deficiencies and a major exercise in expansion of capacity and modernisation and technological upgradution is necessary.
- The Indian Railways had modest beginnings in 1853 when the first railway train journeyed a distance of 22 miles between Bombay and Thana. From a modest beginning in 1853, the railway development was very rapid and by 1900 there were nearly 25,000 miles of railway line.
- As the Indian Railways constitute the largest transport agency intimately connected with the development of the national economy, the main objective of planning in Railways in the past was to expand railway traffic in such a way as to avoid bottlenecks in the production process and to ensure an efficient rail transport system.
- Before 1924, Railway finances formed part of the Central Government finances. But from 1924, the Railway finances were separated from the general finances of the Central Government.
- Although the railway in India is the cheapest mode of transport tfran any other mode, Indian Railways has never incurred massive losses.
- Today railways requires urgent efforts for expanding railway lines, new engine factories, coach factories and other types railways infrastructure.
- The Seventh Plan (1985-90) brings out the importance of roads as follows : "Since the country's economy is still largely agrarian in character and the settlement pattern is rural-oriented, roads constitute a critical element of the transportation infrastructure.
- Road development in India was neglected in the past for various reasons. In the first place, the governments—Central and State—did not appreciate the importance of developing the road system.
- Railways and roads are complementary to each other much more than other modes of transport and are mutually helpful. The road system links up the cultivators with the local market and the nearest railway station.
- There are two kinds of water transport—inland water transport or river transport and coastal or marine transport.

- Inland water transport (IWT) comprising a variety of rivers, canals, backwaters, creeks etc. is the cheapest mode for certain kinds of traffic, both over long and short levels, provided the points of origin and destination are located on water front and no transhipment of goods is involved.
- Before Independence, Indian shipping companies did not succeed because of severe competition from foreign shipping companies and lack of support by the foreign rulers in india. It was only the Scindia Steam Navigation Company which could face foreign competition.
- Air transport has a significant role to play. It offers saving in time that cannot be matched by surface transport over long distances. Air transport helps optimise technological, managerial and administrative skills in a resource scarce economy.
- The Government of India has selected two joint venture companies (JVCs) to modernize, upgrade and operate Delhi and Mumbai airports. This step to restructure and modernize the Mumbai and Delhi airports through the joint venture route has been taken despite stringent opposition from the left parties.
- The Seventh, Eighth and Ninth Plans have kept certain important considerations while planning for investment in civil aviation. In the first place, they have planned for rationalisation of air services and of tank structure.
- The communication system comprises posts and telegraphs, telecommunication systems, broadcasting, television and information services. By providing necessary information about the markets and also supplying necessary motivation, the communication system helps to bring buyers and sellers together effectively and helps to accelerate the growth of the economy.
- Indian telegraphs is one of the oldest Government-owned public utility organisations in the world. The number of telegraphs offices has increased from 8,200 in 1951 to over 30,000 now.
- The Government introduced the Communication Convergence Bill, 2001 in Parliament, with the purpose of promoting and facilitating the carriage and content of communications (including broadcasting, telecommunications and multimedia) in an orderly manner.
- Urban infrastructure includes water supply and sanitation which are important basic needs for improvement of the quality of life and enhancement of the productive efficiency of citizens.
- Given the need of mega infrastructure required, public sector cannot cope with the need of the hour. Though the Government has been emphasizing the importance of infrastructure for the development of the economy, we witness a cut back in the investment by the government in the infrastructure, both at the central and state level.
- The Planning Commission has openly accepted the fact that lack of infrastructure is a major constraint in India's economic performance.
- During recent years, the UPA Government at the Centre has adopted such an approach in the construction of roads, ports, airports and in railways. Naturally, the people would expect state governments too to adopt similarly transparent approach to ensure that the private projects succeed.

4.8 Key-Words

1. Infrastructure : The term infrastructure has been used since 1927 to refer collectively to the roads, bridges, rail lines, and similar public works that are required for an industrial economy, or a portion of it, to function. The term also has had specific application to the permanent military installations necessary for the defense of a country. Perhaps because of the word's technical sound, people now use infrastructure to refer to any substructure or underlying system. Big corporations are said to have their own financial infrastructure of smaller businesses, for example, and political organizations to have their infrastructure of groups, committees, and admirers. The latter sense may have originated during the Vietnam War in the use of the word by military intelligence officers, whose task it was to delineate the structure of

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the enemy's shadowy organizations. Today we may hear that conservatism has an infrastructure of think tanks and research foundations or that terrorist organizations have an infrastructure of people sympathetic to their cause. The Usage Panel finds this extended use referring to people to be problematic, however. Seventy percent of the Panelists find it unacceptable in the sentence FBI agents fanned out to monitor a small infrastructure of persons involved with established terrorist organizations.

2. Non-commercial energy : Non-commercial (also spelled noncommercial) refers to an activity or entity that does not in some sense involve commerce, at least relative to similar activities that do have a commercial objective or emphasis. For example, advertising-free community radio stations are typically nonprofit organizations staffed by individuals volunteering their efforts to air a wide variety of radio programming, and do not run explicit radio advertisements, included in the United States specific grouping of "non-commercial educational" (NCE) public radio stations. Some Creative Commons licenses include a "Non-Commercial" option, controversial in definition and application.

4.9 Review Questions

1. Discuss the role of infrastructure in economic development.
2. Explain the availability of primary energy in India.
3. What are the non-conventional sources of energy? Discuss.

Answers: Self-Assessment

1. (*i*) (*c*) (*ii*) (*c*) (*iii*) (*a*) (*iv*) (*a*)

4.10 Further Readings

Books

1. Indian Economy; Gaurav Datt and Aswani Mahajan; S. Chand and Company LTD. Ram Nagar, New Delhi-110055.
2. The Indian Economy; S.K. Ray; Prentic, Hall of India Private Limited New Delhi - 110001.

Unit 5: Indian Financial System: Money Market and Monetary Policy

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5.4 Key-Words
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Objectives

After reading this Unit students will be able to:

- Explain the Indian Financial System.
- Describe about the Monetary Policy.

Introduction

At present, the institutional structure of the financial system is characterised by (a) banks, either owned by the Government, RBI or private sector (domestic or foreign) and regulated by the RBI; (b) development financial institutions and refinancing institutions, set up either by a separate statute or under Companies Act, either owned by Government, RBI, private or other development financial institutions and regulated by the RBI and (c) non-bank financial companies (NBFCs), owned privately and regulated by the RBI.

Reforms of 1990s have altered the organisational forms, ownership pattern and domain of operations of Financial Institutions (FIs) on both the asset and liability fronts. Drying up of low cost funds has led to an intensification of the competition for resources for both banks and FIs. At the same time, with banks entering the domain of term lending and FIs making a foray into disbursing short-term loans, the competition for supply of funds has also increased. Besides, FIs have also entered into various fee-based services like stock-broking, merchant banking, advisory services and the like.

5.1 Indian Financial System : Money Market

In a broad sense, finance refers to funds or monetary resources needed by individuals, business houses and the Government. Individuals and households require funds essentially for meeting their current requirements or day-to-day expenses or for buying capital goods (commonly known as investment).

A business unit — a factory or a workshop — needs funds for paying wages and salaries, for buying raw materials, for purchasing new machinery or replacing an old one, etc. Traders require finance for buying and stocking goods in their shops and godowns.

Farmers require finance for short periods of 12 to 15 months for cultivation purposes, such as for buying seeds, manure, fodder for cattle, etc. Such short-period loans are normally paid off after the harvest has been collected. The farmers may need finance for medium term and long-term—say, for periods up to 5 to 10 years —for the purchase of livestock, agricultural machinery and implements, digging wells, making permanent improvements on land, etc.

Finally, the government needs funds to meet its expenditure on goods and services (revenue expenditure) and finance its development programmes (capital expenditure).

The Structure of the Financial System

The financial system of India refers to the system of borrowing and lending of funds or the demand for and the supply of funds of all individuals, institutions, companies and of the Government. Commonly, the financial system is classified into :

(a) **Industrial finance :** Funds required for the conduct of industry and trade;

(b) **Agricultural finance :** Funds needed and supplied for the conduct of agriculture and allied activity;

(c) **Development finance :** Funds needed for development; actually it includes both industrial finance and agricultural finance; and

(d) **Government finance :** Relates to the demand for and supply of funds to meet Government expenditure.

India's financial system includes the many institutions and the mechanism which affects the generation of savings by the community, the mobilisation of savings and the effective distribution of the savings among all those who demand the funds for investment purposes. Broadly, therefore, the Indian financial system is composed of :

(a) The banking system, the insurance companies, mutual funds, investment funds and other institutions which promote savings among the public, collect their savings and transfer them to the actual investors; and

(b) The investors in the country composed of individual investors, industrial and trading companies and the government—these enter the financial system as borrowers.

Apart from these two broad categories of institutions which promote savings on the one side and investment on the other, there are certain other essential institutions of the Indian financial system which are actually **facilitators**.

The Function of the Indian Financial System : Promotion of Capital Formation

The Indian financial system performs a crucial role in economic development of India through saving investment process, also known as capital formation. It is for this reason that the financial system is sometimes called the financial market. The purpose of the financial market is to mobilise savings effectively and allocate the same efficiently among the ultimate users of funds, *viz*., investors.

A high rate of capital formation is an essential condition for rapid economic development. The process of capital formation depends upon :

(a) Increase in savings, that is, the resources that would have been normally used for consumption purposes, should be released for other purposes;

(b) Mobilisation of savings—domestic savings collected by banking and financial institutions and placed at the disposal of actual investors; and

(c) Investment proper, which is the production of capital goods.

The third stage or process is the real capital formation but this stage cannot arise or exist without the first two processes. Thus, the general public should save and be prepared to release real resources from consumption goods to capital goods. The savings of the people should mobilised by banking and financial institutions. Finally, the savings of the people should be made available to investors to produce capital goods. All these three steps or processes, though independent of each other, are necessary for accumulation of capital. The importance of banking and financial institutions in the capital formation process arises because those who save and those who invest in India are generally not the same persons or institutions. The financial institutions and the banks act as intermediaries to bring the savers and investors together.

Composition of the Indian Financial System

The Indian financial system which refers to the borrowing and lending of funds or to the demand for and supply of funds, consists of two parts, *viz.*, the Indian Money market and the Indian Capital market.

The Indian money market is the market in which short-term funds are borrowed and lent. The capital market in India, on the other hand, is the market for medium-term and long term funds.

Usually, we classify the Indian money market into organised sector and the unorganised sector. The organised sector of the money market consists of commercial banks in India, which includes private sector and public sector banks and also foreign banks. The unorganised sector consists of indigenous bankers including the non-banking financial companies (NBFCs). Besides these two, there are many sub-markets in the Indian money market, as we shall see later.

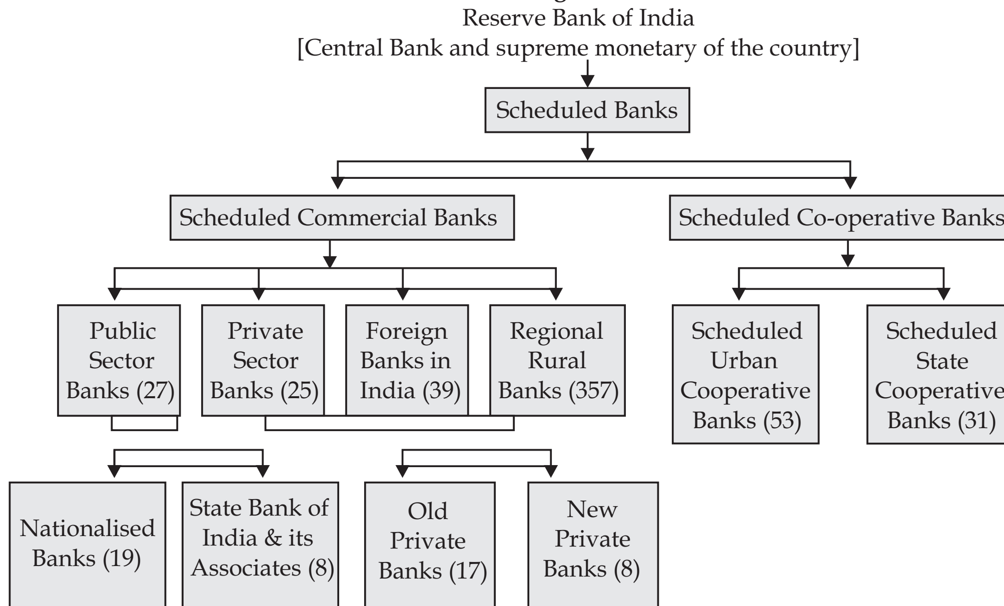
The Composition of the Indian Banking System

The organised banking system in India can be broadly divided into three categories, *viz.*, the central bank of the country known as the Reserve Bank of India, the commercial banks and the co-operative banks. Another and more common classification of banks in India is between scheduled and non-scheduled banks. The Reserve Bank of India is the supreme monetary and banking authority in the country and has the responsibility to control the banking system in the country. It keeps the cash reserves of all scheduled banks and hence is known as the "Reserve Bank".

Scheduled and Non-Scheduled Banks

Under the Reserve Bank of India Act, 1934, banks were classified as scheduled banks and non-scheduled banks. The scheduled banks are those which are entered in the Second Schedule of RBI Act, 1934. Such banks are those which have a paid-up capital and reserves of an aggregate value of not less than ₹ 5 lakhs and which satisfy RBI that their affairs are carried out in the interests of their depositors. All commercial banks—Indian and foreign, regional rural banks and State co-operative banks—are scheduled banks. Non-scheduled banks are those which have not been included in the

Chart 1 : Scheduled Banking Structure in India



Second Schedule of RBI Act, 1934. At present, there are only three non-scheduled banks in the country. Scheduled banks are divided into commercial banks and cooperative banks. Commercial banks are based on profit, while cooperative banks are based on cooperative principle.

Notes

5.1.1 The Indian Capital Market

The Indian capital market is the market for long-term capital; it refers to all the facilities and institutional arrangements for borrowing and lending "term funds"—medium-term and long-term funds. The demand for long-term money capital comes predominantly from private and public manufacturing industries, trading and transport units, etc and agriculture too requires some funds for long-term purposes. The Central and State Governments raise substantial amounts from the capital market. The supply of funds for the capital market comes largely from individual savers (they supply through banks and insurance companies), corporate savers, commercial banks insurance companies, public provident funds and other, specified agencies. The capital market in India can be classified into :

(a) Gilt-edged market or market for Government and semi-government securities;

(b) Industrial securities market;

(c) Development financial institutions; and

(d) Non-banking financial companies.

The gilt-edged securities market is the market for Government and semi-government securities which carry fixed interest rates. The industrial securities market is the market for equities and debentures of companies of the corporate sector. This market is further classified into (a) new issue markets for raising fresh capital in the form of shares and debentures, (commonly referred to as primary market) and (b) old issues market (or secondary market) for buying and selling shares and debentures of existing companies—this market is commonly referred to as the stock market or stock exchange.

1. **The Composition of the Indian Money Market**

   A money market is not a market for money but it is a market for "near money"; or it is the market for lending and borrowing of short-term funds. It is the market where the short-term surplus investible funds of banks and other financial institutions are demanded by borrowers comprising individuals companies and the Government. Commercial banks are both suppliers of funds in the money market and borrowers. The composition of the Indian money market is given in Chart 2:

   The Indian money market consists of two parts : the unorganised and the organised sectors. The unorganised sector consists of indigenous bankers who pursue the banking business on traditional lines and non-banking financial companies (NBFCs). The organised sector comprises the Reserve Bank, the State Bank of India and its associate banks, the 20 nationalised banks and private sector banks, both Indian and foreign.

   The organised money market in India has a number of sub-markets such as the treasury bills market, the commercial bills market and the inter-bank call money market.

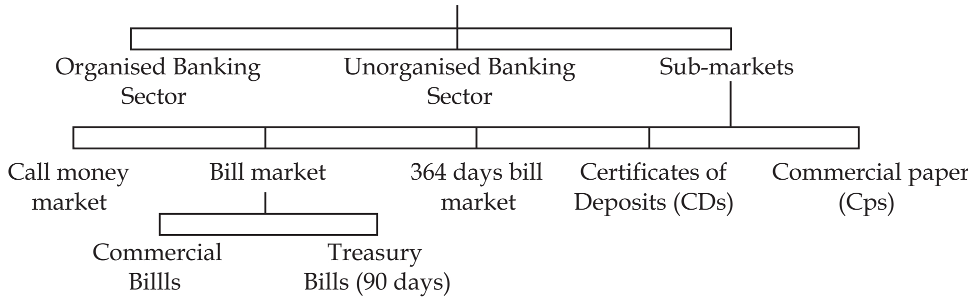
   The Indian money market is not a single homogeneous market but is composed of several sub-markets, each one of which deals in a particular type of short term credit.

   Call Money Market

   One important sub-market of the Indian money market is the Call Money Market, which is the market for very short-term funds. This market is also known as money at call and short notice. This market has actually two segments, *viz*. (a) the call market or overnight market, and (b) short notice market. The rate at which funds are borrowed and lent in this market is called the call money rate.

   Call money rates are market determined, i.e., by demand for and supply of short term funds. The public sector banks account for about 80 per cent of the demand (that is, borrowings) and foreign banks and Indian private sector banks account for the balance of 20 per cent of borrowings. Non-banking financial institutions such as IDBI, LIC, GIC, etc enter the call money market as lenders and supply up to 80 per cent of the short-term funds. The balance of 20 per cent of the funds is supplied by the banking system. While some banks operate both as lenders and borrowers, others are either only borrowers or only lenders in the call money market.

Chart 2 : Indian money market



Bill Market in India

The bill market or the discount market is the most important part of the money market where short term-bills—normally up to 90 days–are bought and sold. The bill market is further subdivided into commercial bill market and treasury bill market.

The market for commercial bills has not become popular in India, unlike in London and other international money markets where commercial bills are extensively bought and sold (i.e., discounted).

The 91-day treasury bills are the most common way the Government of India raises funds for the short period. Some years ago, the government had introduced the 182-day treasury bills which were later converted into 364-day treasury bills. In 1997, the Government introduced the 14-day intermediate treasury bills.

The Indian Money Market and RBI

Over all these institutions of the Indian money market, there is RBI which, as the ultimate authority and controller of monetary and banking conditions in the country, is the accepted leader of the money market. RBI has the responsibility to guide and control the institutions of the money market and towards this end, it is armed with both qualitative and quantitative weapons of credit control.

2. **Features and Defects of the Indian Money Market**

   (i) **Existence of Unorganised Money Market :** The major defect of the Indian money market has always been the existence of the indigenous bankers who do not distinguish between short-term and long-term finance, nor even between the purposes of finance (as the Hundi does not indicate whether it is a genuine trade bill or a financial paper). Many attempts were made by RBI to bring the indigenous bankers under its direct influence and control. During the last 50 years, there is a whole lot of non-banking financial companies (NBFCs) who raise funds from the general public but who are generally outside the control and supervision of RBI. To the extent these bankers/NBFCs are outside the organised money market, RBI's control over the money market is limited.

   (ii) **Absence of Integration :** An important defect of the Indian money market at one time was the division of the money market into several segments or sections, loosely connected to each other. Each section of the money market—such as the State Bank of India and its subsidiaries, the foreign exchange banks, the urban co-operative banks and indigenous bankers—limited itself broadly to a particular class of business and remained independent in its own sphere. Moreover, the relations between the various sections of the money market were not cordial. This is so even now between Indian banks and foreign banks. With the passage of the Banking Regulation, Act, 1949, all banks have been treated equally by RBI as regards licensing, opening of branches, share capital, the type of loans and advances to be given, etc. Accordingly, the Indian money market is getting closely integrated.

   RBI is now fully effective in the organised sectors of the money market, as it is in a position to control the operations of the organised sector. Both commercial and; cooperative banks

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have come to rely increasingly on the rediscounting and borrowing facilities provided by RBI, especially during the busy season. Besides, RBI guides and directs them in their lending policies and regularly; inspects the books of scheduled commercial banks.

However, RBI's control and monitoring of the commercial banking sector are not always fully effective. This is clear from Harshad Mehta scam in 1992 and Ketan Parekh scam in 2001.

(iii) Diversity in Money Rates of Interest : Another defect of the Indian money market related to the existence of too many rates of interest—the borrowing rate of the government, the deposit and lending rates of commercial banks, deposit and lending rates of cooperative banks, the lending rates of DFI's, etc. The basic reason for the existence of so many rates of interest simultaneously is the immobility of funds from one section of the money market to another. In recent years the different money rates of interest have been promptly adjusting to changes in the bank rate.

(iv) Seasonal Stringency of Money : A very striking characteristic of the Indian money market was the seasonal monetary stringency and high rates of interest during a part of the year—during the busy season from November to June when funds were required to move the crops from the villages and up country districts to the cities and ports. During the off-season (July to October) or slack season, banks have large surplus funds and the rates of interest reach low levels. There are even now wide fluctuations in the money rates of interest from one period of the year to another. RBI attempts to lessen the seasonal fluctuations in the money market by pumping money into the money market during busy seasons and withdrawing the same during off seasons. This feature of the money market—seasonal stringency or glut—is present even now.

(v) Absence of the Bill Market : Another defect of the Indian money market was the absence of a commercial bill market or a discount market for short term commercial bills. A well organised bill market is necessary for linking up the various credit agencies ultimately and effectively to RBI. No bill market was developed in India due to certain historical accidents—such as the practice of banks keeping a large amount of cash for liquidity purposes, preference of industry and trade for borrowing rather than rediscounting bills, the improper drafting of the bazar hundi, the system of cash credit as the main form of borrowing from banks, the preference of cash transactions in certain lines of activity, the absence of warehousing facilities for storing agricultural produce and the high stamp duty on usance bills.

The commercial bill market has not been fully developed, even though there is general appreciation of the need for such a market :

(a) Commercial bills, along with bank credit, are an important source of finance for business and industrial houses;

(b) Banks with surplus funds like to buy (that is, discount) commercial or trade bills, as they yield a good rate of return; they are for a short period (90 days) and they are self-liquidating, that is, the drawee of the bills would pay off at the time of maturity.

(c) Commercial bills are useful to RBI for its open market operations. In times of monetary shortage, RBI can buy bills from the market and pump in additional funds and help create more bank credit. In times of glut of funds in the money market, RBI can sell bills in the market and absorb the surplus funds with banks.

RBI introduced a bill market scheme known as the New Bill Market Scheme in 1970 under which RBI rediscounted genuine trade bills. The Scheme was not developed fully as was anticipated. Basically, the development of a bill market would depend on whether industry and trade are prepared to recover their receivables through the medium of bills and whether the buyers of goods are prepared to bind themselves to the discipline of the bills, that is, pay the amount due on the specified date mentioned on the bills.

Development of a bill market is extremely useful to the country from the point of expanding credit as well as from the point of monetary policy.

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(vi) **Highly volatile call money market :** As explained earlier, the call money market is the market for short term funds, known as "money at call and short notice". The rate at which funds are borrowed in this market is called the call money rate. Call money rates are **market-determined**, i.e., by demand for and supply of short term funds. Despite all the efforts made by RBI to moderate the fluctuations in the call money rates, the latter have continued to be highly volatile. The highest and lowest quotations of the call money rate during the past few years were as follows :

Table 1: Inter Bank Call Money Rates in India

(per cent per annum)

Year	Highest	Lowest
1990-91	70.00	4.00
1993-94	17.00	0.25
2000-01	14.00	4.00
2007-08	55.0	6.15
2008-09	23.0	1.0
2009-10	9.00	0.50

Source : RBI Handbook of Statistics on Indian Economy 2009-10.

The high rates reflect the huge demand for short term funds by the banking system specially to meet the RBI requirement of minimum CRR. RBI attempts to moderate the fluctuations through supporting the market with additional funds - by buying securities from the market when there is short supply of funds and high call rates and absorbing the additional funds when the call market has large surplus funds – through selling securities. In general, however, RBI has only a limited success in its efforts to check the high volatility of the call money market in India in the past.

(vii) **Absence of a well-organised banking system :** Another major defect of the Indian money market was the absence of a well-organised banking system. Branch banking was extremely slow before bank nationalisation in 1969. There are only a few big banks in the country and they have concentrated themselves in large towns and mandi towns. The extreme sluggishness in the movement of funds and the existence of different interest rates in different regions are the result of slow branch banking in the country.

Since Independence and specially after the passing of the Banking Regulation Act, 1949, the Reserve Bank has been exercising considerable influence and control over the banking system. Through mergers and amalgamations the number of banks has been considerably reduced. Besides, branch banking has been speeded up since 1969.

In spite of the various steps taken to strengthen the Indian banking system, RBI has failed to really control and guide it. In this connection, we may refer to three instances.

(a) Harshad Mehta engineered securities scam in 1992 by using funds from well-known banks, both foreign and Indians.

(b) Ketan Parekh used the funds of urban co-operative banks and those of Bank of India and UTI to manipulate the prices of shares of a few companies in which he was interested. This led to a virtual crash of the Indian stock market as a whole in 2001; and

(c) C.M. Agarwal of Home Trade used the funds of urban cooperative banks and of pension funds to play in the gilt-edged market in March 2002.

The failure of RBI to prevent these abuses of the banking system proves clearly that the Indian banking system is still far from being a well organised and efficiently supervised system :

(viii) Availability of credit instruments : Till 1985-86, the Indian money market did not have adequate short-term paper instruments. Apart from the call money market, there was only the treasury bill market. At the same time, there were no specialist dealers and brokers dealing in different segments of the Indian money market and in different kinds of paper instruments.

5.2 Monetary Policy

Monetary policy, in general, refers to the action taken by the monetary authorities to control and regulate the demand for and supply of money with a given purpose. Monetary policy is one of the two most powerful tools of economic control and management of the economy. The various aspects of monetary policy have been discussed in a theoretical framework in different previous chapters, especially the effect of different kinds of monetary policies on the aggregate production, interest rate and the price level. In this section, we will discuss monetary policy in detail. The major aspects of the monetary policy discussed include :

(i) Meaning and scope of monetary policy;

(ii) Monetary policy instruments and target variables;

(iii) Role of monetary policy in achieving macroeconomic goals;

(iv) Effectiveness and limitations of monetary policy; and

(v) Monetary *vs* Fiscal policy controversy.

These aspects of monetary policy are discussed in theoretical tone with brief inputs from India's monetary policy.

Meaning and Scope of Monetary Policy

The economists have defined monetary policy in different words. For example, Harry Johnson defines monetary policy as a "policy employing central bank's control of the supply of money as an instrument of achieving the objectives of general economic policy." G. K. Shaw defines monetary policy as "any conscious action undertaken by the monetary authorities to change the quantity, availability or cost ... of money."

Notes Monetary policy is essentially a programme of action under-taken by the monetary authorities, generally the central bank, to control and regulate the supply of money with the public and the flow of credit with a view to achieving predetermined macroeconomic goals.

The objectives of monetary policy are generally the objectives of macroeconomic policy, *viz. growth*, *employment*, *stability of price and foreign exchange*, and the *balance-of-payment equilibrium*. The macroeconomic goals are determined on the basis of the economic needs of the country. Once macroeconomic goals are determined, then the monetary authorities will have to decide accordingly *whether to increase or decrease the supply of money*. Then the next step is to make the choice of instruments that can effectively increase or decrease money supply with the public.

Scope of Monetary Policy

The scope of monetary policy spans the entire area of economic transactions involving money and the macroeconomic variables that monetary authorities can influence and alter by using the monetary policy instruments. The scope of monetary policy depends, by and large, on two factors :

(i) the level of monetization of the economy, and

(ii) the level of development of the Financial market.

In a *fully monetized economy*, the scope of monetary policy encompasses the entire economic activities. In such an economy, all economic transactions are carried out with money as a medium of exchange. In that case, monetary policy works by changing the supply of and demand for money and the general price level. It is therefore capable of affecting all economic activities—production, consumption, savings and investment. The monetary policy can influence all major macro variables—GDP, savings and investment, employment, the general price level, foreign trade and balance of payments.

Notes

Another factor that matters in determining the scope and the effectiveness of the monetary policy is how developed and integrated is the capital-market. Some instruments of monetary control (bank rate and cash reserve ratio) work through the capital market. Where capital market is fairly developed, monetary policy affects the level of economic activities through the changes in the capital market. It works faster and more effectively in an economy with a fully developed financial market. Incidentally, a developed financial market is one which has the following features : (i) there exists a large number of financially strong commercial banks, financial institutions, credit organizations, and short-term bill market, (ii) a major part of financial transactions are routed through the banks and the capital markets, (iii) the working of capital sub-markets is inter-linked and interdependent, and (iv) commodity sector is highly sensitive to the changes in the capital market. Monetary weapons like bank rate and cash reserves ratio work through the commercial banks. Therefore, for the monetary policy to have a widespread impact on the economy, other capital sub-markets must have a strong financial link with the commercial banks.

Instruments of Monetary Policy

The instruments of monetary policy refer to the economic variables that the central bank is empowered to change at its discretion with a view to controlling and regulating the supply of and demand for money and the availability of credit. The instruments are also called '*weapons of monetary control*.' Samuelson and Nordhaus call them 'The Nuts and Bolts of Monetary Policy.' Monetary instruments are generally classified under two categories :

(i) General credit control measures, and

(ii) Selective credit controls.

The General Credit Control Measures

The general measures of monetary control include the monetary weapons that aim at controlling the aggregate supply of and demand for money, given the objective of the monetary policy. As noted in the previous chapter, general credit control measures, also called as *traditional measures* of monetary control are following.

(i) Bank rate

(ii) Cash Reserve Ratio (CRR), and

(iii) Open Market Operations

In addition to these traditional measure of monetary control, Reserve Bank of India has introduced an extra-ordinary measure, named **Statutory Liquidity Ratio (SLR)** to facilitate the government borrowing from the banks. We describe here briefly the meaning and working of these monetary measures. While discussing these aspects, brief references will be made to the RBI approach. A detailed discussion follows in the forthcoming section.

(i) **Bank Rate Policy :** 'Bank rate' is the rate at which central bank lends money to the commercial bank and rediscounts the bills of exchange presented by the commercial banks. The RBI Act 1935 defines 'bank rate' as the **"standard rate at which (the bank) is prepared to buy or rediscount bills of exchange or other commercial papers eligible for purchase under this Act."** The RBI rediscounts only the government securities, approved bills and the 'first class bills of exchange.' When commercial banks are faced with shortage of cash reserves, they approach the central bank to borrow money for short term or get their bills of exchange rediscounted. It is a general method of borrowing by the commercial banks from the central bank, the 'lender of the last resort'. The central bank rediscounts the bills presented by the commercial bank at a discount rate. This rate is traditionally called **bank rate**. Thus, *bank rate is the rate which central bank charges on the loans and advances made to the commercial banks.*

The central bank can change this rate—increase or decrease—depending on whether it wants to expand or reduce the flow of credit from the commercial banks. When it wants to increase the credit creation capacity of the commercial banks, it reduces the discount rate and when it decides to decrease the credit creation capacity of the banks, it increases the bank rate. This policy action by the central bank is called the **bank rate policy**.

The bank rate policy was first adopted by the Bank of England in 1839. It was the only and the most widely used weapon of credit control until the open market operation, first used in 1922 in the US, emerged as a more powerful instrument of monetary control. In India, the RBI has been using the bank rate as monetary control measure, though infrequently, since its inception in 1935. The bank rate remained constant at 3% till 1950. In 1951, it was increased to 3.5% and to 4% in 1956, and remained in force till 1962. In the subsequent year, the bank rate was increased more frequently and it was raised to 12% in 1992 and was maintained till 1997. With growing need for credit facility with economy growing at 5-6% and also decreasing rate of inflation, the bank rate was reduced gradually to 6.5% in 2001, which was lowest since 1973. The bank rate was reduced to 6 percent in 2004 which was maintained till 2006-07. However, bank rate was raised to 7.5 percent in 2008 with the objective of controlling inflation which was as high as 11.5 percent in July 2008.

The **working of the bank rate policy** is simple. When the central bank changes the bank rate, commercial banks change their own discount rate accordingly with a difference of generally one percent. The change in the bank rate affects the flow of bank credit to the public. For example, if the central bank wants to reduce the money supply by reducing the flow of credit from the banks to the public, it will raise the bank rate. Raising bank rate reduces credit flow in three ways.

One, a rise in the bank rate (virtually the interest rate) reduces the net worth of the government bonds (the Treasury Bills and Promissory Notes) against which commercial banks borrow funds from the central bank. This reduces commercial banks' capacity to borrow from the central bank. As a result, commercial banks find it difficult to maintain a high cash reserve. This reduces the credit creation capacity of the commercial banks. So the flow of credit is reduced.

Two, when the central bank raises its bank rate, commercial banks raise their discount rate too. Rise in the discount rate raises the *cost of bank credit* which discourages business firms to get their bill of exchange discounted. Also, a rise in the bank rate pushes the market interest rate structure up. If demand for credit is interest-elastic, the demand for funds decreases too.

Three, bankers' lending rate is quickly adjusted to deposit rates. Therefore, a rise in the bank rate causes a rise in the deposit rate. Therefore, savings flow into the banks in the form of time deposits and money with public decreases. This is called **deposit mobilization effect**.

Exactly reverse happens when the central bank cuts down the bank rate.

Selective Credit Control Measures

The *general credit control methods* of monetary controls affect, when they are effective, the entire credit market in the same direction. They lead either to expansion or to contraction of the total credit as intended by the monetary authorities. Besides, their impact on all the sectors of the economy is uniform. This may not be always desirable or intended by the policy-makers. The monetary authorities are often required to take policy actions for (a) rationing of credit for different sectors of the economy, (b) diverting the flow of credit from the non-priority sectors to the priority sectors, and (c) curbing speculative tendency based on the availability of bank credit. These objectives of credit control are not well served by the quantitative measures of credit control. The monetary authorities resort, therefore, to **qualitative** or **selective credit controls.** Some of the common selective credit controls are discussed below.

(i) **Credit Rationing :** When there is a shortage of institutional credit available for the business sector, the highly developed and financially strong sectors and industries tend to capture the lion's share in the total institutional credit. As a result, priority sectors and essential industries are starved of necessary funds, while the bank credit goes to the non-priority sectors. In order to curb this tendency, the central bank resorts to credit rationing measures. Generally, two measures are adopted : (a) imposition of upper limits on the credit available to well-developed industries and large-scale firms, and (b) charging a higher or progressive interest rate on bank loans beyond a certain limit. This is done with a view to making bank credit available to the essential and priority sectors.

(ii) Change in Lending Margins : The banks advance money more often than not against the mortgage of some asset or property—-land, building, jewelry, share, stock of goods, and so on. The banks provide loans only up to a certain percentage of the value of the mortgaged property. The gap between the value of the mortgaged property and amount advanced is called 'lending margin.' For example, if value of stock is Rs. 10 million and the amount advanced is only Rs. 6 million, the lending margin is 40 percent. Since 1956, the RBI has made an extensive use of this method with a view to preventing speculation in scarce agricultural products, namely, food grains, cotton, oil seeds, vegetable oil (*vanaspati*), sugar, *Khandsari* and *gur*, and cotton textiles and yarns. The speculative rise in the price of scarce agricultural products had taken place because high price of such goods could secure higher loans through mortgaging. Higher loans provided more funds to buy and accumulate the stock of the scarce agricultural commodities to be mortgaged for further borrowing. This created a kind of artificial scarcity which pushed the prices further up. By increasing the lending margin, the RBI could curb this kind of speculative borrowing. This method is no more used widely India.

Did u know? The central bank is empowered to increase the lending margin with a view to decreasing the bank credit. This method was used for the first time by the RBI in 1949 with the objective of controlling speculative activity in the stock market.

(iii) Moral Suasion : The moral suasion is a method of persuading and convincing the commercial banks to advance credit in accordance with the directives of the central bank in overall economic interest of the country. This method is adopted in addition to quantitative and other qualitative methods, particularly when effectiveness of other methods is doubtful. Besides, quantitative and qualitative methods are, in fact, ineffective in the underdeveloped countries with underdeveloped money and credit markets. Under this method, the central bank writes letter to and hold meetings with the banks on money and credit matters.

(iv) Direct Controls : When all other methods prove ineffective, the monetary authorities resort to direct control measures with clear directive to carry out their lending activity in a specified manner. There are, however, rare instances of use of direct control measures.

The Limitations and Effectiveness of Monetary Policy

The effectiveness of monetary policy, in practice, depends on the following factors, knows as the limiting factors of monetary policy.

(i) The Time Lag : The first and the most important limitation in effective working of monetary policy is the *time lag,* i.e., the time taken in chalking out the policy action, its implementation and response time. The time lag is divided in two parts : (i) 'inside lag' or preparatory lag, and (ii) 'outside lag' or response lag. The **inside lag** refers to the time lost in (a) identifying the nature of the problem, (b) identifying the sources of the problem, (c) assessing the magnitude of the problem, (d) choice of appropriate policy action, and (d) implementation of policy actions. The **outside lag** refers to the time taken by the households and the firms to react to the policy action taken by the monetary authorities.

If preparatory and operational lags are long, not only the nature and the magnitude of the problem may change rendering the policy ineffective, but also it may worsen the situation. It has been the experience of many countries including developed ones that both inside and outside lags have been unduly long, making monetary policy less effective than expected. The time lag of monetary policy, particularly its response lag, has been found to be generally longer than the time lag of fiscal policy. However, the issue of time lag in case of monetary policy is controversial. Friedman and Schwartz find an average time lag of 18 months between peaks (troughs) of money supply and peaks (troughs) of business cycle. Their findings have been questioned by the findings of other economists. However, 'the evidence from several sources suggest that the lag associated with monetary policy is long and possibly variable' and 'the consensus seems to be that the lag is about 12 to 16 months long.'

(ii) Problems in Forecasting : The formulation of an appropriate monetary policy requires that the magnitude of the problem—recession or inflation—is correctly assessed, as it helps in determining the dose of the medicine. What is more important is to forecast the effects of

monetary actions. In spite of advances made in the forecasting techniques, reliable forecasting of macroeconomic variables remains an enigma. In this regard, it is interesting to quote Stephen McNees.

"How can forecasters go wrong ? They may not predict' disturbances (the Gulf War, for example); they may misread the current state of the economy and hence base their forecasts on a wrong picture of the present situation; and they may misjudge the timings and the vigour of the government's monetary and fiscal responses to booms or recessions. The fact is that forecasting has not reached perfection, particularly at major turning points in the economy,...."

Because of the low degree of reliability of forecasting, prediction of the outcome of a policy action and hence formulation of an appropriate monetary policy has remained an extremely difficult task. This point has been adequately evidenced by unpredictability of recession in the US economy and inflation in India, both in 2008. An inappropriate policy based on guesswork is bound to be unsatisfactorily effective. There is a large empirical evidence to support this point of view.

(iii) Growth of Non-banking Financial Intermediaries : Apart from the above limitations of the monetary policy, the structural change in the financial market due to rapid growth of non-banking financial intermediaries has reduced the scope of effectiveness of this policy. The proliferation of non-banking financial intermediaries including industrial financial corporations, industrial development banks, mutual saving funds, insurance companies, chits and funds, and so on, have reduced the share of the commercial banks in the total credit. Although financial intermediaries cannot create credit through the process of credit multiplier, their huge share in the financial operations reduces the effectiveness of monetary policy which works through the banking finance.

(iv) Underdeveloped Money and Capital Markets : In addition to the factors discussed above, the effectiveness of monetary policy in the less developed countries is reduced considerably because of the underdeveloped character of their money and capital markets. The money and capital markets are fragmented, while effective working of monetary policy requires a fairly developed money market and that money market and the sub-markets of the capital market are interactive and work interdependently.

Monetary Policy of India

We have discussed above the meaning, scope, instruments and working mechanism of monetary policy in a general framework and have also used examples of monetary measures adopted by the RBI. In this section, we take a look at India's monetary policy including its objectives, instruments and targets.

The RBI, the central monetary authority of India, has been changing the objectives and their priorities of its monetary policy from time to time in accordance with the needs of the country. The RBI has, in fact, managed monetary affairs of the country, especially the control, regulation and allocation of bank credit as and when required by the needs of the country. However, RBI's monetary policy has not been found to be working very effectively. The reason was that the RBI was severely constrained by the growing deficit financing by the Government of India. A comprehensive knowledge of India's recent monetary policy and its working can be had from the Chakravarty Committee Report, the writings of C. Rangarajan, a former Governor of RBI and Rakesh Mohan, Deputy Governor of RBI.

Monetary Policy Objectives

As already noted above, monetary policy being an organ of the overall economic policy, its objectives could not be different from or be in conflict with the overall objectives of other economic policies of the country. The three major objectives of India's overall economic policy have been (i) economic growth, (ii) social justice, i.e., an equitable distribution of income, and (iii) price stability. Of these objectives, *growth* and *price stability* have been in general the objectives of India's monetary policy. Of these two objectives, however, Chakravarty Committee considered promoting price stability as 'the dominant objective of the monetary policy' (Report). For, in the Committee's opinion, "It is price

stability which provides the appropriate environment under which growth can occur and social justice can be ensured". "The case for price stability as the dominant objective of monetary policy began to assume importance in the early 1990s".... In essence [however], monetary policy aims to maintain a judicious balance between price stability and economic growth".

However, macroeconomic conditions of the country—especially the financial structure of the country, demand for and supply of money and the nature of monetary management needs of the country—have been changing over time. Therefore, the objectives of monetary policy and instruments of monetary control and management issues have also been changing, though *price stabilization* remained the central theme of India's monetary policy. In simple words, with changing economic conditions of the country, the RBI has been changing *monetary policy objectives,* and it has been using a combination of *monetary policy instruments* to achieve its targets. We discuss here briefly the objectives of monetary policy and instruments adopted by the RBI to achieve its objective.

Monetary Measures

The RBI has been using various monetary measures from time to time including some non-traditional measures for price stabilization and other monetary policy objectives. We give here a brief description of the measures adopted by the RBI, and also their effectiveness.

1. **Bank Rate :** The bank rate has been one of the important instruments used by the RBI to control inflation, whenever required. As mentioned above, the bank rate remained unchanged at 3 percent during 1935-1950. Since 1951, however, bank rate has been frequently changed — mostly increased — as shown in Table 2. As can be seen in Table 2, the RBI was using bank rate infrequently as a weapon of monetary control till mid-1990s with the purpose of mitigating mounting inflationary pressure in the country. After mid-1990s, however, inflation rate declined with rise in the growth rate of the economy, due mainly to economic reforms. As a result, the RBI started reducing bank rate from the year 1997 which continued till May 2008. However, the RBI started enhancing the bank rate and raised it to 7.5 percent in July 2008 due to rate of inflation crossing double digit. However, due to fall in the inflation rate in late 2008, the bank rate was cut down to 6 percent in January 2009. This rate is likely to be maintained in fiscal year 2008-09.

Table 2 : Changes in Bank Rate in India

Year	Bank Rate (%)	Month and Year	Bank Rate (%)
1935	3.0	April 1997	11.0
1951	3.5	June 1997	10.0
1957	4.0	October 1997	9.0
1963	4.5	October 1999	8.0
1964	5.0	April 2000	7.0
1965	6.0	October 2001	6.5
1975	9.0	April 2003	6.0
1981	10.0	April 2004	6.0
1991	11.0	March 2005	6.0
1992	12.0	June 2008	7.0
		July 2008	7.5
		August 2008	6.0
		January 2009	6.0

Source : CMIE, *Basic Statistics Relating to the Indian Economy* — August 1993 and various issues of *Economic Surveys*, MQF, GOI.

Notes

As regards the effectiveness of bank rate as an instrument of monetary control, India's experience, and also that of other countries, shows that the bank rate has not proved to be an effective method of controlling money supply. The reason is that banks do not depend on the RBI greatly for their financial requirements. Besides, even if commercial banks borrow from the RBI, their total borrowing accounts for a small proportion of the total credit created by the commercial banks, especially when there are other sources of credit.

2. **Cash Reserve Ratio (CRR) :** The *CRR* is another traditional monetary tool that RBI has been using to control inflation in the country, and also to restrain credit flow to the business sector. Recall that *CRR* refers to the percentage of net demand and time liabilities (NDTL) which commercial banks are required to maintain in the form of '*cash reserves*'. The NDTL are essentially the net demand and time deposits. The *cash reserves* are practically divided under two heads : (i) 'required reserves (RR)', and (ii) 'excess reserve'. The **required reserve** is the cash reserve that commercial banks are statutorily required to maintain with the RBI. Incidentally, this is a non-traditional method. The RBI was empowered in 1956 to impose the 'statutory cash reserve ratio' between 3 percent and 15 percent of bank's demand and time deposits. The **'required reserve**' is calculated fortnightly (on the second Friday of the month) on the basis of average daily deposits. The **excess reserve** is the cash reserve which banks maintain as 'cash in hand' with the purpose of meeting the currency demand by the depositors. The excess reserves are determined generally by the bank's own experience regarding the 'currency drain'.

   As regards the use of the *CRR* method as monetary control, till 1973, the RBI used this method only once in 1960. However, As shown in Table 3, since 1973, the RBI has been using *CRR* quite frequently as a major instrument of controlling the excess supply of money. The RBI raised the statutory *CRR* from 3 percent fixed in 1935 to 5 percent in 1960 and raised it further frequently. As a result, the bank rate had gone up to 15 percent in July 1989. This rate was maintained till 1994. But, since 1995, the *CRR* has been regularly reduced by the RBI until January 2006, as shown below. However, due to inflationary pressure in the economy, the RBI began to raise the *CRR* and raised it 8.75% in July 2008. With inflation rate declining, the RBI cut down the *CRR* to 5 percent in June 2009.

Table 3 : Changes Made in CRR

Month and Year	CRR (%)
1994-95	15.00
November 1995	14.50
December 1995	14.00
May 1996	13.00
July 1996	12.00
January 1997	10.00
February 2001	7.50
March 2001	7.00
October 2001	6.50
October 2002	6.25
June 2003	4.50
March 2005 to Jan. 2006	5.00
April 2007	6.50
July 2008	8.75

3. **Statutory Liquidity Ratio (SLR) :** In addition to *CRR*, the RBI was empowered to impose 'statutory cash reserve ratio' (*SLR*) to control and regulate the credit creation by the banks for the private sector and the availability of finance to the government. Under the *SLR* scheme, the

Notes

commercial banks are required by statute to maintain a certain percentage of their total daily demand and time deposits in the form of liquid assets. Liquid assets, as specified by the RBI, include (i) excess reserves, (ii) unencumbered government securities, e.g., bonds of IDBI, NABARD, Development banks, cooperative debentures, debentures of port trusts, etc., and (iii) current account balance with other banks. The method of determining the SLR can be specified as follows.

$$SLR = \frac{\text{ER} + \text{GS} + \text{CB}}{\text{DD} + \text{TD}}$$

where ER = excess reserves, GS = Government (unencumbered) securities, *CB* = current account balance with other banks, *DD* = demand deposits, and *TD* = time deposits.

The basic purpose of using *SLR* was to prevent the commercial banks from going for liquidating their assets when *CRR* was raised to control money supply. When *CRR* was raised, what commercial banks used to do was to convert their liquid assets into cash to replenish the fall in their funds due to the rise in the *CRR* and maintained their credit creation ability. This made monetary policy ineffective. The *SLR*, as a tool of monetary control, works in two ways : (i) it provides an alternative to the borrowing of the government from the RBI, and (ii) it affects banks' freedom of buying and selling the government bonds. In both ways, it affects the money supply, depending on whether the RBI wants to control or enhance the money supply. When the intention is to increase money supply, the RBI reduces the *SLR* and when it wants to reduce the money supply with the public, it increases the *SLR*.

The *SLR* was first imposed in 1949, and was fixed at 20 percent, and remained unchanged till August 1964. In September 1964, the *SLR* was raised to 25 percent and was maintained at the same level till September 1970. Since then, the *SLR* has been raised quite frequently as shown below. The *SLR* was raised in September 1990 to 38.5 percent — very close to the prescribed upper limit of 40 percent. The *SLR*, as tool of monetary control, has, in fact, been used as a monetary-fiscal tool. The deficit financing method — a fiscal measure — led to rapid increase in money supply which continued to build inflationary pressure in the economy. The RBI now used the *SLR* for controlling the short-term money supply. The use of *SLR* restricted the flow of funds from the banks to the private sector. Since 1992, however, the *SLR* has been gradually reduced. It was reduced to 25 percent in April 1992, mainly because the rate of inflation had declined to around 5 percent in the early 1990s. The *SLR* continues to be maintained at 25 percent.

Year	SLR (%)
1971	25.0
1972	30.0
1973	32.0
1974	33.0
1978	34.0
1990	34.5
1992	25.0
2009	25.0

4. **Open Market Operations (OMO) :** In developed countries like the USA and the UK, open market operation is considered to be a very powerful and efficient tool of monetary management. But in India, the open market operation has not been until recently a successful instrument of monetary management for the following reasons.

   (i) In India, the security market, especially the Treasury bill market, is not yet well developed and fully organized, and the Government securities market is almost non-existent; and

   (ii) The government bonds were earlier not very popular because of low rate of return. The rates were much lower than the market rate of interest.

It is for these reasons that open market operation was not used until the mid 1980s to control money supply, nor was this tool effective when used. In fact, open market operation was not used during the 1970s and the first half of the 1980s. The open market operation failed not only in India but also in other developing economies. In a nutshell, open market operation did not prove to be a very successful tool of monetary control. However, some important changes were made in India on the recommendations of the Chakravarty Committee (1985). The interest rate on Government securities was raised during the late 1980s and scheduled commercial banks were granted freedom to determine their own prime lending rates. These two factors made open market operation a fairly effective tool to control short-term credit.

After the economic reforms of 1991–92, *OMO* was assigned a greater role in monetary management. "Since the onset of reforms,..., the Reserve Bank reactivated open market operations (*OMO*) as an instrument of monetary management.... Active use of *OMO* for mitigating inflationary pressures was undertaken during 1993-1995 in the wake of unprecedented capital flows...".

5. **The Repo Rate : A New Monetary Tool** Till the late 1980s, the RBI had been using the traditional methods of monetary control. However, as mentioned above, on the recommendations of the Chakravarty Committee (1985), some important changes were made in the monetary policy. However, some major changes were introduced in the monetary policy only after the foreign exchange crisis of 1990 and subsequent economic reforms. But the major problem that the RBI continued to face was to control and regulate the high rise in money supply. The high rise in money supply throughout was mainly due to monetization of the government's deficit financing. It was in 1991 that the World Bank and the IMF—the World Bodies that bailed India out of the foreign exchange crisis—exerted pressure on the government to make certain major economic reforms including monetary reforms. Some major monetary reforms and some new tools of monetary management were introduced including the *repo rate*. We describe here briefly a new monetary tool that is often used by the RBI, i.e., Repurchase Operation Rate — the repo rate.

In April 1997, the RBI introduced a new system, called *Repurchase operation rate* (abbreviated as *repo rate*), to manage the short-run liquidity of the banking system. As mentioned above, under the *SLR* system, the commercial banks are required to invest a certain percentage of their demand and time deposits in government securities. This system blocks the bank money with the RBI, often causing liquidity problem. The repo system provides a solution to this problem of liquidity. Under the repo system, the RBI buys securities back from the banks and, thereby provides funds to the banks. It is a form of lending money to the banks for a short period 1—14 days. The rate of interest at which the RBI lends money to the bank is the *repo rate*. In contrast, there is **reverse repo rate**. The reverse repo rate is the rate at which the banks can buy the securities or deposit money with the RBI.

The operational rule of the repo rate is quite simple. When the central bank aims at increasing liquidity or money supply, it buys back the securities at a low repo rate. This increase the funds with commercial banks which can be used to create credit. On the other hand, when the objective is to control the money supply, the RBI uses the reverse repo rate and increases the repo rate. In June 1998, the repo rate was fixed at 5 percent. However, due to anticipated increase in liquidity via Resurgent India bonds and East Asian crisis, the repo rate was raised to 8 percent in August 1998. But it was later reduced gradually to 4.5 percent in 2004, to 5 percent on April 28, 2005, and to 6.25 percent on October 26, 2006. However, due to mounting inflationary pressure in the economy, repo rate was increased to 7.25 percent *m* 2006-07. Along with the changes made in the repo rate, the reverse repo rate was also simultaneously raised. In 2008, the Indian economy was facing a 13-year high rate of inflation which was touching 12 percent. With the objective of controlling inflation, the RBI kept increasing the repo rate. On July 29, 2008, the RBI raised the repo rate from 8.5 percent in the previous week to 9 percent.

Evaluation of India's Monetary Policy

At the end of the discussion, the question that arises about the monetary measures undertaken by the RBI is : Has the monetary policy of India been successful ? This question takes us to the evaluation of

monetary policy. Monetary policy, or any policy for that matter, has to be evaluated by examining whether its objectives have been achieved over time. As mentioned above, on the recommendation of the Chakravarty Committee, the RBI had adopted 'price stability', i.e., controlling inflation, as the 'dominant objective of the monetary policy', while at the same time, maintaining an adequate liquidity in the economy. The question arises here is : Price stability at what rate of inflation ? This question arises because some inflation is inevitable in a growing economy like India. It is, perhaps, in view of this fact that the Chakravarty Committee had recommendation price stability at 4 percent rate of inflation. Even other economists have suggested, on empirical basis, that a 3-5 percent annual inflation is desirable for a developing economy.

Examined against the price stability objective, India's monetary policy appears to be only partially successful. Instead of looking at annual variation in the inflation rate, let us look at decennial rate of inflation to examine the effectiveness of monetary policy.

In India, inflationary pressure started building up during the 1960s, due to the Chinese war in 1962, the Pakistan war in 1965, and near-famine conditions in 1965-66. As a result, inflationary pressure started mounting from 1962-63, and inflation rate shot up to 13.9% in 1966-67. The decennial average rate of the 1960s was worked out at 6.4 percent.

The things were much worse in the 1970s. The inflation rate during the 1970s was much higher — the highest rate during the period was 25.2 percent in 1974-75. This has been the highest rate of inflation in India so far. The decennial average inflation rate was 9 percent, due mainly, to the failure of the kharif crop and rise in oil prices. Incidentally, these aspects fall outside the scope of monetary controls.

During the 1980s, things improved marginally. The decennial rate of inflation declined from 9 percent in the 1970s to 8 percent in the 1980s, with the highest inflation rate of 18.2 percent in 1980-81. However, there was an upsurge of inflationary pressure during the first five years of 1990s. The average rate of inflation during the period from 1990-91 to 1995-96 was worked out at 10.6 percent. Thereafter, however, the inflation rate declined considerably. The inflation rate varied between 3.4 percent in 2002-03 and 6.4 percent in 2004-05. The annual average rate of inflation during the period from 1995-96 to 2006-07 works out to be 5 percent. This was quite close to the economically and socially desirable rate of inflation.

If one compares the high rate of inflation (varying between 6% and 10%), one would conclude that during the entire period from 1960-61 to 1995-96, i.e., during a period of 35 years, the monetary policy was unsuccessful in achieving its objectives. Although inflation rate was quite within the desirable limit 4-5% during the period from 1995-96 to 2006-07, it can hardly be attributed to the monetary policy. The lower rate of inflation was mainly due to high growth rate— 7-9 percent. The only point that goes in favour of the monetary policy is the fact that things might be much worse in the absence of monetary controls adopted by the RBI. What is alarming is the fact that, in spite of all monetary measures, inflation rate shot up to about 12 percent—to be precise, 11.98 percent—in June-July 2008. However, had RBI not adopted a monetary policy with prime objective of price stabilization, inflation rate could have been much higher.

It may be added at the end that inflation rate has been within the desirable limit (5%) during the period from 1995-96 to 2006-07, which can be attributed to the monetary policy. It may be argued that the lower rate of inflation was mainly due to high growth rate. But then maintaining a reasonably high growth rate was also the second most important objective of the monetary policy. It may be this be concluded that monetary policy of India has been only fairly successful.

Self-Assessment

1. Choose the correct option:

(*i*) For implementing a comprehensive Khadi Reform Programme, a financial aid of $ I million over a period of three years has recently been tied up with?

(*a*) International Monetary Fund

(*b*) International Development Agency

(*c*) Asian Development Bank

(*d*) International Finance Corporation

(*ii*) The measure of the degree of association between the values of two random variables is called?

(*a*) Correlation (*b*) Association

(*c*) Regression (*d*) Co-variance

(*iii*) In any set of numbers, the geometric mean exists only when all numbers are?

(*a*) Positive (*b*) Negative

(*c*) Zero (*d*) Positive, zero or negative

(*iv*) Through open market operations, the Federal Reserve buys and sells government securities to influence the supply of bank reserves. When the Fed wants to increase reserves, it does what?

(*a*) Sells securities (*b*) Nothing

(*c*) Buys securities

(*v*) Which of these is NOT a monetary policy tool?

(*a*) Reserve requirements (*b*) Open market operations

(*c*) Balance accounts (*d*) Discount rate

(*vi*) Federal Reserve Board of Governors members serve .... terms to help insulate them from political influence.

(*a*) 7 year (*b*) Lifetime

(*c*) 25 year (*d*) 14 year

(*vii*) Monetary policy refers to what the Federal Reserve does to influence the amount of .... and .... in the U.S. economy.

(*a*) Taxes and revenue (*b*) Currency and gold reserves

(*c*) Interest and debt (*d*) Money and credit

5.3 Summary

- In a broad sense, finance refers to funds or monetary resources needed by individuals, business houses and the Government. Individuals and households require funds essentially for meeting their current requirements or day-to-day expenses or for buying capital goods (commonly known as investment).
- The financial system of India refers to the system of borrowing and lending of funds or the demand lor and the supply of funds of all individuals, institutions, companies and of the Government. Commonly, the financial system is classified into :
- The Indian financial system performs a crucial role in economic development of India through saving investment process, also known as capital formation. It is for this reason that the financial system is sometimes called the financial market.
- The Indian financial system which refers to the borrowing and lending of funds or to the demand for and supply of funds, consists of two parts, *viz*., the Indian Money market and the Indian Capital market.
- The Indian capital market is the market for long-term capital; it refers to all the facilities and institutional arrangements for borrowing and lending "term funds"—medium-term and long-term funds. The demand for long-term money capital comes predominantly from private and public manufacturing industries, trading and transport units, etc .
- A money market is not a market for money but it is a market for "near money"; or it is the market for lending and borrowing of short-term funds. It is the market where the short-term surplus investible funds of banks and other financial institutions are demanded by borrowers comprising individuals companies and the Government.
- One important sub-market of the Indian money market is the Call Money Market, which is the market for very short-term funds.

- An evaluation of the various characteristics and defects of the Indian money market which we have described above will show clearly that the Indian money market is relatively undeveloped and cannot be compared with such advanced money markets as the London and New York money markets.
- While describing the characteristics of the Indian money market, we pointed out to the important steps taken by RBI to correct some of those defects. For example, RBI has considerably reduced the differences which existed between the different sections of the money market.
- Monetary policy, in general, refers to the action taken by the monetary authorities to control and regulate the demand for and supply of money with a given purpose. Monetary policy is one of the two most powerful tools of economic control and management of the economy.
- The scope of monetary policy spans the entire area of economic transactions involving money and the macroeconomic variables that monetary authorities can influence and alter by using the monetary policy instruments.
- The instruments of monetary policy refer to the economic variables that the central bank is empowered to change at its discretion with a view to controlling and regulating the supply of and demand for money and the availability of credit.
- We have discussed above the instruments, 'the nuts and bolts' of monetary policy. In this section, we discuss how changes made in the monetary policy instruments affect the monetary and real sectors and the economy as a whole.
- We have discussed above the meaning, scope, instruments and working mechanism of monetary policy in a general framework and have also used examples of monetary measures adopted by the RBI. In this section, we take a look at India's monetary policy including its objectives, instruments and targets.

5.4 Key-Words

1. Urban infrastructure : Infrastructure is the basic physical and organizational structures needed for the operation of a society or enterprise, or the services.
2. Monopoly : The exclusive possession, control, or exercise of something: "men don't have a monopoly on unrequited love".

5.5 Review Questions

1. What do you mean by the term Indian Capital Market? Discuss.
2. Discuss the features of the Indian Money.
3. Explain the reform of the Indian Money Market.
4. Write a short note on the Monetary Policy of India.
5. What are the objectives of Monetary Policy?

Answers: Self-Assessment

1. (*i*) (*c*) (*ii*) (*a*) (*iii*) (*a*) (*iv*) (*b*) (*v*) (*b*)
   (*vi*) (*d*) (*vii*) (*d*)

5.6 Further Readings

Books

1. The Indian Economy; S.K. Ray; Prentic, Hall of India Private Limited New Delhi - 110001.
2. Indian Economy; Gaurav Datt and Aswani Mahajan; S. Chand and Company LTD. Ram Nagar, New Delhi-110055.

Unit 6: Capital Market in India and Working of SEBI

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Objectives

After reading this Unit students will be able to:

- Explain the Capital Market in India and Working of SEBI.
- Discuss the Working of SEBI.

Introduction

The capital market is a market for long-term debt as well as equity shares as compared to the money market which is a market for short-term debt. This market issues debt and equity instruments to the public as well as placed privately to a select group of investors. This market includes stock exchanges also where most of these instruments are traded. Here, we have broadly two segments : primary market and secondary market. The market for new issues of these securities is called the primary market. After the securities are issued, they are traded in the secondary market. We have three main categories of participants in the capital market. While the issuers are the borrowers or deficit savers, who issue securities to raise funds, the investors, who are surplus savers, deploy their savings by subscribing to these securities. The third category is the intermediaries who are the agents who match the needs of users and suppliers of funds for a commission. In the primary market, the corporate sector as well as the Central Government and State Governments issue securities. The secondary market provides the much needed liquidity and information on asset prices for the investor. In India, the regulatory authority that regulates both the primary and secondary markets is the Securities and Exchange Board of India (SEBI). SEBI protects the interests of the investors in securities and to promote the development of the securities market. In India, stock market has a history of over 200 years but the first organised stock exchange was set up in Bombay in 1875.

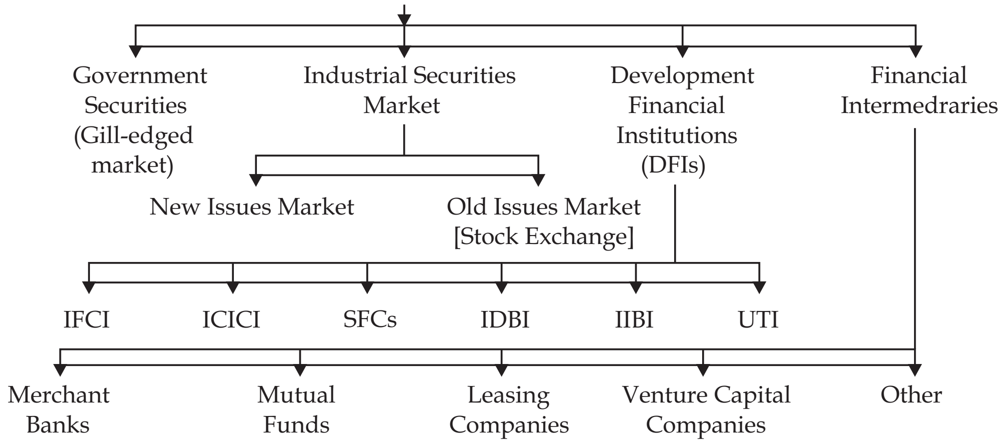
6.1 Capital Market in India

Capital market is the market for long-term funds, just as the money market is the market for short-term funds. It refers to all the facilities and the institutional arrangements for borrowing and lending term funds (medium-term and long-term funds). It does not deal in capital goods but is concerned with the raising of money capital for purposes of investment.

The demand for long-term money capital comes predominantly from private sector manufacturing industries and agriculture and from the Government largely for the purpose of economic development.

As the Central and State Governments are investing not only on economic overheads as transport, irrigation and power development but also on basic industries and sometimes even consumer goods industries, they require substantial sums from the capital market.

Chart 1 : Capital market in India



The supply of funds for the capital market comes largely from individual savers, corporate savings, banks, insurance companies, specialised financing agencies and the government. Among institutions, we may refer to the following :

(a) Commercial banks are important investors, but are largely interested in government securities and, to a small extent, debentures of companies;

(b) LIC and GIC are of growing importance in the Indian capital market, though their major interest is still in government securities;

(c) Provident funds constitute a major medium of savings but their investments too are mostly in government securities;

(d) Special institutions set up since Independence, viz., IFCI, ICICI, IDBI, UTI, etc. - generally called development financial institutions (DFIs) — aim at supplying long-term capital to the private sector.

(e) There are financial intermediaries in the capital market, such as merchant bankers, mutual funds, leasing companies etc. which help in mobilising savings and supplying funds to investors.

The Government Securities (G-SEC) Market VS Industrial Securities Market

The Government Securities Market, also known as the gilt-edged market differs from the industrial securities market in many important respects :

(i) There are no uncertainties regarding yield, management, additions to capital, etc, and, therefore, there is much less speculation in this market.

(ii) The investors in government securities are predominantly institutions which are often compelled by law to invest a certain portion of their funds in these securities. The commercial banks, the LIC, the GIC and the provident funds come under this category; these are often referred to as the captive market for Government securities.

(iii) The average value of the transactions in the Government securities market is very much larger than in the case of shares and debentures of companies. Often a single transaction in government securities may run into several crores or even hundreds of crores of rupees.

(iv) The Government securities market, unlike the market for shares, is not an auction market but an "over the counter" market. The average size of the transactions is so large that each transaction has to be negotiated.

(v) LIC, GIC and the provident funds rarely sell more than a small percentage of their holdings, but commercial banks may engage in considerable buying and selling, depending upon their deposit resources on the one hand and their policies on the other.

(vi) Finally, RBI plays a dominant role in the gilt-edged market through its open-market operations which are governed by the twin objectives of monetary stability and of ensuring the success of government's borrowing programme.

Besides gilt edged market and variable yield industrial securities, the Indian capital market includes development financial institutions and financial Intermediaries.

Indian Capital Market before Independence

The Indian capital market was not properly developed before Independence. The growth of the industrial securities market was very much hampered since there were very few companies and the number of securities traded in the stock exchanges was still smaller. Most of the British enterprises in India looked to the London capital market for funds than to the Indian capital market. A large part of the capital market consisted of the gilt-edged market for government and semi-government securities.

Before independence, individual investors were very few and limited to the affluent classes in the urban and rural areas. Besides, the Government had placed many restrictions on the institutional savers such as banks and insurance companies which necessarily had to prefer government securities and only to a small extent to the fixed interest-bearing debentures.

Specialised issue houses, so common in Western countries were not developed in India, and the managing agency system, a peculiar institution in pre-Independence India, performed to some extent the functions of promotion, issue and underwriting of new capital issues. Finally, there were no specialised intermediaries and agencies to mobilise the savings of the public and channelise them to investment. Such institutions were started only after Independence.

The Indian Capital Market since Independence

Since Independence and particularly after 1951, the Indian capital market has been broadening significantly and the volume of saving and investment has shown steady improvement. All types of encouragement and tax relief exist in the country to promote savings. Besides, many steps have been taken to protect the interests of investors. A very important indicator of the growth of the capital market is the growth of joint stock companies or corporate enterprises. In 1951 there were about 28,500 companies both public limited and private limited companies with a paid-up capital of ₹ 775 crores; in 2000, there were over 70,000 companies with a paid-up capital of over ₹ 200,000 crores.

The rate of growth of investment has been phenomenal in recent years, in keeping with the accelerated tempo of development of the Indian economy under the impetus of the Five Year Plans. The growth of public borrowings for investment purposes is also an indicator of the growth of the capital market. By 2003-04, there were 250 non-departmental public enterprises of the Central Government alone with capital investment of ₹ 150,000 crores.

In the last two decades alone, the capital market in India has witnessed rapid growth. The volume of capital market transactions has increased sharply; its functioning has been diversified. New financial instruments, such as fully and partly paid convertible debentures (FCDs and PCDs) 364-day treasury bills, commercial paper, CDs have appeared. These reflect the growing diversification and a measure of sophistication of the financial services in the capital and money markets. The volume of new issues was ₹ 31,800 crores during 1994-95, though it declined in the subsequent years (₹ 12,900 crores during 1996-97). The number of shareholders runs into several millions indicating the growth of the cult of equity.

6.2 Development Financial Institutions (DFIs)

Soon after Independence, the Government of India set up a series of financial institutions to be of special help to the private sector industries in the matter of finance. IFCI was the first of these institutions (1948). It was followed by SFCs (set up by State Governments with cooperation of RBI and other banks) to provide long term finance to small and medium industrial units. ICICI (1955), IDBI (1964) and UTI (1964) followed soon after. LIC was set up in 1956 to mobilise individual savings and to invest part of the savings in the capital market. Many more specialised financial institutions were set up and are commonly called public sector financial institutions. These institutions have

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been doing very useful work in subscribing to the shares and debentures of new and old companies, in giving loan assistance, in underwriting new issues, and so on. At present, many of them have become powerful shareholders in many prominent companies. LIC and UTI mobilise resources from the public and place them at the disposal of the capital market. On the other hand, the development financial institutions (DFIs) are engaged in providing funds to the private sector enterprises. The structure of public sector financial institutions is shown in chart 3 next page.

1. Industrial Finance Corporation of India (IFCI)

The Government of India set up the Industrial Finance Corporation of India (IFCI) in July 1948 under a special Act. The Industrial Development Bank of India, scheduled banks, insurance companies, investment trusts and co-operative banks are the shareholders of I.F.C.I. The Union Government had guaranteed the repayment of capital and the payment of a minimum annual dividend. The Corporation was authorised to issue bonds and debentures in the open market, to borrow foreign currency at from the World Bank and other organisations, accept deposits from the public and also borrow from the Reserve Bank.

The IFCI performed three important functions :

(a) It granted loans and advances to industrial concerns and subscribed to the debentures floated by them.

(b) It guaranteed loans raised by the industrial concerns in the capital market.

(c) It underwrote the issue of stocks, shares, bonds and debentures of industrial concerns. It also subscribed to the equity and preference shares and debentures of companies.

IFCI was authorised to give long and medium-term finance to companies engaged in manufacturing, mining, shipping and generation and distribution of electricity.

IFCI had played a pioneering role in financing private sector investment and had a big hand in the rapid industrial development of India. The loans sanctioned by IFCI increased from ₹ 210 crores in 1980-81 to Rs 2.430 crores in 1990-91 and 1,860 crores in 2000-01. This was partly due to the mobilization of large financial resources by IFCI (in fact, by all public sector financial institutions such as IDBI and ICICI) and also due to the rapid development of industries during this period. But the same time, IFCI was plagued by the accumulation of non-paying assets (NPAs) mainly because it was forced to lend to wrong parties. Accordingly IFCI is no more a development financing institution.

2. State Financial Corporations

The scope of assistance provided by the Industrial Finance Corporation of India was limited since it dealt with large public limited companies and co-operative societies which were engaged in manufacturing, mining, shipping and generation and distribution of electricity. But there were both small-scale and medium-sized industries which require financial assistance and for this purpose the State Governments desired to set up State Financial Corporations. The Government of India passed the State Financial Corporations Act in 1951 and made it applicable to all the states. The authorised capital of a State Financial Corporation is fixed by the State Government within the minimum and maximum limits of ₹ 50 lakhs and ₹ 5 crores and is divided into shares of equal value which are taken by the respective State Governments, the Reserve Bank of India, scheduled banks, co-operative banks, other financial institutions such as insurance companies and investment trusts and private parties. The shares are guaranteed by the State Government. A State Financial Corporation can augment its funds through issue and sale of bonds and debentures.

All types of industrial concerns can get accommodation from State Financial Corporations. A State Financial Corporation can:

(a) guarantee loans raised by industrial concerns which are repayable within a period not exceeding 20 years and which are floated in the public market; (b) underwrite the issue of stocks, shares, bonds or debentures of industrial concerns; (c) grant loans or advances to industrial concerns repayable within a period not exceedingly 20 years; and (d) subscribe to debentures floated by industrial concerns.

Notes

Industrial Credit and Investment Corporation of India (ICICI)

The Industrial Credit and Investment Corporation was sponsored by a mission from the World Bank for the purpose of developing small and medium industries in the private sector. It was registered in January, 1955 under the Indian Companies Act. The aim of I.C.I.C.I. was to stimulate the promotion of new industries, to assist the expansion and modernisation of existing industries and to furnish technical and managerial aid so as to increase production and afford employment opportunities. The Corporation granted :

(a) long-term or medium-term loans, both rupee loans and foreign currency loans;

(b) participated in equity capital and in debentures and underwrote new issues of shares and debentures,

(c) guaranteed loans from other private investment sources.

(d) provided financial services such as deferred credit, leasing credit, instalment sale, asset credit and venture capital.

There was a remarkably significant increase in financial assistance by ICICI in recent years :

Table 1: Financial Assistance by ICICI

(₹ crores)

	1980-81	1990-91	2000-01
Loans sanctioned	310	3,740	55,820
Disbursements	180	1,970	31,660

In a matter of 20 years, loans between, 1981 and 2001 sanctioned by ICICI had increased from ₹ 310 crores to over ₹ 55,820 crores and loans disbursed had increased from ₹ 180 crores to ₹ 31,660 crores.

The Corporation assisted industrial concerns with loans and guarantees either in rupees or in any foreign currency. Besides, it underwrote ordinary and preference shares and debentures and it also subscribed directly to ordinary and preference shares issues. A significant function performed by the Corporation was the provision of foreign currency loans and advances to enable Indian Industrial concerns to secure essential capital goods from foreign countries.

ICICI commenced leasing operation in 1983. It provided leasing assistance for computerisation, modernisation/replacement, equipment of energy conservation, export orientation, pollution control etc. The industries helped under leasing included textiles, engineering, chemicals, fertilizers, cement, sugar, etc.

ICICI had set up a Merchant Banking Division which was working very creditably. ICICI had joined with J.P. Morgan & Co. to set up ICICI Securities and Finance Co. Ltd. (I-SEC) to offer services in areas relating to issue management and credit syndication services. ICICI has also set up ICICI Asset Management Co Ltd. in June 1993 to operate the schemes of the ICICI Mutual Fund— this was later called Prudential ICICI Mutual Fund. Yet another subsidiary called ICICI Investors Services Ltd (March 1994) and ICICI Banking Corporation Ltd. (January 1994) were also set up.

Apart from these, ICICI had promoted the following companies and institutions in recent years :

(a) Credit Rating Information Services of India Ltd. (CRISIL), set up by ICICI in association with Unit Trust of India (UTI) to provide credit rating services to the corporate sector;

(b) Technology Development and Information Company of India Ltd. (TDICI), promoted by ICICI, to finance the transfer and upgradation of technology and provide technology information - this was christened as ICICI Venture Funds in 1988.

(c) The SCICI Ltd. (formerly Shipping Credit and Investment Company of India Ltd.) specialised in giving loans for acquisition of ships. It had diversified its operations to cover all sectors of the economy with focus on sectors of special significance to exports and infrastructure. As a

result of this diversification of activities, SCICI Ltd. lent to a variety of industries, besides shipping and fishing industries such as automobiles and its ancillaries, chemicals and petrochemicals, electronics, information technology, power generation, and distribution, steel and steel products, other metals, textiles and food processing. However, shipping and fishery industries continued to be the priority for the SCICI Ltd. Till the end of March 1996, SCICI had sanctioned a total assistance of ₹ 12,750 crores. SCICI was, however, merged with ICICI in April 1996.

Of all the development financial institutions set up by the Indian Government after Independence, ICICI registered the most spectacular success. In fact, the financial assistance sanctioned and disbursed by ICICI rose tremendously during the 1990's and had exceeded the assistance extended by IDBI which was the apex institution in the field of development finance.

Another pioneering event was the reverse merger of ICICI with its subsidiary the ICICI Bank in March 2002 and the creation of the first universal bank in India. With this merger, ICICI was no more a development financial institution.

The Industrial Development Bank of India (IDBI)

The Industrial Development Bank of India was set up since 1947 to provide long-term finance to industry. IFCI, the SFCs, ICICI, and the Refinance Corporation of India were functioning for several years provided direct plans, subscribed to shares and bonds and to guarantee loans and deferred payments. The volume of long-term finance provided by these institutions were substantial and were steadily increasing too, but it was found inadequate to meet the requirements of new and growing industrial enterprises. On the one side, the needs of rapid industrialisation necessitated the establishment of a new institution with large financial resources. On the other side, there was the need to co-ordinate the activities of all agencies which are concerned with the provision of finance for industrial development. It was to fulfil this two-fold objective that the Government establish the Industrial Development Bank of India (IDBI) which formally came into existence in July 1964.

IDBI was a wholly-owned subsidiary of the Reserve Bank of India till 1976. The general direction, management and superintendence of IDBI was vested in a Board of Directors, which was the same as the Central Board of Directors of the Reserve Bank of India. The Governor and Deputy Governor of the Reserve Bank were the Chairman and Vice-Chairman of IDBI. The Finance Ministry of the Government of India, however, wanted direct control and direction of IDBI. Accordingly, IDBI was delinked from the Reserve Bank of India and was taken over by the Finance Ministry in 1976.

Functions of IDBI

The main function of IDBI, as its name suggests was to finance industrial enterprises such as manufacturing, mining, processing, shipping, and other transport industries and hotel industry. IDBI granted direct assistance by way of project loans, underwriting of and direct subscription to industrial securities, soft loans, technical refund loans and equipment finance loans. The Bank guaranted loans raised by industrial concerns in the open market from scheduled banks, the State cooperative banks, I.F.C.I. and other "notified" financial institutions. It could assist industrial concerns in an indirect manner also, that is, through other institutions. It could refinance term loans to industrial concerns given by the IFCI, the State Financial Corporations, scheduled banks or State co-operative banks.

The Industrial Development Bank of India Act, 1964, had provided for the creation of a special fund known as the Development Assistance Fund. This Fund was used to assist those industrial concerns which were not able to secure finances in the normal course because of low rate of return.

IDBI became the most important institution assisting industrial units till 2000-01.

IDBFs loan sanctions had increased from ₹ 1,280 crores in 1980-81 to ₹ 26,830 crores in 2000-01; and during the same period disbursements had increased from ₹ 1,010 crores to ₹ 17,480 crores —also reflecting the rapid industrial and business growth of the country on the one side and the corresponding increase in the mobilisation of resources by the development financial institutions on the other. In this, IDBI had a leading role as it was the apex financial institution of the country.

Notes

Table 2: Financial Assistance by IDBI

(₹ crores)

	1980-81	1990-91	2000-01	2004-05
Loans sanctioned	1,280	6,250	26,830	5,470
Disbursements	1,010	4,460	17,480	4.820

As in the case of other public sector term lending institutions, IDBI registered steep decline in loans satictioned and disbursed since 2000-01. For instance, the financial assistance sanctioned by IDBI declined from ₹ 26,830 crores in 2000-01 to ₹ 5,470 crores in 2004-05. Disbursements by IDBI declined from ₹ 17,480 crores to ₹ 4,820 crores between 2001 and 2005. This was mainly due to heavy accumulation of NPAs and paucity of funds.

IDBI, like other public development financial institutions, managed by the Finance Ministry of the Union Government, collapsed and was merged with IDBI Bank in October 2004. With that, the chapter on development banks was closed for ever.

Small Industries Development Bank of India (SIDBI)

The Small Industries Development Bank of India (SIDBI) was set up by the Government of India under a special Act of the Parliament in April 1990 as a wholly-Brned subsidiary of IDBI. SIDBI took over the outstanding portfolio of IDBI relating to the small scale sector worth over ₹ 4,000 crores.

SIDBI is now the principal financial institution for promotion, financing and development of small scale industries in the country. It coordinates the functions of existing institutions engaged in similar activities. Accordingly, SIDBI has taken over the responsibility of administering Small Industries Development Fund and National Equity Fund which were earlier administered by IDBI.

While extending financial assistance to the small units scattered all over the country, SIDBI makes use of the existing banking and financial institutions, such as the commercial banks, cooperative banks and RRBs, SFCs, and SIDCs which have a vast net work of branches 111 over the country. As many as 870 institutions are eligible for assistance from SIDBI.

The important functions of SIDBI are as follows :

(i) SIDBI refinances loans and advances extended By the primary lending institutions to small scale industrial units, and also provides resources support to them;

(ii) SIDBI discounts and rediscounts bills arising from sale of machinery to or manufactured by industrial units in the small scale sector;

(iii) SIDBI extends seeds capital/soft loan assistance under National Equity Fund, Mahila Udyam Nidhi and Mahila Vikas Nidhi and seed capital schemes through specified lending agencies;

(iv) SIDBI grants direct assistance as well as refinance loans extended by primary lending institutions for financing export of products manufactured by Industrial concerns in the small scale sector;

(v) SIDBI provides services like leasing, factoring etc. to industrial concerns in the small scale sector;

(vi) SIDBI extends financial support to State Small Industries Development Corporations for providing scarce raw materials to and marketing the end-products of industrial units in the small scale sector; and

(vii) SIDBI provides financial support to National Small Industries Corporation for providing, leasing, hire-purchase and marketing support to industrial units in the small scale sector.

Industrial Investment Bank of India (IIBI)

At one time, several industrial units, particularly in the Eastern Region, were in severe difficulties and were on the verge of closing down. Lack of adequate demand, managerial imprudence, labour troubles, shortage of raw materials and import restrictions were some of the reasons responsible for this state of affairs. In view of their importance to the national economy and the needs of employment of a large work force, these units had to be assisted financially. The Government of India set up the

Industrial Reconstruction Corporation of India (IRCI) in April 1971 under the Indian Companies Act mainly to look after special problems of 'sick' units and provide assistance for their speedy reconstruction and rehabilitation, if necessary, by undertaking the management of the units and developing infrastructure facilities like those of transport, marketing etc.

Since its inception in 1971 till the end of March 1984, IRCI had sanctioned reconstruction assistance of ₹ 266 crores to 242 sick or closed industrial units and had disbursed ₹ 185 crores. Textiles, engineering, mining and foundry industries were assisted by IRCI which had paid special attention to the units located in the classified backward areas as also to those in the small scale sector. The Corporation had also charged concessional rate of interest.

In 1984 the Finance Ministry of the Government of India renamed the Industrial Reconstruction Corporation of India (IRCI) as Industrial Reconstruction Bank of India (IRBI) and made it as the principal all-India credit and reconstruction agency for industrial revival, rehabilitation and promotion of sick units. In 1995, the Finance Ministry again renamed IRBI as Industrial Investment Bank of India (IIBI). Despite all these changes in names, the financial assistance rendered by this institution was meagre and could be rendered by other development financial institutions : IIBI is currently being wound up.

Investment Institutions : The Unit Trust of India

The Unit-Trust of India was formally established in February 1964. The initial capital of the Trust was ₹ 5 crores which was subscribed fully by the Reserve Bank of India, the Life Insurance Corporation, the State Bank of India and the scheduled banks and other financial institutions. The general superintendence, direction and management of the affairs and business of the Trust is vested in a Board of Trustees.

The primary objective of the Unit Trust was two-fold : (a) stimulate and pool the savings of the middle and low-income groups, and (b) to enable them to share the benefits and prosperity of the rapidly growing industrialisation in the country.

These two-fold objectives were to be achieved through a three-fold approach : (i) by selling Units of the Trust among as many investors as possible in different parts of the country; (ii) by investing the sale proceeds of the Units in industrial and corporate securities; and (iii) by paying dividends to those who have bought the units of the Trust.

The operations of the Trust picked up conspicuously almost from the very begining. The total number of unit holders registered with the Trust at one time exceeded 25 million with mobilised funds exceeding ₹ 73,000 crores (in June 2000).

The Trust had built up a portfolio of investments which was balanced between the fixed income-bearing securities and variable income-bearing securities—the main objective of the Trust was to maximise income consistent with safety of capital.

The Trust had invested in securities of about 300 sound concerns, which were on regular dividend paying basis. Barring investment in bonds of public corporations, the Trust funds were invested in financial, public utility and manufacturing enterprises.

Apart from subscribing to the shares and debentures of companies, UTI sanctioned loans to the corporate sector.

The commencement of sales of units by the Unit Trust from July 1964 was acclaimed as a landmark in the development of India's capital market. In principle, the aim of the Unit Trust was praiseworthy since it sought to mobilise the community' s savings for investment in trade and industry. The Trust, being a public sector enterprise, created confidence among the general public. Besides, it received a number of tax concessions from the Government. Not only the capital was safe but it was highly liquid in the sense that any Unit holder could return his/her Units and get back cash from the Trust.

The operation of the Unit Trust during the first three decades showed that the returns for unit holders were reasonable. On an average UTI paid annual dividend at 20 per cent. The response of investors especially of the small and medium income groups, to the Unit scheme was very encouraging and it seemed that the Unit Trust had met the genuine needs of a large number of investors by providing a

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form of investment which was safe, which brought in steady income and which was liquid enough. "Two crore investors come to UTI with safety and income expectations", stated the last CMD of UTI.

The whole edifice of UTI, however, crumbled in September-October 1998 when the prestigious Unit Scheme 1964 called US 64 came under serious trouble because of a serious depression in the Indian Stock market.

UTI finally collapsed during 2001-02. An institution built on the confidence and faith of crores of savers from lower and middle income groups was been callously ruined by scheming and petty politicians colluding with incompetent and corrupt bureaucrats on the one side and unscrupulous business houses and stock exchange brokers on the other. There were many reasons for the failure and collapse of UTI.

(a) UTI was forced—top officials of UTI and of the finance ministry were heavily bribed - to invest in the shares of scheming business houses and fly-by-night operators. These shares lost their value or, some cases, they became worthless pieces of paper. UTI was made to lose thousands of crores of rupees in this way.

(b) The management of UTI was again bribed heavily by leading business houses to extend loans to them or to their subsidiaries; these loans were not repaid and became NPAs.

(c) While the basic purpose of UTI was to mobilise the savings of the poor and the middle classes, the Finance Ministry used these funds it as an instrument to support and influence the stock exchange. The UTI funds were extensively borrowed by unscrupulous stock brokers—Ketan Parekh was one-to manipulate the stock exchange, often against the interests of UTI itself.

(d) Finally, the former Finance Minister, Mr. Yashwant Sinha and the Finance Ministry officials, killed public confidence in UTI through their wrong and misleading statements about the ownership and management of UTI. They allowed large corporate members to withdraw their investments in US-64 units at high prices, when they had the secret information that UTI was about to collapse.

 The complete failure of UTI was yet another glaring example of the interference and mismanagement of financial institutions by ill-qualified and corrupt Finance Ministry officials of the Government of India.

LIC and GIC

Apart from the Unit Trust of India which mobilises the savings of the public to specifically invest in the industrial securities, there are two other, investment institutions in the country—the Life Insurance Corporation of India (LIC) and the General Insurance Corporation of India (GIC). These two institutions specially LIC collect large amounts of funds from the general public to provide insurance cover but they use part of their funds to give long term loans to the corporate sector or to acquire industrial securities (shares and debentures) from the market. Because of the large funds they are able to mobilise, these two institutions have become powerful operators in the stock exchange.

During 2006-07, LIC had disbursed term finance and other financial assistance amounting to ₹ 27,000 crores to the corporate sector.

DFIs and the Corporate Sector

It is useful to remember that the public sector financial institutions, specially IDBI, ICICI and IFCI sanctioned direct financial assistance to newly established companies to meet their block capital requirements. In the case of existing companies, direct financial assistance was made available on account of expansion of existing capacities, modernisation plans, etc.

Apart from the fact that there was considerable increase in the volume of loans sanctioned and the amount disbursed by the term-lending institutions, till 2000-01 there was a noticeable rising scale of financial assistance rendered by them to the small-scale industries, to projects in backward districts and to new/small entrepreneurs. For example, in case of projects located in backward districts, sanctions and disbursements by term-lending institutions had increased substantially in recent years.

The DFIs were set up and developed to meet specifically the requirements of industry for term finance and equity capital and foreign currency resources. They were expected to overcome the inadequately

developed state of the capital market and the traditional preference of the banking sector in India to meet only the working capital requirements of industry and trade. In the last four decades, the DFIs had largely succeeded in meeting their primary objective of providing funds for industrial investment. They had also tried to channel increasing flow of assistance to industrially less-developed and backward areas. Besides, they had attempted a wide range of promotional activities including :

(a) a major thrust towards entrepreneurship development programmes;

(b) identifying industrial promotion needs of deserving segments of the industrial sector and evolving measures for their growth; and

(c) providing avenues for commercialisation of indigenous resources.

Broadly, all-India development financial institutions looked after the needs of large industrial enterprises; and state level institutions (SFCs and SIDCs) were meeting the financial requirements of the small and medium sector enterprises in the respective areas of their jurisdiction.

DFIs accounted for a major share of corporate debt, with increasing reliance of the corporate sector on them, DFIs had representation in the boards of management and also had a say in internal management of companies.

DFIs had been increasing their share in the equity of the private corporate sector, through the use of the convertibility clause and through their underwriting commitments. Along with investment institutions (LIC, GIC and UTI) their equity holdings in most major companies were considerable. They could and often did influence mergers and acquisitions.

6.3 Non-Banking Finance Companies (NBFCs)

In recent years, non-banking finance companies variously called as “finance corporations”, “Loan Companies”. “Finance Companies”, etc., have mushroomed all over the country. These finance companies, with very little capital of their own — often less than ₹ 1 lakh — have been raising deposits from the public by offering attractive rates of interest and other incentives. They advance loans to wholesale and retail traders, small-scale industries and self-employed persons. Bulk of their loans are given to parties which do not either approach commercial banks or which are denied credit facilities by the latter. The finance companies give loans which are generally unsecured and the rate of interest charged by them may range anywhere between 24 to 36 per cent per annum. Besides giving loans and advances to the small sector, NBFCs, in coporated under the companies Act 1956, run chit funds, purchase and discount hundis, and have also taken up merchant banking, mutual funds, hire-purchase, leasing, etc.

Historically, after Independence, all-India financial institutions like IFCI, ICICI, IDBI and others played, a very important role in providing medium and long term credit to various sectors of the economy. By the beginning of the 21st century, these financial institutions - called variously as public sector term lending financial institutions, development financial institutions, etc. - declined in importance and some of them disappeared (ICICI and IDBI) and some were wound up (IDBI). Some specialized lending and refinance institutions like Import Export Bank of India, National Housing Bank (NHB), NABARD, SIDBI and Tourism Finance Corporation of India have continued to grow in importance by generally providing refinance to banks and other financial companies. LIC is also a financial institution which deploys its assets largely in marketable securities. State Finance Corporations (SFCs) and State Industrial Development Corporation (SIDCs) and North Eastern Development Finance Corporation Ltd. (NEDFI) are notified public sector financial corporations. All these non-banking financial institutions are mostly government-owned and they have been providers of long-term project loans.

Other non-banking institutions include wide variety of intermediaries such as insurance companies, non-banking financial companies, primary dealers, capital market intermediaries such as mutual funds.

RBI itself accepts the attractiveness of NBFCs : “Simplified sanction procedures, orientation towards customers, attractive rates of return on deposits and flexibility and timelines in meeting the credit

needs of specified sectors (like equipment leasing and hire purchase) are some of the factors enhancing the attractiveness of this sector."

Essentially, these finance companies are banks, since they perform the basic twin functions of attracting deposits from the public and making loans. RBI again argues : "... The rapid growth of NBFCs especially in the nineties, has led to a gradual blurring of dividing lines between banks and NBFCs, with the exception of the exclusive privilege that commercial banks exercise in the issuance of cheques."

Since NBFCs are not regarded as banking companies, they did not come under the control of RBI, there is no minimum liquidity ratio or cash ratio, no specific ratio between their owned funds and deposits. That the depositors of these companies are subject to extreme insecurity is clear from the fact that :

(a) bulk of their loans are unsecured and are given to very risky enterprises and hence their charging high rates of interest;

(b) the loans, though given for short periods, can be and are renewed frequently and thus become long-term loans;

(c) as there is no exchange of communication between different companies, it is possible for a person or party to borrow from more than one finance company; and

(d) the deposits of the public with the finance companies are not protected by the Deposit Insurance Corporation.

Chart 2 shows how RBI has classified the non-banking sector in the country under three categories, viz. : non-banking financial companies (NBFCs), mutual benefit financial companies (MBFCs) and miscellaneous non-banking companies (MNBCs). Properly speaking, only the first really qualifies to be called NBFCs— namely, those receiving deposits from the public under any scheme and lending in any manner. MBFCs and MNBCs are now regulated by the Department of Company Affairs, Government of India and are not considered as NBFC.

Chart 2 : Types of Non-banking Financial Institutions

(Regulated by RBI)

Institution	Principal Business
I Non-banking Financial Company (NBFC) :	The principal business is receving deposits from the public under any scheme and lending in any manner.
	Equipment leasing or financing of such activity.
(a) Equipment Leasing Company*	Hire purchase transactions or financing of such transactions.
(b) Hire Purchase Finance Company*	Buying and selling of securities. These include
(c) Investment Company	Primary Dealers (PD who deal in underwriting and market making for government securities.
(d) Loan Company	Making loans or advances for an activity other than its own.
(e) Residuary Non-banking Company (RNBC)	Receives deposits from the public under any scheme but it does not belong to any of the categories mentioend above (under NBFC).
II. Mutual Benefit Financial Company (MBFC) :	Any company which is notified by the Central Government as a *Nidhi* company under Section 620A of the Companies Act, 1956.
III. Miscellaneous Non-banking Company (MNBC) :	Manages conducts and supervises *chit funds*. * Under a new classification adopted by RBI in 2006, these are called as "Asset Finance Companies (AFCs)

In a sense, NBFC **resembles** a banking company since it receives deposits from the public and lends the same to ready parties. It is not, however, a **bank** because it is not incorporated as a bank and is not governed by the provisions of the Banking Regulation Act, 1949—hence it is called a **non-banking financial company**.

The RBI has mentioned 5 kinds of NBFCs (see chart - 2). Of these, there are four clearly defined categories of NBFCs, viz. (a) Leasing Finance Companies, (b) Hire-Purchase Finance Companies, (c) Loan Finance Companies and (d) Investment Finance Companies. The RBI mentions one more NBFC - the fifth category which cannot be classified under any of the first four categories. Hence the RBI has called them Residuary Non-Banking Companies (RNBCs). According to the RBI, there are only four such companies registered under section 451 A of the RBI Act, 1934 (amended in 1997).

Legislative Control of NBFCs

NBFCs do not have any specific legislation governing them. Instead, they come under three different authorities :

(a) Being limited liability companies, NBFCs are governed by the Companies Act, 1956 which does not even contain the definition of a finance company. Application of general provisions of this Act, perforce, has invited avoidable violations by NBFCs.

(b) In the matter of deposits, NBFCs are governed by Non-banking Financial Companies (Reserve Bank) Directions, 1997.

(c) NBFCs which engaged in merchant banking and portfolio management services are governed by SEBI.

NBFCs have thus been working under a complex web of directives and guidelines formulated from time to time. Inevitably, some of the directives are viewed by NBFCs as being formulated in arbitrary manner, and at odds with practical realities. They have demanded separate legislation to guide and control them.

In May 1992, RBI constituted a working group under the chairmanship of Dr. A.C. Shah to conduct a comprehensive study of finance companies and recommend measures to facilitate their healthy growth. In its report submitted in September 1992, the Shah Working Group recommended specific regulations for companies with net owned funds of ₹ 50 lakhs and above and prescribe entry norms for new financial companies. It also prescribed capital adequacy standards, prudential norms for income recognition and provisions forbad and doubtful debts. RBI accepted the group's recommendations and started implementing them in phases.

In the mean time, instead of accepting their industry's demand for a separate and comprehensive law for NBFCs, the Government of India enacted the Reserve Bank of India (Amendment) Act, 1997 which confers wide ranging powers on RBI for controlling the functioning of non-banking financial companies.

Salient Features of RBI Amendment Act, 1997

The Act defines a non-banking financial company (NBFC) as a financial institution or as non-banking institution which has, as its principal business, the receiving of deposits under any scheme or arrangement and lending in any manner. Institutions carrying on agricultural or industrial activity as their principal business are excluded from the definition of NBFC.

RBI has taken a series of measures to enhance the regulatory and supervisory standards of the NBFCs and to bring them at par with commercial banks over a period of time. These include :

1. Secure a certificate of registration from RBI, the net owned funds (NoF) should be ₹ 2 crores (initially only ₹ 25 lakhs).
2. There is a quantum of public deposits which can be received by an NBFC, depending upon whether it is a loan and investment company or whether it is a leasing and hire-purchase company, and so on—fixed between 1.5 times to 4 times NoF.
3. NBFCs have to invest at least 5 per cent of their assets in unencumbered approved securities.
4. Every NBFC has to create a reserve fund and transfer at least 20 per cent of its net profit every year to the reserve fund.

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5. Prudential norms are fixed for those NBFCs which are raising public deposits. For instance, such NBFCs should maintain Capital to Risks Asset Ratio (CRAR) comprising TIER I and II Capital :

   12% for leasing, hire-purchase finance companies.

   15% for loan and investment companies, and

   12% for RNBCs.

   Certain norms were prescribed for all NBFCs whether they hold or receive public deposits or not.

6. Under RBI regulations, RNBCs are required to invest not less than 80 per cent of aggregate liabilities with the depositors in Government securities, Government-guaranteed bonds, debentures, etc. RBI has reviewed these regulations.

7. All registered NBFCs should submit half yearly returns to RBI at the end of March and September every year. As non-submission of periodic returns to RBI was a common feature, RBI has now decided to impose penalties besides cancellation of certificates of registration and permission to receive deposits from the public.

The RBI is now entrusted with the following powers :

(a) specify from time to time a minimum percentage of investment for NBFCs in unencumbered "approved" securities;

(b) determine their policies and give directions to any or all NBFCs on capital adequacy, provisioning and other prudential norms, as also on the deployment of funds (similar to those applicable to banks);

(c) direct them on balance sheet, profit and loss accounts and disclosure of liabilities,

(d) levy fines and penalty on a NBFC for contravention and default, as also cancel its registration,

(e) prohibit an NBFC from accepting deposits and alienate its assets; and

(f) file a winding up petition for continued violation of the provisions of the Act and / or failure to comply with any direction or orders of the RBI.

Mutual Funds

In recent years, mutual funds are the most important among the newer capital market institutions. Several public sector banks and financial institutions have set up mutual funds on a tax-exempt basis, virtually on the same footing as Unit Trust of India (UTI). Their main function is to mobilise the saving of the general public and invest them in stock market securities. Accordingly, they attracted strong investor support and showed significant progress. There was even diversion of savings of the middle classes from banks to mutual funds. The Government threw the field open to the private sector and joint sector mutual funds.

Regulation of Mutual Funds by SEBI

SEBI has the authority to lay guidelines and supervise and regulate the working of mutual funds. The guidelines, issued by SEBI relate to advertisements and disclosures and reporting requirements. The investors have to be informed about the status of their investments in equity, debentures and government securities. SEBI has introduced a uniform set of regulations governing the mutual funds in the country, known as SEBI (Mutual Fund) Regulations, 1993, under which :

(a) mutual funds have to be formed as trusts and managed by a separate asset management company (AMC) and supervised by a board of trustees;

(b) the AMC must have a minimum net worth of ₹ 6 crores, of which the sponsors must contribute at least 40 per cent;

(c) SEBI should approve the offer documents of schemes of mutual funds;

(d) SEBI prescribes the minimum amounts to be raised by each scheme — a close-ended scheme should raise a minimum of ₹ 20 crores and open-ended scheme should raise a minimum of ₹ 50

crores. In case, the amount collected falls short by the prescribed minimum, the subscription amount must be refunded within a period of six weeks;

(e) the advertisement code prescribes norms for fair and truthful disclosure by the mutual funds in advertisements and publicity materials.

Growth of Mutual Funds

In the 1990s, MFs found it hard to attract investors. The competition for funds was hotting up from banks and the Government. With the Government offering interest rates of nearly 14 per cent for medium term securities — the Government of India proposed to offer 10-year paper on tap with a coupon rate of 14% — and banks pegging short term rates at 12 per cent, investors were focusing on debt instruments which were gaining popularity over equity. HDFC, leading housing finance company was offering 14% interest on fixed deposits; IDBI had decided on a 15.75% for a twin-bond issue.

Under these conditions, it was difficult for mutual funds to rival such high yields on debt instruments. They also found it hard to meet the high expectations of investors who were yet to break out of the get-rich-quick syndrome. Accordingly, the first wave of mutend funds failed.

The performance of mutual funds was not encouraging for many years. Investor confidence in mutual funds was low. This could be attributed partly to lack of confidence and partly to stock market conditions which had affected the perception of investors.

The revival of the MF market since 1995-96 was due to the entry of corporate majors—the Tatas, Birlas, Reliance and SBI. Many others followed with products designed for investor specific needs. They also offered improved liquidity, easy exit routes and regular income flows. All these changes coincided with the revival of the stock market. Sensex, for instance, crossed 6,000 mark in February 2000. Investors left the banking system and flocked to the mutual funds. This period of booming stock exchanges and mutual funds was, however, short lived.

After Ketan Parekh incident, the stock market crashed with sensex touching 2,600 (with 1974-75 = 100) during 2001 -02. This led to a two-year period of recession in the MF market. In the mean time, the Unit Trust of India (UTI), the public sector mutual fund went through a crisis and had to be restructured. As a result, the share of the private sector MF companies increased considerably.

The overall assets under management (AUM) declined from 1,02,830 crores to ₹ 89,240 crores between April 2002 and 2003. but later rose rapidly to ₹ 3,26,290 crores by March, 2007. The Mutual Fund companies are now mobilising about ₹ 90,000 crores annually.

6.4 Stock Exchange in India

In a modern capitalist economy, almost all commodities, even the smallest, are produced on a large scale; and large-scale production implies large amounts of capital. The joint stock company or the corporate form of organisation is ideally suited to secure large amounts of capital from all those who have surplus funds and who are willing to take risks in investing in companies. It issues stocks and bonds and enables those with surplus funds to invest them profitably in either of them, according to their convenience and temperament. An investor who puts his savings in a company by buying its securities cannot get the amount back from the company directly. The only way the capital invested in stocks and shares of a joint stock company may be realised by its owner is through the sale of those stocks and shares to others. **The stock market or exchange is a place where stocks and shares and other long-term commitments or investments are bought and sold.** For the existence of the capitalist system of economy and for the smooth functioning of the corporate form of organisation, the stock exchange is, therefore, an essential institution.

History of Stock Exchanges in India

The first organised stock exchange in India was started in Bombay when the Native Share Stock Brokers' Association known as the Bombay Stock Exchange (BSE) was formed by the brokers in Bombay. BSE was Asia's oldest stock exchange. In 1894, the Ahmedabad Stock Exchange was started to facilitate dealings in the shares of textile mills there. The Calcutta Stock Exchange was started in

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1908 to provide a market for shares of plantations and jute mills. The Second World War saw great speculative activity in the country and the number of stock exchanges rose from 7 in 1939 to 21 in 1945. Besides these organised exchanges, there were a number of unorganised and unrecognised exchanges known as kerb markets which functioned under a set of usages and conventions and did not have any set of rules which could be enforced in courts of law. There were also illegal "Dabba' markets in which stocks and shares were also bought and sold.

Under the Securities Contract (Regulation) Act of 1956, the Government of India has so far recognised 23 stock exchanges. Bombay is the premier exchange in the country. With the setting up of National Stock Exchange, all regional stock exchanges have lost relevance.

How Business is Transacted in a Stock Exchange

A typical investment transaction will consist of four stages :

(a) **Placing an order with a broker :** A client places his order with a stock broker who alone is entitled to transact business in a stock exchange either to buy or to sell the shares of a company at fixed prices or at best market prices.

(b) **Execution of the order :** The broker or his authorised clerk will execute the order and the same will appear in the Stock Exchange Daily Official List which Will include the number and price of shares which exchanged hands.

(c) **Reporting the deal to the client :** As soon as the deal is transacted, the broker sends a contract note to the client giving details of the security bought or sold, the price, the broker's commission, etc.

(d) **Settlement of transactions :** There are two methods of settlement of transactions . In the case of ready delivery (or cash) transactions, payment has to be made immediately on the transfer of the securities or within a period of one to seven days. In the case of forward delivery contracts, the settlement is made on a fixed day--it is generally fortnightly, though in some stock exchanges like Chennai, it is weekly. In the case of forward delivery, there is a system of carry-over i.e. post-ponement of delivery or payment involving a payment by one to another). This system of carry-over provides great scope for speculation in the forward market.

Speculation and Stock Exchange

A high degree of speculation is associated with stock exchanges in India. There are two types of transactions in a stock exchange, viz., investment transactions and speculative transactions. Investment transactions refer to purchase or sale of securities undertaken with the long-term prospect relating to their yield and price. An investment transaction normally involves the actual delivery of the security and the payment of its full price. Actually, no stock exchange can-operate purely on the basis of investment buying and selling alone, **since pure investors cannot provide the requisite volume of business or continuity of business** which alone will ensure correct valuation of the shares according to their real worth. Investment transactions are, therefore, supplemented by speculative transactions.

In a speculative transaction--buying or selling--the delivery of securities or the payment of full price are rare; instead, only the differences in prices are paid or received. The predominance of speculative transactions over investment transactions in a stock exchange is due to the fact that the latter involve a larger volume of money (as securities bought have to be paid in full) while speculative transactions are possible with smaller amounts of money (as delivery of securities and payment of full price are rare).

Speculative transactions too are of different types depending upon whether a transaction is settled in spot, ready and forward markets. A spot transaction implies that delivery of and payment for securities will take place on the same day. A ready delivery transaction (also known as cash transaction) is one which is completed in a short period of time, i.e. the delivery of and payment for securities will be completed within a specified period of one to seven days. A forward transaction implies that the delivery of and payment for securities will be made on certain fixed settlement days, coming once in 15 or 30 days. Of these three different types of transactions in the stock exchange, the forward transactions provide the greatest scope for speculation.

Firstly, the settlement of transactions in the forward market involves a long period of time, and therefore, there is an incentive to the speculator to keep his commitments open as long as possible. This often leads to over-speculation and over-trading in stock exchange in India.

Secondly, the dealers in the cash market have only two alternatives before them, viz., (a) to square up their transactions by offering their purchase by sale and their sale by purchase before the expiry of the time limit, or (b) to deliver the securities and accept full payment (for sale) or to take delivery of the securities and make full payment (for purchase).

The dealers in the forward market have, besides the above two alternatives, a third alternative, that is, the postponement of delivery and payment to the next settlement day by mutual consent of the two parties to the contract. **This system of carry** over, i.e., postponement of delivery and payment usually involves the payment of a consideration by one party to the other. If the buyers (bulls) want postponement—for they have undertaken to buy but do not wish to buy—for they pay a consideration to the sellers, known as contango or the **budla**. If the sellers (the bears) desire the postponement (they have undertaken to sell but do not wish to sell) they pay a consideration to the buyers for agreeing to accommodate them until the next settlement known as backwardation or **undha budla** in Indian stock exchanges.

6.5 SEBI and Capital Market Reforms

The functioning of the stock exchanges in India has shown many weaknesses, with long delays, lack of transparency in procedures and vulnerability to price rigging and insider trading. To counter these shortcomings and deficiencies and to regulate the capital market, the Government of India set up the Securities Exchange Board of India in 1988. Initially, SEBI was set up as a non-statutory body but in January 1992 it was made a statutory body. SEBI was authorised to regulate all merchant banks on issue activity, lay guidelines and supervise and regulate the working of mutual funds and oversee the working of stock exchanges in India. SEBI, in consultation with the Government, has taken a number of steps to introduce improved practices and greater transparency in the capital markets in the interest of the investing public and the healthy development of the capital markets:

The Capital Issues (Control) Act, 1947 governed capital issues in India so as ensure sound capital structure for corporate enterprises, to promote rational and healthy expansion of the joint stock companies in India and to protect the interests of the investing public from the fraudulent practices of fast operators. The capital issues control was administered by the Controller of Capital Issues (CCI) according to the principles and policies laid down by the Central Government. The Narasimham Committee on the Reform of the Financial System in India (1991) recommended the abolition of CCI and wanted SEBI to protect the investors and take over the regulatory function of CCI. The Government of India accepted this recommendation, repealed the Capital Issues (Control) Act, 1947 and abolished the post of CCI. Companies were allowed to approach the capital markets without prior government permission subject to getting their offer documents cleared by SEBI. In other words, SEBI was given the power to control and regulate the new issue market as well as the old issues market (commonly known the stock exchange).

Primary Market Reforms in India

SEBI has introduced various guidelines and regulatory measures for capital issues. Companies issuing capital in the primary market are now required to disclose all material facts and specific risk factors with their projects; they should also give information regarding the basis of calculation of premium leaving the companies free to fix the premium. SEBI has also introduced a code of advertisement for public issues for ensuring fair and truthful disclosures.

In order to encourage Initial Public Offers (IPO) SEBI has permitted companies to determine the par value of shares issued by them (i.e. SEBI has now dispensed with fixed par values of ₹ 10 and ₹ 100). SEBI has allowed issues of IPOs to go for "book building" - i.e. reserve and allot shares to individual investors. But the issuer will have to disclose the price, the issue size and the number of securities to be offered to the public.

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In recent years, **private placement market** has become popular with issuers because of stringent entry and disclosure norms for public issues. Low cost of issuance, ease of structuring investments and saving of time lag in issuance has led to the rapid growth of private placement market. Total resource mobilisation through private placement market had increased sharply from ₹ 13,360 crores during 1995-96 to nearly ₹ 50,000 crores during 1998-99.

To reduce the cost of issue, SEBI has made underwriting of issue optional, subject to the condition that if an issue was not underwritten and was not able to collect 90% of the amount offered to the public, the entire amount collected would be refunded to the investors. The lead managers have to issue due diligence certificate which has now been made part of the offer document.

SEBI has raised the minimum application size and also the proportion of each issue allowed for firm allotment to institutions such as mutual funds. SEBI has also introduced regulations governing substantial acquisition of shares and take-overs and lays down the conditions under which disclosures and mandatory public offers have to be made to the shareholders.

Merchant banking has been statutorily brought under the regulatory framework of SEBI. The merchant bankers are now to be authorised by SEBI. They have to adopt the stipulated capital adequacy norms, abide by a code of conduct which specifies a high degree of responsibility towards investors in respect of pricing and premium fixation of issues and disclosures in the prospectus or offer letters for issues. Merchant bankers have now a greater degree of accountability in the offer document and issue process.

In order to induce companies to exercise greater care and diligence for timely action in matters relating to the public issues of capital, SEBI has advised stock exchanges to collect from companies making public issues, a deposit of one per cent of the issue amount which could be forfeited in case of non-compliance of the provisions of the listing agreement and, non-despatch of refund orders and share certificates by registered post within the prescribed time.

SEBI has advised stock exchanges to amend the listing agreement to ensure that a listed company furnishes annual statement to the stock exchanges showing the variations between financial projections and projected utilisation of funds in the offer documents and the actual utilisation. This would enable the share-holders to make comparisons between promises and performance.

The Government has now permitted the setting up of private mutual funds and a few have already been set up. UTI has now been brought under the regulatory jurisdiction of SEBI. All mutual funds are allowed to apply for firm allotments in public issues. To improve the scope of investments by mutual funds, the latter are permitted to underwrite public issues. Further, SEBI has relaxed the guidelines for investment in money market instruments. Finally, SEBI has issued fresh guidelines for advertising by mutual funds.

SEBI vets offer documents to ensure that all disclosures have been made by the company in the offer document. All the guidelines and regulatory measures of capital issues are meant to promote healthy and efficient functioning of the issue market (or the primary market). Despite all these steps, there are flagrant breaches of issue procedures through collusion between unscrupulous promoters and corrupt officials in the lead banks and even of the top officials of SEBI, as was the case of the now famous or infamous M.S. Shoes East Ltd. whose megaissue was literally aborted by SEBI in February-March 1995, soon after the issue was made public and subscribed.

Global Depository Receipts (GDRs) : Since 1992, the Government of India allowed Indian companies to access international capital markets through dollar and Euro equity shares. Up to January 1995, Indian companies had raised US $3.6 billion through launching GDR issues, and US $1.1 billion through launching Euro Convertible Bonds (ECBs). Initially, the Euro-issue proceeds were to be utilised for approved end uses within a period of one year from the date of issue. Since there was continued accumulation of foreign exchange reserves with RBI and there were long gestation periods of new investment, the Government required the issuing companies to retain the Euro-issue proceeds abroad and repatriate only as and when expenditure for the approved end uses were incurred.

The Government of India has also liberalised investment norms for NRIs so that NRIs and Overseas corporate bodies can buy shares and debentures without prior permission of RBI subject to an upper limit of 10 per cent by any one FII in an Indian entity.

Secondary Market Reforms in India

SEBI has started the process of registration of intermediaries, such as the stock brokers and sub-brokers under the provisions of the Securities and Stock Exchange Board Act, 1992. The registration is on the basis of certain eligibility norms such as capital adequacy, infrastructure, etc. There has been much opposition and resistance to this step of SEBI. SEBI has also made rules for making client/broker relationships more transparent, in particular, segregating client and broker accounts.

SEBI has notified regulations on insider trading under the provisions of SEBI Act. Such regulations are meant to protect and preserve the integrity of stock markets and, in the long run, help inspire investor confidence in the stock exchange. Despite these regulations, **insider trading is rampant** in our stock exchanges, and, rigging the market and manipulating stock market price quotations are quite common. M.S. Shoes East Ltd. fiasco was an example of market rigging; SEBI could do nothing about it.

Since 1992, SEBI has constantly reviewed the traditional trading systems in Indian Stock Exchanges. It is simplifying procedures and achieving transparency in costs and prices at which customers' orders are executed, speeding up clearing and settlement, and, finally transfer of shares in the names of buyers.

To make the governing bodies of stock exchanges broad based, the governing body of stock exchanges should have 5 elected members, not more than 4 members nominated by the Government or SEBI and 3 or fewer members nominated as public representatives.

The Government has allowed foreign institutional investors (FIIs) such as pension funds, mutual funds, investment trusts, asset or portfolio management companies etc. to invest in the Indian capital market provided they are registered with SEBI. Till January 1995, as many as 286 FIIs have been registered with SEBI — they were only 10 in January 1993 and 136 in January 1994. The cumulative net investments of FIIs has increased from $200 million in January 1993 to $3 billion in January 1995, reflecting the economic liberalisation policy of the country and to some extent, the prevalence of low rates of interest abroad. The Government of India has now permitted joint venture stock broking companies to have non-Indian citizens on their Board of Directors.

To prevent excessive speculation and volatility in the stock market, SEBI has introduced rolling settlements from July 2,2001, under which settlement has to be made every day. This, however, has not succeeded extreme volatility in the stock market.

Insurance Reforms

The most notable event during 1999-2000 in the field of contractual savings has been the passing of the Insurance Regulation and Development Authority (IRDA) Act despite stiff opposition from trade unions and the Left parties. The IRDA Act ends the monopoly of the Government in the insurance sector because it seeks to promote the private sector (including limited foreign equity) in the insurance sector. It gives priority in the utilisation of policy holders funds for the development of social and infrastructure sectors. The Government has given licences to a number of private sector companies to do insurance business.

Strengthening of SEBI

In January 1995, the Government of India promulgated an ordinance to amend SEBI Act, 1992 so as to arm SEBI with additional powers for ensuring the orderly development of the capital market and to enhance its ability to protect the interests of the investors. The important features of this ordinance are:

1. To enable SEBI to respond speedily to market conditions and to reinforce its autonomy, SEBI has been empowered to file complaints in courts and to notify its regulations without prior approval of the Government.
2. SEBI is now provided with regulatory powers over companies in the issuance of capital, the transfer of securities and other related matters.
3. SEBI is now empowered to impose monetary penalties on capital market intermediaries and other participants for a listed range of violations. The amendment proposes to create adjudicating

mechanism within SEBI for leaving penalties and also constitute a separate tribunal to deal with cases of appeal against orders of the adjudicating authority.

Earlier the SEBI Act provided for the suspension and cancellation of registration and for the prosecution of intermediaries which led to the stoppage of business. The new system of monetary penalties constitutes an alternative mechanism for dealing with capital market violations.

4. While investigating irregularities in the capital market, SEBI is now given the power to summon the attendance of and call for documents from all categories of market intermediaries, including persons from the securities market. Likewise, SEBI has now the power to issue directions to all intermediaries and persons connected with securities markets with a view to protect investors or secure the orderly development of the securities market.

It was thought that SEBI has all necessary powers to control and regulate the securities market on the one side and effectively protect the interests of the shareholders on the other. However, SEBI **failed miserably** to prevent a small coterie of brokers in Mumbai to hammer the SENSEX in March 2001 and in May 2004. The stock markets in India went through one of the worst and most prolonged crises in their history.

Self-Assessment

1. Answer the following questions

   (*i*) What is the name of the organization that regulates the securities markets in India?

   (*ii*) Stock split increases a companys equity capital: TRUE or FALSE?

   (*iii*) Which of the following investments has the highest liquidity: shares, fixed deposit, closed-end mutual funds?

   (*iv*) What is the income called as that you receive from a company that it may distribute to its shareholders from its profits each year?

   (*v*) Stock market investments are ideal for what time horizon: long-term or short-term?

   (*vi*) What is the short form of BSE Sensitive Index?

   (*vii*) If an investor can invest Rs. 1.0 lac or less in an IPO, that investor is categorized as what?

6.6 Summary

- Capital market is the market for long-term funds, just as the money market is the market for short-term funds.
- The demand for long-term money capital comes predominantly from private sector manufacturing industries and agriculture and from the Government largely for the purpose of economic development.
- The Indian capital market is broadly divided into the gilt-edged market and the industrial securities market. The gilt-edged market refers to the market for government and semi-government securities, backed by the Reserve Bank of India.
- Since Independence and particularly after 1951, the Indian capital market has been broadening significantly and the volume of saving and investment has shown steady improvement.
- Soon after Independence, the Government of India set up a series of financial institutions to be of special help to the private sector industries in the matter of finance.
- The Industrial Development Bank of India was set up since 1947 to provide long-term finance to industry. IFCI, the SFCs, ICICI, and the Refinance Corporation of India were functioning for several years provided direct plans, subscribed to shares and bonds and to guarantee loans and deferred payments.
- The main function of IDBI, as its name suggests was to finance industrial enterprises such as manufacturing, mining, processing, shipping, and other transport industries and hotel industry.
- In recent years, non-banking finance companies variously called as “finance corporations”, “Loan Companies”. “Finance Companies”, etc., have mushroomed all over the country.

- In recent years, mutual funds are the most important among the newer capital market institutions. Several public sector banks and financial institutions have set up mutual funds on a tax-exempt basis, virtually on the same footing as Unit Trust of India (UTI).
- Venture capital financing is one of the more recent entrants into the capital market. There is significant scope for them in the context of emergence of technocrat entrepreneurs who have technical competence and expertise but lack venture capital. Financial institutions generally insist on greater promoter contribution to investment financing, in which case, the technorcrat entrepreneurs need the support of venture capital companies.

6.7 Key-Words

1. Urban infrastructure : Infrastructure is the basic physical and organizational structures needed for the operation of a society or enterprise, or the services.
2. Monopoly : The exclusive possession, control, or exercise of something: "men don't have a monopoly on unrequited love".

6.8 Review Questions

1. What do you mean by the term Indian Capital Market? Discuss.
2. Discuss the features of the Indian Money.
3. Explain the reform of the Indian Money Market.
4. Write a short note on the Monetary Policy of India.
5. What are the objectives of Monetary Policy?

Answers: Self-Assessment

1. (*i*) SEBI (Securities and Exchange Board of India)

(*ii*) False	(*iii*) Shares	(*iv*) Dividend
(*v*) Long-term	(*vi*) Sensex	(*vii*) Retail investor

6.9 Further Readings

Books

1. The Indian Economy; S.K. Ray; Prentic, Hall of India Private Limited New Delhi - 110001.
2. Indian Economy; Gaurav Datt and Aswani Mahajan; S. Chand and Company LTD. Ram Nagar, New Delhi-110055.

Notes

Unit 7: Sectoral Performance III - Foreign Trade and Balance of Payments

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Objective
Introduction
7.1 Foreign Trade
7.2 Balance of Payments
7.3 Summary
7.4 Key-Words
7.5 Review Questions
7.6 Further Readings

Objectives

After reading this Unit students will be able to:

- Explain the Foreign Trade.
- Describe about the Balance of Payments.

Introduction

In the age of globalisation, interdependence between the economies of the world has increased many times. Thus, the external sector in the Indian economy has gained prime importance. It may be noted that both exports and imports contribute to the production process. They can be used in raising the income levels of the people in a developing economy. In addition to flow of goods, increasing flow of services and capital between the nations give rise to payments and receipts in foreign exchange. This, in turn, has an impact on the Balance of Payment's position for a country. Foreign trade and Balance of Payments, trade policy and various policy measures for rapid growth of exports may help in the economic growth of the country.

7.1 Foreign Trade

It is generally agreed that the status of a country's economy depends in some measure upon the character of its commercial dealings with other countries. India cannot afford to remain insular in international trade and commerce. Imports and exports are vital for economic growth. In this context, international trade, balance of payments and international monetary system are important. We have discussed the first-two issues in this Section, and covered the third in Section 16.

Foreign/Before Independence

India has had from ancient times a flourishing world trade, particularly with the Mediterranean, the Far East and the Levant. Geographically, India was ideally located for this purpose 'in the centre of the world.' But internecine political uncertainties and serious maritime anarchies became two principal deterrents to this trade's further development during the Muslim period.

With the entrenchment of the British rule, the situation largely changed. Two catalytic factors were : (1) the opening of the British countryside by the proliferation of rail, road and inland shipping networks; and (2) the establishment of a shorter route to Great Britain and Europe via the Suez Canal. In consequence, India's foreign trade substantially expanded in the second half of the nineteenth century. Between 1860 and 1900 the value of India's foreign trade went up nearly three-fold. Between 1900 and 1940 there was a further doubling of the value of trade.

Table 1 : Expansion of India's Foreign Trade after 1869

(Rupees in crore)

Period	Exports (annual average)	Imports (annual average)
1864–65 to 1868–69	55.86	31.70
1894–95 to 1898–99	107.53	73.67
1924–25 to 1928–29	353.51	251.02

Source : Dhires Bhattacharya, *A Concise History of the Indian Economy 1750-1950* (1979), Prentice-Hall of India, New Delhi.

During the British regime, the international trade policy of India had a clear and perceptible orientation. This was to promote exports of raw materials from mining and agronomy to the mills and manufactories in Great Britain, and the import of their finished products like cotton textiles (nearly half of total exports) and engineering goods in to the vast Indian colony. To this end, the Government of both the UK and India continually *adjusted* all economic machineries like export and import tariffs, customs and excise duties and protection and liberalization.

Post Independence Thrusts

A profile of our international trade is indicated in Table 2

Table 2 : Foreign Trade : Balance of Trade

(₹ in crore)

Year	Exports	Imports	Total value of trade	Balance of trade
1950–1951	606	608	1,214	–2
1960–1961	642	1,122	1,764	–480
1970–1971	1,535	1,634	3,169	–9
1980–1981	6,711	12,549	19,260	–838
1990–1991	32,553	43,198	75,751	–10,645
1997–1998	1,30,100	1,54,176	2,84,276	–24,076
1998–1999	1,39,752	1,78,332	3,18,084	–38,580
1999–2000	1,59,561	2,15,236	3,74,797	–55,675
2000–2001	2,03,571	2,30,873	4,34,444	–27,302
2001–2002	2,09,018	2,45,200	4,54,218	–36,182
2002–2003	2,55,137	2,97,206	5,52,343	–42,067
2003–2004	2,93,367	3,59,108	6,52,475	–65,741

Source : *Economic Survey* 2004–05.

Table 2 shows interesting ups and downs in total value of trade. While it had shot up in 1990–91, we have not looked back—the figures rising from ₹ 75,751 crore in 1990–91 to ₹ 652,475 crore in 2003–04. While this looks okay on a graph, in actual fact the figure should have quadrupled by now if we had taken care of the contents of our export basket and if the growth of the GDP would have been around 10%.

It will be interesting to enumerate some of the broad features of the growth curve in our international trade:

Imports

This shows a galloping rise during the last four decades, as indicated in Table 22.3. The rise has not only been galloping from year to year and from decade to decade, there has also been wide and

perceptible changes in the components of imports—with a high percentage being accounted for by oil and technical hardware (in many cases with technical expertise). In recent years, the percentage of imports of technical expertise in the service sector is getting substantially counter-balanced by export of IT oriented expertise in the service sector and the expanding base of outsourcing.

Table 3 : Movement of Imports

Period	Total Imports % Growth	
	Over base year 1970–71 = 100	Over earlier year mentioned
1970-1971	100	3.8
1980-1981	768	22.6
1990-1991	2,644	13.2
1997-1998	9,435	19.9
1998-1999	10,914	15.7
1999-2000	13,172	20.7
2000-2001	14,129	7.3
2001-2002	15,006	6.2
2002-2003	18,189	21.2
2003-2004	21,977	20.8

Exports

The rise has been astronomical—from ₹ 1,535 crore in 1970–71 (base year) to ₹ 1,30,100 crore in 1997–98 and ₹ 2,93,367 crore in 2003-04. What is of greater importance is the relative rise in the export of technology, hardware, manufactured commodities and *knowledge*—spearheaded by IT. The portent of growth is also highly satisfactory. For instance, in the iron and steel sector, while we are still exporting considerable volume of iron ore and pellets to China, Japan and some other countries of South-East Asia and Europe, there are clear indications that during the next decade such export will be largely overtaken by steel and steel products. Such a manifest change in both import and export baskets during the forthcoming decades will be highly encouraging and growth-oriented, and will augur well for our international balance of payments (Table 4).

Table 4 : Movement of Exports

Period	Total exports % growth with 1970–71 = 100	Growth over the previous year mentioned (% p.a.)
1970-1971	100	9.1
1980-1981	437	15.9
1990-1991	2,121	17.1
1997-1998	8,476	21.9
1998-1999	9,104	7.4
1999-2000	10,395	14.2
2000-2001	13,262	27.6
2001-2002	13,617	2.7
2002-2003	16,621	22.1
2003-2004	19,112	15.0

Foreign Trade Policy, 2004–2009

For India to become a major player in world trade, a comprehensive view is necessary. While increase in exports is of vital importance, we have also to facilitate those imports which are required to stimulate our economy. Thus, independent of the annual EXIM Policy, it is necessary to take an overall view of India's foreign trade. This is the context of the new Foreign Trade Policy.

The objectives of the new policy are :

(1) To double our percentage share of global merchandise trade within the next five years.

(2) To act as an effective instrument of economic growth by giving a thrust to employment generation.

These objectives are proposed to be achieved by adopting, among others, the following strategies:

(i) Unshackling of controls and enabling the innate entrepreneurship of our businessmen, industrialists and traders.

(ii) Simplifying procedures and bringing down transaction costs.

(iii) Neutralizing incidence of all levies and duties on inputs used in export products, based on the fundamental principle that duties and levies should not be exported.

(iv) Facilitating development of India as a global hub for manufacturing, trading and services.

(v) Identifying and nurturing special focus areas which would generate employment opportunities, particularly in semi urban and rural areas, and developing a series of 'Initiatives' for each of these.

(vi) Facilitating technological and infrastructural up gradation of all the sectors of the Indian economy, especially through import of capital goods and equipment, thereby increasing value addition and productivity, while attaining internationally accepted standards of quality.

(vii) Avoiding inverted duty structures and ensuring that our domestic sectors are not disadvantaged in the Free Trade Agreements/Regional Trade Agreements/Preferential Trade Agreements that we enter into in order to enhance our exports.

(viii) Upgrading our infrastructural network, both physical and virtual, related to the entire Foreign Trade chain, to international standards.

(ix) Revitalizing the Board of Trade by redefining its role, giving it due recognition and inducting experts on Trade Policy.

(x) Activating our Embassies as key players in our export strategy and linking our Commercial Wings abroad through an electronic platform for real time trade intelligence and enquiry dissemination.

FTP, 2004–2009 envisions a pervasive set of strategies involving different sectors of the economy. Many of these are also integral to our policies of national economic development. It is to be hoped, therefore, that the new FTP will be seriously translated into actual strategic performance in order to optimise our international trade, and that too much to our own advantage.

7.2 Balance of Payments

We have had decades of atrophied balance of payments in our exchange accounts, interlaced with years or periods of revival. That is all a story now. However, our foreign exchange account has become strong, in the trail of the continuing phases of economic reforms.

There has been a current account surplus for three successive years. This has, coupled with an expanding capital account, further strengthened India's balance of payments account in 2003–04. The year witnessed accumulation of reserves of US $ 31.4 billion (excluding valuation changes, gold, SDRs and Reserve Tranche at the IMF).

Nearly a third of the reserves were contributed by the surplus in current account (Table 5). Rising surpluses in the current account have been one of the distinguishing features of India's balance of payments in the current decade.

Notes

There has been strong growth in merchandise exports. This has been a *propellant* behind many international trade account indices. Out of this we may mention the current account surpluses, buoyant invisible inflows, particularly private transfers comprising remittances. The strength provided by the surplus in the current account was reinforced by robust capital inflows in 2003–04.

As evident from Table 5, the current account surpluses during the current decade are largely attributable to the buoyant inflows of receipts. Apart from software services, growing volume of private transfers, driven essentially by workers remittances, have been one of the main reasons behind the expanding surpluses in the current account. Besides, in

Table 5 : Balance of Payments : Summary

(in US $ million)

	1990-91	1997-98	1998-99	1999-2000	2000-01	2001-02	2002-03	2003-04
1. Exports	18,477	35,680	34,298	37,542	45,452	44,703	53,774	64,723
2. Imports	27,915	51,187	47,544	55,383	57,912	56,277	64,464	80,177
3. Trade balance	**–9,43S**	**–15,507**	**–13,246**	**–17,841**	**–12,460**	**–11,574**	**–10,690**	**–15,454**
4. Invisibles (net)	–242	10,007	9,208	13,143	9,794	14,974	17,035	26,015
5. Current account balance	**–9,680**	**05,500**	**–4,038**	**–4,698**	**–2,666**	**3,400**	**6,345**	**10,561**
6. External assistance (net)	2,204	885	799	891	410	1,117	–3,128	–2,742
7. Commercial borrowing (net)	2,254	4,010	4,367	333	4,303	–1,585	–1,692	–1,526
8. IMF (net)	1,214	–618	–393	–260	–26	0	0	0
9. Non-resident deposits (net)	1,537	1,125	960	1,540	2,316	2,754	2,978	3,642
10. Rupee debt service (net)	–1,193	–767	–802	–711	–617	–519	–474	–376
11. Foreign investment (net)	103	5,353	2,312	5,117	5,862	6,686	4,161	14,776
12. Other flows (net)*	2,283	–595	624	3,930	–3,740	–96	8,795	7,086
13. Capital account total (net)	**8,402**	**9,393**	**7,867**	**10,840**	**8,508**	**8,357**	**10,640**	**20360**
14. Reserve-use (–increase)	**1,278**	**–3,893**	**–3,829**	**–6,142**	**–5,842**	**–11,757**	**–16,985**	**–31,421**

* Includes, among others, delayed export receipts and errors & omissions.

Source : Reserve Bank of India.

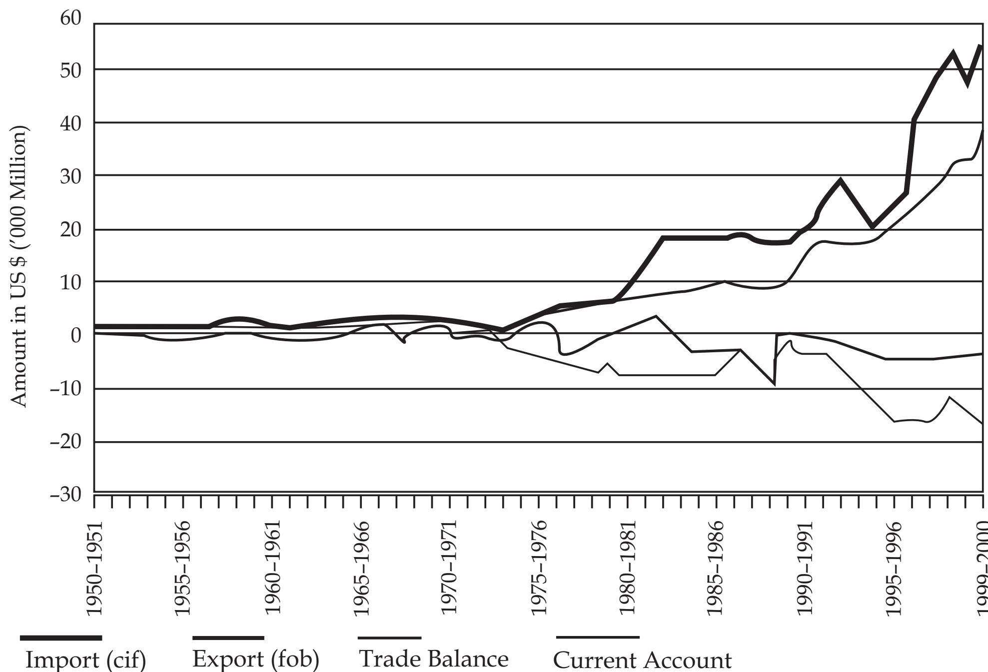
terms of annual average rate of growth, world exports of commercial services, i.e. non-factor services not only increased faster (7%) than such exports of merchandise (5%) between 2000 and 2003, but also accelerated from 7% in 2002 to 13% in 2003. The continuously widening base of outsourcing by many advanced countries—the USA in particular, as also UK, France, Germany and Japan is going to prove an important component of such growth during the next few decades. India in this context should be wary of the Chinese competition.

Concluding Observations

Our foreign trade is now buoyant and the exchange account is robust. The days of disequilibrium in the exchange counter have gone by.

However, what is disquieting is that our international trade still stands at a level which is less than one per cent of the total world trade. This is precipitated *inter alia* due to the relative low share of hardware in our export basket and large volume of the same in the import basket. The situation is aggravated further by oil. There has to be a whole range of export import strategies in the field. There should be more finished manufacturers and less of ores and grains in export, and a shrinking import basket as far as consumables are concerned. All these hinge on the overall policy of the Government information technology and the widening base of outsourcing but the basic character in our export and import baskets will require drastic overhaul.

What India should aim at is nothing less than a five per cent share—as in the 1950s—by the end of the Eleventh Five-Year Plan and not less than 10% in the decade following. Here again, the exchange account surplus will have to continue to grow steadily from one year to another.



Source : Planningcommission.nic.in

Figure 1 : Trade balance and current account.

Utopian

A tall order ! There is, however, no other way out for the economy to be on a galloping growth path with a GDP of 10% plus in competition with our nearest neighbour China.

Use of Reserves

There is a continuing debate in recent years as to whether our expanding exchange reserve should remain *frozen* or some portion of it—may be a small percentage to start with—should be used for socioeconomic development—mainly for planned growth of infrastructure. The issue is highly problematical. For one thing, there may be a sudden erosion in our reserves due to the effects of an international trade cycle. For another, the practice may become habit forming. On the other hand, like a bank balance, investment on a capital infrastructure may earn us positive growth in GDP. It, however, will require deployment of farsighted economic sense.

Notes

Self-Assessment

1. Choose the correct options:

(*i*) If a citizen could buy £25,000 for $100,000, the rate of exchange for the pound would be

(*a*) $40 (*b*) $25

(*c*) $4

(*ii*) Canadian residents demand foreign currencies to

(*a*) produce goods and services exported to foreign countries

(*b*) pay for goods and services imported from foreign countries

(*c*) receive interest payments on investments in Canada

(*d*) have foreigners make real and financial investments in Canada

(*iii*) A nation's balance of trade is equal to its exports less its imports of

(*a*) goods (*b*) goods and services

(*c*) financial assets (*d*) official reserves

(*iv*) A nation's balance on the current account is equal to its exports less its imports of

(*a*) goods and services

(*b*) goods and services, plus Canadian purchases of assets abroad

(*c*) goods and services, plus net investment income and net transfers

(*c*) goods and services, minus foreign purchases of assets in Canada

(*v*) The net investment income of Canada in its international balance of payment is the

(*a*) interest income it receives from foreign residents

(*b*) dividends it receives from foreign residents

(*c*) excess of interest and dividends it receives from foreign residents over what it paid to them

(*d*) excess of public and private transfer payments it receives from foreign residents over what it paid to them

(*vi*) A nation may be able to correct or eliminate a persistent (long-term) balance of payments deficit by

(*a*) lowering the barriers on imported goods

(*b*) reducing the international value of its currency

(*c*) expanding its national income

(*d*) reducing its official reserves

(*vii*) If exchange rates float freely, the exchange rate for any currency is determined by the

(*a*) demand for it (*b*) supply of it

(*c*) demand for and the supply of it (*d*) official reserves that back it

(*viii*) If a nation had a balance of payments surplus and exchange rates floated freely, the foreign exchange rate for its currency would

(*a*) rise, its exports would increase, and its imports would decrease

(*b*) rise, its exports would decrease, and its imports would increase

(*c*) fall, its exports would increase, and its imports would decrease

(*d*) fall, its exports would decrease, and its imports would increase

7.3 Summary

- It is generally agreed that the status of a country's economy depends in some measure upon the character of its commercial dealings with other countries. India cannot afford to remain insular in international trade and commerce. Imports and exports are vital for economic growth.

Notes

- India has had from ancient times a flourishing world trade, particularly with the Mediterranean, the Far East and the Levant. Geographically, India was ideally located for this purpose 'in the centre of the world.'
- During the British regime, the international trade policy of India had a clear and perceptible orientation. This was to promote exports of raw materials from mining and agronomy to the mills and manufactories in Great Britain, and the import of their finished products like cotton textiles (nearly half of total exports) and engineering goods in to the vast Indian colony.
- This shows a galloping rise during the last four decades, as indicated in Table 22.3. The rise has not only been galloping from year to year and from decade to decade, there has also been wide and perceptible changes in the components of imports—with a high percentage being accounted for by oil and technical hardware (in many cases with technical expertise).
- The rise has been astronomical—from ₹ 1,535 crore in 1970–71 (base year) to ₹ 1,30,100 crore in 1997–98 and ₹ 2,93,367 crore in 2003-04. What is of greater importance is the relative rise in the export of technology, hardware, manufactured commodities and *knowledge*—spearheaded by IT.
- From the beginning of the twentieth century (₹ 263 crore in 1904–05) to independence (₹ 652 crore in 1946-47), the value of India's foreign trade registered a clear rise, but this certainly paled into insignificance when compared to the post independence thrusts.
- It is however worth noticing that while exports and imports have grown, the growth in imports has been out of all proportion to exports.
- As agronomy and industry picked up, imports of fertilizers, POL and metals also peaked. With a relative rise in purchasing power, imports of edible oils, paper, sugar and cement grew as well. Import of foodgrains had ceased altogether.
- The Foreign Trade Policy of 2004 (discussed later) enunciated by the Government of India retains the emphasis on the growth in both quantity and components of exports—so that the same remains ahead of the increasing volume of imports.
- India's exports and imports have been guided, if at all, under different relevant acts and covenants and rules and regulations. It was for the first time in 1988 that an Export-Import Policy—that too for three years—was promulgated.
- For India to become a major player in world trade, a comprehensive view is necessary. While increase in exports is of vital importance, we have also to facilitate those imports which are required to stimulate our economy.
- We have had decades of atrophied balance of payments in our exchange accounts, interlaced with years or periods of revival. That is all a story now.
- There has been strong growth in merchandise exports. This has been a *propellant* behind many international trade account indices.
- Our foreign trade is now buoyant and the exchange account is robust. The days of disequilibrium in the exchange counter have gone by.
- There has to be a whole range of export import strategies in the field. There should be more finished manufacturers and less of ores and grains in export, and a shrinking import basket as far as consumables are concerned.
- What India should aim at is nothing less than a five per cent share—as in the 1950s—by the end of the Eleventh Five-Year Plan and not less than 10% in the decade following.
- There is a continuing debate in recent years as to whether our expanding exchange reserve should remain *frozen* or some portion of it—may be a small percentage to start with—should be used for socioeconomic development—mainly for planned growth of infrastructure.

7.4 Key-Words

1. Development banks : Such banks are specially meant for giving loans to the business sector for the purchase of latest machinery and equipments. Examples: SFCs (State Financial Corporation of India) and IFCI (Indian Finance Corporation of India).
2. Co-operative banks : These banks are nothing but an association of members who group together for self-help and mutual-help. Their way of working is the same as commercial banks. But they are quite different. Co operative banks in India are registered under the Co-operative Societies Act, 1965. The cooperative bank is regulated by the RBI.

7.5 Review Questions

1. What is foreign trade? Discuss its status before Independence.
2. Discuss the balance of payments.

Answers: Self-Assessment

1. (*i*) (*c*) (*ii*) (*b*) (*iii*) (*a*) (*iv*) (*c*) (*v*) (*c*)
   (*vi*) (*b*) (*vii*) (*c*) (*viii*) (*b*)

7.6 Further Readings

Books

1. The Indian Economy; S.K. Ray; Prentic, Hall of India Private Limited New Delhi - 110001.
2. Indian Economy; Gaurav Datt and Aswani Mahajan; S. Chand and Company LTD. Ram Nagar, New Delhi-110055.

Unit 8: Role of Foreign Capital - FDI and Multinational Corporations

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Objectives

After reading this Unit students will be able to:

- Explain the Role of Foreign Capital-FDI .
- Discuss Multinational Corporations.

Introduction

The role of multinational companies for enterprise and capital in the economies of the world has hugely increased with the spread of information technology and recent technological advances. It is more important to understand for a developing Economy because here they are needed to fill investment saving gap; technology gap, and foreign exchange gap. This must be regulated. Form July, 1991, a large number of high-tech areas have been left open to foreign investment. In India's context, the response of foreign capital to policy initiatives can only be called a mixed one. It is true there are many proposals and even many approvals but the actual inflows have been limited. Here, the various issues involved in the foreign capital and role of MNCs in this regard is to be discussed. This would provide an understanding about the changing scenario in the economy of the country.

8.1 Role of Foreign Capital - FDI

The foreign capital contributes to gap-filling in an economy. Savings gap, Trade gap and Technology gap are three gaps that can be filled by foreign capital. This would create conditions suitable for fast economic growth. Thus, inflow of capital from abroad is vital for the growth of a developing economy, especially in the initial stages.

Savings Gap : Raising the rate of capital formation is the key to the development. This needs a much higher level of investment than is warranted by the present level of savings in a developing economy. The prevailing low level of income, slow rates of growth and rising consumption needs in these economies limit the scope for a sharp rise in domestic savings. Thus, foreign capital can be used to fill the gap between investment requirements and domestic savings. It may be noted that the availability of foreign capital increases the availability of total resources in the economy. The increase in resources, in turn, influences investment decisions and makes possible construction of many new projects. Moreover, establishment of bigger projects and projects with a high investment component open up new opportunities of investment.

Trade Gap or Foreign Exchange Gap : There are two structural constraints in a developing economy a minimum requirement of inputs to sustain a given rate of growth of GNP; and an actual or potential ceiling on export earnings. The difference between the required imports and total exports, which is the foreign exchange gap, is represented as :

$$M_n - X_n = M_o + \beta (V_n - V_o) - X_o (1 + x)^n$$

Where, M_o = Observed initial level of imports,

V_o = The GNP in the initial year,

$V_n = V_o (1 + r)^n$, r being the compound growth rate and n the number of years after o,

X_o = The initial level of export,

β = The marginal rate of imports per additional unit of GNP,

r = Rate of growth of exports.

If the foreign exchange gap is dominant, the total import capacity would be

$$X_n = X_o (1 + x)^n$$

It will effectively set the limit to the increase in GNP. The constraint will be more severe if any of the following two situations obtains :

First, it may be noted that Technical conditions of industrialisation require a complement of foreign resources alongwith domestic resources. Second, some Strategic goods such as capital equipment and technical know-how, are not available locally and could be procured only from external sources. In both cases, the availability of foreign exchange can save an economy from an impasse.

Technological Gap : Technology has played significant role in economic growth. Its level in a developing economy can be raised through certain steps. For instance, through the internal evolutionary process of education, research, training and experience, or the external process of importing from other countries technology can be stepped up. However, the import of technology is related to two issues, viz., the choice of technology and local adaptation in the country. It may be noted that foreign capital can supply a package of needed resources that can be transferred to their local counterparts by means of training programmes and the process of learning by doing. Three sensitive areas are touched by the foreign capital and these areas are crucial in the development strategy.

8.2 Types of Foreign Capital

Foreign aid and private investment are two types of inflows of capital from abroad. Loans and grants from Foreign Governments and Institutions are included in the foreign aid. Since these may have repayment obligations, this source of foreign capital, especially loans, has a limitation. The supporters of foreign investment have highlighted the beneficial effects in terms of encouragement to the development of technology, integration with the world economy, exports and higher growth, managerial expertise, etc. They have claimed that debt financing generates fixed debt servicing obligations, while equity needs to be serviced only after profits are made. It may be observed that the opponents of foreign investment have drawn attention to several imperfections and adverse effects, including capital intensity of such investment, the possible adverse effects on income distribution, inappropriate technology, transfer pricing and the negative contribution that such investment often makes to the balance of payments of an economy.

Sources of Private Foreign Capital : There are two types of foreign private equity capital flows : (1) portfolio investment (an investor holds shares in a firms in a developing country but is not involved in its management) and (2) foreign direct investment (investment where the investor participates in the management of the firm in which he owns shares); FDI comprises a larger proportion of foreign private capital flows to developing countries than portfolio investment.

(a) Portfolio Investment : Portfolio investment contains the following.

(i) Non-residents hold equity in the joint stock companies of the recipient country,

(ii) Recipient country's joint stock companies have creditor capital from official sources.

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(iii) There is also creditor capital from private sources abroad invested in recipient country's joint stock companies.

(b) Foreign Direct Investment : The Foreign Direct Investment (FDI) in any country abroad is the net inflow of investment (capital or other), in order to acquire management control and profit sharing (10% or more voting stock) or the whole ownership of an accredited company operating in the country receiving investment. The foreign direct investment generally encompasses the transfer of technology and expertise, and participation in the joint venture and management. Highly productive advantages of *foreign direct investment* have been constantly being harvested by both governmental and private companies and organizations of all over the world.

The foreign direct investment is profitable both to the country receiving investment (foreign capital and funds) and the investor. For the investor company FDI offers an exclusive opportunity to enter into the international or global business, new markets and marketing channels, elusive access to new technology and expertise, expansion of company with new or more products or services, and cheaper production facilities. While the host country receives foreign funds for development, transfer of new profitable technology, wealth of expertise and experience, and increased job opportunities.

Owing to the ever-increasing globalization of businesses of almost all sectors, liberalization of trade policies, and loosening of foreign investment restrictions, the foreign direct investment (FDI) has been quite revolutionary and vital for faster economic growth of most of the developing and developed countries of all across the world for last few decades. Supported by refinement in the information and telecommunication technology, and the increasing trend of Mergers and Acquisitions, the FDI is to receive tremendous impetus in various sectors in the future times to come, especially in the developing countries of the world. It has been observed that more than two-thirds (2/3th) of direct foreign investment is made in infrastructure, commercial and residential buildings, machinery, equipment, mines, and land.

FDI India

The steadily growing one of the major economies of the world, India has been enjoying huge and regular FDI from diverse investors of all around the world for the last few decades. According to a recent UNCTAD (United Nations Conference on Trade and Development) Survey, India has emerged out as the second most famous and popular destination in the world for FDI, after China. Majority of this foreign direct investment in india is made in the sectors of telecommunication, computer hardware and software, construction, and services, by investor companies from USA, UK, Singapore, Mauritius, etc. The foreign direct investment in india can be made in a variety of ways and in a rather wide range of economic sectors. Worldwide prominent Global Jurix has been helping individuals, associations, private and public companies/organizations, and institutions of diverse sectors for making their cherished FDI in India, through both the Automatic and Government Routes, for a long time.

There are three main categories of FDI :

(i) Equity Capital : It may be defined as the value of the Multinational Corporations (MNCs) investment in shares of an enterprise in a foreign country.

(ii) Reinvested Earnings : The MNCs share of affiliate earnings not distributed as dividends or remitted to the MNCs.

(iii) Other Capital : The short-term or long-term borrowing and lending of funds between the MNCs and the affiliate of the MNCs.

Types of FDI : The FDI inflows are of three types :

(i) Market-seeking : The size of the local market is the main focus of these FDIs.

(ii) Efficiency-seeking : Economic efficiency and commercial logic dictate that capital should flow from the relatively less-profitable developed countries to the relatively more profitable developing world.

(iii) Other Location Advantages : Among these can be included trade and macro policies of the country, the technological status, brand name and goodwill enjoyed by the local firms, openness of the economy and intellectual property protection.

8.3 Multinational Corporations

MNCs are involved in foreign direct investment which means they own or control income generation assets in more than one country. Thus, they produce goods or services outside its country of origin. There are more than eleven thousand MNCs with more than eighty-two thousand subsidiaries in operation in today's world economy.

Characteristics of Multinational Corporations : The important characteristics of MNCs are given below :

(i) Giant Size : Their assets and sales run into billions of dollars.

(ii) International Operations : The control resides in the hands of a single institution but its interests and operations sprawl across countries.

(iii) Oligopolistic Structure : An MNC has awesome power and along with its giant size it becomes oligopolistic.

(iv) Spontaneous Evolution : Generally, MNCs grow in a spontaneous and unconscious manner.

(v) Collective Transfer of Resources : They facilitate multi-lateral transfer of resources.

Importance and Significance of MNCs : In today's world economy, MNCs have become a powerful force.

The Case for MNCs : MNCs carry the potential benefits that a developing economy can hope to get from MNC operations. Today, foreign investment is the only instrument that can reduce the inequalities between nations of the world.

The Case against MNCs : At present, MNCs acknowledge their responsibility to the concerns and interests of the host country. However, international capital has no loyalty towards any nationality.

Need for Regulation of MNCs : MNCs are needed to regularised due to the following reasons :

(i) After a specific period, restrictions may be imposed on foreign holdings of MNCs, or there may be provision for gradual disinvestments.

(ii) There is threat of nationalisation which is an important tool of regulation.

(iii) In certain areas, the Government may allow or deny permission.

(iv) The Government may demand MNCs to carry out a minimum fixed share of their total research and development activities within the host countries of MNCs.

(v) The MNCs may be taxed at a higher rate.

(vi) The host country may lay down certain export criteria for MNCs.

Foreign Capital in India

Foreign capital has been given an important role to play in the planned economy of India. In the first stage, foreign capital was looked upon as a means to supplement domestic investment but gradually the emphasis shifted to encouraging technological collaboration between Indian entrepreneurs and foreign entrepreneurs. Of late, free flow of foreign capital is invited.

Government Policy towards Foreign Capital : In India, foreign investment is subject to the same industrial policy as all other business ventures. Moreover, there are some additional policies and rules specially governing foreign collaboration. The Industrial Policy Resolution, 1948 (IPR, 1948) is the first articulate expression of free India's attitude towards foreign capital. It stressed the need for carefully regulating as well as inviting private foreign capital. Special stress, *inter-alia*, was put on the

need to ensure that in all cases of foreign collaboration, the majority interest was always Indian. Later, this was followed by the Fiscal Commission of 1949-50. The Commission recommended that foreign investment may be permitted, first, in the public sector projects needing imported capital good. Moreover, in new capital industries where no indigenous capital or technical know-how was likely to be available. It may be noted that a statement on policy towards foreign capital made by the Government on April 6, 1949 was brought after this. The underlying principles of the policy by and large are valid even now. The policy tried restrict foreign collaboration to those cases which would bring technical know-how into the country such as was not available indigenously for developing new lines of production in the country. These define the broad contours within which the state policy towards foreign capital has been framed all through the different five-year plans. Three distinct phases can be marked during the plan period :

- From 1951 to 1965, the policy was characterised by a liberal attitude towards foreign capital providing many concessions and incentives.
- In the second stage, strict controls were observed and the broad policy was to restrict the area of operation of foreign capital in the economy.
- With the beginning of economic reforms in 1991, the country has adopted a more liberal attitude and has tried to attract a free flow of FDl in India.

Policy Changes 1991-2005 : Regarding foreign investment and foreign technology Agreements, the new Industrial Policy, 1991, can be described as a minor revolution. There are four types of changes in the policy :

1. **Choice of Product :** The number of products has been significantly increased.
2. **Choice of Market :** Free competition allowed with the domestic producers.
3. **Choice of Ownership Structure :** The foreign investor is broadly free to own a majority share in equity of the business.
4. **Simplification of Procedures : Two routes for FDI inflows have been opened :** The RBI route (or the Mumbai route) and the Foreign Investment Promotion Board (FIPB) route (or the Delhi route). The RBI route is transparent in the sense that the guidelines are clear. Thus, if projects satisfy the guidelines, the approvals are practically automatic and speedy. It consists of 42 industries for FDI proposals and are listed in Annexure III of the industries list. The Foreign Investment Promotion Board (FIPB) route (or the Delhi route) entertains the cases which do not fit into the first case. These proposals by the foreigners are considered case by case. These changes mean that the Government is keen to attract more of foreign investment and apparently believes the following:
   - To go out to borrow is worse than allowing equity.
   - While profit is usually reinvested, the capital is generally never repatriated.
   - FDI brings technology which spreads to other sectors. These firms produce cheaper and better capital goods or intermediate products. There is competitiveness of sectors which spurs development and accelerates the growth process in the economy.

8.4 Critical Evaluation of the New Policy

The foreign investment environment in India has been improved by the economic reforms and the success of the new economic policy depends in a large measure on the liberal response of the foreign capital. The response of the foreign capital to the policy Initiatives can be described as follows :

It may be noted that the response of the foreign capital has not been ungrudging and the performance has been far below expectations. At present, there are less than 40 of the top 100 MNCs operating in India.

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Points of Concern to Foreign Investors : Main concerns of foreign investors regarding the new policy are given below.

1. **Comparative Advantage among Different investment Markets :** There are three basic advantages in India :
   (i) Cheap manpower.
   (ii) Large domestic market.
   (iii) Inputs with easy availability and lower costs. However, it is argued that low wage levels may be offset by productivity level to a large extent. For taking hard investment decisions, consumption patterns are more relevant than classifications based on incomes and in this regard, India may not score very high in foreigners' projections. Moreover, the numbers of industries where India can offer such input advantages are few.
2. **Permanence of New Policy :** India must assure the foreign investors of the liberalisation policy in the future also.
3. **Exit Policy :** Disinvestment requires approvals which are both cumbersome and time-consuming and are virtually dictated by the RBI. This makes potential foreign investors more cautious in considering investment proposals.
4. **Procedural Simplifications :** The procedures should be simplified.
5. **Removal of Comparative Disadvantages :** India must convince that the existing comparative advantages are not offset by the comparative disadvantages they have to cope with in the country.

Self-Assessment

1. Choose the correct options:

(*i*) .... is (are) the sourcing of goods and services from locations world-wide in seeking advantage of national differences and a form of competitive advantage.

(*a*) Factors of production (*b*) Distribution of production
(*c*) Globalization of production (*d*) Dominance of production

(*ii*) Which of the following is the oldest institution to maintain order in the international monetary system?

(*a*) United Nations (UN)
(*b*) International Monetary Fund (IMF)
(*c*) World Trade Organization (WTO)
(*d*) General Agreement on Tariffs and Trade (GATT)

(*iii*) .... is when a firm invests resources in business activities outside its home country.

(*a*) Capital intensive investment (*b*) Overseas selective borrowing
(*c*) Venture capital development (*d*) Foreign direct investment

(*iv*) Which of the following is NOT one of the four major factors that help the U.S. to continue to hold competitive advantages over other national players for global market share?

(*a*) the reputation of U.S. graduate schools of business and management
(*b*) the U.S. dominance in direct foreign investment
(*c*) the dominance of U.S. multinational corporations on the international business scene
(*d*) the U.S. dominance in trade and commercial diplomacy which few nations can compete

(*v*) Which of the following reflects the trends of the global economy in the 21st Century?

(*a*) Globalization is not inevitable.
(*b*) The skill, scope and authority of world institutions mean global financial shocks and challenges to global business systems will be mild and short-lived and will eventually disappear.

(*c*) There will be little change in the current leaders in world trade.

(*d*) The adoption of liberal economic policies will likely continue everywhere throughout the world because of their undeniable success.

(*vi*) Which of the following is NOT true about employment and income in the face of continuing globalization:

(*a*) The wage gap between developed and developing nations is closing.

(*b*) Recent evidence suggests that technological change had has a bigger impact on globalization on the declining share of national income enjoyed by labor.

(*c*) Real labor compensation has declined in most developed nations since the 1980s, including for the U.S.

(*d*) The solution to stagnant incomes among the unskilled is not in limiting free trade but increasing society's investment in education to reduce the supply of unskilled workers.

8.5 Summary

- The foreign capital contributes to gap-filling in an economy. Savings gap, Trade gap and Technology gap are three gaps that can be filled by foreign capital. This would create conditions suitable for fast economic growth. Thus, inflow of capital from abroad is vital for the growth of a developing economy, especially in the initial stages.
- There are two structural constraints in a developing economy a minimum requirement of inputs to sustain a given rate of growth of GNP; and an actual or potential ceiling on export earnings.
- Foreign aid and private investment are two types of inflows of capital from abroad. Loans and grants from Foreign Governments and Institutions are included in the foreign aid. Since these may have repayment obligations, this source of foreign capital, especially loans, has a limitation.
- There are two types of foreign private equity capital flows : (1) portfolio investment (an investor holds shares in a firms in a developing country but is not involved in its management) and (2) foreign direct investment.
- The Foreign Direct Investment (FDI) in any country abroad is the net inflow of investment (capital or other), in order to acquire management control and profit sharing (10% or more voting stock) or the whole ownership of an accredited company operating in the country receiving investment.
- The foreign direct investment is profitable both to the country receiving investment (foreign capital and funds) and the investor. For the investor company FDI offers an exclusive opportunity to enter into the international or global business, new markets and marketing channels, elusive access to new technology and expertise, expansion of company with new or more products or services, and cheaper production facilities.
- MNCs are involved in foreign direct investment which means they own or control income generation assets in more than one country. Thus, they produce goods or services outside its country of origin. There are more than eleven thousand MNCs with more than eighty-two thousand subsidiaries in operation in today’s world economy.
- Foreign capital has been given an important role to play in the planned economy of India. In the first stage, foreign capital was looked upon as a means to supplement domestic investment but gradually the emphasis shifted to encouraging technological collaboration between Indian entrepreneurs and foreign entrepreneurs.
- ln India, foreign investment is subject to the same industrial policy as all other business ventures. Moreover, there are some additional policies and rules specially governing foreign collaboration.
- The foreign investment environment in India has been improved by the economic reforms and the success of the new economic policy depends in a large measure on the liberal response of the foreign capital.

- It may be noted that the response of the foreign capital has not been ungrudging and the performance has been far below expectations. At present, there are less than 40 of the top 100 MNCs operating in India.

8.6 Key-Words

1. FDI : Foreign direct investment (FDI) is direct investment into production or business in a country by a company in another country, either by buying a company in the target country or by expanding operations of an existing business in that country. Foreign direct investment is in contrast to portfolio investment which is a passive investment in the securities of another country such as stocks and bonds.
2. Multinational corporations : A corporation that has its facilities and other assets in at least one country other than its home country. Such companies have offices and/or factories in different countries and usually have a centralized head office where they co-ordinate global management. Very large multinationals have budgets that exceed those of many small countries. Sometimes referred to as a "transnational corporation".

8.7 Review Questions

1. What is the role of FDI? Discuss.
2. Discuss the type of foreign capital.
3. Explain the characteristics of Multinational corporation.

Answers: Self-Assessment

1. (*i*) (*c*) (*ii*) (*b*) (*iii*) (*a*) (*iv*) (*a*) (*v*) (*a*)
   (*vi*) (*c*)

8.8 Further Readings

Books

1. The Indian Economy; S.K. Ray; Prentic, Hall of India Private Limited New Delhi - 110001.
2. Indian Economy; Gaurav Datt and Aswani Mahajan; S. Chand and Company LTD. Ram Nagar, New Delhi-110055.

Unit 9: Fiscal Federalism in India

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Objectives

After reading this Unit students will be able to:

- Discuss about the Fiscal Federalism in India.

Introduction

To build a strong united India, India has adopted federalism. It has been done in order to actualise and uphold the values of national unity, cultural diversity, democracy, regional autonomy and rapid socio economic transformation through collective efforts. The Commission on Centre State Relations chaired by Justice R.S. Sarkaria which reported in 1988 has discussed the diverse political, economic and juridical aspects of federal fiscal relations. As a reaction to over-centralisation in the past decades, the States have been asking for greater freedom in the exercise of economic powers. Besides, the current policy of decentralising economic decision-making through liberalisation can aggravate regional disparities and here the Centre has an important role to play. At the same time, the less developed States will have to make corrections in their policies to attract investment, otherwise there are going to be more disparities. The Constitution envisages that fiscal resources would be transferred to the States on the recommendations of the Finance Commission. The capital resources for planned development are now transferred on the recommendations of the Planning Commission. The National Development Council, considers questions of national developmental policy and recommends measures for the implementation of the objectives and targets set out for the national plans. These institutions are expected to play a very effective role as adequate forum of consultation and co-operation between the States and Union, but within a centralised framework.

9.1 Fiscal Federalism in India

The India Constitution has divided the powers in various fields between the Central Government and States. For instance, in the financial field, it has very elaborate provisions. It may be noted that the financial relations between the Centre and States are among the most difficult problems in a federation. It seems to be more logical if we opt for complete separation of taxation powers but according to K. Santhanam, it has given rise to a new set of difficult problems regarding transfer of funds from the Centre to the States. In India, there are three main principles : the Centre as well as the States should be autonomous in their finances; (i) they should be able to obtain enough funds; and (ii) the receipts should grow. However, the reconciliation of these principles is never easy. Today, what is needed is a functional and not a political or ideological approach.

Constitutional Provisions

Allocation of Revenues between the Centre and States : The Constitution has divided tax-sources between the Centre and the States so that there should be no overlapping of tax jurisdiction, otherwise, it will cause confusion and conflict. Thus, the distribution of taxes in India is more logical and thorough than in other federations. There are three lists : the Union List (List I), the State List (List II) and the Concurrent list (List III).

Taxing Powers : In effecting a division of resources, the Constitution provides for a strong centre. The Constitution ensures the supremacy of the action of the Union Government over the fairly comprehensive Union list as also over concurrent jurisdiction. Allocation of the heads of taxation between the Union and the States is based on; he broad principle that taxes which are location-specific and relate to subjects of local consumption have been assigned to the States. Those taxes like for example Income tax which are of inter-state significance and where the place of residence is not a correct guide to the true incidence of tax have been vested in the Union. This clear-cut division of heads of taxation between the Union and States has minimised the scope for conflicts and litigation between them. The taxes over which the Union has legislative jurisdiction can be classified as follows:

(a) Taxes which are to be levied and collected by the Union and the entire proceeds therefrom are to be retained by it. These include co-orpration tax and Customs duties.

(b) Taxes which are levied and collected by the Union but proceeds are shared with the States. These are income tax, and excise duties.

(c) Taxes which are levied by the Union but collected and retained by the States. These are estate duties and terminal taxes on goods and services.

(d) Taxes which are levied by the Union but collected and retained by the States. These are excise duties on medicinal and toilet preparations (containing alcohol), opium, etc.

Article 286 of the Constitution forbids taxation by States of

(a) Imports into or exports from the tercitory of India;

(b) Inter-state trade; and

(c) sale of goods declared the Parliament by law to be essential for the life of the community.

The property of the Union is exempt from State taxation. The property and income of the States are exempt from the Union taxation. In addition to the provisions for tax-sharing, Article 275 of the Constitution provides for both general purpose and specific grants. However, it has been left to the Parliament to decide which States are in need of grant assistance and to what extent subject to the recommendations of the Finance Commission.

Finance Commission

The Finance Commission of India came into existence in 1951. It was established under Article 280 of the Indian Constitution of India by the President of India. It was formed to define the financial relations between the Centre and state. The Finance Commission Act of 1951 States the terms of qualification, appointment and disqualification, the term, eligibility and powers of the Finance Commission. As per the Constitution, the commission is appointed every five years and consists of a chairman and four other members. Since the institution of the first Finance Commission, stark changes have occurred in the Indian economy causing changes in the macro-economic scenario. This has led to major changes in the Finance Commission's recommendations over the years. Till date, Thirteen Finance Commissions have submitted their reports.

Planning Commission

In Centre-State financial relations, the Planning Commission is another important body which has an important place. The responsibility for taking decisions and implementing plans rests with the Union and the State Governments. It may be noted that the resolution emphasised the need for "adequate coordination" between the development schemes initiated by the Union and the States. This was also to be done for comprehensive planning based on a careful appraisal of resources and essential conditions of progress of the country.

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Finance Commission Versus Planning Commission

According to Dr. P.V. **Rajamanner,** Chairman of the Fourth Finance Commission, the Planning Commission has restricted the scope and functions of the Finance Commission. Plan grants are given under various developmental heads. The discretionary grants made under the recommendations of the Planning Commission have been much greater than the grants given under Article 275 (1). Moreover, these grants are available only for the plan period at the end of which they become committed expenditure for which the States are exclusively responsible. Therefore, the States approach the Finance Commission and try to get a greater share of revenue and larger grants. It was greatly intensified by the loans issued by the Centre. However, a considerable portion of these loans have been spent for purposes which do not yield any income, and their burden of interest and repayment fall on the State revenues. Due to planning, the federal financial relations have become seriously distorted in our country.

Issues in Fiscal Federalism

The sprawling powers of the Central Government eroding the foundations of fiscal federalism have been questioned from time to time. Now, under the changed circumstances, need for change in the outlook of the Union towards the States and of the States towards the Union is being felt. The Central Government is finding it difficult to impose its will or decision on the States. The root cause of States' chorus of more and more demands is too much financial dependence on the Centre. Consequently, it has caused demand for more financial powers. We have to find a satisfactory and enduring solution to the problem of Centre and State relations through a rigorous and concerted drive against tax evasion, tax avoidance and waste and extravagance in public expenditure. At the same time, we must ensure all round efficiency in the deployment of public funds in particular, investments in productive enterprises in the public sector. It may be seen that the appointment of the Sarkaria Commission by the Centre reflected its recognition of the seriousness of the issue.

In the context of the States asking for greater decentralisation of powers to manage their economies, the Centre-State economic relations have assumed special significance. The Finance Commission alone cannot solve the difficult problems faced by it. Therefore, a harmonious, equitable and efficient delegation of financial powers between Centre and States must be an integral part of the overall investment and planning objectives of the economy. While the earlier arrangements have provided a flexible mechanism for the operation of fiscal federalism, there is a widespread feeling that they have proved inadequate. The issues in Union-States financial relations may identified as follows :

(i) The institutions to safeguard the fiscal autonomy of the States have not helped much.

(ii) Looking at the Constitution, we find that the distribution of responsibilities and powers as a chronic imbalance with concentration of fiscal powers in the Centre.

(iii) The fact that the Planning Commission is not a statutory body is a point of discord.

(iv) Centre decides about one-fifth of the total transfers on its own discretion.

(v) Above all, the unitary elements further strength over the years with concentration of fiscal powers in the Centre and growing dependence of the States on financial transfers.

For the improvement in the situation, a few suggestions may be given. The purpose is three-fold (i) Due share of States in responsibilities and rights; (ii) A continuing system of communication and clearing should be available; and (iii) The Centre has to discharge its coordinating, corrective and lead functions in a truly federal system.

Recommendations of the Twelfth Finance Commission (TFC)

The Twelfth Finance Commission was incorporated in the year 2005. The commission made recommendations for the distribution of the net proceeds of the taxes between the Union and the States. It also recommended taking of certain measures for augmenting the Consolidated Fund of a State. It also reviewed the financial status of the States and ensured macro-economic stability in the same, evaluated the debt positions of the States and the schemes implemented by the Central

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Government to ensure an improved financial system. The TFC has recommended about 74 per cent step up in transfer of resources. There has been a sharp rise in the grant portion of 143% from ₹ 58,5 87 crore awarded by the EFC. At the same time, taxes portion has gone up by 63% from ₹ 3,76,318 crore. The share of States' in Centre's divisible pool of tax and duties has been enhanced to 30.5%. An estimated ₹ 6,13,112 crore is to be devolved to the States as their share in Centre's tax and duties and ₹ 1,42,639 crore as grants-in-aid, according to the TFC.

Restructuring Public Finances :

(i) The combined tax-GDP ratio to 17.6% to be improved by 2009-10 by Centre and States.

(ii) By 2009-10, 75% reduction in the combined debt-GDP ratio.

(iii) 3% fiscal deficit to GDP.

(iv) Zero revenue deficit by 2009-10.

(v) The interest payments relative to revenue receipts should be 28% for the Centre and 15% for States.

(vi) The total salary bill, relative to revenue expenditure, net of interest payments, should not exceed 35%.

(vii) A fiscal responsibility legislation should be enacted which provides for elimination of revenue deficit by 2008-09 and reducing fiscal deficit to 3% of State Domestic Product.

(viii) On-lending to be stopped.

9.2 Meaning and Scope of Fiscal Policy

The word 'fisc' means 'state treasury' and 'fiscal policy' refers to policy concerning the use of 'state treasury' or the government finances to achieve certain macroeconomic goals. Fiscal policy has however been variously defined by the economists. Arthur Smithies defined fiscal policy as "a policy under which government uses its expenditure and revenue programs to produce desirable effects and avoid undesirable effects on the national income, production, and employment."G. K. Shaw, a well-known expert on the subject, defines fiscal policy as "any decision to change the level, composition or timing of government expenditure or to vary the burden, structure or frequency of the tax payment." Shaw's definition presumes that national economic goals are given. Samuelson and Nordhaus offer a more complete definition of fiscal policy. By fiscal policy they "mean the process of shaping taxation and public expenditure to help dampen the swings of the business cycle and contribute to the maintenance of a growing, high-employment economy, free from high or volatile inflation." In their opinion, the role of fiscal policy is confined largely to stabilization of employment and the price level. Its seems, they have defined fiscal policy keeping in view the problems of the developed countries. Fiscal policy can be defined in more general terms as follows. **Fiscal policy is the government programme of making discretionary changes in the pattern and level of its expenditure, taxation and borrowings in order to achieve certain economic goals such as economic growth, employment, income equality, and stabilization of the economy on a growth path.**

A narrow concept of fiscal policy is **budgetary policy.** While *budgetary policy* refers to current revenue and expenditure of the financial year, fiscal policy refers to budgetary operations including both current and capital receipts and expenditure. The essence of fiscal policy lies, in fact, in the budgetary operations of the government. The two sides of the government budget are *receipts* and expenditure. The **total receipts** of the government are constituted of tax and non-tax revenue and borrowings (including deficit financing). These items in the budget represent the budgetary resources of the government. The **government expenditure** refers to the total expenditure made by the government in the fiscal year. The total government expenditure consists of payments for goods and services, wages and salaries, interest and loan repayments, subsidies, pensions and grants-in-aid, and so on. From economic analysis point of view, receipt items give the measure of the flow of money from the private sector to the government sector. The government expenditure, on the other hand, represents the flow of money from the government to the economy as a whole. The government receipts are *inflows* and expenditures are *outflows*.

Notes

The government can, by using its statutory powers, change the magnitude and composition of inflows and outflows and thereby the magnitudes of macroeconomic variables—aggregate consumption expenditure and private savings and investment. The magnitude and composition of inflows and outflows can be altered by making changes in taxation and government spending. The policy under which these changes are made is called *fiscal policy*.

The scope of fiscal policy comprises the *fiscal instruments* and the *target variables*. *Fiscal instruments* are the variables that government can use and maneuver at its own discretion to achieve certain economic goals. *Fiscal instruments* include taxation (direct and indirect), government expenditure, transfer payments (grants and subsidies) and public investment. The *target variables* are the macro variables including disposable income, aggregate consumption expenditure, savings and investment, imports and exports, and the level and structure of prices. The fiscal policy instruments and target variables are discussed below in detail.

Compensatory Fiscal Policy

Another variant of stabilizing policy is *compensatory fiscal policy*. The compensatory fiscal policy is a deliberate budgetary action taken by the government to compensate for the deficiency in, and to reduce the excess of, aggregate demand. The compensatory action is taken by the government in the form of *surplus budgeting* or *deficit budgeting*. In this kind of fiscal policy, the government uses a greater degree of discretion than in automatic stabilization policy and compensatory fiscal policy can be revised from time to time as per need of the country. Besides, the policy of surplus budgeting is adopted when the government is required to control inflation and policy of deficit budgeting is adopted when the objective is to control deflation.

The policy of **deficit budgeting** is adopted to fight depression in the economy. During the period of depression, the government is required to boost up the aggregate demand, especially when the economy is facing depression due to lack of effective demand. The government in this case is required to take compensatory fiscal measures. The compensatory measures may be in the form of tax reduction and enhanced government spending. This kind of fiscal measures increases aggregate demand. Increase in aggregate demand leads first to the rise in price level. It adds to the producers' profit with a time lag in increase in costs. This increase in profits creates an optimistic environment. Therefore, both opportunity and incentive to invest increase. This is supposed to push up the level of employment and output. This is the kind of fiscal policy that most countries affected by the recent global recession had adopted.

The policy of **surplus budgeting** is adopted by the governments during the period of high rate of inflation, especially when inflation is caused by excessive demand. Surplus budgeting is a powerful tool to control the aggregate demand. Under this policy, the government keeps its expenditure lower than its revenue. If necessary the government may resort to a higher rate of taxation and cut its expenditure further down. Taxation reduces disposable income. As a result, the aggregate demand decreases at the rate of tax multiplier. On the expenditure side, a cut in the government expenditure reduces the aggregate demand at the rate of expenditure multiplier. The two-prong attack on the aggregate demand helps reducing the demand pressure and, thereby, the inflation.

Discretionary Fiscal Policy

A discretionary fiscal policy is one in which ad hoc changes are made in the government expenditure and taxation system and tax rates at the *discretion* of the government as and when required. In discretionary fiscal policy, the government makes deliberate changes in (a) the level and pattern of taxation, (b) the size and pattern of its expenditure, and (c) the size and composition of public debt. The discretionary changes in these fiscal instruments are made with a view to achieving certain specific objectives. The discretionary changes in taxation and government expenditure and their effects on the target variables are described here briefly.

(a) **Changes in Taxation :** The discretionary changes in taxation include such changes in both direct and indirect taxes as (i) increasing or decreasing the tax rates, (ii) imposition of new taxes or abolition of existing taxes, and (iii) imposition of taxes on new tax bases. All these kinds of changes in taxation result in either *the flow of household incomes to the government* or to *reduction in such flows*. Tax changes that reduce disposable incomes of the housholds cause a decline in

the consumer demand and, therefore, a *contractionary effect* on the economy. This proves helpful in reducing the *inflationary pressure* in the economy.

(b) Discretionary Changes in Government Expenditure : The discretionary changes in the government spending include change in (i) the size of the government expenditure, (ii) the pattern of government expenditure, (iii) the methods of financing government expenditure, (iv) transfer payments (e.g., subsidies, old age pensions, unemployment relief, etc.), (v) overall budgetary surplus and deficit, and (vi) the methods of deficit financing.

Here again, there are no set rules for making changes in the fiscal policy. Any or many of these changes can be made at any time at the discretion of the government. Changes can be altered or reversed at the discretion of the government. It is this character of fiscal policy which makes a *discretionary policy*.

Limitations of Discretionary Fiscal Policy : It is generally alleged that a discretionary fiscal policy works in theory better than in practice. The discretionary fiscal policy does not work effectively in practice because it has certain limitations.

First, an *important limitation* of discretionary policy is that it is suitable and effective only when it is used for short-run corrections in the economy. Attempts to solve the macroeconomic malad-justments or disequilibrium of long-term nature through the discretionary fiscal policy creates a greater mess and distortions in the economy rather than resolving them.

Second, an important factor that makes effectiveness of discretionary fiscal policy doubtful even in the short run is the problem in making an accurate assessment of the magnitude of the problem and forecasting expected results of policy changes. In the absence of reliable estimates and fore-casting, the decisions are likely to go wrong and the consequences may be disastrous. For example, like all other countries affected by the global recession, India had implemented certain short-run stimulus package. Since the economy has started recovering, the government is in dilemma as to whether or not to withdraw the stimulus package because its effects are unpredictable.

Third, there are two kinds of **time-lags** in the implementation of fiscal actions : pre-implementation and post-implementation time-lags. Pre-implementation time-lag arises due to time, taken in the process of decision-making, called 'decision lag'. The policy measures and policy tools are decided upon by the policy-makers and the think-tank of the government. For instance, in India, for all long-term fiscal actions or policy reforms, a committee is appointed to make its recommendation. The committee takes more time than stipulated in its terms of reference. After the committee makes its recommendations, the report is placed for the bureaucratic appraisal. It is then sent for ministerial consideration for its approval. The committee's recommendations are then placed before the Parliament for discussion. After its approval by the Parliament, proposals find a place in the Finance Bill. The time lost in decision-making is called 'decision lag. After the Finance Bill is voted, it takes further time in the implementation of the policy. It is called 'execution lag'.

Thus, a considerable time is lost in the process of decision-making and its execution. As regards the post-implementation time-lag, it arises due to lagged effect of fiscal actions. The lagged effect arises because fiscal changes work through the related variables and, therefore, take a long time to produce the expected result or unexpected/undesired effects or to show that they cannot produce any satisfactory results.

The time-lag associated with the working of the discretionary fiscal policy makes the efficacy of the policy doubtful. Its working is further complicated when other changes are made in the fiscal policy before the full effect of a previous action is realized. This also complicates the assessment of the performance of the policy. In India, such changes were of regular nature—fiscal changes were made invariably in each annual budget—before the Economic Reforms were made in 1990— 91. Changes in taxation and expenditure are also made within a financial year. Now, the frequency of discretionary fiscal changes has considerably reduced.

Fiscal Policy of India

India's fiscal policy was formulated initially in 1950-51 in the background of India's economic conditions at the time of Independence. The Indian economy was trapped in a *vicious circle of poverty*

with the lowest per capita income and consumption in the world. Over the entire period of 40 years from 1910 to 1950, the growth rate of the economy had been nearly zero. After Independence, the government assumed the responsibility of creating conditions for the growth of economy. The Government of India adopted a policy of 'mixed economy' under democratic framework, in which the public sector had to play a leading role. The government assumed a leading role in the economy because the economy was dominated by the primitive agricultural sector. The private industrial sector of the country was underdeveloped and, therefore, could not be relied upon to play a significant role in the economic development of the country for at least a decade or two. As a strategic measure, the government adopted the Five Year Development Plans. The basic objectives of Development Plans are (i) to achieve a target growth rate, generally 5 percent, (ii) to promote employment opportunities, (iii) to remove poverty, and (iv) to reduce income inequalities. The basic philosophy of the government's overall economic policy was 'growth with social justice'.

India's Discretionary Fiscal Policy

The most difficult problem that the Government of India faced was how to mobilize resources for development. It was with this background that the government formulated its *fiscal policy*. Under the conditions highlighted above, the Government of India adopted **discretionary fiscal policy.** The government has throughout used its discretion to determine the pattern and level of both taxation and its expenditure. In order to raise financial resources, the government adopted very extensive direct and indirect taxation with highly progressive tax rates. Prior to economic reforms of 1991, the government changed its tax rate and exemption limits almost every third year, sometimes in each annual budget. So was the case with the level and pattern of its expenditure. The dominant aspect of the government's discretionary fiscal policy was to raise maximum possible revenue through direct and indirect taxation for meeting its revenue requirement, and to allocate expenditure in the manner that could promote growth and employment. Whether the government succeeded in these objectives with its fiscal policy is a different issue.

However, total tax revenue collected through taxation had fallen much short of government's plan expenditure. Therefore, the government had rely heavily on *deficit financing*, especially on borrowing from the RBI. In effect, India has adopted a *deficit budgeting policy*.

The fiscal policy of the Central Government is reflected in its annual budget. Let us have an overview of the annual budgets of the Government of India in recent years. The annual budget has two sides : (i) revenue side, and (ii) expenditure side. The government revenue includes tax revenue and non-tax revenue, and government expenditure includes both development and non-development expenditures. Both government revenue and expenditure are further classified under : (i) revenue account, and (ii) capital account. Let us have a glance at the pattern of government revenue and expenditure in some detail.

Fiscal Reforms and Fiscal Deficits Since 1991

Till 1990-91, the Government of India made minor modifications in its fiscal policy (including both taxation policy and expenditure pattern). But drastic changes were made in the fiscal policy and fiscal management of the country in 1991. Here we present a brief analysis of the reforms made by the government in its fiscal policy since 1991.

In 1990, India faced an unprecedented foreign exchange crisis mainly due to rise in crude oil prices following the Gulf War. Due to a sharp rise in oil price, import bill of the country shot up from a monthly average of $287 million in June-August 1991 to $671 million in the following 6 months. As a result, the foreign exchange reserves declined from $3.11 billion in August 1990 to $896 million in 16 January 1991. The Indian economy was almost on the verge of economic collapse. However, financial help provided by the IMF in the form of a loan of $665 million in September 1990 helped the country tide over the crisis. This crisis created conditions and need for evaluating the significance and relevance of country's economic policies in general and fiscal policy and foreign trade policy in particular. Fiscal reform was one of the main aspects of the economic policy reforms made in 1990-91.

In the opinion of the experts, a reversal of the fiscal expansionism was essential for restoring the macroeconomic balance in the economy. The government adopted a policy to reduce the fiscal deficit.

Notes

As a result, the ratio of fiscal deficit to **GDP** declined considerably. It declined from 5.5 percent in the late 1980s to 4.5 percent in the 1990s, and then to 3.2 percent in the 2007-08 Budget (see Appendix). Fiscal deficit was reduced by restraining the growth rate of both the revenue and capital expenditures. In order to regularize the fiscal management of the country, an Act — Fiscal Responsibility and Budget Management Act (FRBMA) — was passed in 2003. The FRBM Act prescribes 3 percent of **GDP** as the upper limit for fiscal deficit, to be achieved by 2008-09. The 2007-08 budget estimates show that the government is close to achieving this target.

Apart from constraints imposed by the **FRBM** Act, robust economic growth and improved performance of the manufacturing and services sectors kept the tax revenue buoyant in the last five years. The average revenue growth rate, over this period, was 16.2 percent and growth rate of net tax revenue of the central government was 20.7 percent. The gross tax-**GDP** ratio increased from 8-9 percent during the preceding decade to 11.5 percent in 2006-07, and is estimated to rise to 12.9 percent in 2008-09 (BE). However, inflation rate has risen from about 5 percent during 2003-07 to 12 percent in July 2008. In order to control inflation, the RBI adopted a stringent monetary policy. It had raised the prime lending rates. However, due to low impact of global recession on the Indian economy and a prudent monetary policy, inflation rate has gone down to a negative rate of — 1.6 percent. But, in 2008-09, (RE) the fiscal deficit was 6.1 of **GDP**. The fiscal deficit remains a challenge for the government.

Self-Assessment

1. Choose the correct options:

(*i*) Federal Reserve Board of Governors members are appointed by the ____________ and confirmed by the _____________.

(*a*) Treasury; Congress (*b*) President; Senate

(*c*) Federal Reserve presidents; Treasury (*d*) Public; House of Representatives

(*ii*) FOMC, the policy making body of the Federal Reserve, stands for ________________________.

(*a*) Financial Options Management Corporation

(*b*) Final Organized Money Company

(*c*) Federal Open Market Committee

(*d*) Fiscal Operating Money Committee

(*iii*) The federal funds rate is set by the FOMC and refers to _________________.

(*a*) The rate that affects what fees banks charge consumers

(*b*) The rate in which the Treasury measures the deficit

(*c*) The interest rate that banks are charged to borrow from the Fed

(*d*) The interest rate that banks use to lend to each other overnight

(*iv*) The finance commission of India came into existence in

(*a*) 1951 (*b*) 19 45

(*c*) 1972 (*d*) 1989

9.3 Summary

- The India Constitution has divided the powers in various fields between the Central Government and States. For instance, in the financial field, it has very elaborate provisions. It may be noted that the financial relations between the Centre and States are among the most difficult problems in a federation.
- The Constitution has divided tax-sources between the Centre and the States so that there should be no overlapping of tax jurisdiction, otherwise, it will cause confusion and conflict. Thus, the distribution of taxes in India is more logical and thorough than in other federations.

Notes

- The property of the Union is exempt from State taxation. The property and income of the States are exempt from the Union taxation. In addition to the provisions for tax-sharing, Article 275 of the Constitution provides for both general purpose and specific grants.
- Under the Constitution, the Government of India can borrow internally as well as externally. The Article 292 empowers the Government of India to borrow upon the security of the Consolidated Fund of India. States too are empowered to borrow under Article 293 which States that a State cannot borrow outside India.
- The Finance Commission of India came into existence in 1951. It was established under Article 280 of the Indian Constitution of India by the President of India.
- In Centre-State financial relations, the Planning Commission is another important body which has an important place. The responsibility for taking decisions and implementing plans rests with the Union and the State Governments.
- It is observed that population has been given greater weightage for the basis of distribution of shareable taxes amongst the States. The two salient features of tax-sharing determined by the Finance Commissions are the growing importance of Union excise amongst the shared taxes and the ascendancy of population as the principal basis of distribution.
- The sprawling powers of the Central Government eroding the foundations of fiscal federalism have been questioned from time to time. Now, under the changed circumstances, need for change in the outlook of the Union towards the States and of the States towards the Union is being felt.
- The Twelfth Finance Commission was incorporated in the year 2005. The commission made recommendations for the distribution of the net proceeds of the taxes between the Union and the States. It also recommended taking of certain measures for augmenting the Consolidated Fund of a State.
- According to the TFC recommendations, the total transfers should be 73.8% more than what its predecessor allowed with both the share in Central taxes and grants-in-aid being higher. This means the States have scant cause for complaint over the TFC report.
- The word 'fisc' means 'state treasury' and 'fiscal policy' refers to policy concerning the use of 'state treasury' or the government finances to achieve certain macroeconomic goals. Fiscal policy has however been variously defined by the economists.
- A narrow concept of fiscal policy is **budgetary policy.** While *budgetary policy* refers to current revenue and expenditure of the financial year, fiscal policy refers to budgetary operations including both current and capital receipts and expenditure.
- The scope of fiscal policy comprises the *fiscal instruments* and the *target variables*. *Fiscal instruments* are the variables that government can use and maneuver at its own discretion to achieve certain economic goals.
- Fiscal policy is implemented through fiscal instruments also called 'fiscal handles', 'fiscal tools' and Tiscal levers'. The changes made in fiscal tools work through their linkage to the target variables.
- Public borrowings include both internal and external borrowings. The governments make borrowings, generally, with a view to financing their budget deficits.
- There is no unique fiscal policy that can provide appropriate solution to all kinds of economic problems and under different condition in different countries and at different points of time.
- The automatic fiscal policy means adopting a fiscal system with *built-in-flexibility* of tax revenue and government spending. *Built-in-flexibility* means automatic adjustment in the government expenditure and tax revenue in response to rise and fall in **GDP**.
- The working of automatic stabilizer is simple. In a fast growing economy, tax collection increases with increase in incomes which constraints aggregate demand. On the other hand, unemployment decreases causing decline in government spending.

- Another variant of stabilizing policy is *compensatory fiscal policy*. The compensatory fiscal policy is a deliberate budgetary action taken by the government to compensate for the deficiency in, and to reduce the excess of, aggregate demand.
- A discretionary fiscal policy is one in which ad hoc changes are made in the government expenditure and taxation system and tax rates at the *discretion* of the government as and when required.
- Peston has rightly remarked, "The literature on economic policy makes a great deal of fuss about discretionary versus automatic policy making. "The distinction between *automatic* and *discretionary* fiscal policies is a matter of frequency of government discretion in changing the taxation and expenditure programmes.
- The mechanism of fiscal policy described above appears to be theoretically simple and feasible. In practice, however, policy-makers face a number of problems in the formulation and execution of the fiscal policy.
- India's fiscal policy was formulated initially in 1950-51 in the background of India's economic conditions at the time of Independence. The Indian economy was trapped in a *vicious circle of poverty* with the lowest per capita income and consumption in the world.
- The most difficult problem that the Government of India faced was how to mobilize resources for development. It was with this background that the government formulated its *fiscal policy*. Under the conditions highlighted above, the Government of India adopted **discretionary fiscal policy.**
- The fiscal policy of the Central Government is reflected in its annual budget. Let us have an overview of the annual budgets of the Government of India in recent years.
- In order to understand the basic features of India's fiscal policy, let us study the central government's budget's of the last few years.
- Till 1990-91, the Government of India made minor modifications in its fiscal policy (including both taxation policy and expenditure pattern). But drastic changes were made in the fiscal policy and fiscal management of the country in 1991.
- Apart from constraints imposed by the FRBM Act, robust economic growth and improved performance of the manufacturing and services sectors kept the tax revenue buoyant in the last five years.

9.4 Key-Words

1. Fiscal federalism : As a subfield of public economics, fiscal federalism is concerned with "understanding which functions and instruments are best centralized and which are best placed in the sphere of decentralized levels of government" (Oates, 1999). In other words, it is the study of how competencies (expenditure side) and fiscal instruments (revenue side) are allocated across different (vertical) layers of the administration.
2. Fiscal policy : The three main stances of fiscal policy are:
   (*i*) Neutral fiscal policy is usually undertaken when an economy is in equilibrium. Government spending is fully funded by tax revenue and overall the budget outcome has a neutral effect on the level of economic activity.
   (*ii*) Expansionary fiscal policy involves government spending exceeding tax revenue, and is usually undertaken during recessions.
   (*iii*) Contractionary fiscal policy occurs when government spending is lower than tax revenue, and is usually undertaken to pay down government debt.

9.5 Review Questions

1. What is the meaning and scope of Fiscal Policy? Explain.
2. What are the constitutional provisions for the fiscal federalism? Discuss.
3. Write a note on the fiscal federalism in India.

Answers: Self-Assessment

1. (*i*) (*b*) (*ii*) (*c*) (*iii*) (*d*) (*iv*) (*a*)

9.6 Further Readings

Books

1. The Indian Economy; S.K. Ray; Prentic, Hall of India Private Limited New Delhi - 110001.
2. Indian Economy; Gaurav Datt and Aswani Mahajan; S. Chand and Company LTD. Ram Nagar, New Delhi-110055.

Unit 10: Government Finance: Union and States

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Objectives

After reading this Unit students will be able to:

- Describe the Government Finance: Union and States.

Introduction

It has been observed that since the mid-1980s, the fiscal position of the both Centre and States Government in India has been under pressure. The stress originates from the inadequacy of receipts in meeting the growing expenditure requirements. We find that the State finances have not been properly managed not only by the States but also by the Planning Commission and the Central Government, which include economists. They do not see States as autonomous, responsible organisations which have to take care of the debt by themselves. Today, one of the major obstacles in the way of reviving growth is the sorry state of State finances since they could not do the minimum that they should do. They have no money to invest. Apart from the persistent problem of unacceptable revenue deficits and high fiscal deficits, many State Governments are now faced with the problem of mounting debt, particularly the burden of contingent liabilities in the form of outstanding guarantees. At present, the estimated total debt of the Central and State Governments are above 80% of GDP. It may be noted that recent years have seen a very sharp upsurge in the indebtedness of both the Centre and the States.

10.1 Government Finance: Union and States

India has a federal structure, in which a clear distinction is made between the Union and State functions and sources revenue, but the residual powers belong to the Centre. Although the States have been assigned certain taxes which are levied and collected by them, they also share in the revenue of certain Union taxes, and there are certain other taxes which are levied and collected by the Union but the proceeds of which wholly go to the States. In addition, the States receive grants-in-aid of their revenue from the Union which further increase the amount of transfers between the two levels of governments. The transfer of resources from the Central Government to the States is an essential feature of the present financial system of India.

Division of Resources

The Constitution of India makes a clear division of fiscal powers between the Union (on the centre) and, the State Governments. The principle adopted for this classification is that taxes which have an interstate base are levied by the Union, while those with a local base are levied by the States. The residuary powers belong to the Union.

The Union taxes as laid down in List I, Seventh Schedule of the Constitution of India, are as under :

1. Taxes on income other than agricultural income, 2. Corporation tax, 3. Customs duties, 4. Excise duties except on alcoholic liquors and narcotics not contained in medical or toilet preparations. 5. Estate and succession duties other than on agricultural land, 6. Taxes on the capital value of assets, except agricultural land, of individuals and companies, 7. Rates of stamp duties on financial documents, 8. Taxes other than stamp duties on transactions in stock exchanges and future markets, 9. Taxes on sale or purchase of newspapers and on advertisements therein, 10. Taxes on railway freight and fares, 11. Terminal taxes on goods or passengers carried by railways, sea, or air, and 12. Taxes on the sale or purchase of goods in the course of inter-State trade.

Taxes within the jurisdiction of the States as given in List 11 of the Seventh Schedule of the Constitution of India are as follows :

1. Land revenue, 2. Taxes on the sale and purchase of goods, except newspapers, 3. Taxes on agricultural income, 4. Taxes on land and buildings, 5. Succession and estate duties on agricultural land, 6. Excise on alcoholic liquors and narcotics, 7. Taxes on the entry of goods into a local area, 8. Taxes on mineral rights, subject to any limitations imposed by Parliament, 9. Taxes on the consumption and sale of electricity, 10. Taxes on vehicles, animals and boats, 11. Stamp duties except those on financial documents, 12. Taxes on goods and passengers carried by board or inland waterways, 13. Taxes on luxuries including entertainments, betting and gambling, 14. Tolls, 15. Taxes on professions, trades, callings and employment, 16. Capitation Taxes, and 17. Taxes on advertisements other than those contained in newspapers.

The Union and the State Governments have concurrent powers to fix the principles on which taxes on motor vehicles shall be levied and to impose stamp duties on non-judicial stamps. The property of the Union is exempted from State taxation and the property and income of the State are exempted from Union taxation. The Parliament may, however, pass legislation for taxation by the Union of any trading or business activities of a State which are not part of the ordinary functions of the Government. States may delegate part of their taxation power to the Central Government, as had happened in the base of agricultural land being included in the purview of the Estate Duty Act in many States. Parliament has exclusive power to tax sales or purchases of goods in the course of inter-State trade.

Distribution and Allocation of Central Revenue

Apart from the taxes levied and collected by the States, the Constitution had provided for the revenues for certain taxes on the Union list to be allocated, partly or wholly, to the States. These provisions fall into various categories.

There are, in the first place, certain duties which are levied by the Union but are collected and appropriated by the States. These include stamp duties and excise duties on medical preparations containing alcohol or narcotics.

Secondly, there are certain taxes which are levied and collected by the Union, but the entire proceeds of which are assigned to the States, in proportion determined by the Parliament. These taxes include succession and estate duties, terminal taxes on goods and passengers, taxes on railway freight and fares, taxes on transactions in stock exchanges and futures markets, the taxes on the sale and purchase of newspapers and advertisements therein.

Thirdly, Central tax on income and Union excise duties were levied and collected by the Union but were shared by it with the States in a prescribed manner.

Finally, the proceeds of additional excise duties on mill-made textiles, sugar and tobacco, which were levied by the Union in 1957 in replacement of States' sales taxes on these commodities, are wholly distributed among the States in a manner as to guarantee their former incomes from the displaced sales taxes.

Resources Transferred to the States

The importance of Central contributions to State resources becomes clear from Table 1 showing the transfer in broad categories since the inception of economic planning.

Notes

The figures indicate the rising contribution of the Centre to State resources. On an average, the States received ₹ 280 crores per year from the Centre during the First Plan, ₹ 3,020 crores per year during the fourth plan, and ₹ 21,000 crores per year during the the Seventh Plan.

During the first plan, 36 per cent of the State expenditure was met by resources transferred by the Centre. Currently, transferred resources from the Centre pay for 46 per cent of the total expenditure of the States. The growing transference of resources from the centre to the states is evidence of : (a) increasing integration between the Central and State finances; (b) helpless dependence of States on the Centre; and (c) growing power and interference of the Centre in the affairs of the State.

Table 1 : Gross Devolution and Transfer of Resources from the Centre to the States

(₹ crores)

		Shared Taxes	Grants	Loans (net)	Total	Transferred Resources as percentage of States' total expenditure
	1951-52	50	30	70	150	25
First Plan	(1951-56)	340	290	800	1,430	36
Second Plan	(1956-61)	670	790	1,430	2,870	42
Third Plan	(1961-66)	1,200	1,300	3,100	5,650	43
Fourth Plan	(1969-74)	4,560	3,830	6,710	15,100	37
Sixth Plan	(1980-85)	23,730	15,470	14,120	53,320	46
Seventh Plan	(1985-90)	49,460	42,810	31,260	1,23,530	46
For the period	(1990-95)*	98,890	90,720	54,650	2,44,260	43

Source : Report of the Twelfth Finance Commission (2005-10) and other Finance Commissions

The Finance Commission Awards

Under the provisions of Article 280 of the Constitution, the President is required to appoint a Finance Commission for the specific purpose of devolution of non-plan revenue resources. The functions of the Commission are to make recommendations to the President in respect of

(i) the distribution of net proceeds of taxes to be shared between the Union and the States and the allocation of share of such proceeds among the States,

(ii) the principles which should govern the payment by the Union of grants-in-aid to the revenues of the States, and

(iii) any others matter concerning financial relations between the Union and the States.

The appointment of the Finance Commission is of great importance, for it enables the financial relation between the Centre and the units to be altered in accordance with changes in need and circumstances. The elasticity in relationship introduced by this provision has great advantage.

(a) Division and Distribution of Income Tax

The personal income tax is imposed and collected by the Union Government but the net proceeds are shared between the Centre and the States under Article 270 of the Indian Constitution. The Finance Commissions have to give their award on two points :

(a) the share of the States in the total collection of income tax (this is known as vertical division) and

(b) the principle/principles which should govern the share of each State in the divisible pool (this is konwn as horizontal division of resources between states).

Vertical division of Income Tax

The First Finance Commission (presided over by J.P. Neogi) recommended that the States should share 55 per cent of the proceeds of the income tax. But the successive Finance Commissions

Notes

had raised the States' share in income tax to the level of 85 per cent (Seventh, Eighth and Ninth Finance Commissions). However, the Tenth Finance Commission in its report for the period 1995-2000 recommended that 77.5 per cent of the net proceeds of taxes on income should be assigned to states.

Horizontal division of income tax proceeds

As regards the basis for the distribution of the States' pool of income tax proceeds among the States, the first few commissions had used the double criteria of population and tax collection.

The First Finance Commission, for instance, recommended the allocation of income tax proceeds on the basis of 80 per cent and 20 per cent for population and collection. This criterion benefited populous states as well as those richer states which contributed more income tax revenue. The Second Finance Commission regarded population of a State as a more important basis for distribution and, accordingly, awarded that 90 per cent of the States' divisible pool of income tax should be distributed on the basis of population. This criterion naturally favoured populous states like Uttar Pradesh and Bihar which were the poorest states in India. This was reversed by the Third and Fourth Finance Commissions which raised the share of collection to 20 per cent and thus gave greater share to States like Maharashtra and West Bengal which contributed most of the collection of income tax (because of the location of metropolitan cities like Bombay and Calcutta). From the Fifth Commission onwards, population had again become the major criterion for distribution of income tax proceeds among the States.

For the first time, the Eighth Finance Commission presided over by Y.B. Chavan, introduced a new formula for distribution of the income tax proceeds among the States :

(a) 10 per cent would continue to be distributed among the States on the basis of collection of income tax;

(b) 90 per cent of the proceeds of the income tax would be distributed among the States on the following criteria :

25 per cent on the basis of population;

25 per cent on the basis of inverse of the per capita income of the state multiplied by population; and 50 per cent on the basis of the distance of the per capita income of a state from the highest per capita income state (i.e., Punjab) and multiplied by the population of the State.

The basic objective of this three-factor formula was to bring about a high degree of equity among the States. The Ninth Finance Commission (NFC) basically followed the above formula with minor modifications.

The Tenth Finance Commission (TFC) evaluated the formula of both Eighth and Ninth Finance Commissions and introduced the following formula/criteria to determine the shares of the different States in the shareable proceeds of income tax :

(a) 20 per cent on the basis of population of 1971;

(b) 60 per cent on the basis of distance of per capita income of a State from that of the State having the highest income;

(c) 5 per cent on the basis of area adjusted;

(d) 5 percent on the basis of index of infrastructure; and

(e) 10 per cent on the basis of tax effort.

It would be clear from the above table that (a) the successive finance commissions, except the Tenth, had increased the share of the States in the income-tax levied and collected by the Centre, and (b) the proceeds are shared among States mainly on the basis of population, economic backwardness and other criteria.

(b) Division and Distribution of Excise Duty

Vertical division : The First Finance Commission selected three excise duties—on tobacco, matches and vegetable products—for division with the States, so as to give them larger revenues. These commodities are widely consumed and yield a substantial revenue to the Government.

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The Commission recommended 40 per cent of the net proceeds of these duties to be distributed among the States on the basis of population. The Second Finance Commission added to the list of duties shared between the Union and the states, but reduced the share of the States from 40 per cent to 25 per cent. The Third Finance Commission increased the number of excisable commodities in the divisible pool from 8 to 35 by including all commodities on which duties were collected in 1960-61 but reduced the States' share from the divisible pool from 25 per cent to 20 percent. The Fourth Finance Commission enlarged the list to 45 commodities, but the share of the duties was retained at 20 per cent. The Fifth and Sixth Commissions did not make any change.

The Seventh Finance Commission, however, raised the States' shares to 40 per cent of the net proceeds. The Eighth Commission raised the States' share to 45 percent and distributed 40 percent on the basis of a new formula—the same as for income tax—and 5 per cent to deficit states. The Ninth Finance Commission proposed to distribute the entire amount of 45 per cent as a consolidated amount without dividing it into two components of 40 per cent and 5 per cent.

Finally, the Tenth Finance Commission has raised the share of the states in the net proceeds of union excise duties to 47.5 percent. This rise in the States' share in excise duties is to compensate for the reduction in their share in come tax.

It is necessary to emphasise here that all finance commissions kept one basic objective, that is, *to increase the share of the States in the proceeds of Central excise duties*. The first few finance commissions brought in more and more central excise duties under the divisible pool, but reduced the percentage share of the States. The Seventh, and subsequent Finance Commissions, however, have

(a) brought **all** the Central excise duties under the divisible pool; and

(b) raised the share of the States from 20 per cent to 40 percent and then finally to 47.5 per cent.

Thus, over the years, Finance Commissions have increasingly relied on Union Excise Duties in meeting the revenue needs of the States.

Horizontal division

As regards the horizontal distribution of the proceeds of Central Excise Duties among States, the Finance Commissions had initially adopted two criteria, *viz*., the population of the State and the backwardness of the States. This system of distribution clearly favoured populous bin economically backward states like Uttar Pradesh and Madhya Pradesh.

The Seventh Finance Commission was the first to introduce a new formula for distribution of the States' share of the Central excise duty : 25 per cent weightage equally to (a) population, (b) increase in the per capita income of the state, (c) the percentage of the poor in each state, and (d) a formula for income equalisation between states.

The Ninth Finance Commission (NFC) recommended the following method for distribution of the net proceeds of the Union Excise Duties among the States :

(a) 25 per cent should be distributed among the States on the basis of 1971 population;

(b) 12.5 per cent should be distributed among the States on the basis of Income Adjusted Total Population (IATP)

(c) 12.5 per cent should be distributed on the basis of index of backwardness;

(d) 33.5 per cent should be distributed on the basis of distance of the per capita income of a State from that of the State having the highest per capita income i.e. Punjab; and

(e) the remaining 16.5 per cent should be distributed among the States with deficits, after taking into account their shares from income tax, excise duties and other shareable taxes.

The Tenth Finance Commission used the same formula prepared for the sharing of income tax for sharing the proceeds of 40 percent of excise duties among the states as well. The remaining 7.5 per cent is distributed among deficit states.

(c) Additional Excise Duties in lieu of Sales Tax

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Apart from the usual excise duties, the Central Government has been levying additional excise duties on sugar, tobacco, cotton fabrics, woollen fabrics and man-made fabrics-- these goods were declared to be goods of special importance in inter-state trade and commerce. This scheme of levying additional excise duties on the above goods was the outcome of an agreement reached at the meeting of the National Development Council (NDC) held in December 1956, by which the States agreed to refrain from exercising their power to levy sales tax on these commodities in lieu of a share in additional excise duties to be levied by the Centre. Accordingly, since 1957, the Centre has levied and collected these additional excise duties and the entire proceeds (after deducting the share of Union territories) are distributed among the States in accordance with the principles of distribution laid down by the Finance Commissions from time to time.

The Second, Third, Fourth and Fifth Finance Commissions adopted a procedure under which they first

(a) set apart the guaranteed level of States' revenue which the States were realising from sales tax on these commodities in 1956-57 and then (b) the balance amount of additional excise duties was distributed among the States according to specific principles. The Finance Commissions adopted such criteria as

(a) Percentage increase in the collection of sales tax in each State since 1956-57; and

(b) size of population of each State.

The Sixth Finance Commission made a departure from the earlier practice of first setting apart a minimum guaranteed amount for each State and then distributing the balance—the Commission was convinced that the share of each State would always exceed the revenue they would have realised in 1956-57 from the respective sales taxes on these commodities.

As regards the basis of distribution, the Sixth Finance Commission took the view that the additional duties of excise were levied in lieu of sales tax, which was itself a tax on consumption, the shares of various states should correspond to their shares in the consumption of these commodities. However, the Commission felt that reliable consumption figures were not available and, accordingly, it took State domestic product (SDP) and population as reliable approximation of consumption levels. Besides, the Commission also felt that the States would have realised sales tax not merely on what was consumed in the State but also on what was produced in the State and sold in the course of inter-state transactions of these commodities. Hence, the Sixth Finance Commission allocated the shares of additional duties on excise on the basis of population, State domestic product (SDP) and production in the ratio of 70 : 20 : 10. The subsequent finance commissions accepted this principle with minor modifications.

(d) Grant in lieu of Tax on Passenger Fares

Article 269 of the Constitution empowers the Government of India to levy and collect taxes on railway fares and freights but the net proceeds are to be assigned to the States. This tax was first imposed in 1957 and the proceeds were distributed to the States. The tax was repealed in 1961. Actually, the tax on passenger fare was merged with the basic fare and the system of grant was introduced to compensate States for the consequential loss of revenue. The tax on passenger fare was revived in 1971 but was again repealed in 1973. Now, the Finance Commissions were given the responsibility to suggest the grants to be made to the States in lieu of the tax on passenger fares. There are two points to be decided :

(a) What should be the volume of grant the Centre should transfer to the States in lieu of the tax on passenger fares, i.e., should it be a fixed amount or should it be a fixed percentage of the total passenger earnings; and

(b) What should be the basis of inter-state sharing of the grant ?

On the first question, there has always been differences between the Centre and the States. At the time the tax on passenger fare was repealed, it contributed 10.7 per cent of the non-suburban railway passenger earnings. Accordingly the States have insisted that the grant should be pegged at 10.7 per cent of the railway passenger earnings at all times. On the other hand, the Railways

have always insisted that the quantum of grant should be fixed as a given amount. This amount was originally fixed at ₹ 23 crores. The Railways' case for a fixed amount of grant was based on the following arguments :

(a) The impact of social obligations has been rising continuously and the annual loss to the Railways by way of subsidisation of passenger fares and tariff on low-rated commodities was around ₹ 2,000 crores. In other words, the Railways have been subsidising not only passengers traffic but also freight traffic.

(b) Railway receipts should not be treated on part with Central Government tax revenues, part of which devolves on the States. The Railways –being a major public utility undertaking - have to find adequate resources to provide a modern and efficient transport infrastructure to meet the demands of a growing economy which is acquiring further complexity and sophistication. Accordingly, increasing the amount of grant in lieu of the tax on passenger fare beyond the current size would put their development efforts at jeopardy.

Evaluation of the First Eleven Finance Commission Awards

The appointment of a Finance Commission at intervals of five years or less has great significance for the financial relations between the Union and the States. Periodic examination of the division of resources and suitable modifications in it imparts a degree of flexibility to the finance of both the Centre and the States. This flexibility is of great value in these days of changing needs and resources. The planned development of the country involves growing expenditure and, therefore, larger revenues, and an elastic system of finance is a great necessity. Through the transfer of resources from the Centre to the States, the elasticity of the Union sources of revenue is transmitted to the State finances also. The Finance Commissions help in this process by making suitable suggestions.

The general complaint against the awards of Finance Commissions is that they generally estimate revenue gaps of States (excess of revenue expenditure over their own revenues) and devise measures for 'gap filling'. In other words, the Finance Commission awards have been characterised as 'gap-filling' awards. This type of criticism may not hold good especially for the awards of Seventh and Eighth Finance Commissions. The Seventh Finance Commission was probably the first finance commission to be deeply concerned with the equitable system of federal transfers and accordingly the devolution under the Seventh Finance Commission award was twice that of the Sixth Finance Commission. The Eighth Finance Commission was also deeply concerned with the need to help the most poverty-stricken states, hill states and backward states and its award almost doubled the devolution of the Seventh Finance Commission. There was, therefore, some justification in the claim of the Eighth Finance Commission that its award was not simply 'gap-filling', but that it attempted to achieve the twin objectives of a more equal relationship between the Centre and the States and interstate equity.

In this context, a major shift in the awards of the Finance Commission from 7th to 11th Finance Commissions may be mentioned here. In their attempt to fill the resource gap of the states, the first Six Finance Commissions relied heavily on grants-in-aid to cover their revenue deficits. The Seventh Finance Commission raised the states' share in the divisible pool of taxes by (a) raising the states' share in income tax from 80 per cent to 85 per cent, (b) bringing all excise duties under the divisible pool and (c) by raising the states' share in excise duties from 20 per cent to 40 per cent. The Eighth Finance Commission further increased the states' share in excise duties to 45 percent (the additional 5 per cent to be meant for deficit states). As a result of these recommendations, the devolution of tax revenue to the states was so much that the Seventh and Eighth Finance Commissions did not find it necessary to recommend large grants-in-aid to cover the revenue deficit of States. This trend was reversed by the successive Finance Commissions and we do find sizable grants-in-aid to cover revenue deficit of the states by Ninth to Eleventh Finance Commission.

Centre-State Conflict on Finances

In the last few decades, there has always been growing conflict and tension between the Indian Union and the States in the matter of finance. This con flict has often been aggravated by political and ideological differences between the different parties governing the Centre and the States.

The framers of the Indian Constitution provided for grants and loans so that the Centre might come to the help of those States which were in difficulty and also to bring about balanced development of the different regions. The use of grants and loans in the last 40 years or so, however, has resulted in the complete domination and control of the States by the Centre and to a certain extent, even financial irresponsibility and indiscipline on the part of the States. The enormous increase in transferred resources from the Centre to the States, the phenomenal growth in loan assistance to the states and the political pressure amounting to blackmail by the Centre through the instrument of grants have frightened the States. Hence, there has been an insistent demand for a comprehensive review of Centre-State relations in general and Centre-State financial relations in particular. The J.K. Thavaraj Committee (Report of the taxation Enquiry Committee, Kerala Government), the Rajamannar Committee on Centre-State relations appointed by the DMK Government of Tamil Nadu and the document on Centre-State relations (1978) adopted by the West Bengal cabinet led by the CPI-M United Front—all these have the same theme *viz*., political and financial autonomy for the States and drastic restriction of the power and financial resources of the Centre.

Responsibility and Resources of the Centre and of the States

According to the Constitution, the Centre has to concern itself with the most generalised features of the Indian economy such as the creation and maintenance of the banking system, railways and ports as well as facilities for national economic planning with the regulation and development of large-scale industries, exploitation of mineral resources, regulation of foreign trade, etc., besides, of course, the defence of the nation from foreign aggression. On the other hand, the States are concerned with important aspects of the life of the people, such as the maintenance of law and order, the construction and maintenance of irrigation, power, road transport, etc the development of educational and health facilities, the promotion of primary sector such as agriculture, fisheries, forests and secondary sector *viz*., tiny, small and medium industries.

In order to carry out these responsibilities the Constitution provided for different types of financial resources. The Union is entrusted with taxes on personal incomes and profits of companies, excise duties and customs duties. In a rapidly developing economy, these are precisely the most productive taxes in the country. In the case of the States, land constitutes an important base of taxation. In a densely populated country like India, the volume of land coming under tax remains almost stationary. Therefore, land, as a source of revenue has been responsible for the inelastic nature of State revenues to a considerable extent. On the other hand, the various taxes on commodities and services like sales tax, State excise duties, duties in electricity rates, motor vehicles tax etc can be quite productive.

Taxation of industrial and commercial properties has been the preserve of the Centre, and tremendous expansion in the base of industrial and commercial property, income and wealth as a result of economic development 11 as been responsible for raising the financial resources of the Centre. At the same time while rapid industrial development boosted Central excise duty collection, expansion of imports pushed up customs duty collections. This seems to have given a buoyancy to the Central revenues which is not available to any tax head assigned to the States except sales tax.

The period since 1951 has witnessed an enormous expansion of financial powers of the Central Government whose dimensions have progressively increased in relation to the combined resources of all State Governments put together. For instance, the current tax revenues of the Centre have risen from ₹ 360 crores in 1950-51 to ₹ 65,000 crores in 1994-95 and to ₹ 5,48,120 crores in 2007-08 (budget) On the other hand, current tax revenues of the States (excluding transfers from the Centre) have risen from ₹ 280 crores in 1951-52 to ₹ 53,400 crores in 1994-95 and ₹ 2,57,250 crores in 2006-07 (budget). The rate of growth of revenues of the Centre is much faster as compared to that of the States. But then, the Centre has only limited functions to perform while the functions of the States are almost unlimited.

In a way, the Indian Constitution itself is responsible for the existence of a financially strong-Centre and weak-States. Until partition, there was a growing consensus in favour of the corporation tax and export duties to be included in the divisible pool. This was the case made out before the Sircar Committee known as the Expert Committee on Financial Provisions. It was partition which alerted the Constituent Assembly against possible dangers to the unity of India arising from the divisive forces. Its effect is reflected in the strong-Centre theme which runs through the Constitution. The financial provisions of the Constitution clearly reflect this strong-Centre bias.

Report of the Central Government on SubSidies in India (2004)

Finance Minister P. Chidambram presented the *Report on Central Government Subsidies in India* in December 2004. It is just coincidental that in May 1997, Mr. Chidambram had also presented the discussion paper '*Government Subsidies in India.*' The present report has, a narrow focus on account of the following reasons. Firstly, it focuses on only Central Government subsidies and leaves out state Government subsidies. The earlier Discussion Paper was thus more comprehensive. Secondly, while it gives a total estimate of explicit and implicit subsidies, it concentrates on a detailed analysis of only explicit subsidies which account for only 40 percent of total subsidies in 2003-04 and undertakes no analysis about the composition, structure and need for 60 percent implicit subsidies. Even in explicit subsidies, it makes a detailed, though very useful analysis of only three major subsidies on food, fertilizers and petroleum. With these limitations, it appears that the Report was intended to provide some suggestions for reducing only explicit subsidies for the 2005-06 budget, but did not make a penetrating analysis on the need for reducing overall subsidies, at the Central as well as the State level.

The Report classifies subsidies in two broad groups -merit and non-merit subsidies. Merit subsidies are further classified into Merit-I and Merit-II subsidies.

Merit-I : Elementary education, primary health care, prevention and control of diseases, social welfare and nutrition, soil and water conservation, ecology and environment.

Merit-II : Education (other than elementary), sports and youth services, family welfare, urban development, forestry, agricultural research and education, other agricultural programmes, special programmes for rural development, land reforms, other rural development programmes, special programmes for north-eastern areas, flood control and drainage, non-conventional energy, village and small industries, ports and light houses, roads and bridges, inland water transport, atomic energy research, space research, oceanographic research, other scientific research, census surveys and statistics, and meteorology.

Non-merit : All others.

But the classification into Merit I and Merit II loses its significances since the Report states : Subsidy reforms should aim at "limiting these two only merit I and Merit II categories while eliminating non-merit subsidies." In case, it in intended for prioritization, even then it depends on the subjective judgment of State and Central governments. Both kinds of subsidies Merit I and Merit II are considered sacrosanct. Thus, the sub-classification into the two is of academic value.

Data provided by the Report reveals that total subsidies have grown from ₹ 36,829 crores in 1992-93 to ₹ 1,15,824 crores in 2003-04. Thus, the average annual growth rate (AGR) was 11.0 percent during the 11-year period. Out of them, explicit subsidies have increased from ₹ 11,995 crores in 1992-93 to ₹ 46,869 crores in 2003-04, indicating an annual growth rate of 13.2 percent. As a percentage of total subsidies, explicit subsidies have increased from 32.6 percent to 40.5 percent during this period. Likewise, implicit subsidies have jumped from ₹ 24,834 cores in 1992-93 to ₹ 68,955 cores in 2003-04, indicating an annual average growth rate of 9.7 percent. The share of implicit subsidies in total subsidies has, however, fallen from 67.4 percent to 59.5 percent during the period. The point which deserves attention is that the absolute size of implicit subsidies is nearly one and half times the size of explicit subsidies.

Another, interesting revelation is that in 2003-04 the share of merit subsidies in total subsidies was 42 percent and that of non-merit subsidies was 58 percent. Since subsidies are the difference between the cost of providing goods and services and the receipts obtained from the users, then it may be noted that in merit goods, the recovery rate is only 0.9 percent and in non-merit goods, it is 47.3 percent. As a policy prescription, there is a need to gradually increase the recovery rate in non-merit goods to reduce the huge outgo in the form of subsidies to this sector, but this is again apolitical decision that coalition government which have been in power during the last 15 years in India are unable to take due to various kinds of political pressures from different sectors of the population.

The share of social services which include education, health, family welfare, water supply and sanitation and labour and employment is only 21.2 percent in total subsidies, and the share of economic

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services, viz., agriculture, rural development, energy, industry and minerals, irrigation and flood control, science, technology and environment is 78.8 percent in the total subsidies. Although it is possible to reduce subsidies in social services to some extent by raising recovery rates in university and higher education and to some extent in some unnecessary youth and welfare programmes, but this shall have to be compensated by increasing subsidies in compulsory elementary education and expanding public health services for the poor. In short, the scope for reducing subsidies in social services in practically negligible.

There is, however, enough scope for reducing subsidies in economic services. For instance, in agriculture and rural development activities, subsidies of the order of ₹ 50,579 cores were provided in 2003-04, but recovery rate was barely 1.3 percent. Similarly, in coal and lignite which is a non-merit good, the recovery rate is only 3.3 percent. Another big area for reducing subsidies is industry and minerals which receives a subsidy of ₹ 29,532 crores and the recovery rate is only 6 percent. Besides bringing about an overall increase in recovery rate, there is a need to give pointed attention to reducing subsidies in agriculture and rural development, coal and lignite and industry and minerals. But the farm lobbies on the one hand and industrial lobbies on the other, besides the coal mafia would put up resistance. Again, the decisions have to be taken at the political level.

Let us examine the issues at the level of the Central Government. Of the total Central Government subsidies in 2011 -12 of the order of ₹ 1,43,570 crores, food subsidy accounts for ₹ 60,573 crores (42.2%), fertilizer subsidy Rs, 49,981 crores (34.8%) and petroleum subsidy ₹ 23,640 crores (16.5%). Taking food, fertilizer and petroleum, these three subsidies account for 93.5 percent of the total explicit subsidies. Other Central Government subsidies on Railways, interest subsidy etc. account for barely 6.5 percent. Obviously, if explicit subsidies have to be reduced, then steps have to he taken to limit these three subsidies.

Food subsidy

Food subsidy in India comprises of three components : (i) subsidies to farmers through support prices, (ii) subsidies to consumers through public distribution system, and (iii) subsidies to the Food Corporation of India (FCI) in its purchase and maintenance of buffer stocks. Data reveal that during 1997-98 and 2003-04, the Central issue price of rice was increased from ₹ 350 per quintal to ₹ 565 per quintal - an increase by 61.4 percent and that of wheat was increased from ₹ 250 per quintal to ₹ 415 per quintal - an increase by 66 percent. However, the consumers price index for agricultural labourers (CPIAL) increased by only 25.8 percent during this period. The purpose of raising the issue price at a relatively higher rate than the rise in CPIAL was to subsidize the farmers to keep foodgrains production at a comfortable level.

Since the FCI continues to purchase foodgrains without any limit, this has resulted in the creation of buffer stocks in FCI godowns far in excess of the prescribed minimum norms. Food stock reached a peak of 63 million tonnes in July 2002, more than 2.5 times the norm of 24 million tonnes. By April 2004, the stocks were brought down to 20 million tonnes, not by increasing PDS offtake of foodgrains, but by exporting foodgrains at near BPL prices. The cost of handling and carrying costs of foodgrains by the FCI over and above the minimum norm is met by the subsidy to FCI. Since FCI operations are concentrated only in five states, viz., Punjab, Haryana, Western UP, Andhra Pradesh and Chhattisgarh, the entire subsidy is available to farmers in these states only. Moreover, since the Minimum Support Price (MSP) is limited to only two crops, rice and wheat, this has distorted the cropping pattern in favour of these two foodgrains.

The Report has suggested the following policy reforms :

(i) Minimum Support Price (MSP) should correspond to CACP-determined C2 cost, which includes all cash costs and the imputed value of family labour.

(ii) Before every sowing season, food procurement targets should be fixed on the basis of norms and a margin of error of about 10 percent. FCI should suspend puchase of operations once the targets are achieved.

(iii) A system of price insurance, similar to Farm Income Insurance Program introduced recently on a pilot basis, may be developed.

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(iv) FCI should include a greater number of states in their price-support operations.

(v) In order to enforce efficiency, the reimbursement to FCI should be on the basis of normative unit costs and actually involved quantity, instead of reimbursement on actual basis.

(vi) To improve PDS penetration and reduce leakages, the Government can introduce the system of food coupons for the poor. A uniform PDS price will be fixed for APL and BPL facilities, but the poor can buy foodgrains partly with coupons and partly with cash. Since the poor cannot afford monthly procurement of foodgrains in one go, the PDS purchases should be allowed only on a weekly basis. Restricting monthly bulk purchases at PDS will discourage the not-so-needy from PDS outlets. This will help self-targeting of PDS.

All these measures appear to be good intentioned. But the major problem relates to their implementation. It is said that habits die hard and hardened habits are still difficult to break. For all these years, the State has been succumbing to farm lobby pressures, thereby responding by raising the minimum support price as also undertaking unlimited procurement. With limiting PDS operations to only five states, a huge buffer stock surplus was created which the state frittered away in exports at nearly BPL prices. Now on the one hand, a proposal is made to extend procurement to more states, and on the other, to limit procurement to the procurement target fixed in the beginning of the agricultural season, appears to be a non-feasible proposition. It would have been better if the present practice of procuring foodgrains by FCI had been continued and the Government should resist further increase in MSP beyond the increase in CPIAL. At the same time, the surplus in FCI godowns should be used to guarantee employment to all unemployed by extending the provisions of the Employment Guarantee Act. Wages can be paid partly in cash and partly in kind - foodgrains. This will be a more practical way of converting food subsidy into employment. The Government will earn the goodwill of farmers as well as unemployed-landless labourers, marginal farmers, and other semi-literates in rural areas.

Fertilizer Subsidy

Fertilizer subsidy which was ₹ 6,735 crores in 1995-96 shot up to Rs, 13,800 crores in 2000-01- more than double the level during the five year period. There after, it slightly declined and was around ₹ 12,000 crores in 2003-04. As a proportion of GDP, fertilizer subsidy which was only 0.23 percent in the early- 1980s increased to a peak of 0.93 percent in 1989-90 and thereafter, it started to decline. It was barely 0.53 percent in 1993-94. In the subsequent period, reversal of trend occurred, it reached a level of 0.68 percent in 1999-00, but had declined since then to an estimated level of 0.43 percent in 2003-04. In 2010-11 (BE) fertilizer subsidy has been kept at ₹ 49,981 crores.

Fertilizer subsidy is the difference between the retention price of fertilizers and the price at which fertilizers are made available to consumers. The difference is paid to industry as subsidy. A serious attempt was made by the Government to reform the Retention Price Scheme (RPS) so as to rationalize fertilizer subsidies. Government decontrolled the import of phosphorus and potassium fertilizers and provided a flat-rate concession on their imports. But urea imports continued to be restricted and canalized. In 2000, on the recommendation of Expenditure Reform Commission (ERC) a group-concession rate scheme was introduced on 1st April 2000. ERC recommended phasing out of the unit-wise RPS in stages over a period of six years.

Studies have revealed that overall, for the entire period of 1981-82 to 2002-03, the average share of farmers in fertilizer subsidy was 62 percent and that of industry was 38 percent. Any scheme of rationalization of fertilizer subsidy depends on two factors : (i) efficiency of domestic fertilizer industry and the domestic cost of production, and (ii) the international price of urea. In the event of opening up of fertilizer sector imports, the gas-based plants would survive, whereas others, particularly naphtha-based plants, would not. This is due to the fact that naphtha or fuel oil or low sulphur feedstock is more costly as a raw material than natural gas.

The Report suggests that there is a need to reduce the subsidy to farmers as well as industry. In the short run, the subsidy may be continued. But in the long run, the option of setting up fertilizer plants in such countries where natural gas is available in plenty may be considered. Secondly, there is a need to increase the farm-gate price of urea at regular intervals. The Report is of the opinion that the

application of fertilizers is "more dependent on technological and non-price factors than on price or agro-economic variables. These factor include irrigation facilities, cropping pattern, spread of high yielding varieties (HYVs), effective fertilizer distribution and availability of credit." The Report, therefore, is of the view that the increase in urea prices may not translate into lower production. It recommends public investment as "an effective instrument to promote the use of fertilizers." Moreover, rationalization of urea price would have a salutary impact on balanced application of N (Nitrogen), P (Phosphate) and K (Potash).

Future Policy on Subsidies

It is now really over a decade that a comprehensive paper on subsidies was presented by National Institute of Public Finance and Policy (NIPFP) in 1997. The situation has changed drastically since then and there is a need to re-examine the issue. The main reasons are :

1. Implicit subsidies in various forms are growing both at the Central and State levels. Take for instance, the large number of tax exemptions on Special Economic Zones (SEZs) granted by the Government. They imply a big loss of tax revenues. Another instance is the role of the state governments in acquiring land for SEZs and passing on to industrial houses.

   West Bengal in its drive for industrialisation agreed to the following subsidies on its Singur project to the Tatas. The land at Singur has been provided by the Government to the Tatas on a 90-year lease, with no downpayment. Secondly, for the first five years, Tatas will pay ₹ 1 crore as rent and the yearly payment will increase by 25% for each year interval for five years for the next 25 years. For the next 30 years, payment will increase by 33% at a five year interval and for the final 20 years, the rent would be ₹ 20 crore per year. The West Bengal Government also agreed to provide a loan to the Tatas of ₹ 200 crores at 1 percent rate of interest while the VAT proceeds accruing from the sale of cars will be handed back to the Tatas against 1 % loan for the first 10 year period. But as against this, the total compensation to the farmers will be of the order of ₹ 200 crores.

   The question raised by the crities of industrialisation paradigm of development is : Are we following a policy of inclusive growth by taking away the livelihoods of farmers, sharecroppers and other associated persons dependent on land ? On the other hand, are we providing heavy subsidies of several kinds—land acquisition and development by the Government on behalf of industry, subsidised power, generous tax holidays, financial support for purchase of equipment, subsidised credit and exemption of waiver from exports etc. to industrialists.

   Similarly, the state governments have been providing free or highly subsidised electricity for agriculture which benefit mainly the rich farmers.

   It has been estimated that various kinds of tax exemptions have resulted in revenue foregone to the tune of ₹ 2,78,644 crores - a colossal sum indeed. The Government has been praising the corporate sector for better tax compliance resulting in a sharp increase in corporation tax revenues, but facts as they stand, reveal that although notionally, the corporation tax rate is 33%, its effective rate is only 19%. This sharp reduction in effective rate as against the prescribed rate of 33% is the result of the plethora of exemptions granted to the corporate sector.

2. There is a need a consider the legitimacy of other subsidies as well which fall in the category of non-merit subsidies.

3. There is a tremendous change in the situation with respect to petroleum subsidy since international price of crude petroleum has crossed $ 110 per barrel. If the government provides the subsidy fully to oil companies, then the subsidy amount is likely to reach 1.5 lakh crores this years. As a consequence, the fiscal deficit could be pushed up by an additional 3.2% of GDP. The Government could partially salvage the situation by providing 50% subsidy in the form of bonds and thus, only the interest on bonds will be reflected in the budget as a cost. But when the bonds mature at a future date, their redemption will exercise pressure on the fiscal deficit.

The situation in case of fertilizer subsidies is no better. The international price of fertilizers is 4-5 times the domestic price. The likely impact of fertilizers subsidy is going to be ₹ 80,000 crores as

against the provision of ₹ 31,000 crores in 2008-09 budget.

A similar situation prevails in food subsidies. The international price of foodgrains has also risen sharply. On account of shortage at home, India has decided to import one million tonne of foodgrains so that the weaker sections of society are provided foodgrains at subsidized rates. Thus, the foodgrains subsidy bill will be much higher than the provision in the 2008-09 budget of the order of ₹ 32,667 crores.

The Finance Minister made a provision of ₹ 66,537 crores in the budget for 2008-09 for food subsidy ₹ 32,666 crores, for fertilizers ₹ 30,986 crores and for petroleum for ₹ 2,885 crores. But both national and international factors are going to jeopardise these predictions. Even by issuing bounds to some public sector companies for petroleum subsidy, the country shall be only postponing a part of the burden for future years. Despite this, experts estimate that the total subsidy on food, fertilizers and petroleum products is likely to go up to 4-5% GDP. The situation is, therefore, very grim.

But what are the policy options ? Firstly, the Government has no option but to accept the subsidy on petroleum imports. It can further increase the domestic price of petroleum products. Even if this is done, it will only reduce the burden of the Government partially. The option of reducing petroleum imports is not available to the Government in view of expanding demand for petroleum due to sharp increase in the growing demand and production for automobiles—motor cycles, three wheelers and cars. Secondly, in case of food and fertilizers, the chances of charging the consumers more appear to be very bleak since the coalition government has to face the electorate in the General Election due in early 2009. Thirdly, the Government has to take a decision about the large scale exemptions granted to industry so as to enchance its revenues. But in view of the commitment made on SEZ projects, the Government requires great amount of courage to slash down exemptions.

The only policy option available with the Government is to present a comprehensive paper on all subsidies Central as well as state levels, both implicit and explicit. It is quite possible that a national debate on the question of subsidies may result in throwing up a consensus on some short-term and some long-term options to reduce the mounting burden of subsidies.

Self-Assessment

1. Choose the correct options:

(*i*) In which city is the Board of Governor's Office located?

(*a*) Philadelphia (*b*) New York City

(*c*) Washington D.C. (*d*) Boston

(*ii*) Who among the following is the head of the government-appointed panel on the legislative reforms in the financial sectors?

(*a*) Subroto Roy (*b*) T.N. Srinivasan

(*c*) Vijay Kelkar (*d*) B.N. Shri Kkrishna

3. Rcently which among the following State government has announced special Rs. 300 crore public toilets scheme for the urban poor?

(*a*) Gujarat (*b*) Maharashtra

(*c*) West Bengal (*d*) Bihar

4. The first finance commission recommended that the states should share 55 per cent of the proceeds of the income tax. This commission was presided by

(*a*) K.C Pant (*b*) J.P Neogi

(*c*) Vijay Kelker (*d*) None of these

10.2 Summary

- India has a federal structure, in which a clear distinction is made between the Union and State functions and sources revenue, but the residual powers belong to the Centre. Although the

States have been assigned certain taxes which are levied and collected by them, they also share in the revenue of certain Union taxes, and there are certain other taxes which are levied and collected by the Union but the proceeds of which wholly go to the States.

- The Constitution of India makes a clear division of fiscal powers between the Union (on the centre) and, the State Governments. The principle adopted for this classification is that taxes which have an interstate base are levied by the Union, while those with a local base are levied by the States.
- Apart from the taxes levied and collected by the States, the Constitution had provided for the revenues for certain taxes on the Union list to be allocated, partly or wholly, to the States. These provisions fall into various categories.
- The importance of Central contributions to State resources becomes clear from Table 1 showing the transfer in broad categories since the inception of economic planning.
- Under the provisions of Article 280 of the Constitution, the President is required to appoint a Finance Commission for the specific purpose of devolution of non-Plan revenue resources.
- The First Finance Commission, for instance, recommended the allocation of income tax proceeds on the basis of 80 per cent and 20 per cent for population and collection. This criterion benefited populous states as well as those richer states which contributed more income tax revenue.
- As regards the horizontal distribution of the proceeds of Central Excise Duties among States, the Finance Commissions had initially adopted two criteria, *viz*., the population of the State and the backwardness of the States. This system of distribution clearly favoured populous but economically backward states like Uttar Pradesh and Madhya Pradesh.
- Apart from the usual excise duties, the Central Government has been levying additional excise duties on sugar, tobacco, cotton fabrics, woollen fabrics and man-made fabrics-- these goods were declared to be goods of special importance in inter-state trade and commerce.
- The estate duty was levied by the Centre in 1953 but the proceeds were to be assigned to the States. The Second Finance Commission recommended that one per cent of the net proceeds should be assigned to the Union Territories and balance to be divided among the States.
- The finance commissions only recommended writing-off of some loans and rescheduling some portion" of them. The Ninth Finance Commission was against such steps and asked states to be careful and exercise restraint in incurring additional debt.
- The appointment of a Finance Commission at intervals of five years or less has great significance for the financial relations between the Union and the States. Periodic examination of the division of resources and suitable modifications in it imparts a degree of flexibility to the finance of both the Centre and the States.
- In the last few decades, there has always been growing conflict and tension between the Indian Union and the States in the matter of finance. This conflict has often been aggravated by political and ideological differences between the different parties governing the Centre and the States.
- Taxation of industrial and commercial properties has been the preserve of the Centre, and tremendous expansion in the base of industrial and commercial property, income and wealth as a result of economic development 11 as been responsible for raising the financial resources of the Centre.
- The period since 1951 has witnessed an enormous expansion of financial powers of the Central Government whose dimensions have progressively increased in relation to the combined resources of all State Governments put together.
- West Bengal, Jammu and Kashmir, Punjab, Maharashtra and Southern states have generally been very agitated over the question of state's autonomy.
- A serious complaint of some of the States like Kerala is about the regional imbalance in industrial development. The complaint is that the Centre has not used its fiscal dominance over States to correct regional imbalances.
- The Rajamannar Committee on Centre-State relations (it submitted its report in May 1971) and the West Bengal Memorandum came out with a string of suggestions and recommendations aiming at autonomy of the states, consistent with the integrity of the country.

- The problem of Centre-State financial relations has thus been a part of the general and more important problem of Centre-State relations. The West Bengal Memorandum would allow The Centre to perform only three or four functions and leave the rest of the functions to the States.
- The States' complaint about inadequate financial resources and their demand for large taxation powers would sound more reasonable if the States had fully exploited the resources they command.
- The Finance Minister's estimate of subsidies is focused on budget-based subsidies. The estimation of budgetary subsidies are computed **as excess of the cost of providing a service over the recoveries from the service.**
- Food subsidy in India comprises of three components : (i) subsidies to farmers through support prices, (ii) subsidies to consumers through public distribution system, and (iii) subsidies to the Food Corporation of India (FCI) in its purchase and maintenance of buffer stocks.
- Since the FCI continues to purchase foodgrains without any limit, this has resulted in the creation of buffer stocks in FCI godowns far in excess of the prescribed minimum norms. Food stock reached a peak of 63 million tonnes in July 2002, more than 2.5 times the norm of 24 million tonnes.
- It is now really over a decade that a comprehensive paper on subsidies was presented by National Institute of Public Finance and Policy (NIPFP) in 1997. The situation has changed drastically since then and there is a need to re-examine the issue.
- The only policy option available with the Government is to present a comprehensive paper on all subsidies Central as well as state levels, both implicit and explicit. It is quite possible that a national debate on the question of subsidies may result in throwing up a consensus on some short-term and some long-term options to reduce the mounting burden of subsidies.

10.3 Key-Words

1. Allocation : The act of allocating or the state of being allocated
2. Jurisdiction : Jurisdiction (from the Latin ius, iuris meaning "law" and dicere meaning "to speak") is the practical authority granted to a formally constituted legal body or to a political leader to deal with and make pronouncements on legal matters and, by implication, to administer justice within a defined area of responsibility. The term is also used to denote the geographical area or subject-matter to which such authority applies.

   Jurisdiction draws its substance from public international law, conflict of laws, constitutional law and the powers of the executive and legislative branches of government to allocate resources to best serve the needs of its native society.

Answers: Self-Assessment

1. (*i*) (*c*) (*ii*) (*d*) (*iii*) (*a*) (*iv*) (*b*)

10.4 Review Questions

1. Discuss the distribution and allocation of central revenue.
2. Explain the role of finance commission.
3. What are the responsibilities and resources of the centre and of the states?

10.5 Further Readings

Books

1. The Indian Economy; S.K. Ray; Prentic, Hall of India Private Limited New Delhi - 110001.
2. Indian Economy; Gaurav Datt and Aswani Mahajan; S. Chand and Company LTD. Ram Nagar, New Delhi-110055.

Unit 11: 12th and 13th Finance Commissions

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Objectives

After reading this Unit students will be able to:

- Explain the 12th Finance Commissions.
- Discuss about the 13th Finance Commissions.

Introduction

The Finance Commission of India came into existence in 1951. It was established under Article 280 of the Indian Constitution by the President of India. It was formed to define the financial relations between the centre and the state. The Finance Commission Act of 1951 states the terms of qualification, appointment and disqualification, the term, eligibility and powers of the Finance Commission. As per the Constitution, the commission is appointed every five years and consists of a chairman and four other members. Since the institution of the first finance commission, stark changes have occurred in the Indian economy causing changes in the macroeconomic scenario. This has led to major changes in the Finance Commission's recommendations over the years. Till date, Thirteen Finance Commissions have submitted their reports.

11.1 12th Finance Commission

The Twelfth Finance Commission was constituted by the President under Article 280 of the Indian Constitution, with Dr. C. Rangarajan as chairman. This was the second finance commission after he 80th Amendment Act (2000) of the Constitution. The terms of reference of the 12th FC were the same as those of the 11th FC, except the last one which was actually added later through a special notification. The terms of reference of the 12th FC were :

(i) The distribution between the Centre and the States of the net proceeds of all taxes and the allocation between the States of the respective shares of such proceeds;

(ii) The principles which should govern

    (a) The grants-in-aid to the States out of the Consolidated Fund of India; and

    (b) The sums to be paid to the States which are in need of assistance by way of grants-in-aid under Article 275 of the Indian Constitution.

(iii) The measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the States;

(iv) Review the Fiscal Reform Facility introduced by the Central Government on the basis of the recommendations of the 11th FC and suggest measures for effective achievement of its objectives;

Notes

(v) Assess the debt position of the States at the end of March 2004 and suggest necessary corrective measures consistent with macro-economic stability and debt main-tainability;

(vi) Review the present arrangements as regards financing of Disaster Management; and

(vii) To recommend whether the non-tax income of profit petroleum to the Centre, arising out of contractual provisions, should be shared with the States from where the mineral oils are produced, and if so, to what extent.

The Award of the Twelfth Finance Commission

While giving its award on the various terms of reference, the 12th FC had carefully considered the views of the Central and State Governments on the various items of terms of reference...*The Commission's basic objective was*

(a) *to sustain the growth momentum,*

(b) *to bring about fiscal consolidation, and*

(c) *to recommend a scheme of transfers that could serve the twin objectives of equity and efficiency*.

The transfers from the Centre to the States - in the form of tax devolutions and grants - are meant to correct, both the vertical and the horizontal imbalances.

The 12th FC considered the recommendations of previous commissions on this point and also the memoranda submitted by various States regarding :

(a) The continuation of the use of population as a factor;

(b) The use of income distance criteria;

(c) Continuation of area as a factor; and

(d) Retaining the tax effort and index of fiscal discipline criteria.

There is no objective factor in any of the above criteria. Till now, every FC has attempted to work out different criteria and different weightages for each criterion to arrive at a reasonable degree of equalization. In practice, this is impossible to arrive at and every FC award has been criticized by those States who felt that they should have got a bigger share in the shareable. Central revenue pool.

Let us take only one criterion, viz., the population factor, which is a basic indicator of need for public goods and services, and as a criterion, it ensures equal per capita transfers among all States. This was recognized by all FCs, even though, different FCs have given different weights. The 12th FC stated in this connection, "Looking at the recent periods, during the Seventh and Eighth Finance Commissions, the weight attached to population, varied between 22.5 percent to 25 percent. This weight was reduced to 20 percent by the Ninth Commission and further to 10 percent by the Eleventh Commission. We feel that a strong case exists for increasing the weight and have fixed it at 25 percent." Incidentally, in their memoranda submitted to the 12th FC, different States had demanded the weightage for population to be fixed between 10 percent to 50 percent.

Local Bodies - Panchayats and Municipalities

For the first time, it was the 11th FC which was required to suggest "the measures needed to augment the Consolidated Fund of a State to supplement the financial resources of Panchayats and Municipalities. The 11th FC recommended a number of measures which could be taken by State Governments and local bodies for augmenting the consolidated fund of the States to supplement the resources of local bodies. These measures included assignment of land tax, profession tax, surcharges cesses on State taxes for improving the basic civic services and taking up schemes of social and economic development. At the same time, the 11th FC also noted the additional burden the States had to bear while implementing the recommendations of State Finance Commissions (SFCs). Accordingly, the 11th FC awarded **ad hoc** annual grant of ₹ 1,000 crores for Panchayats and ₹ 400 crores for municipalities - a total of ₹ 7,000 crores for the period 2000-05.

The 12th FC kept the above points and, ascertained the views of State Governments, of the Ministry of Rural Development, and of the Ministry of Urban Development and Poverty Alleviation, of the

Government of India. The Commission felt that there was a case to augment the consolidated fund of the states through additional grants from the Centre, keeping in view the special circumstances of the states. Besides, there was a clear need to provide an impetus to the decentralization process. Accordingly, the Commission recommended a sum of ₹ 25,000 crores for the award period, (2005-10) as grant-in-aid to supplement the resources of municipalities and the panchayats.

The 12th FC argued that the urban local bodies (Municipalities) had a greater access to tax and non-tax resources of their own, and therefore, it were the panchayats which required substantial support. According to the 2001 Census Report, urban population in India constituted 26.8 percent of the total population. Hence, the 12th FC's grant-in-aid was based on the ratio of 20:80. That is, ₹ 5,000 crores (20 percent of the grant) would go to municipalities and ₹ 20,000 crores (80 percent) would go to Panchayats. In this connection, the 12th FC had also recommended separately grants for maintenance of roads and buildings which include the roads maintained by the municipalities. The municipalities would thus be major beneficiaries.

The criteria used for inter-State distribution of the above grants were as follows :

	Criterion	Weight (percent)
1.	Population	40
2.	Geographical area	10
3.	Distance from highest per capita income	20
4.	Index of deprivation	10
5.	Revenue effort	20
	Total	**100**

The 12th Commission has emphasized that, of the grants allocated to panchayats, priority should be given to expenditure on the operation and maintenance costs (O & M) of water supply and sanitation and at least 50 percent of the grants provided to each State for the urban local bodies should be earmarked for the scheme of solid waste management. Besides, expenditure on the O & M costs of water supply and sanitation in rural areas and on the scheme of solid waste management in panchayats and urban local bodies should, out of the grants allotted should give high priority to expenditure on data base and maintenance of account.

Financing of Calamity Relief Expenditure

The 12th FC was asked to review the present arrangements as regards financing of disaster management with reference to the National Calamity Relief Fund (CRF) and the National Calamity Contingency Fund (NCCF) and make appropriate recommendations. After a careful study of the present system of disaster management, the 12th FC recommended the continuance of the scheme of CRF in its present form with contributions from the Centre and the States in the ratio of 75 : 25. The Commission fixed the size of the CRF for the award period, 2005-10 at ₹ 21,333 crores, of which the Centre's share would be ₹ 16,000 crores and the balance would be the share of the States (₹ 5,333 crores).

The 12th FC has also recommended continuance of the scheme of NCCF in its present form with core corpus of ₹ 500 crores. The outgo from the NCCF may continue to be replenished by way of collection of National Calamity Contingent Duty and levy of special surcharges.

11.2 13th Finance Commission

The Thirteenth Finance Commission (FC-XIII) was constituted by the President under Article 280 of the Constitution on 13 November 2007 to make its recommendations for the period 2010-15. Dr. Vijay Kelkar was appointed the Chairman of the Commission.

Notes

Terms of Reference

The Terms of Reference (ToR) of the Commission included the following :

The Commission shall make recommendations as to the following matters, namely :-

(i) The distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them under Chapter I Part XII of the Constitution and the allocation between the States of the respective shares of such proceeds;

(ii) The principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India and the sums to be paid to the States which are in need of assistance by way of grants-in-aid of their revenues under article 275 of the Constitution for purposes other than those specified in the provisos to clause (1) of that article; and

(iii) The measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State.

Subsequently, the commission was given additional terms of reference including the mandate to review the roadmap for fiscal adjustments and suggest a suitably revised one with a view to maintaining the gains of fiscal consolidation through 2010 to 2015 particularly considering the need to bring the liabilities of the Central Government on account of oil, food and fertilizer bonds into the fiscal accounting, and the impact of various other obligations of the Central Government on the deficit targets. The TFC has since submitted its Report.

The Approach of the Thirteenth Finance Commission

Following the mandate under the Presidential Order indicating the terms of reference, the Thirteenth Finance Commission submitted its report on December 30, 2009. The overall approach of the commission was as follows :

(a) To foster "inclusive and green growth promoting fiscal federalism"

(b) Focus on fiscal consolidation process in a medium-term debt reduction framework. The commission observed that as against the level of 75 per cent targeted by the Twelfth Finance Commission, the combined debt-GDP ratio was 82 per cent in the terminal year (2009-10). It purposed reducing the combined debt-GDP ratio to 68 per cent by 2014-15 with the Centre's debt-GDP ratio declining to 45 per cent.

(c) The commission recommended fiscal consolidation through the elimination of revenue deficit as the long-term target for both the Centre and States. Following a design similar to that adopted by the recent Finance Commissions, the FC-XIII indicated a normative discipline for both Centre and State; with equal treatment which entailed no automatic priority for any level of Government and a focus on equalization (and not equity). The latter signaled the intent of the FC-XIII to ensure that States and local bodies have the fiscal potential to provide comparable levels of public service at reasonably comparable levels of taxation. This principle does not guarantee uniformity in public services across the country; but it addresses the fiscal requirements of each jurisdiction to enable such uniformity.

Vertical Devolution : Issues and Approach

The Thirteenth Finance Commission Justified the existing constitutional arrangement of division of taxes between Central and the States, that many direct taxes like Income Tax are levied and collected by the Centre, but the proceeds are shared with the states. Similar tax treatment, irrespective of geographical or political consideration is the key to efficient function of the market. The vertical and horizontal devolution should be based on the principal of equality of access to public services, irrespective of jurisdiction.

Asymmetric Fiscal Arrangement at Present

TFC elaborated on the asymmetric fiscal arrangement which the constitution specifies the taxing powers of the Centre and states with respect to different sources of tax revenue. It can be argued that

there is a vertical imbalance in the distribution of these taxing powers which has worsened over time, while in the total revenue expenditure there has been long term stability in the relative shares of the Centre and the states after implementation of the transfers recommended by the Finance Commission, the buoyancy of central taxes has been higher than those of the states and such a trend is expected to continue, given the nature of tax assignment to the Centre and states. Thus the commission recommended that to maintain constancy in the share of states in post-devolution total tax revenue, there is a need to increase the share of states by the margin by which the buoyancy of central tax revenue exceed the buoyancy of combined tax revenue. This implies that given the higher buoyancy of central tax revenue, share of states in total central tax revenue to be increased, so that the revenue of centre and state taxes equalises in post devolution stage.

On the expenditure side, the commission notes that the, states have higher 'fixed costs' than the Centre, as reflected in their higher share of committed expenditure in total non-plan expenditure relative to the Centre. In addition, states have restrictions placed on their borrowing powers. In addition, over the period 2010-15, there is an added fiscal burden posed by the states' pay awards, following that of the Sixth Central Pay Commission (CPC). The fiscal burden of the latest round of pay awards is much higher for the states in absolute as well as relative terms.

The commission preferred to discount the projected growth rates as given to it by the Planning Commission. This implies conservative revenue buoyancy for the centre and the states. The commission notes that its fiscal correction targets are not overly ambitious, and are more likely to lead to a situation where performance is better than the promise.

Poor States Get Less Subsidies

Commission further notes that there is always a choice between delivery of public goods and services and provision of subsidies for private goods. But there is always a need for well directed subsidies such that they reach the target group. But this always does not happen. For instance poorer states don't stand to gain from three major subsidies, viz. food, fertiliser and petroleum, as share of poorer states were found to be far lower than the national average. The reasons for this may vary across the subsidies. Food subsidies are determined inter alia by efficiency of administrative arrangements in the respective states, as well as by their fiscal capacity to provide additional subsidies. The use of fertilisers is directly linked to irrigation facilities created and the size of land holdings. Consumption of petroleum products is directly proportional to the purchasing power of citizens. This implies that poorer states tend to receive much lower share in subsidies (food, fertiliser and petroleum given by the centre. In view of the objective of inclusive growth, regressive untargeted subsidies that reduce fiscal space for key growth-promoting public investments and delivery of public goods to enhance inclusiveness are, today, a fiscal obstacle to the acceleration of India's development transformation. Therefore the commission favored a fiscal path, wherein subsidies are closely targeted.

In view of all the arguments, as given above the Thirteenth Finance Commission recommended that

1. The share of States in net proceeds of shareable Central taxes shall be 32 per cent every year for the period of the award.
2. Revenue accruing to a State is to be protected to the levels that would have accrued to it had service tax been a part of the shareable Central taxes, if the 88th Amendment to Constitution is notified and followed up by a legislations enabling States to levy service tax.
3. Centre is to review the levy of ceases and surcharges with a view to reducing their share in its gross tax revenue.
4. Future fiscal roadmap should be designed in such a manner that subsidies are closely targeted. Public spending on subsidies that detract from inclusive growth should be discouraged.

Horizontal Devolution : Issues and Approach

The commission noted that the previous finance commissions have identified for major issues which are needed to the addressed. First, the fiscal needs vary from state to state, as they are at different stages of the development transformation. Some times aggregate state level development indicators do not capture the fiscal needs as there are variations even at district level. Second, fiscal capacity

which is measured by the revenue base available to each state - varies. Third, cost of providing similar levels of public goods and services may also vary from state to state due to historical circumstances, adverse physical geography, sparse terrain, or geopolitical constraints to development. To some extent, the definition of some states as 'special category states' addresses this issue. But greater attention is needed to be paid to such factors. Fourth, commission highlighted the endeavor of previous finance commissions in rewarding the efficiency in public management, fiscal effort and outcomes. The commission notes that the adoption of fiscal responsibility legislation after the report of Twelfth Finance Commission has improved the fiscal health of many states. The Thirteenth Finance Commission favored to build upon this effort and incentivising improved efficiency in public expenditure management and revenue effort.

In horizontal devolution of resource transfers the commission clearly stated that it is concerned with *equalisation, not equity*, (italics added) it says at it is both feasible and possible to address efficiency and fiscal equalisation, using both instruments available to the commission, *viz*. grants and devolution. The Commission recommended that due weight be given to considerations of efficiency and performance in its overall design. In other words it implies that the states which do not respond to incentives as designed by the commission stand to lose and those who do respond stand to gain in terms of their share in total revenue. Giving effects to its thinking on horizontal devolution, the Thirteenth Finance Commission adopted the following criteria and weights for *inter se* determination of shares of states.

Local Bodies - Panchayats and Muncipalities

Thirteenth Finance Commission provided ₹ 87,519 crores as grants for local bodies. It is significant that out of total transfers from center to states share of local bodies made a jump from 3.3 per cent by Twelfth Finance Commission to 5.1 percent by Thirteenth Finance Commission (Table 3). In absolute terms this increase seems to be much greater as total grants for local bodies have increased from ₹ 25,000 crores to ₹ 87,519 crores. This shows the importance given by the Thirteenth Finance Commission to local bodies. Another major recommendation of the commission was with regard to sharing of income from royalties received by the state government with those local bodies in whose jurisdiction such income arises. Commission also recommended for sharing of revenues of local development authorities with local bodies.

Goods and Service Tax

Thirteenth Finance Commission had to deal with a special issue and that was Goods and Service Tax (GST), which was scheduled to be implemented by October 1, 2010 (earlier it was scheduled for April 2010). The Finance Commission was entrusted with the task of facilitating transition from prevailing system of indirect taxation to a new tax named GST. Thirteenth Finance Commission recommended that both the Centre and the states should conclude a 'Grand Bargain' to implement the Model GST. The Grand Bargain comprises six elements :

(i) The design of the Model GST

(ii) The operational modalities.

(iii) The proposed agreement between the Centre and states, with contingencies for changes.

(iv) The disincentives for non-compliance are described.

(v) The implementation schedule is described.

(vi) The procedure for claiming compensation.

To facilitate and incentivise the implementation of this Grand Bargain, the commission recommended a grant of ₹ 50,000 crore. The grant would be used to meet the compensation claims of State Governments for revenue losses on account of implementation of GST between 2010-11 and 2014-15, consistent with the Grand Bargain. Unspent balances in this pool would be distributed amongst all the states, as per the devolution formula, on 1 January 2015. However there is a rider clause in the recommedations of the Commission - "In the unlikely event that a consensus with regard to implementing all the elements of the Grand Bargain cannot be achieved and the GST mechanism finally adopted is different from the Model GST suggested by us, this Commission recommends that this amount of ₹ 50,000 crore shall not be disbursed."

Revised Roadmap for Fiscal Consolidation

Notes

The Thirteenth Finance Commission has recommended fiscal consolidation through the elimination of revenue deficit as the long-term target for both the Centre and States.

Following a design similar to that adopted by the recent Finance Commissions, the Thirteenth Finance Commission indicated a normative discipline for both Centre and States; with equal treatment which entailed no automatic priority for any level of Government and a focus on equalization (and not equity). The latter signaled the intent of the Thirteenth Finance Commission to ensure that States and local bodies have the fiscal potential to provide comparable levels of public service at reasonably comparable levels of taxation. This principle does not guarantee uniformity in public services across the country; but it addresses the fiscal requirements of each jurisdiction to enable such uniformity. The Commission recommended as follows :

- The revenue deficit of the Centre needs to be progressively reduced and eliminated, followed by emergence of a revenue surplus by 2014-15.
- A target of 68 per cent of GDP for the combined debt of the Centre and states should be achieved by 2014-15. The fiscal consolidation path embodies steady reduction in the augmented debt stock of the Centre to 45 per cent of GDP by 2014-15, and of the states to less than 25 per cent of GDP, by 2014-15
- The Medium Term Fiscal Plan (MTFP) should be reformed and made a statement of commitment rather than a statement of intent. Tighter integration is required between the multi-year framework provided by MTFP and the annual budget exercise.
- Along with the annual Central Budget/MTFT, some disclosures have been recommended. They include
  - (i) Detailed breakup of grants to states under the overall category of non-plan and plan grants.
  - (ii) Statement on tax expenditure to be systematised and the methodology to be made explicit.
  - (iii) Compliance costs of major tax proposals to be reported.
  - (iv) Revenue Consequences of Capital Expenditure (RCCE) to be projected in MTFP.
  - (v) Fiscal impact of major policy changes to be incorporated in MTFP.
  - (vi) Public Private Partnership (PPP) liabilities to be reported along with MTFP.
- Transfer of disinvestment receipts to the public account to be discontinued and all disinvestment receipts be maintained in the consolidated fund.
- Government of India should list all public sector enterprises that yield a lower rate of return on assets than a norm to be decided by an expert committee.
- The FRBM Act needs to specify the nature of shocks that would require a relaxation of FRBM targets.
- In case of macroeconomic shocks, instead of relaxing the states' borrowing limits and letting them borrow more, the Centre should borrow and devolve the resources using the Finance Commission tax devolution formula for inter se distribution between states.
- Structural shocks such as arrears arising out of Pay Commission awards should be avoided by, in the case of arrears, making the pay award commence from the date on which it is accepted.
- An independent review mechanism should be set-up by the Centre to evaluate its fiscal reform process. The independent review mechanism should evolve into a fiscal council with legislative backing over time.
- Given the exceptional circumstances of 2008-09 and 2009-10, the fiscal consolidation process of the states was disrupted. It is expected that states would be able to get back to their fiscal correction path by 2011-12, allowing for a year of adjustment in 2010-11.
  - (i) States that incurred zero revenue deficits or achieved revenue surplus in 2007-08 should eliminate revenue deficit by 2011-12 and maintain revenue balance or attain a surplus thereafter. Other states should eliminate revenue deficit by 2014-15.

Notes

(ii) The General Category States that attained a zero revenue deficit or a revenue surplus in 2007-08 should achieve a fiscal deficit of 3 per cent of Gross State Domestic Product (GDSP) by 2011-12 and maintain such thereafter. Other general category states need to achieve 3 per cent fiscal deficit by 2013-14.

(iii) All special category states with base fiscal deficit of less than 3 per cent of GSDP in 2007-08 could incur a fiscal deficit of 3 per cent in 2011-12 and maintain it thereafter. Manipur, Nagaland, Sikkim and Uttarakhand to reduce their fiscal deficit to 3 per cent of GSDP by 2013-14.

(iv) Jammu & Kashmir and Mizoram should limit their fiscal deficit to 3 per cent of GSDP by 2014-15.

- States should amend/enact FRBM Acts to build in the fiscal reform path worked out. State-specific grants recommended for a state should be released upon compliance.
- Independent review/ monitoring mechanism under the FRBM Acts should be set up by states.
- Borrowing limits for states to be worked out by Ministry of Finance using the fiscal reform path, thus acting as an enforcement mechanism for fiscal correction by states.
- Loans from Government of India to states and administered by ministries/department other than Ministry of Finance, outstanding as at the end of 2009-10, to be written off, subject to conditions prescribed.

Assessment of the Thirteenth Finance Commission Report

Vertical Devolution : Increase in the over-all share of the States from Central revenues

Thirteenth Finance Commission recommended that the share of States in net proceeds of shareable Central taxes shall be 32 percent every year for the period of the award. It has also recommended for greater grants-in-aid to states. In all States will get 136 percent higher amount in comparison with Twelfth Finance Commission. This has been due to increase in the expected revenue of the Centre and secondly due to increase in the share of states as recommended by Thirteenth Finance Commission. In comparison to the indicative ceiling of 38 percent by Twelfth Finance Commission, Thirteenth Finance Commission recommended for indicative ceiling at 39.5 percent of gross revenue receipts of the centre as overall transfers to states on revenue account.

Therefore one may conclude that with regard to vertical devolution Thirteenth Finance Commission has done better by granting more revenue transfer to the states.

Table 1 : Share of States in Taxes in 11th, 12th and 13th Finance Commission

States	11th Finance Commission	12th Finance Commission	13th Finance Commission
Andhra Pradesh	7.701	7.356	6.948
Arunachal Pradesh	0.244	0.288	0.328
Assam	3.285	3.235	3.634
Bihar	14.598	11.028	10.934
Chhattisgarh	0.000	2.654	2.474
Goa	0.206	0.259	0.266
Gujarat	2.821	3.569	3.046
Haryana	0.944	1.075	1.050
Himachal Pradesh	0.683	0.522	0.782
Jammu & Kashmir	1.290	1.297	1.394
Jharkhand	0.000	3.361	2.806
Karnataka	4.930	4.459	4.335

Kerala	3.057	2.665	2.345
Madhya Pradesh	8.838	6.711	7.131
Maharashtra	4.632	4.997	5.207
Manipur	0.366	0.362	0.452
Meghalaya	0.342	0.371	0.409
Mizoram	0.198	0.239	0.269
Nagaland	0.220	0.263	0.314
Orissa	5.056	5.161	4.787
Punjab	1.147	1.299	1.391
Rajasthan	5.473	5.609	5.862
Sikkim	0.184	0.227	0.239
Tamil Nadu	5.385	5.305	4.977
Tripura	0.487	0.428	0.512
Uttar Pradesh	0.000	19.264	19.708
Uttarakhand	19.798	0.939	1.122
West Bengal	8.115	7.057	7.276
All States	**100.000**	**100.000**	**100.000**

Source : Report of Thirteenth Finance Commission (Original Source : Indian Public Finance Statistics 2008-09)

Table 2 : Share of States in Central Taxes & Duties and Grants-in-aid

States	Share in Central Taxes & Duties	% of Total	Total Grants-in-aid	% of	Total Transfers (col.2 + col.4)	% of Total
1	2	3	4	5	6	7
1. Andhra Pradesh	100616.0	6.948	13532.3	5.233	114148.3	6.688
2. Arunachal Pradesh	4755.6	0.328	4348.2	1.682	9103.8	0.533
3. Assam	52620.6	3.634	5215.1	2.017	57832.7	3.389
4. Bihar	158341.2	10.934	14602.8	5.647	172944.1	10.133
5. Chhattisgarh	35825.2	2.474	6175.5	2.388	42000.7	2.461
6. Goa	3857.8	0.266	516.2	0.200	4374.0	0.256
7. Gujarat	44107.1	3.046	9682.9	3.745	53789.9	3.152
8. Haryana	15199.5	1.050	4270.8	1.652	19470.3	1.141
9. Himachal Pradesh	11327.3	0.782	10364.4	4.008	21691.6	1.271
10. Jammu & Kashmir	20182.7	1.394	20255.9	7.833	40438.7	2.369
11. Jharkhand	40640.3	2.806	7238.4	2.799	47878.6	2.805
12. Karnataka	62774.9	4.335	11601.4	4.487	74376.3	4.358
13. Kerala	33954.3	2.345	6371.5	2.464	40325.8	2.363
14. Madhya Pradesh	103268.9	7.131	13324.5	5.153	116593.4	6.832
15. Maharashtra	75406.9	5.207	16302.8	6.305	91709.8	5.374
16. Manipur	6541.2	0.452	7026.3	2.717	13567.5	0.795
17. Meghalaya	5918.5	0.409	3923.9	1.517	9842.4	0.577

Notes

18.	Mizoram	3901.3	0.269	4904.0	1.897	8805.3	0.516
19.	Nagaland	4552.9	0.314	9191.3	3.555	13744.2	0.805
20.	Orissa	69316.1	4.787	9658.8	3.735	78974.9	4.627
21.	Punjab	20146.4	1.391	5540.3	2.143	25686.6	1.505
22.	Rajasthan	84892.2	5.862	12949.8	5.008	97842.0	5.733
23.	Sikkim	3466.8	0.239	1058.8	0.409	4525.7	0.265
24.	Tamil Nadu	72070.4	4.977	11366.9	4.396	83437.3	4.889
25.	Tripura	7411.5	0.512	5716.1	2.211	13127.6	0.769
26.	Uttar Pradesh	285397.1	19.708	26742.9	10.342	312140.0	18.289
27.	Uttarakhand	16245.1	1.122	4063.0	1.571	20308.1	1.190
28.	West Bengal	105358.6	7.276	12638.7	4.888	11997.2	0.703
	Total	**1448096.0**	**100.000**	**258581.0**	**100.000**	**1706676.0**	**100.000**

Source : Report of Thirteenth Finance Commission

Table 3 : Criteria and Weights for determining the Relatives Share of States in Taxes and Duties

		Tenth Finance Commission	Eleventh Finance Commission	Twelfth Finance Commission	Thirteenth Finance Commission
1.	Population	20%	10.00%	25.00	25.00
2.	Distance of per capita income of the state from that of the State having highest per capita income	60 %	62.50%	50.00	47.50
3.	Fiscal Capacity Distance	5%	7.50%	10.00	10.00
4.	Area	5%	7.50%		
5.	Index of Infrastructure	5%	7.50%		
6.	Tax effort	10%	5.00%	7.50%	
7.	Fiscal Discipline	-	7.50%	7.50	17.5
	Total	**100.00**	**100.00**	**100.00**	**100.00**

Source : Report of Tenth, Eleventh, Twelfth & Thirteenth Finance Commission (Original Source : India Public Finance Statistics 2008-09)

Self-Assessment

1. Choose the correct option
   (*i*) "Shareholder wealth" in a firm is represented by:
   - (*a*) the number of people employed in the firm.
   - (*b*) the book value of the firm's assets less the book value of its liabilities.
   - (*c*) the amount of salary paid to its employees.
   - (*d*) the market price per share of the firm's common stock.

Notes

(*ii*) The long-run objective of financial management is to:

(*a*) maximize earnings per share.

(*b*) maximize the value of the firm's common stock.

(*c*) maximize return on investment.

(*d*) maximize market share.

(*iii*) A (n) ------ would be an example of a principal, while a(n) ------- would be an example of an agent.

(*a*) shareholder; manager (*b*) manager; owner

(*c*) accountant; bondholder (*d*) shareholder; bondholder

(*iv*) The market price of a share of common stock is determined by:

(*a*) the board of directors of the firm.

(*b*) the stock exchange on which the stock is listed.

(*c*) the president of the company.

(*d*) individuals buying and selling the stock.

(*v*) The focal point of financial management in a firm is:

(*a*) the number and types of products or services provided by the firm.

(*b*) the minimization of the amount of taxes paid by the firm.

(*c*) the creation of value for shareholders.

(*d*) the dollars profits earned by the firm.

(*vi*) The decision function of financial management can be broken down into the decisions.

(*a*) financing and investment

(*b*) investment, financing, and asset management

(*c*) financing and dividend

(*d*) capital budgeting, cash management, and credit management

(*vii*) The controller's responsibilities are primarily in nature, while the treasurer's responsibilities are primarily related to .

(*a*) operational; financial management (*b*) financial management; accounting

(*c*) accounting; financial management (*d*) financial management; operations

11.3 Summary

- The Twelfth Finance Commission was constituted by the President under Article 280 of the Indian Constitution, with Dr. C. Rangarajan as chairman. This was the second finance commission after he 80th Amendment Act (2000) of the Constitution. The terms of reference of the 12th FC were the same as those of the 11th FC, except the last one which was actually added later through a special notification.
- The transfers from the Centre to the States - in the form of tax devolutions and grants - are meant to correct, both the vertical and the horizontal imbalances.
- As in the case of the 11th FC, the 12th FC considered all the relevant factors as regards receipts and expenditures of the Centre and of the States, the level of over-all transfers relative to Centre's gross revenue receipts, the relative balance between tax devolution and grants, etc.
- The horizontal aspect of transfers relates to the sharing of the total shareable pool between the States. If all the States in the Indian Union have the same or almost the same per capita income, and if all the States have similar fiscal capacities, the problem of transfer between the States would be simple - namely, equal per capital transfers to every State...In practice, there are considerable horizontal imbalances - States differ in area, size of population, income, tax base, forest and mineral wealth, etc.

Notes

- There is no objective factor in any of the above criteria. Till now, every FC has attempted to work out different criteria and different weightages for each criterion to arrive at a reasonable degree of equalization. In practice, this is impossible to arrive at and every FC award has been criticized by those States who felt that they should have got a bigger share in the shareable. Central revenue pool.
- For the first time, it was the 11th FC which was required to suggest "the measures needed to augment the Consolidated Fund of a State to supplement the financial resources of Panchayats and Municipalities.
- The 12th Commission has emphasized that, of the grants allocated to panchayats, priority should be given to expenditure on the operation and maintenance costs (O & M) of water supply and sanitation and at least 50 percent of the grants provided to each State for the urban local bodies should be earmarked for the scheme of solid waste management.
- The twin objectives of the 12th FC, were to give debt relief to the States and urge them to reduce and completely eliminate revenue deficit.
- The award of the Twelfth Finance Commission has been accepted by the Government, though in some cases, the Finance Ministry has added some conditionalties - as, for example, the total share of the States in the Central Government's gross revenue should not exceed 38 percent.
- The Thirteenth Finance Commission (FC-XIII) was constituted by the President under Article 280 of the Constitution on 13 November 2007 to make its recommendations for the period 2010-15. Dr. Vijay Kelkar was appointed the Chairman of the Commission.
- On the expenditure side, the commission notes that the, states have higher 'fixed costs' than the Centre, as reflected in their higher share of committed expenditure in total non-plan expenditure relative to the Centre.
- In view of the objective of inclusive growth, regressive untargeted subsidies that reduce fiscal space for key growth-promoting public investments and delivery of public goods to enhance inclusiveness are, today, a fiscal obstacle to the acceleration of India's development transformation. Therefore the commission favored a fiscal path, wherein subsidies are closely targeted.
- In horizontal devolution of resource transfers the commission clearly stated that it is concerned with *equalisation, not equity*, (italics added) it says at it is both feasible and possible to address efficiency and fiscal equalisation, using both instruments available to the commission, viz. grants and devolution.
- Thirteenth Finance Commission provided ₹ 87,519 crores as grants for local bodies. It is significant that out of total transfers from center to states share of local bodies made a jump from 3.3 per cent by Twelfth Finance Commission to 5.1 percent by Thirteenth Finance Commission.
- Thirteenth Finance Commission had to deal with a special issue and that was Goods and Service Tax (GST), which was scheduled to be implemented by October 1, 2010 (earlier it was scheduled for April 2010). The Finance Commission was entrusted with the task of facilitating transition from prevailing system of indirect taxation to a new tax named GST.
- The Thirteenth Finance Commission has recommended fiscal consolidation through the elimination of revenue deficit as the long-term target for both the Centre and States.
- Thirteenth Finance Commission recommended that the share of States in net proceeds of shareable Central taxes shall be 32 percent every year for the period of the award. It has also recommended for greater grants-in-aid to states. In all States will get 136 percent higher amount in comparison with Twelfth Finance Commission.
- According to the basic spirit of the Constitution, Finance Commission is supposed to make recommendations in such a manner that devolution of taxes and grants in aid tend to reduce the prevailing disparities among different states by allocating more resources for the development of less privileged and underdeveloped states.

- Basic cause of all these upheavals is the formula adopted by the 13th Finance Commission to decide the share of different states in devolution of Union Taxes. The 13th Finance Commission made radical changes in the formula for devolution such that more deprived states are put at loss and better off are given more resources.
- 12th Finance commission had given 7.5 per cent importance to fiscal discipline and in 13th Finance Commission its importance has been enhanced to 17.5 percent. It is worth noting that this factor was absent in 10th Finance Commission.
- Now that poorer states would receive less money from the central taxes, the aspirations of the residents of those poorer states would remain unfulfilled.

11.4 Key-Words

1. Panchayats : The word "panchayat" literally means "assembly" (ayat) of five (panch) wise and respected elders chosen and accepted by the local community. However, there are different forms of assemblies. Traditionally, these assemblies settled disputes between individuals and villages. Modern Indian government has decentralized several administrative functions to the local level, empowering elected gram panchayats. Gram panchayats are not to be confused with the unelected khap panchayats (or caste panchayats) found in some parts of India.
2. Municipalities : A municipality is usually an urban administrative division having corporate status and usually powers of self-government. The term municipality is also used to mean the governing body of a municipality.

11.5 Review Questions

1. Discuss the term 12th finance commission.
2. Write a short note on the local bodies.
3. Why the 13th finance commission was instituted ? Discuss the recommendations made in the thirteenth finance commission.

Answers: Self-Assessment

1. (*i*) (*d*) (*ii*) (*b*) (*iii*) (*a*) (*iv*) (*d*) (*v*) (*c*)
   (*vi*) (*b*) (*vii*) (*c*)

11.6 Further Readings

Books

1. The Indian Economy; S.K. Ray; Prentic, Hall of India Private Limited New Delhi - 110001.
2. Indian Economy; Gaurav Datt and Aswani Mahajan; S. Chand and Company LTD. Ram Nagar, New Delhi-110055.

Unit 12: Governance of the Economy—Implementation of Economic Policies

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Objectives

After reading this Unit students will be able to:

- Understand the Governance of Economy.
- Discuss the Implementation of Economic Policies.

Introduction

Although there have been many far-reaching and notable achievements in India but the country is still very far from achieving the objectives of our freedom struggle, Constitution and the plans. Combining continuity with change, the private enterprise-market economy was allowed to continue and expand. This was done by enabling and active assistance of the State for overcoming our age-old problems of poverty and stagnation. For the purpose, India went in for a non-laissez faire, active role of the State beyond the conventional, universal functions of the State. Gradually, the State and the political sphere became important, large and decisive, facilitated and legitimised by the adoption of plural democracy. This model, based on very sound insights, could not deliver the desired positive results and we call policy or State failure in Indian context. There are many studies available to document these failures of policy and planning. However, there are vast differences of opinion concerning whether or what kind of policy or State failure it is. Against this backdrop, we throw light on how the policy implementation has been poor in India. Further, its consequences and implications have also been discussed. For instance, one of the severe consequences is the emergence and flourishing of the parallel economy. Thus, the concept, nature and effects of parallel economy have been discussed.

12.1 Governance of the Economic Policies : Implementation of Economic Policies

The situations regarding policy failure have been given below :

(i) Only partial or inadequate attainment of the objectives of public policy or in a distorted manner;

(ii) Counter-productive results;

(iii) Costs are disproportionate to positive;

(iv) Policy outcomes are related to or generate heavy present and future negative externalities; and

(v) The State's capacity to initiate course-correction measures gets weakened and failure of policy gives rise to domestic or external forces posing problems before the policy objective.

In the ultimate analysis, this kind of State failure is essentially related to State character, State capacity and State-society relationship in a historical perspective is pretty obvious but is often lost right of.

The Implications of Failures of Policy Implementation

There is an implicit assumption in most policy studies that once a policy has been formulated the policy will be implemented. This assumption is invalid for policies formulated in many Third World nations and for types of policies in Western societies. Third World Governments tend to formulate broad, sweeping policies, and Governmental bureaucracies often lack the capacity for implementation. Interest groups, opposition parties, and affected individuals and groups often attempt to influence the implementation of policy rather than the formulation of policy. Policymakers can attempt to minimize disruptive tensions faced during implementation which can result in the failure of policy outcomes to match policy expectations. It may be noted that the policy implementation failures make the State stray from the chosen declared path of policy.

An Illustration : Tax Policy Implementation : For our purpose of discussion on implementation, we can take the case of tax policy. This policy tried to raise, resources by a combination of direct and indirect taxes to finance a large part of increasing public expenditure. In India, the tax administration could not prove itself equal to the task to prevent widespread and regular leakages of revenue. There appears to be inadequate recognition of the limitations and built-in defects in the design and law of the taxes. Moreover, their frequent changes made its success problematic. Apart from this, avenue of tax avoidance was sought to be plugged by imposing gift tax. Gradually, poor and indifferent implementation of tax laws forced the Government to place greater reliance on indirect taxes and Non-tax revenue like internal and external public borrowing and deficit financing (i.e., printing money) to finance public expenditure. It may be observed that a tax policy is not just a matter of tax base and tax rates or even the tax law. Thus, non-realisation of its wide ramifications and deep roots in the social reality, particularly the power of the sections called upon to pay a better part of the taxes, became a major element of many-sided policy failures in India. The fiscal crunch arising from inept and weak implementation of tax laws made the Indian State reduce its normal responsibilities, leaving large gaps in the provision of minimum essential services in areas like socio-economic infrastructure, education, health services and move in the direction of either abdicating many pressing social tasks or hope to achieve them by privatisation.

Factors Responsible for Policy Failures

There are several factors ranging from population pressure, political, bureaucratic and business elite values and modes of behaviour, legacy of colonialism and the domineering policies of the rich countries, national character, etc. we may also include transparency, accountability, widespread corruption, lack of popular peoples' organisation for active participation in democratic State processes and the adverse, improper policy advice, kibitsing and interference by the rich countries by means of peripatetic advisers, to lack of technical expertise and proper appreciation of the narrow, vested interests hidden as international 'development' expertise, as responsible for the policy failures in our country. Moreover, there are general factors, for every specific policy, a set of particular factors have often been identified. It may be noted that even a major policy shift like the one towards globalisation liberalisation and privatisation in the early 1990s appears to have become stuck in the deep-seated morass of cozy, crony relationships and partial, unrealistic analysis of the underlying reality. Apart from the neglect of popular concerns, at least some of the factors are still crying for attention. Such as tax reforms, public debt management, public expenditure and fiscal stabilisation etc.

Lack of Integration in Policy Formulation and Policy Implementation : The main problems for lack of integration are related to the implementation procedures, the agencies, the bureaucracy, politicians, business ethics, archaic methods of financial controls, legal and administrative framework wanting in transparency, accountability, etc. which impede effective implementation of policies. In short, while the theoretical framework and the mechanism of the interaction between the policy variables and the economy are usually declared appropriate and/or easily correctible, a rather sticky and difficult terrain is encountered in the sphere of implementation.

Although there is substantial expansion of the role of the State and economic policies, the lingering, influence of the outdated theories of economic policies is seen in the form of neglect of implementation issues. However, the possibility of something like Government failure was hardly taken note of. The empirical and realistic theoretical studies recognise that the policy processes carry the impact of both market and non-market incentives, information, social power and influence conflicts and contradictions between divergent economic interests, partisan character of the State and its personnel as compulsions of a State chosen by competitive, democratic electoral processes in highly non-egalitarian societies. Another potent source is growing global linkages that make the policy arena a virtual battleground. It is observed that tax evasion, black marketing and violation of economic regulation are manifestations of the 'revolt' by the market against high tax rates, 'unjust' price, distribution, investment and movement controls and the curtailment of private and corporate freedom to take independent economic decisions for the legitimate pursuit of their goal of maximising profits etc. The State has the responsibility to moderate and modify economic policies and make them market-friendly if the parallel economy is to be reduced to represent the marginal, deviant behaviour of some economic entities with little macro-societal significance except as pinpricks. It may be noted that this parallel economy imposes high, unnecessary or avoidable costs on business, or increases the transactions cost of business by imposing rent of authority on private business i.e., illegal gratification extorted or collected from or paid to the people enjoying and exercising State authority to permit the market players to operate according to their own lights.

12.2 The Parallel Economy : Concept, Nature and Effects on Policy Processes

Black money or unaccounted money circulating in the parallel economy is a big menace to the economy. It is also a cause of big loss in the tax-revenues for the Government. As such it needs to be curbed. Its elimination will benefit the economy in more than one way. It will also generate more revenues for the Government.

Black money may be defined as the money that is generated by activities that are kept secret in the sense that these are not reported to the authorities. As such this money is also not accounted to the fiscal authorities i.e., taxes are not paid on this money. Contrasted to this is the white money that is shown in relevant accounts and tax paid, if due.

Parallel economy connotes the functioning of an unsanctioned sector in the economy whose objectives run parallel, rather in contradiction with the aroused social objectives.

The money involved in black/secret transactions or used in parallel economy (i.e., parallel to the legitimate economy) is very large indeed. Very recently the National Institute of Public Finance Policy has estimated that the sum involved is as much as about Rs. 40,000 crores. This constitutes around 20 per cent of the gross domestic product of the economy. A recent estimate puts the size of black money at over 50 per cent of GDP (at factor cost). It is also Stated that the annual rate of growth of black money is higher than the annual growth-rate of GDP. The present size of black money is thus very large indeed.

Future Directions

The country must evolve a new concept, theory, strategy and policy framework of development. It may be noted that these are long-term and uncertain tasks, depending on mega socio-economic factors of both the national and global politics. For effective intervention, people must have at least a minimum of livelihood adequacy and security. The existing order and its beneficiaries are the fountain head of the black economy and perversion of policy processes. As a positive sign for strengthening the anti-black economy forces in the economy, there should be a political framework which guarantees the livelihood adequacy and security, as seems to be on the horizon with the enactment of the Employment Guarantee law by the Government at the center. Moreover, democratisation of political parties and electoral reforms in order to break the unholy nexus between politicians, corrupt business persons, bureau-crats and the criminal mafia gangs can go a long way in moving towards a clean democratic society in India. It may be observed that democracy and peoples' own efforts are the means which may be slow, difficult, at times frustrating. However, they do produce desirable outcomes over the

time. Over the time India would move towards a genuine, honest pro-people State, economy and society and in the process the black economy and policy perversions would become marginal instances of deviant behaviour.

Self-Assessment

1. Choose the correct options:

(*i*) For the first half of the 1800s, which level of government was most active in promoting and regulating private economic activity?

(*a*) just local and national governments were active in the early 1800s.

(*b*) neither the national nor state levels were active

(*c*) state

(*d*) the national and state levels were equally active

(*e*) national

(*ii*) The doctrine of laissez-faire as it applies to government regulation of the economy

(*a*) holds that consumers and workers would fare better if the economy were regulated by government.

(*b*) was applied completely through the 1800s.

(*c*) holds that government regulation of the economy is wrong.

(*d*) had no impact on U.S. economic policy in the 1800s.

(*e*) has been regularly applied to communist systems.

(*iii*) National government intervention in the economy during the 1800s was exhibited by the

(*a*) Homestead Act.

(*b*) Sherman Antitrust Act.

(*c*) Interstate Commerce Act.

(*d*) all of the above

(*e*) none are correct

(*iv*) Which of the following acts of Congress created a system to regulate the national banking system in 1913?

(*a*) Sixteenth Amendment

(*b*) Federal Trade Commission

(*c*) Clayton Act

(*d*) Missouri Compromise

(*e*) Federal Reserve Act

(*v*) The New Deal of President Franklin D. Roosevelt in the 1930s represented a significant step

(*a*) away from the laissez-faire state.

(*b*) toward turning over much of the national regulation of the economy to the states.

(*c*) toward turning over much of the national regulation of the economy to the local governments.

(*d*) toward the laissez-faire state.

(*e*) away from the interventionist state.

(*vi*) Economic regulation grew significantly in which of the following industries during the early 1900s?

(*a*) banking and the stock market

(*b*) none--economic regulation did not grow during the early 1900s.

(*c*) trucking and aviation

(*d*) all of the above

(*e*) agriculture

(*vii*) Social regulation is concerned with such areas as the

(*a*) control of entry into a business.

(*b*) prices or rates of charges to society for goods and services.

(*c*) activities of interest groups as they apply grassroots lobbying efforts on the people.

Notes

(*d*) practice of abortion.

(*e*) quality and safety of products.

12.3 Summary

- The situations regarding policy failure have been given below :
  (i) Only partial or inadequate attainment of the objectives of public policy or in a distorted manner;
  (ii) Counter-productive results;
  (iii) Costs are disproportionate to positive;
- In the ultimate analysis, this kind of State failure is. essentially related to State character, State capacity and State-society relationship in a historical perspective is pretty obvious but is often lost right of.
- There is an implicit assumption in most policy studies that once a policy has been formulated the policy will be implemented. This assumption is invalid for policies formulated in many Third World nations and for types of policies in Western societies.
- For our purpose of discussion on implementation, we can take the case of tax policy. This policy tried to raise, resources by a combination of direct and indirect taxes to finance a large part of increasing public expenditure.
- The fiscal crunch arising from inept and weak implementation of tax laws made the Indian State reduce its normal responsibilities, leaving large gaps in the provision of minimum essential services in areas like socio-economic infrastructure, education, health services and move in the direction of either abdicating many pressing social tasks or hope to achieve them by privatisation.
- There are several factors ranging from population pressure, political, bureaucratic and business elite values and modes of behaviour, legacy of colonialism and the domineering policies of the rich countries, national character, etc.
- It may be noted that even a major policy shift like the one towards globalisation liberalisation and privatisation in the early 1990s appears to have become stuck in the deep-seated morass of cozy, crony relationships and partial, unrealistic analysis of the underlying reality.
- Although there is substantial expansion of the role of the State and economic policies, the lingering, influence of the outdated theories of economic policies is seen in the form of neglect of implementation issues.
- It may be noted that this parallel economy imposes high, unnecessary or avoidable costs on business, or increases the transactions cost of business by imposing rent of authority on private business i.e., illegal gratification extorted or collected from or paid to the people enjoying and exercising State authority to permit the market players to operate according to their own lights.
- Black money or unaccounted money circulating in the parallel economy is a big menace to the economy. It is also a cause of big loss in the tax-revenues for the Government.
- Black money may be defined as the money that is generated by activities that are kept secret in the sense that these are not reported to the authorities. As such this money is also not accounted to the fiscal authorities i.e., taxes are not paid on this money. Contrasted to this is the white money that is shown in relevant accounts and tax paid, if due.
- It is the High Networth Individuals (HNWIs) and private companies that were the primary drivers of illicit flows from the private sector in India rather than the common man.
- The country must evolve a new concept, theory, strategy and policy framework of development. It may be noted that these are long-term and uncertain tasks, depending on mega socio-economic factors of both the national and global politics.
- Over the time India would move towards a genuine, honest pro-people State, economy and society and in the process the black economy and policy perversions would become marginal instances of deviant behaviour.

12.4 Key-Words

1. Policy implementation : Represents the stage where government executes an adopted policy as specified by the legislation or policy action. At this stage, various government agnecies and departments, responsible for the respective area of policy, are formally made responsible for implementation. Policy implementation is what happens after a bill becomes law.
2. Parallel economy : Parallel economy connotes the functioning of an unsanctioned sector in the economy whose objectives run parallel, rather in contradiction with the aroused social objectives. This is variously termed as 'black economy', 'unaccounted economy', 'illegal economy', 'subterranean economy', 'unsanctioned economy' or 'hidden economy'. The National Institute of Public Finance and Policy (NIPFP) defines black money as the aggregate of incomes which are taxable but not reported to the tax authorities.

   A hidden economy in its broadest sense may consist of - a) illegal economy, such as money laundering, smuggling, etc; b) unreported economy including tax evasion; c) unregulated economy, ie economic activities outside regulations.

12.5 Review Questions

1. What is the concept of Parallel economy? Discuss.
2. Discuss the factors responsible for policy failures.
3. What do you mean by the governance of policy economic policy?

Answers: Self-Assessment

1. (*i*) (*c*) (*ii*) (*c*) (*iii*) (*d*) (*iv*) (*e*) (*v*) (*a*)
   (*vi*) (*d*) (*vii*) (*e*)

12.6 Further Readings

Books

1. Indian Economy ; Gaurav Datt and Aswani Mahajan; S. Chand and Company LTD. Ram Nagar, New Delhi-110055.
2. The Indian Economy ; S.K. Ray; Prentic, Hall of India Private Limited New Delhi - 110001.

Unit 13: Parallel Economy

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Objectives

After reading this Unit students will be able to:

- Discuss Parallel Economy.

Introduction

India's parallel economy is so deeply entrenched that possession of black money is not even considered worthy of reproach in social reckoning. In fact, custodians of the administrative machinery themselves seem to have joined the race to accumulate such wealth.

Perhaps such attitudes were understandable to an extent during the high noon of repressive taxation and socialist subjugation in the 1960s and 1970s, when anything other than a frugal lifestyle was all but impossible for an honest taxpayer to maintain. Those were days of misery. But tax rates in India today are moderate by any yardstick in the world, and the persistence of the impunity with which black money is held suggests a much older provenance. Looking further back in history, the black sector emerged in India during World War II, when daily necessities were in acute scarcity and the government of the day adopted rationing as a welfare policy, thus introducing a system of controls. With prices no longer set by the natural interaction of market demand and supply, black marketeering-the surreptitious sale of diverted goods at higher prices-emerged. The continuance of controls, post-1947, that defied economic sense was justified in the context of the prevailing deprivation then. The parallel economy began to expand, and once the control mechanisms were instiutionalised, it attained multifarious dimensions.

13.1 Parallel Economy

Parallel economy connotes the functioning of an unsanctioned sector in the economy whose objectives run parallel, rather in contradiction with the avowed social objectives. This is variously referred to as **'black economy', 'unaccounted economy'. 'illegal economy'. 'subterranean economy',** or **'unsanctioned economy'.** The term 'parallel economy' emphasizes a confrontation between the objectives of the legitimate and illegitimate sectors. For instance, in the broad long-term objectives of planning to establish a socialist pattern of society, we include full employment, removal of disparities of income and wealth, avoidance of conspicuous consumption so that more resources are available for a larger volume of saving, the removal of poverty, the attainment of self-reliance and provision of equality of opportunity. The main purpose of planning was to subordinate the capitalist spirit of an acquisitive society to the goals of planned development so that greater social welfare is promoted. Naturally, the vested interests are bound to oppose these progressive trends and the curbs that may be imposed on their unfettered right of exploitation. The principal function of the state pledged to the establishment of a democratic socialist society is to ensure that state policies and the controls are so

geared that the progressive forces dominate and are able to subjugate those who attempt to frustrate the efforts of the state to establish a social order based on equality and justice for all, more especially for the downtrodden.

With the attainment of independence and the advent of planning, more avenues of investment in a large number of industries were opened. The concept of the mixed economy envisaged the co-existence of a public sector and a private sector. Both were expected to promote investment and output. The criterion in the public sector was social gain and thus it concentrated on the creation of economic infrastructure in the form of roads, railways, irrigation and hydro-electric works, etc., the development of heavy, basic and defence industries and the provision of better education and health facilities. The rest of the economy was left to be developed by the private sector.

With the expansion of economic activity in the post-independence period, the magnitude of the black sector has grown and proliferated to such an extent that it has begun to play a dominant role in moulding state policies, in changing the structure and composition of output, in promoting a class which derives its maximum source of power from black money. Obviously, the magnitude of operations of the black money operators has resulted in the establishment of a parallel economy. D.K. Rangnekar rightly mensions : "If the "Parallel economy" poses a serious threat to stability and growth of the official economy, surely it stems from the fact that the magnitude of "black money" is large and rigged deals are growing in volume and complexity at an alarming rate. Apart from the wide ramifications of the "parallel economy", one might also be alive to the fact that "black incomes" are accentuating the inequalities in income and wealth and breeding a new class of "black" rich in a society which is already harshly stratified. The inequalities are no longer below the surface. The conspicuous consumption of the new "black" rich, their vulgar display of pomp and opulence, their unlimited accessibility to finance, their nest-eggs in various places and countries, their influence in important places, all these are now common knowledge". To understand the impact of black economy, it is essential to have an estimate of 'black income' over a period of time.

13.1.1 Estimates of Black Income in India

Several attempts have been made to quantify black incomes in India. Broadly speaking, the various estimates of black incomes made so far follow two approaches : (i) Kaldor's approach of quantifying non-salary incomes above the exemption limit of income tax and (ii) Edgar L. Feige's method of working out transaction-income on the basis of currency deposit ratio and from it deriving the black income of the economy. Kaldor's method has been used in the report on Indian Tax Reform, and later by the Direct Taxes Enquiry Committee with some modifications. D.K. Rangnekar, former Editor, **Economic Times**, used the same technique with some more modifications and later Mr. O.P. Chopra developed a series of black income by further modifying the Wanchoo Committee's assumptions. Feige's method has been used by Poonam Gupta and Sanjeev Gupta. It would be of interest to study these methods in some detail.

Estimates of black income based on Kaldor's approach

(i) **Kaldor's estimate :** N. Kaldor in his report on Indian Tax Reform estimated the non-salary income on the basis of the break-up of national income into (a) wages and salaries, (b) income of the self-employed, and (c) profit, interest, rent etc. Excluding wages and salaries from the contributions to net domestic product, he derived total non-salary income. For various sectors of the economy, on the basis of assumed proportions of non-salary incomes above the exemption limit. Kaldor estimated non-salary income above the exemption limit. An estimate of the actual non-salary income assessed to tax was made for each sector in order to arrive at the total non-salary income assessed to tax. The difference between the estimated non-salary income above the exemption limit and the actual non-salary income assessed to tax measures the size of the black income. (Refer table 1).

(ii) **Wanchoo Committee's Estimate :** Direct Taxes Enquiry Committee (Wanchoo Committee) followed the method adopted by Kaldor with suitable modifications. According to Wanchoo Committee, "the estimated income on which tax has been evaded (black income) would probably be ₹ 700 crores and ₹ 1,000 crores for the years 1961-62 and 1965-66 respectively. Projecting this

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estimate further to 1968-69 on the basis of percentage increase in national income from 1961-62 to 1968-69. the income on which tax was evaded for 1968-69 can be estimated at a figure of ₹ 1800 crores."

(iii) Rangnekar's Estimate : Dr. D.K. Rangnekar as member of the Wanchoo Committee, in his minute of dissent considers the estimates made by the Wanchoo Committee as under-estimates. According to him, tax evaded income for 1961-62 was the order of ₹ 1,150 crores, as compared to the DTEC estimate of ₹ 850 crores. For 1965-66, it was ₹ 2,350 crores, as against ₹ 1,216 crores estimated by DTEC. The projections of black income for 1968-69 and 1969-70 were ₹ 2,833 crores and ₹ 3,080 crores respectively. Rangnekar concluded : "The compound rate of growth of "black income" was of the order of 13 per cent per annum at current prices whereas the compound rate of growth of national income for the same period was 11 per cent per annum." Rangnekar further clarifies that if one took into account the leakage of foreign currency incomes and surreptitious foreign income transfers, the estimates of black income may have to be marked up by ₹ 200 crores.

(iv) Chopra's Estimate : Mr. O.P. Chopra prepared a series of unaccounted income (black income) for a period of 17 years, i.e., 1960-61 to 1976-77. Chopra uses a slightly modified methodology recommended by the Direct Taxes Enquiry Committee. Since it is difficult to obtain information on non-salary income actually assessed, the DTEC assumed the ratio of evaded income to non-salary assessable income to remain constant to the one observed in 1960-61. Chopra gives up this assumption in favour of a less demanding assumption. Chopra's methodology marks a significant departure from the DTEC approach and as a consequence, he finds a larger divergence in the two series from 1973 onwards when the income above the exemption limit registered a significant increase. The underlying assumptions of the methodology are :

(i) Only non-salary income is evaded. While this may be true for government employees, this does not capture additional benefits given by the private sector to its salary earners, more especially, business executives.

(ii) Taxes other than income tax are evaded and the study is restricted to only that part of income which is subject to income tax. Thus tax evasion which may be due to (a) non-payment or under-payment of excise duty, (b) sales-tax, (c) customs duties, or (d) substituting non-agricultural income for agricultural income is not captured.

(iii) The efficiency of the tax administration remains unchanged.

(iv) The ratio of non-salary income above the exemption limit to total non-salary income has remained the same.

(v) The ratio of non-salary income to total income accruing from various sectors of the economy remains the same.

(vi) Unaccounted income generation in the agricultural sector has not been taken into account.

The study shows that a buoyant economy offers more opportunities for unaccounted income. During periods of recession, it may be difficult for producers to extract unaccounted money.

The crucial finding of Chopra's study is that after 1973-74. the ratio of unaccounted income to assessable non-salary income has gone up, whereas the Wanchoo Committee assumed this ratio to have remained constant. As a consequence, after 1973-74, there is wide divergence between the estimates of Wanchoo Committee and those of Chopra. Chopra also corroborates the hypothesis that tax evasion is more likely the higher the rate of tax.

(v) Gupta's Study of Black Income using Feige's method of transaction-income ratio

Poonam Gupta and Sanjeev Gupta have raised some fundamental objections regarding Kaldor's methodology used in estimating black income in India. Since the income generated in the illegal economy is not reported for the calculation of official GNP, the estimates of GNP which are used as the basis for estimation of black economy are serious under-estimates. Consequently, the exclusion of black market activity biases all the important indicators of economic activity in any society. Official statistics on income, therefore, grossly under-estimate the true size of the economy. That being so, the size of the black economy is also seriously under-estimated.

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Guptas made use of Feige's method of estimating the magnitude and growth of the black market. Feige assumed that the ratio of total transactions to total income was relatively stable. Therefore, it would be more logical to calculate the total volume of transactions, both legal and illegal. The Official GNP measures only the legal economic activity. Thus, if a proportional relationship exists between transactions and income, then significant increases in this ratio would be due to the expansion of illegal (or black) economic activity.

Feige's methodology requires preparation of estimates of chequing transactions and currency transactions. Chequing transactions are equal to the average stock to demand deposits multiplied with their turnover rate (i.e., the average number of times the demand deposits turnover). Transactions supported by currency (or cash) can be estimated by calculating the turnover of a unit of currency and then multiplying it by the total currency with the public. A bench-mark year is chosen where it is assumed that there was no illegal activity or black income generation was zero. For this base year, the ratio of transactions of GNP is first obtained. Estimates of the magnitude of legal and illegal activities in the succeeding years can be obtained by dividing the total volume of transactions in each year by the base year's ratio. Subtracting measured GNP gives us the estimate of black income generated in these years.

According to this study, the absolute size of the black income in India increased from ₹ 3,034 crores in 1967-68 to ₹ 46,867 crores in 1978-79, i.e., by more than 15 times. The relative share of the black economy was 9.5 per cent of GNP in 1967-68, but it has jumped to nearly 49 per cent by 1978-79. According to Guptas : "Thus, currently almost half of the official income is being produced outside the "legal" sector. Not only is the black economy a substantial proportion of the regular economy but it has also grown at a rate faster than that of the official economy."

The study further indicates that 1 per cent increase in overall taxes leads to more than 3 per cent increase in the black income relative to the official economy.

(vi) NIPFP Study on Black Economy in India

National Institute of Public Finance and Policy conducted a study under the direction of Dr. S. Acharya, formerly of the World Bank. Dr. Raja Chelliah was the overall supervisor of the Study. The study defines black income as "aggregate of incomes which are taxable but are not reported to tax authorities". The study, however, gives a broader definition of black income and calls it as "unaccounted income" for purposes of clarity. It is "the extent to which estimates of national income and output are biased downwards because of deliberate, false reporting of incomes, output and transactions for reasons of tax evasion, flouting of other economic controls and related motives."

13.1.2 A Review of the Various Estimates of Black Income

IMF staff survey on the unaccounted sector of the economy has estimated black money in India at 50 per cent of Gross National Product (GNP), which was ₹ 1,45,141 crores in 1982-83 at current prices. On this computation, India's unaccounted sector is of the order of ₹ 72,000 crores.

The estimate of black income prepared by Guptas indicates the highest proportion, i.e., 49 per cent of GNP. As against it, other estimates indicate that black income was near about 10 per cent of GNP. The question arises : which one of these estimates can be considered reliable ? Some economists have expressed serious doubts about the validity of the estimate of Guptas. J.C. Sandesara writes : "The estimation of black money, at any rate, for India is far too serious a business to be handled exclusively by the tool of currency-deposit ratio, and/or to be left to monetary statisticians/economists." The main point of criticism is that the value of total transactions is affected by several factors, viz., the degree of monetisation, the extent of vertical integration of the economy, the rate of introduction of technical change, etc. It would be advisable to disaggregate the effect of these factors. To that extent, there would be over-estimation. But there is a serious element of under-estimation which has not been noted by the critics. A good number of transactions which are effected through 'hundis' or other near money instruments which go unrecorded in chequing or currency transactions are not covered in the estimate of total transactions. An upward adjustment on this account has to be made and it may be noted that the number and size of such transactions is quite large.

A review of the various estimates clearly reveals that the Kaldor's method of concentrating attention on official GNP seriously under-estimates the size of black income generated in the economy. There is a serious under-reporting of production and there is enough evidence about it. By corrupting excise department officials, the capitalist classes are able to evade the reporting of a significant proportion of total production.

It would not also be fair to discard the monetary approach altogether because this also serves as a cross-check on the other estimate. It is probable that truth lies somewhere between the two extremes. In that sense, more research has to be directed in this regard. If only 9-10 per cent of GNP is generated as black income, it cannot pose the threat as suggested in the phrase "Parallel economy", but if the magnitude is much larger as many economists believe, then the threat of "parallel economy" is real. Moreover, it would be more relevant if the size of black income is compared not to total GNP but to GNP minus income from the agricultural sector (Y–Ya), as Chopra has done. Such an approach is more useful for an underdeveloped country like India where agricultural income constitutes about 40 per cent of GNP.

The main findings of the various studies on black income are :

(i) The amount of black money has not only been growing in absolute terms, but also in relative terms as a percentage of GNP.

(ii) Black income which was less than 10 per cent of GNP upto 1975-76 began to grow at a much faster rate thereafter. According to NIPFP estimate for 1983-84, it was in the range of 18 to 21 per cent of GNP, though as per the estimate of Dr. Suraj B. Gupta, it was about 46 per cent of GNP in 1983-84 and rose further to about 51 per cent in 1987-88.

(iii) The rate of growth of black income generation is faster than the rate of growth of Gross National Product.

(iv) Higher rates of taxation motivated businessmen and industrialists to go for massive tax evasion.

(v) The political system winked at the growth of black income but did not take effective measures to curb the growth of unaccounted income.

13.1.3 Impact of Black Incomes on the Economic and Social System

The creation of a parallel economy as a consequence of the growing proliferation of black money in every sector of the economy has very serious and in a number of ways pernicious influences on the working of the Indian economy. It would be of interest to study their impact on the Indian economic and social system.

First of all, the direct effect of black income is the loss of revenue to the state exchequer as a consequence of tax evasion, both from direct and indirect taxes. Moreover, tax evasion does not include loss of revenue resulting from unreported production or illegal economic activity. Since the Government is not able to plug the leakage of tax evasion, it has to resort to other avenues of raising funds. So it imposes more taxes on commodities or raises the existing rates of taxation on commodities. As a consequence, India developed a regressive tax structure. Direct Taxes Enquiry Committee in this connection mentioned : "Black money and tax evasion, which go hand in hand, have also the effect of seriously undermining the equity concept of taxation and warping its progressiveness. Together, they throw a greater burden on the honest taxpayer and lead to economic inequality and concentration of wealth in the hands of the unscrupulous few in the country." It is the salaried person (who cannot escape taxation) who suffers and the dishonest tax-payer is able to get away and then use the evaded income in luxurious and ostentatious consumption. Emphasizing this fact, D.K. Rangnekar mentions : "So while the tax paying public finds its own income falling, the non-tax paying public is having a free run of swelling concealed incomes thereby adding a new dimension to the problem of inequality of incomes and wealth."

Secondly, the availability of black incomes with businessmen and capitalists and the consequent inequalities of income place a large amount of funds at their disposal. Easy money as it obtains, finds ready outlets in non-essential articles of conspicuous consumption. This has a demonstration effect on all classes of people. As a consequence, the consumption pattern is tilted in favour of the rich and elite classes, at the cost of encouraging the production of articles of mass consumption. A rise in the

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overall consumption leaves less resources for investment in priority areas. These distortions in the product-mix in favour of non-essential consumption have adverse effects on production and thus they distort the objectives of planning.

Thirdly, black money encourages investment in precious stones, jewellery, bullion, etc. This has an adverse effect on growth via its demonstration effect.

Fourthly, black money has encouraged diversion of resources in the purchase of real estate and investment in luxury housing. There is large scale under-valuation of property and in this way, lot of black money is made white. This has also pushed up the prices of land to astronomical heights because of speculative purchases of land by black money operators. As a consequence, the middle classes are priced out in the purchase of land for houses. Not only that, a lot of nation's resources are used in only making inputs available for luxury housing. Since most of these buildings are registered at under-valued prices, the Government loses by way of tax revenues when these buildings are transferred as gifts or are bequeathed.

Fifthly, a part of the black incomes is held in cash and as a consequence there is an abundance of liquidity which becomes available through the accumulation of savings held in the form of cash, bullion, gold, silver, etc. This is popularly termed as 'black liquidity'. Thus, whenever the Government attempts to control excess demand with the help of measures of credit control or rationing, such attempts are frustrated by the huge liquidity provided by black money. Since this liquidity results in heavy inventory build-up, it becomes a threat to price stability.

Sixthly, black money results in transfer of funds from India to foreign countries through clandestine channels. Such transfers are made possible by violations of foreign exchange regulations through the device of under-invoicing of exports and over-invoicing of imports. The country thus finds itself in a paradoxical situation, "where capital and more particularly foreign exchange resources are scarce, (the country) becomes a de facto lender of aid and capital to economically advanced and wealthier nations, with the concealed outflow of funds." The situation has worsened further over the years.

13.1.4 Factors Responsible for Generation of Black Money

There are several factors responsible for the generation of black money. It would be relevant to discuss those factors so that a correct understanding about the genesis, growth and expansion of black money can be made. The principal factors are :

(i) Divergence between the acceptable net rate of return and legally permissible rate of return : There is a school of thought which believes that the chief factor responsible for generation of black incomes is that individuals expect a higher net rate of return than the legally permissible rate of return. In this connection, the higher marginal rates of taxes assume special importance. The Chambers of Commerce and Industry hold a unanimous view that very high rates of taxation on incomes above a certain limit are in fact expropriatory in nature. For instance, at one time, the marginal rate of income tax was as high as 97.5 per cent and this was tantamount to near nationalisation of all incomes beyond a certain level. The high marginal rates led many experts on public finance to describe that we are "the most highly taxed nation." These high rates were gradually brought down to 40% by former Finance Minister Dr. Manmohan Singh by 1996. Mr. P. Chidambram has further reduced them in 1997-98 budget to 30 % for individual and 35% for corporations.

However, there is another school of thought led by economists of the left who believe that the argument of high marginal tax rates is over-played. They assert that actually paid rates on declared incomes are not as high as determined by the officially prescribed marginal rates of taxation. Consequently, a reduction in rates of taxation, would not result in reduction in tax evasion but it only grants more relief to the tax evaders.

Dr. K.N. Kabra in his empirical study of high rates of income tax and tax evasion has worked out the actual income taxes paid at various levels of income during the period 1971-72 and 1978-79. His study reveals the following :

(a) Tax evasion was of the order of ₹ 1,890 crores in 1971-72 and it jumped to three times this figure (at nearly ₹ 5,400 crores) in 1978-79. Evaded tax as a percentage of potential tax

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revenue was nearly 78 per cent in 1971-72, it declined to 72 per cent in 1975-76 but started rising there after and was of the order of 82 per cent in 1978-79. It follows that reduction in tax rates could not control the propensity towards tax evasion

(b) There was a dramatic increase in actual tax collection from ₹ 874 crores in 1974-75 to ₹ 1,214 crores in 1975-76—an increase of almost 40 per cent. But this spurt in actual tax revenue was the result of tightening up of tax administration during emergency, coupled with a vigorous drive for unearthing black incomes. However, buoyancy in tax revenue was short-lived and with the wearing down of the effects produced by measures taken during emergency, actual tax collections registered a decline.

The upshot of Kabra's analysis is that whereas it may be conceded that higher marginal rates of taxation motivate tax evasion because of its expropriatory nature, a reduction in the marginal rates of taxation, even though substantial, is no guarantee that tax evasion would not be resorted to, if the costs and risks involved in tax evasion are considerably less than the amount of money converted into black income. In other words, elasticity of increase in tax revenue as a consequence of the reduction in the marginal rate of taxation is less than unity. Kabra writes : "In a regime which induces reduction in tax evasion by a method "soft" on tax evaders (like cut in tax rates) rather than by "harder" method which enhances the costs and risks of tax evasion, it would be difficult to expect a better tax compliance through "soft-methods."

(ii) Black money generation as a consequence of controls, licensing system : There is a school of thought which firmly believes that the system of controls, permits, quotas and licences which are associated with maldistribution of the commodities in short supply results in the generation of black money. The Wanchoo Committee explaining this factor as a source of black money observed, "In spite of the vigilance exercised by the Government, controls and regulations came to be used by the unscrupulous for amassing money for themselves. Since considerable discretionary powers lay in the hands of those who administered controls, this provided them with a scope for corruption—'speed money' for turning a blind eye to the violation of controls. All this gave rise to trading in permits, quotas and licences, malpractices in distribution and in the process, it generated sizeable sums of black money."

Dagli Committee on Controls and Subsidies concurring with DTEC observed : "Price and distribution controls have in the past led to the generation of black money on a significant scale. Any price control without any adequate machinery of distribution and speedy arrangement for increasing supplies is potentially a source of black money generation."

Dagli Committee pointed out rent control leads to "pugree system" and is, therefore, another source of black money. Similarly, the system of licences requires large number of inspectors for completing various formalities and thus good amount of hush money has to be paid.

(iii) Donation to political parties : Ever since the Government decided to ban donations to political parties in 1968, it prompted businessmen to fund political parties, especially the ruling party, with the help of black money. Ostensibly, this decision was taken to reduce the influence of big business on the electroral process, but in practice what happened was precisely the opposite. Businessmen everywhere have by now learnt that they should pay a certain charge out of the black money to the coffers of political parties and then be sure that the political leaders will only bark but not bite. Big business, in the process, has been able to tame the political leadership and thus, the latter has started speaking the language of big business etc.

(iv) Ineffective enforcement of tax laws : Whereas the Government has an armoury of tax laws pertaining to income tax, sales tax, stamp duties, excise duty etc., their enforcement is very weak due to widespread corruption in these departments. The high rates of these taxes induce businessmen to avoid recording of these transactions. This evasion largely goes unchecked and thus sets in a chain reaction for the generation of black money at the wholesale, retail as well as production levels.

(v) Generation of black money in the public sector : Every successive five-year plan planned for a larger size of investment in the public sector. The projects undertaken by the public sector have to be monitored by the bureaucrats in Government departments and public sector

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undertakings. Tenders are invited for the various works and these tenders are awarded by the bureaucracy in consultation with the political bosses. Thus, a symbiotic relationship develops between the contractors, bureaucracy and the politicians and by a large number of devices, costs are artificially escalated and black money is generated by underhand deals. Instability of the political system has given a further momentum to this process. The rapidity with which ministers are changed or dropped or cabinets reshuffled, has added another dimension to the problem. Since the ministers are not sure of their tenure and in a majority of cases, the tenure is very short, the principle 'Make hey while the sun shines' is adopted by most of them. The large number of scandals that are unearthed by the Opposition only support the contention that huge investment in the public sector is a big potential source for black money generation.

13.1.5 A Survey of Measures Undertaken to Unearth Black Money

It would be desirable at this stage to make a survey of the measures undertaken to unearth black incomes since independence and to assess their success so that further course of action can be decided. The principal measures undertaken were :

(i) **Measures to check tax evasion :** One of the basic causes of black income generation and then its conversion into either white money by various measures or into black wealth is tax evasion. Therefore, plugging loopholes in tax evasion by a large number of legal and administrative measures was undertaken. Most of these measures were based on the recommendations of various committees and commissions, *viz.*, the Taxation Enquiry Commission (1953), Nicholas Kaldor's proposals for Indian Tax Reform (1956), the Direct Taxes Administrative Enquiry Committee (1958). Recommendations by the Administrative Reforms Commission (1969), the Direct Tax Enquiry Committee (1971). Most of these recommendations pertained to improvement in tax laws. But more important than that, the various committees felt that tax administration was too weak and ineffective. The penalties imposed under the tax laws were not deterrent enough and the tax administration machinery was not able to bring to book the tax evaders. During 1965-69, all the measures taken against tax evasion yielded only ` 105 crores by way of taxes and penalties.

While it is customary to make the income tax officials as scapegoats in the matter, the fact of the matter is that the political support needed by the Tax Administration did not come forth and thus even the income tax officials who pursued their task honestly and vigorously were demoralised. This is evidenced by the fact that when state support was given in 1975, then in one year income tax revenues jumped from ` 874 crores in 1974-75 to ` 1,214 crores in 1975-76, an increase by 39 per cent, but as state support declined, tax revenues also started declining. The rot at the political level only demoralises the tax administration and makes it dysfunctional.

(ii) **Demonetization :** In 1946, demonetization was resorted to but the Direct Taxes Enquiry Committee in its interim report admitted : "Demonetization was not successful then, because only a very small proportion of total notes in circulation was demonetized. Notes demonetized in 1946 were of the value of ` 143.97 crores as against the total notes issued of the value of ` 1,235.93 crores.''

Another demonetization was attempted with effect from January 16, 1978 of high denomination notes, i.e., ` 1.000, ` 5,000 and ` 10,000. The high denomination notes as on that date aggregated to ` 146 crores. Notes tendered to the Reserve Bank of India amounted to ` 125 crores as per data available till August 1981. Obviously, demonetization failed to make a serious dent on unearthing black money.

Demonetization assumes that all black incomes are held in the form of cash balances, but the fact of the matter is that it is only a small part of the total black incomes which is held in liquid form. The rest are in circulation. Secondly, businessmen invent a number of clandestine ways to circumvent demonetization. So the net effect of this limited and partial measure to destroy black incomes is too insignificant.

(iii) **Voluntary Disclosure Schemes :** From time to time, various voluntary disclosure schemes were floated by the Government. These schemes were nothing but a camouflaged version of reduction

in tax rates at higher income levels. Mr. H.R. Machiraju estimated the results of all the various schemes and methods used to unearth black incomes. Up to 1968 a total concealed income of the order of ` 519 crores was declared on which ` 131 crores were paid as tax, this further highlights the failure of the Government to unearth black incomes. The Direct Taxes Inquiry Committee, therefore, categorically opposed the introduction of any further voluntary disclosure schemes since they "placed a premium on fraud and are unfair to the honest tax payers." The DTEC mentioned : **"They were more or less schemes for converting black money into white on payment of what turned out to be in most cases, a small amount of conscience money** (emphasis added). Disclosure made in the name of minors, ladies and **benamidars** has, on the other hand, contributed to perpetuating evasion, and rendering investigation in many a case of suspected tax evasion difficult or even futile. The fact that in the last of the three schemes, namely block scheme, as many as 77 thousand and odd out of a total of 1,64,226 disclosures were from persons not previously assessed to tax would bear ample testimony to this misuse of the scheme. We were informed by the Central Board of Direct Taxes that there were several instances of the same set of persons taking advantage of all the three schemes which would belie the theory that such schemes help to rehabilitate the repentant tax evader who is desirous of mending his ways."

Ignoring the recommendations of the Direct Taxes Enquiry Committee, the Government again introduced a Voluntary Disclosure Scheme of Income and Wealth in 1975. The fear psychosis generated by the emergency had a profound effect. As a consequence, a sum of ` 746 crores was realised as tax. This certainly terrified the black money operators and most of them were on the run. But this atmosphere was shortlived. Neither the Janata Government after 1977 nor the Congress Government after resuming power in 1980 took up the task of unearthing black incomes seriously.

(iv) **Special Bearer Bond Scheme :** Special Bearer Bonds Scheme (1981) was intended for canalising unaccounted money for productive purposes. The Special Bearer Bonds. 1981 of the face value of ` 10,000 each were issued at par with a maturity period of 10 years. The holders of these bonds were to be entitled to receive ` 12,000 on maturity. In other words, they carry an interest of 2 per cent per annum. Complete immunity was granted to the original subscriber or possessor of the bonds from being questioned about the possession of bonds or about the sources of money from which the same were acquired. As per data provided in the budget (1982-83), Special Bearer Bonds were subscribed to the tune of ` 964 crores.

V.L. Mehta, in a very sharp comment condemned the SBB Scheme in the following words. "Such efforts, as the Bearer Bonds Scheme to tackle the problem, are only half-hearted measures. By controlling inflation for the time being, the Bearer Bonds Scheme, might to a certain extent, alleviate the situation, but it has, at the same time **providedan opportunity for parallel economy to function more brazenly and also more effectively.** (Emphasis added). There is thus a great danger of black incomes being generated on a larger scale than hitherto, adding considerably to the volume of large black incomes that is already there." It is strange, he further laments, "possession of currency has to be accounted for but not the possession of the Bearer Bonds."

(v) **Voluntary Disclosure Scheme (1997)**

Finance Minister Mr. P. Chidambaram while presenting 1997-98 budget announced a Voluntary Disclosure Scheme (VDS). The Finance Minister in this connection observed. The scheme is very simple. Irrespective of the year or nature of the source of funds, the amount disclosed either as cash, securities or assets, whether held in India or abroad would be charged to tax at 30 per cent for individuals and 35 per cent for corporations. Total immunity would be granted for any action under the scheme under the Income Tax, Wealth Tax Acts and FERA.

13.1.6 Evolution of a Policy Package to Control Parallel Economy

Broadly speaking, there are two schools of thought on the question of arresting and eliminating the generation, growth and expansion of black money. There are economists who believe that within the framework of the mixed economy as obtaining in India, black money can be eliminated and its size

can be brought within manageable limits so that it does not pose a threat to the very objectives of national economic policies. On the other hand, there is another group of economists who believe that mixed economy is only a euphemism for capitalist system and there is no hope of controlling black economy in the framework of the mixed economy that prevails in India.

Fundamentalist View

Since tax evasion is basic to the phenomenon of black money generation, the question arises : What motivates tax evasion ? Meena Gupta and Thavaraj provide an answer : "It is obvious that tax evasion is a disease associated with an economic system based on private property. The disease assumes epidemic proportions when environmental pollution affecting the social, political, administrative and ethical systems exceeds the limits of tolerance."A similar view has been expressed by Dr. V.M. Dandekar in the following words : "If one had any notions on this point, one would have suggested that if large incomes do not pay taxes they should, the remedy is not to lower the tax rates but abolish altogether incomes above a certain limit."

Sunanda Sen goes a step further and calls for a change in the character of the state since mixed economy does not provide the requisite framework for the purpose. She writes : "The failure of the government's recent drive to curb smuggling is illustrative of the self-defeating nature of controls in a partially planned economy... attempts to control such evasion through a manipulation of instruments open to the state in a mixed economy are not likely to meet with much success unless the reforms are extensive enough to change the character of the state itself."

The fundamentalist view, therefore, does not see any merit in making certain marginal adjustments in tax rates because this will not serve any useful purpose in controlling black money, nor does it see any merit in removing all controls, but it feels that if tangible results have to be achieved, the abolition to private property or at least fixing a ceiling on property is essential so that the motivation for acquiring more wealth itself is blunted.

The Moderate View

There are two variants of the moderate view. One is typified by Kabra who considers the fundamentalist view as "naive, one-dimensional view of the state in as much as it fails to recognise a need for partial, effective controls, without necessarily changing the character of the state in its essentials." It would, therefore, be inadvisable not to initiate measures within the framework of the mixed economy. In support of their contention, they advance the argument that there are mixed capitalist economies in which the extent of black money is much smaller, which are much better managed and in which ethical standards in politics are much better. They, therefore, plead for internally consistent but extensive controls, so that they are relatively strong in comparison with the forces operating the parallel economy. As a consequence, the control mechanisms should make the economy perform much better, not only in the narrow sense of acquiring more revenue or making certain essential goods available, but in the broader sense of creating a social order based on equality and justice.

Prem Shankar Jha who represents the other variant, believes that "by far the worst effect of the regime of controls is that it has perverted the operation of the profit motive in the economy. Instead of being harnessed to increasing production, it is now harnessed to the exploitation of shortage." Four sets of reforms that can have a dramatic effect on the parallel economy, according to Prem Shankar Jha are : (i) lifting of price controls on all products except a few basic consumer goods (where dual pricing is in any case preferable to controls); (ii) the exemption of savings from taxation; (iii) the indexation of direct tax rates to the cost of living; and (iv) the liberalisation of the tax laws governing the depreciation allowance, to permit firms to write off capital at a rate of their own choosing. Jha, broadly speaking, represents the view of the private sector lobby which believes that controls are at the root of prevailing shortages and the operations of the free market mechanism will be able to usher in an era of plenty, remove shortages and thus reduce the size of black market economy.

In the light of these two broad view-points, we discuss in the following section the concrete measures suggested for controlling the parallel economy in India.

(i) **Rationalisation of tax structure :** Various suggestions have been made by different groups of economists in this regard. Most of them are aimed at reduction of tax rates. For instance, it has

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been argued that marginal tax rates on higher incomes should be reduced, there should be liberalisation of tax laws regarding depreciation and writing off of capital; there should be complete exemption of savings from taxation, direct taxes should be indexed to cost of living, etc. If one closely analyses all these suggestions made by Federations of Chambers of Commerce and Industry and some economists who are votaries of more freedom for the private sector, then one reaches the conclusion that all these suggestions are aimed at reducing rates of direct taxes or providing more and more legal avenues of tax avoidance so that the overall burden on the business classes is considerably reduced. The argument of indexation to cost of living is fallacious because inflation by its very nature distributes incomes in favour of business classes and cost of living index is mainly associated with the working class.

The real problem is that even at these modest rates of taxation as obtain today, those in high income brackets do not want to pay taxes and rather like to evade on a massive scale. It is this aspect which needs to be attended to. For this purpose, the 'Soft State' attitude has to be basically altered in favour of 'strong state' which should be keen to realise tax revenue from persons who fall in high income ranges. Obviously, this would require gearing up of tax administration to ensure better tax compliance.

(ii) Removal of controls that are considered unnecessary : A school of thought believes that controls and licensing procedures are all unnecessary, they hinder productivity, obstruct the free play of market forces and should, therefore, be withdrawn.

The Government, in pursuance of this reasoning, lifted control on cement and introduced a dual system of pricing. Even the price of levy cement was raised from ₹ 28 per bag of 50 Kgs. to about ₹ 37. The cement manufacturers fixed the price of open market cement at ₹ 65 per bag. But what have the later developments shown ? The price currently is ₹ 240 per bag and the Government is considering measures to halt the further rise of the price of cement. The abolition of controls has helped to remove shortage of cement, but the other result that the forces of competition in the course of time will lower the price of cement per bag, has not been achieved. In other words, the benefits of liberalisation have been passed on the manufacturers rather than the consumers.

In fact, the ineffective use of controls is responsible for the present state of affairs. The absence of controls creates much worse situations in which businessmen by creating artificial scarcities carry on unbridled exploitation and thus generate black money. Dagli Committee rightly diagnosed the problem : "Leakages in the distribution system even where price control, is accompanied by distribution controls, is another potential source of black money generation. If follows, therefore, that distribution control should be attempted after making sure of the machinery of distribution, and price control should not be attempted without control over distribution." The logic of the Dagli Committee is not to abolish price controls, but to rationalise them and support them with an effective system of distribution. To recommend abolition of all controls in order to speed-up the growth rate of the economy is like the suggestion of removal of breaks from a car so that it can travel faster. The distortions in investment pattern in favour of hoteliers, cosmetic manufacturers and other luxury item producers is the direct result of the manipulations of black money operators, it is not the consequence of statism, but the absence of effective management by the State over affairs of the economy.

(iii) Appropriation of the gains of investment of black income in real estate : A very significant outlet for black income is investment in real estate. Speculation in real estate business is rampant in urban areas. These investments result in very high "capital gains". A very large proportion of black income gets congealed in such residential buildings. Dr. Amit Bhaduri suggests that the most effective way to attack black money system is to appropriate the gains from property speculation. He, therefore, recommends the setting up of "a Corporation in each state and the Union territory to deal in transactions in real estate property, where all private buyers and sellers will have to transact through the corporation for legalisation of urban property transactions. The basic idea can, therefore, be put in a nutshell : neither nationalisation nor "ceiling" on urban private property; but nationalisation of all private transactions in urban real estate." These Corporations, Bhaduri suggests, can be based on the STC pattern wherein the

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seller of say an imported car has to register with the STC and a buyer can only purchase it through the STC. Since the Corporation will be able to know the capital gains accruing from these transactions, it will provide an opportunity to the state to tax these capital gains appropriately. This will act as a double-edged weapon against black money. On the one hand, it will slow down the transactions in urban property thus breaking the back of the speculative boom and on the other, it will bring more revenue to the state.

Dr. K.N. Kabra examining Bhaduri's proposal mentions : "The political pre-conditions for making such a move are not vastly different from those involved in nationalisation of such properties. The feasibility of the proposed remedy on political grounds does not seem to be meaningfully different from that associated with ceilings etc. Kabra, therefore, presents a modified proposal. Since most of the urban property created with the help of black incomes is registered at understated values, Kabra recommends that the state should acquire the right to compulsorily purchase properties at their understated purchase price or construction costs. To enhance the effectivity of the measure, Kabra considers it essential that the right to transfer use of property by means of granting power of attorney be restricted. This will limit benami sales or real estate.

The basic idea underlying both die proposals is to limit the use of black money in real estate and enable the State to appropriate the gains arising there from.

The ultimate aim of both the proposals is to seriously limit investment of black incomes in real estate. Kabra goes to the extent of saying that an all-India ceiling on total value of urban estates should also be enforced to improve the effectivity of the remedy. If that were so, it only implies that whereas the fundamentalist proposition is rejected by Kabra, he imperceptibly and implicitly moves nearer to fundamentalist position. The proposals of appropriating the gains of investment of black income in real estate should be given a fair and honest trial. One more comment which seems pertinent must be made in this context. It would not be advisable to reject Bhaduri's proposal on the basis of administrative feasibility as Kabra does. If this position is taken, the same criticism becomes equally applicable to Kabra's proposal. To consider the economic system a slave of the present administrative set-up will prevent us from taking up any task of gigantic dimensions. To tame parallel economy is a gigantic task and if a meaningful dent has to be made in it, then the administrative set-up must be geared to meet the challenge.

(iv) Establishment of the institution of Ombudsman : The institution of Ombudsman, on the pattern of Sweden, has been discussed for a long time in India. On the basis of the recommendations of the Administrative Reforms Commission (1966), a Lok Pal Bill was introduced for the first time in 1968-69. The Bill was passed by the Lok Sabha, but could not be passed in Rajya Sabha as the Lok Sabha was dissolved. The Lok Pal Bill was introduced in the Lok Sabha for the eighth time on the 14th August 2001. However, it has not been passed so far to become a law. A bone of contention was whether the office of the Prime Minister should be brought within the ambit of the Lok Pal. The NDA government agreed that the office of the Prime Minister shall also be within the jurisdiction of Lok Pal. The Bill, however, excludes from its purview, the President and Vice-President of India, the Speaker of the Lok Sabha, the Chief Justice of India or any other judges of the Supreme Court, the Comptroller and Auditor General of India, the Chief Election Commissioner and Election Commissioners, and the Chairman and other members of the Union Public Services Commission. It may be noted that eight unsuccessful attempts have been made so far to pass legislation in the Parliament to make it mandatory for ministers and legislators to ensure annual declaration of their assets and liabilities. This only underlines the hard reality that while political leaders talk of maintaining integrity and honesty, but when it comes to brass tacks, they create hurdles on one pretext or another to pass legislation binding them to social norms.

Lok Ayukta, the ombudsman at the State level has been set up in Andhra Pradesh, Bihar, Gujarat, Himachal Pradesh, Karnataka, Madhya Pradesh, Rajasthan and Uttar Pradesh. However, a review of

the state legislation reveals that in some states, it is designed to be toothless. In several states, on the completion of the first term, for several years, the Lok Ayukta was not appointed. A study made by Shukla and Singh (1988) observed : “While the institution has potentiality and scope for operation, it may or may not be allowed to operate freely by other structures/systems of the society.”

Notes Another study made by Vinod Pavrala (1996) revealed that though a large number of complaints were received about corruption cases in Andhra Pradesh which clearly indicated that the people in general were eager to avail of the opportunity to combat corruption, but since the recommendations of the Lok Ayukta were routinely ignored by the government, people became disillusioned with the effectivity of the Lok Ayukta to deal with cases of corruption.

The package of measures discussed above are all steps in the right direction within the socio-economic framework of the mixed capitalist economy. Their success depends on the sincerity and vigour with which they are implemented. However, if the State apparatus means business, black money can be brought within manageable limits. But if a symbiotic relationship develops between the capitalist classes, the bureaucracy and political structure in the country, as it obtains today, the chances of controlling the menace of parallel economy appear to be bleak. The crucial issue, therefore, is the nature of state structure, its attitude towards black money, the degree of tolerance and connivance with black money operators.

Self -Assessment

1. Choose the correct options:

(*i*) An outward shift of the production possibilities frontier

(*a*) is always a parallel shift
(*b*) does not relate to the state of the economy
(*c*) reflects economic growth
(*d*) reflects economic decline
(*e*) reflects economic stability

(*ii*) Society's production possibilities frontier

(*a*) demonstrates that, although resources are scarce for individuals, there is no problem of scarcity for society as a whole
(*b*) is based on unrealistic assumptions and therefore has no value as an economic tool
(*c*) helps explain the immense complexity of the real economy
(*d*) is based on simplifying assumptions, but is still useful for illustrating scarcity, opportunity cost, and economic growth
(*e*) is based on the assumption that technology is constantly changing

(*iii*) Which economic question does the decision to give all of the butter the economy produces to the homeless answer?

(*a*) How to produce?
(*b*) Who has an absolute advantage in butter production?
(*c*) For whom to produce?
(*d*) Who has a comparative advantage in butter production?
(*e*) What to produce?

(*iv*) The U.S. economy is best characterized as

(*a*) a command economy
(*b*) a mixed capitalist economy
(*c*) socialism
(*d*) pure capitalism
(*e*) market socialism

(*v*) Which economic concept does the expression "time is money" reflect?

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(*a*) opportunity cost
(*b*) comparative advantage
(*c*) market exchange
(*d*) efficiency
(*e*) specialization

(*vi*) A mixed capitalist economy is one in which

(*a*) all resources are publicly owned and prices are used to coordinate economic activity
(*b*) all resources are publicly owned and economic planning is centralized
(*c*) all resources are privately owned and prices are used to coordinate economic activity
(*d*) decisions are based primarily on religion or custom
(*e*) resources are both publicly and privately owned and some markets are regulated

13.2 Summary

- Parallel economy connotes the functioning of an unsanctioned sector in the economy whose objectives run parallel, rather in contradiction with the avowed social objectives. This is variously referred to as **'black economy', 'unaccounted economy'. 'illegal economy', 'subterranean economy',** or **'unsanctioned economy'.**
- With the attainment of independence and the advent of planning, more avenues of investment in a large number of industries were opened. The concept of the mixed economy envisaged the co-existence of a public sector and a private sector.
- Several attempts have been made to quantify black incomes in India. Broadly speaking, the various estimates of black incomes made so far follow two approaches : (i) Kaldor's approach of quantifying non-salary incomes above the exemption limit of income tax and (ii) Edgar L. Feige's method of working out transaction-income on the basis of currency deposit ratio and from it deriving the black income of the economy. Kaldor's method has been used in the report on Indian Tax Reform, and later by the Direct Taxes Enquiry Committee with some modifications.
- There is no doubt that the estimate of black income prepared by S. Acharya of the NIPFP has meticulously searched for available information and, data and has tried to collate and present a global estimate of black income. In this sense, it makes an advance over the earlier studies in the sense that it is much more comprehensive.
- If similar ranges of black income generation had been developed by the study in immovable property or personal incomes by including illegal acquisitions, its estimate of black income would touch 30 per cent, which it treats as extravagant. To incorporate built-in-depressors in the estimates and then to claim that black income is only 18 per cent appears to be illogical.
- Black income from customs (Import) Duty Evasion has been taken as not less than 30 per cent of the customs duty due if there was no evasion. similarly. Suraj Gupta speaks of smuggling as a "growth industry" in India and its guesstimate has been reckoned at as ₹ 12,000 crores in 1987-88.
- Three major states' taxes, viz., sales tax, state excise duty and entertainment tax are the principal ources of tax evasion. On the basis of some empirical findings, Suraj Gupta assumes evasion of 47 per cent of the potential tax revenue in these three taxes and 30 per cent of tax evasion in the other state taxes.
- IMF staff survey on the unaccounted sector of the economy has estimated black money in India at 50 per cent of Gross National Product (GNP), which was ₹ 1,45,141 crores in 1982-83 at current prices. On this computation, India's unaccounted sector is of the order of ₹ 72,000 crores.
- It would not also be fair to discard the monetary approach altogether because this also serves as a cross-check on the other estimate. It is probable that truth lies somewhere between the two extremes. In that sense, more research has to be directed in this regard.
- The creation of a parallel economy as a consequence of the growing proliferation of black money

in every sector of the economy has very serious and in a number of ways pernicious influences on the working of the Indian economy.

- As a consequence, India developed a regressive tax structure. Direct Taxes Enquiry Committee in this connection mentioned : "Black money and tax evasion, which go hand in hand, have also the effect of seriously undermining the equity concept of taxation and warping its progressiveness.
- There are several factors responsible for the generation of black money. It would be relevant to discuss those factors so that a correct understanding about the genesis, growth and expansion of black money can be made.
- The high marginal rates led many experts on public finance to describe that we are "the most highly taxed nation." These high rates were gradually brought down to 40% by former Finance Minister Dr. Manmohan Singh by 1996. Mr. P. Chidambram has further reduced them in 1997-98 budget to 30 % for individual and 35% for corporations.
- Kabra writes : "In a regime which induces reduction in tax evasion by a method "soft" on tax evaders (like cut in tax rates) rather than by "harder" method which enhances the costs and risks of tax evasion, it would be difficult to expect a better tax compliance through "soft-methods."
- Transparency International (TI) has been preparing Corruption Perception Index (CPI). It was noted that India's rank in CPI slipped to 71 among 102 countries surveyed in 2002 whereas it was 88 among 158 countries surveyed in 2005.
- The dismantling of the system of controls initiated in 1991 Industrial Policy has resulted in a slight improvement in level of corruption. The demand for transparency at a result of Right to Information Act is also acting positively in reducing the level of corruption but we have miles to go before we reach the levels of least corrupt sociaties like New Zealand.
- In short, corruption raises the cost of development, it breeds inefficiency in departments to produce inferior quality of goods—roads, water works, substandard houses built by the PWD, etc.
- It would be desirable at this stage to make a survey of the measures undertaken to unearth black incomes since independence and to assess their success so that further course of action can be decided.
- In 1946, demonetization was resorted to but the Direct Taxes Enquiry Committee in its interim report admitted : "Demonetization was not successful then, because only a very small proportion of total notes in circulation was demonetized. Notes demonetized in 1946 were of the value of ₹ 143.97 crores as against the total notes issued of the value of ₹ 1,235.93 crores.''
- Special Bearer Bonds Scheme (1981) was intended for canalising unaccounted money for productive purposes. The Special, Bearer Bonds, 1981 of the face value of ₹ 10,000 each were issued at par with a maturity period of 10 years. The holders of these bonds were to be entitled to receive ₹ 12,000 on maturity.
- There is no doubt that keeping the maximum tax rate as 30 per cent, the government was able to garner ₹ 10,000 crores from tax evaders, but given the widespread growth of black money, this is really the tip of the iceberg.
- In the connection, some suggestions have been made. First, the imposition of a uniform rate of 35 percent corporation tax on all companies needs to be reviewed. It would be prudent to introduce a slab system and charge only 15 per cent on smaller companies upto a profit of ₹ 50,000.
- As a consequence of the efforts of international division of the Income Tax Department, multinational companies paid a record ₹ 10,000 crores during 2006-07 which was 40 per cent higher than the previous year's collection from this set of companies. The singe in tax figure in unprecedented as the normal increase is 15-20 percent.

- A survey of the measures taken so far reveals that the Government has miserably failed to tackle the problems created by black money. Its approach in combating parallel economy has been half-hearted, misconceived and in some cases, it has collaborated with the black money operators in legitimizing black money.
- Broadly speaking, there are two schools of thought on the question of arresting and eliminating the generation, growth and expansion of black money. There are economists who believe that within the framework of the mixed economy as obtaining in India, black money can be eliminated and its size can be brought within manageable limits so that it does not pose a threat to the very objectives of national economic policies.
- The fundamentalist view, therefore, does not see any merit in making certain marginal adjustments in tax rates because this will not serve any useful purpose in controlling black money, nor does it see any merit in removing all controls, but it feels that if tangible results have to be achieved, the abolition to private property or at least fixing a ceiling on property is essential so that the motivation for acquiring more wealth itself is blunted.
- There are two variants of the moderate view. One is typified by Kabra who considers the fundamentalist view as "naive, one-dimensional view of the state in as much as it fails to recognise a need for partial, effective controls, without necessarily changing the character of the state in its essentials."
- In the light of these two broad view-points, we discuss in the following section the concrete measures suggested for controlling die parallel economy in India.
- The real problem is that even at these modest rates of taxation as obtain today, those in high income brackets do not want to pay taxes and rather like to evade on a massive scale. It is this aspect which needs to be attended to.
- Finance Minister Mr. P. Chidambram stated in his budget speech (2008-09) : "The UPA Government inherited a tax to GDP ratio of 9.2 per cent in 2003-04. At the end of 2007-08, the ratio has risen to 12.5 per cent... Many people are surprised by the buoyancy in tax revenues, especially in direct taxes. I am not. I have always maintained that moderate and stable tax rates coupled with a tax administration that shows no fear or favour will bring high revenues to the exchequer,''
- There is no doubt that even today tax evasion takes place in indirect taxes and this generates black income, but evidence of growth of Gross Tax Revenue only re-inforces the conclusion that the magnitude of black money generation has come down.

13.3 Key-Words

1. Black Economy : A black market or underground economy is the market in which illegal goods are traded. Due to the nature of the goods traded, the market itself is forced to operate outside the formal economy, supported by the established state power. Typically the totality of such activity is referred to with the definite article as a complement to the official economies, by market for such goods and services, e.g. "the black market in bush meat" or the state jurisdiction "the black market in China".
2. Illegal Economy : The "illegal economy" consists of the income produced by those economic activities pursued in violation of legal statutes defining the scope of legitimate forms of commerce. Illegal economy participants engage in the production and distribution of prohibited goods and services, such as drug trafficking, arms trafficking, and prostitution

3. Informal Economy : The "informal economy" comprises those economic activities that circumvent the costs and are excluded from the benefits and rights incorporated in the laws and administrative rules covering property relationships, commercial licensing, labor contracts, torts, financial credit and social security systems.

13.4 Review Questions

1. What do you mean by Parallel economy? Discuss.
2. How will you estimate the black money in India ? Explain.
3. Discuss the factors responsible for generation of Black money.

Answers: Self-Assessment

1. (*i*) (*c*) (*ii*) (*d*) (*iii*) (*c*) (*iv*) (*b*) (*v*) (*a*) (*vi*) (*e*)

13.5 Further Readings

Books

1. Indian Economy; Gaurav Datt and Aswani Mahajan; S. Chand and Company LTD. Ram Nagar, New Delhi-110055.
2. The Indian Economy; S.K. Ray; Prentic, Hall of India Private Limited New Delhi - 11001.

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Unit 14: Role of Bureaucracy and Delivery Mechanism in Implementation of Economic Policies

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Objectives

After reading this Unit students will be able to:

- Describe the Role of Bureaucracy and Delivery Mechanism in Implementation of Economic Policies.

Introduction

An economic policy can not be successful only with the formulation of good policy. The success depends more on efficient and effective implementation but it is a tragedy in our country that implementation process has been very poor. It may be noted that bureaucracy is very important tool for implementation of economic policies. Thus, their role becomes very crucial in this process. Here, bureaucratic hurdles in the effective implementation of economic policies have been discussed. Moreover, good governance, needed changes in its role, required administrative reforms and strategies and policies for improvement in bureaucracy have also been included in the discussion of this issue.

14.1 Role of Bureaucracy

The term Bureaucracy was coined by *M de Gournay*, an economist of France, in the 18th century. He referred to it as "a fourth or fifth form of Government". According to him, in these system officers, clerks, secretaries, inspectors and attendants are not appointed to benefit the public interest. The public interest appears to have been established so that offices might exist. According to Harolds J. Laski, bureaucracy may be defined as a system of Government, the control of which is so completely in the hands of officials that their power jeopardises the liberties of ordinary citizens. The characteristics of bureaucracy were first formulated in a systematic manner by the German Sociologist *Max Weber* (1864-1920). According to Weber, there are three types of authority, viz., traditional, charismatic and legal-rational (bureaucratic). He classsifies traditional authority as the authority resting on an established belief in the sanctity of immemorial traditions and the legitimacy of the status of those exercising authority under them. Charismatic authority rests on the devotion to the specific and exceptional sanctity, heroism or exemplary character of an individual person, and of the normative patterns or order revealed or ordained by him. While the legal authority rests on the premises of legality of patterns of normative rules and the right of those elevated to authority under such rules to issues commands.

The characteristic features of bureaucracy are given below :

1. **Impersonal Order :** In bureaucracy, the authority is inherent in the post and not the individual who performs the official role.

2. **Rules and Regulations :** In this authority, rules must be followed meticulously. Functions are clearly spelled out in rules.
3. **Hierarchy :** Here, the lower offices are under the control of the higher ones.
4. **Contract :** Bureaucracy has officials appointed through contract on the basis of professional qualifications.
5. **Control :** Checks, unified control and disciplinary system is the hallmark.
6. **Division of Work Leading to Specialisation :** The work of the organisation is fixed which leads to specialisation.
7. **Efficiency :** According to *Weber*, the decisive reason for the advance of bureaucratic organisation has always been its purely technical superiority and efficiency over any other form of organisation.
8. **Neutrality :** It is a political and neutral.

Now, we can discuss as to how this bureaucracy runs the administration to put the economic policies into action to deliver the benefits of economic policy.

14.2 Delivery Mechanism in Implementation of Economic Policies

The understanding of Public Administration would help in knowing how this bureaucracy runs the administration to put the economic policies into action to deliver the benefits of economic policy.

Public Administration : Administration may be defined as an activity which demands correct analysis and accurate orientation to achieve the objectives of the organisations and meet the needs of the people in an economic and efficient manner. Woodrow Wilson defined Public administration as a detailed and systematic application of law. According to him, every application of law is an act of administration. Similarly, L.D. White views Public administration as consisting of all those operations having for their purpose the fulfillment or enforcement of public policy. Pfiffner defines Public administration as a system that consists of doing the work of the Government, whether it be running an X-ray machine in a health laboratory or coining money in the mint. This means public administration is concerned with the implementation of public policy, as laid down by the competent authority economically and efficiently for the benefit of the people and the country.

Development Administration : Development administration was introduced to manage new activities such as economic policies. This was necessary because the Government has been entrusted to manage economic and business activities and hence it was found difficult to manage the economic policy with the traditional administration as it has the experience of mostly dealing with law and order and justice. It may be noted that development is a process of growth in the direction of modernity, particularly towards nation-building and socio-economic progress. In the words of *K.S. Dadzie*, the final aim of development must be the constant increase of the well-being of the entire population on the basis of its full participation in the process of development and a fair distribution of the benefits there from. Therefore, the main aim of development should be to enrich the quality of life. In this way, development Administration was introduced to ensure implementation of economic policies sincerely.

Essentials of Development Administration : To be effective and efficient Development administration should have the following :

1. **Administrative Innovation :** It is said that administrative innovation is the *sine quo non* for development administration. According to *Susanne MacGregor*, there is need for 'Life Cycle' of innovation to improve services which involves the following : conception, adoption, early trial and error, mature implementation and routinisation, dominance, and replacement by newer forms of things.
2. **People's Participation :** The potential energy of the people should be utilised through their involvement.
3. **Definite Policies Programmes and Projects :** These should reflect the needs of the people.
4. **Monitoring :** Monitoring and evaluation are needed to locate problems and inject improvements.

5. **Use of Modern Management Technique :** It should be used for optimising personnel, financial and material resources.
6. **Achievement Orientation :** Administration should be achievement oriented.
7. **Commitment and Dedication :** These provide extra power to development.

   It is known that development administration could not achieve much in developing countries because of the fact that the same personnel with the old administrative apparatus are implementing development programmes in their respective countries.

Lack of Implementation: Bureaucratic Problems

In the implementation of economic policies many breaucratic problems are faced. For instance, mounting corrupt practices by public officials caused by the poor remuneration of public officials and their concomitant low self-motivation; culture of secrecy in public service; weak enforcement of laws and regulations; high degree of centralised decision-making; weak instruments of control and accountability; low level of compensation; politicisation of service delivery systems; the supremacy of the executive; inefficient public employment system; inter-cadre rivalry; lack of favourable conditions for women; lack of linkage between rewards and performance; wastages in public offices caused by unscientific management of human resources and wasteful management of public properties; low levels of efficiency, effectiveness, accountability, transparency and dynamism; and over-sized organisations and over-staffing in bureaucracy of our country.

Need of Reforms

A lot of paper work generated in today's Government offices could have been avoided in cases where requisite information could be easily gathered by phone, personal interaction, etc. Personnel administration should not only attend to personnel matters but also improve the general management. Management improvement is a continuous process. The principal responsibility for effecting improvements in administration lies with the administrators themselves. Administrative reforms may be politically necessary or socially desirable, but unless they are administratively feasible and bureaucratically acceptable, they will prove sterile. It may be noted that all reforms require a clear vision, committed leadership and sustained effort. The innate creative and innovative abilities of seniors, colleagues and subordinates should be harnessed. In the new Millennium, the Government would need to relevant itself to become 'citizen-centric' and 'citizen-friendly'. Greater delegation and decentralisation of authority and responsibilities would need to be introduced at all levels. Greater accountability in the administrative system would be ensured by a combination of Citizens' Charters and the Right to Information. Gradually, the process of consultation with the participation of citizens in decision-making would become more pronounced in order to ensure accountability. The civil servants and politicians need to adopt clearly defined ethical standards. This all can be achieved through an innovative use of information technology.

Good Governance to Ensure Implementation of Economic Policy

Today, good governance is an important agenda of Government which has taken measures to make administration accountable, responsive and transparent. It has been done through citizen charters; formulation of a Freedom of Information Bill; review of administrative laws and regulations for dismantling procedures and red tapism by repeal or amendment of outdated and obsolete laws, regulations and procedures that mystify, and confuse the people, creating the environment to reap the benefits of IT by harnessing IT, establishing Information and Facilitation Counters. Today, systemic thinking is necessary as well as to involve the people and the employees in the effort through a shared vision. Today's culture of competition between individuals has to be replaced by competition between teams and organisations.

Now, the Government must possess the certain qualities to ensure implementation of economic policy efficiently in the society. For instance, the bureaucracy should have wide contact with the people administered. A sense of justice, sensitivity and responsiveness to the urges, feelings and aspirations of common people is another reform need in the bureaucracy. Humility and simplicity in the persons

manning the administrative machinery and their easy accessibility to bureaucracy is also needed. Moreover, honesty and integrity in thought and action is required as well as creating and sustaining an atmosphere conducive to development, growth and social change should be there. It may be noted that the widespread poverty and the depressed standards of living among such a large number of people pose a very serious threat to peace as well as socio-economic development. The personnel administration must recognise that the final aim of development must be the constant increase in the well-being of the whole population.

Linkages of Bureaucracy with the Knowledge Centres

For implementing economic policies, officials must make use of knowledge generated in higher seats of learning as has been stressed by the Planning Commission in its report "India as Knowledge Superpower : Strategy for Transportation" (2001). In the 21 st century, only those nations will survive and succeed, which will build them by understanding the dynamics of knowledge and createtrue knowledge societies. A knowledge society has the following characteristics :

(i) A knowledge society uses knowledge as a powerful tool to drive societal change.

(ii) There is capacity to generate, absorb, disseminate and protect knowledge and also use it to create economic wealth and social good.

(iii) Knowledge used through all its constituents and endeavours to empower and enrich its people.

(iv) An integrated view of life a fusion of mind, body and spirit is advocated.

(v) It is committed to learning and innovation.

In this century, there will be three key drivers of knowledge society : societal transformation for just and equitable society; wealth generation; and protection of knowledge, not only the one generated in its research laboratories but also its traditional knowledge, generated by our communities over centuries in laboratories of life and the society.

Administrative Reforms for Implementation of Economic Policy

Phenomenal changes have occurred at a fast rate in the field of science and technology as well as in external environment during the last few decades. They influence public administration also which, today, has to shoulder multifarious tasks designed to fulfil the rising aspirations of the people. However, it is too often not prepared for are the overwhelming managerial problems involved in the implementation of these technologies. Therefore, there is an urgent need to re-orient (improve) the systems of public administration. According to Leif H. Share, good Public Administration could serve as a major instrument for promoting economic and social development and for introducing needed advances in science and technology. According to a United Nations Report, management improvement comprised the planning, implementation and evaluation of various measures conducive to the increase of effectiveness and efficiency in the organisation.

Strategies and Policies for Administrative Reforms

According to the United Nation's Publication, following strategies and policies are needed for administrative improvement in a country :

(a) Classification of objectives and goals;

(b) A responsibility of management;

(c) Administration must be a systematically planned and organised activity, with specific work programmes;

(d) A continuous activity;

(e) Long-term planning and development;

(f) Special resources must be allocated to the projects;

(g) Selection of personnel engaged in the improvement work must be of high quality;

(h) Training and development of the members of the organisation;

(i) In large projects, pilot studies or the implementation of the new organisational structures are often needed; and

(j) Participation and involvement of management in the organisations affected by possible changes are of great importance;

(k) Improvement work must be based on the concept of the organisation as a socio-technical system;

(l) Planning of improvement projects in terms of activities, time and resources.

(m) Orientation improvement towards implementation and change;

(n) Both centralised and decentralised though coordinated programmes needed;

(o) Work programme for improvement should be formalised as an obligation;

(p) The project organisation should be flexible.

The following aspects must be kept in mind to promote administrative reforms in our country :

1. Explore alternatives to direct public provision, which might provide more cost-effective policy results;
2. In terms of efficiency and effectiveness, and service quality, a closer focus on results;
3. Highly centralised hierarchical organisational structures to be replaced with decentralised management environments;
4. To provide greater flexibility in the deployment of staff;
5. Strategic capacities at the centre to be strengthened to steer Government to respond to external changes and diverse interests;
6. Accountability and transparency through results;
7. Mechanisms to improve performance;
8. Incentives to improve performance.

Self -Assessment

1. Choose the correct options:

(*i*) The first president to actually win passage of the first deregulation act was

(*a*) Bill Clinton (*b*) Ronald Reagan.

(*c*) Gerald R. Ford. (*d*) Richard M. Nixon.

(*e*) John F. Kennedy.

(*ii*) Which of the following industries faced near collapse after deregulation?

(*a*) railroads (*b*) trucking

(*c*) commercial airlines (*d*) savings and loan

(*e*) all of the above

(*iii*) The chief responsibility for the development and implementation of monetary policy lies with the

(*a*) Congress. (*b*) president.

(*c*) Commerce Department. (*d*) Federal Reserve Board.

(*e*) Treasury Department.

Notes

(*iv*) The impact by the U.S. president is felt most on the Federal Reserve Board by the fact that the

(*a*) president is a member of the Board.

(*b*) Board is a cabinet department in the executive, giving the president complete control over Federal Reserve operations.

(*c*) president nominates Board members to a fourteen year terms.

(*d*) president becomes a member of the Board after he leaves office.

(*e*) Board actions may be vetoed by the president, just like congressional legislation.

(*v*) Which of the following tools is used by the Federal Reserve to regulate the nation's money supply and control interest rates?

(*a*) discount rate (*b*) selling U.S. government securities

(*c*) buying U.S. government securities (*d*) reserve requirements

(*e*) all are correct

(*vi*) If the Federal Reserve Board wanted to increase the money supply, it would probably be in response to

(*a*) their concern for inflation. (*b*) the need to stimulate the economy.

(*c*) the need to "slow down" the economy. (*d*) an order by the U.S. Supreme Court.

(*e*) a demand from Congress or the president of the U.S.

(*vii*) An example of an application of "commercial Keynesianism" would be the

(*a*) Congress and the president increasing military and social welfare spending.

(*b*) Federal Reserve Board selling U.S. government securities.

(*c*) Congress and the president passing a tax cut.

(*d*) Federal Reserve Board lowering the discount rate.

(*e*) all of the above

(*viii*) Which staff agency was created to assist the president and handle the details of budget preparation?

(*a*) Congressional Budget Office (CBO) (*b*) Department of Treasury (DOT)

(*c*) General Accounting Office (GAO) (*d*) Department of Commerce (DOC)

(*e*) Office of Management and Budget (OMB)

14.3 Summary

- The term Bureaucracy was coined by *M de Gournay*, an economist of France, in the 18th century. He referred to it as “a fourth or fifth form of Government”.
- The characteristics of bureaucracy were first formulated in a systematic manner by the German Sociologist *Max Weber* (1864-1920). According to Weber, there are three types of authority, viz., traditional, charismatic and legal-rational (bureaucratic).
- The understanding of Public Administration would help in knowing how this bureaucracy runs the administration to put the economic policies into action to deliver the benefits of economic policy.
- Development administration was introduced to manage new activities such as economic policies. This was necessary because the Government has been entrusted to manage economic and business activities and hence it was found difficult to manage the economic policy with the traditional administration as it has the experience of mostly dealing with law and order and justice.

Notes

- It is known that development administration could not achieve much in developing countries because of the fact that the same personnel with the old administrative apparatus are implementing development programmes in their respective countries.
- In the implementation of economic policies many breaucratic problems are faced. For instance, mounting corrupt practices by public officials caused by the poor remuneration of public officials and their concomitant low self-motivation; culture of secrecy in public service; weak enforcement of laws and regulations; high degree of centralised decision-making; weak instruments of control and accountability; low level of compensation; politicisation of service delivery systems; the supremacy of the executive; inefficient public employment system; inter-cadre rivalry; lack of favourable conditions for women;
- Gradually, the process of consultation with the participation of citizens in decision-making would become more pronounced in order to ensure accountability. The civil servants and politicians need to adopt clearly defined ethical standards. This all can be achieved through an innovative use of information technology.
- Today, good governance is an important agenda of Government which has taken measures to make administration accountable, responsive and transparent.
- Now, the Government must possess the certain qualities to ensure implementation of economic policy efficiently in the society.
- For implementing economic policies, officials must make use of knowledge generated in higher seats of learning as has been stressed by the Planning Commission in its report "India as Knowledge Superpower :
- Phenomenal changes have occurred at a fast rate in the field of science and technology as well as in external environment during the last few decades.
- However, it is too often not prepared for are the overwhelming managerial problems involved in the implementation of these technologies.
- According to a United Nations Report, management improvement comprised the planning, implementation and evaluation of various measures conducive to the increase of effectiveness and efficiency in the organisation.
- Selection of personnel engaged in the improvement work must be of high quality;

  Explore alternatives to direct public provision, which might provide more cost-effective policy results;

14.4 Key-Words

1. Bureaucracy : A bureaucracy is a group of specifically non-elected officials within a government or other institution that implements the rules, laws, ideas, and functions of their institution; in other words, a government administrative unit that carries out the decisions of the legislature or democratically-elected representation of a state.

   The term "bureaucracy" was created from the French word bureau, meaning desk or office, and the meaning rule or political power.
2. Good Governance : Good governance is an indeterminate term used in international development literature to describe how public institutions conduct public affairs and manage public resources in order to guarantee the realization of human rights. Governance describes "the process of decision-making and the process by which decisions are implemented (or not implemented)". The term governance can apply to corporate, international, national, local governance or to the interactions between other sectors of society.

14.5 Review Questions

1. Discuss the concept and features of Bureaucracy. Also examine the role and significance of Bureaucracy in the development.
2. Examine the available delivery mechanism in implementation of economic policies.
3. Examine the need for reforms in the delivery mechanism for implementation of Economic Policies. Suggest measures for bringing about necessary reforms.
4. Discuss the good governance to ensure implementation of economic policy.
5. Explain the role of bureaucracy and delivery mechanism.
6. What are the strategies and policies for administrative reforms? Discuss.

Answers: Self-Assessment

1. (*i*) (*c*) (*ii*) (*d*) (*iii*) (*d*) (*iv*) (*c*) (*v*) (*e*)
   (*vi*) (*b*) (*vii*) (*c*) (*viii*) (*e*)

14.6 Further Readings

Books

1. Indian Economy; Gaurav Datt and Aswani Mahajan; S. Chand and Company LTD. Ram Nagar, New Delhi-110055.
2. The Indian Economy; S.K. Ray; Prentic, Hall of India Private Limited New Delhi - 110001.

Unit 15: Implementation of Economic Policies: Role of Panchayats and Pressure Groups

Notes

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Objectives

After reading this Unit students will be able to:

- Explain the Role of Panchayats.
- Discuss the Pressure Groups.

Introduction

The role of bureaucracy in the implementation of economic policies and has seen that it is not up to the mark. Thus, we can make use of Local Level initiatives, that is, Panchayats, NGOs and Pressure Groups which are closer to the people. Effective implementation of economic policy can be ensured through people's participation. To understand the importance of this we can discuss the potentialities and problems of local institutions and suggest solutions to make them more effective in the process. It may be noted that decentralisation at local level is needed to encourage local initiatives and run the socio-economic programmes efficiently partly due to the pressure of work at the union and state levels and partly due to corruption at the high places. For the purpose, decentralisation is needed to involve local people for whom the programme is prepared. Such objectives could be achieved through Democratic Decentralisation.

15.1 Role of Panchayats

Decentralisation is the transfer of authority, responsibility, and accountability from Central to Local Governments. Decentralisation can take various forms, commonly described in public administration terms as deconcentration, devolution, and delegation. Decentralisation also has several dimensions that reflect, in general terms, increasing and often sequential stages of progress in achieving the governance objectives of decentralisation. These stages are : Administrative decentralisation (functional responsibility), financial decentralisation (access to resources) and Political decentralisation (accountability). The Political dimension is especially critical for democratic decentralisation because it reconstitutes the state in a democratic way. It provides a process at the local level through which diverse interests can be heard and negotiated and resource allocation decisions can be made based on public discussions. Genuine political power sharing is a key element often missing in the political dimension of decentralisation.

Democratic local governance is autonomous levels of local Government, vested with authority and resources that function in a democratic manner. That is, they are accountable and transparent, and involve citizens and the institutions of civil society in the decision-making process. Democratic local governance It emphasises the presence of mechanisms for fair political competition, transparency,

and accountability, Government processes that are open to the public, responsible to the public, and governed by the rule of law.

Democratic decentralisation is the development of reciprocal relationships between central and local Governments and between local Governments and citizens. It addresses the power to develop and implement policy, the extension of democratic processes to lower levels of Government, and measures to ensure that democracy is sustainable. Democratic decentralisation incorporates both decentralisation and democratic local governance.

Panchayati Raj

Genesis and Legal Framework : In India, panchayats have been very important in the structure of the Indian villages since the beginning of the history. The three-tier *Panchayati Raj* made Gandhiji's dream of every village being a republic a reality. The Constitution (73rd Amendment) Act, 1992 came into force on 24th April, 1993 Which became a landmark in the history of *Panchayati Raj* in India since on this day the *Panchayati Raj* Institutions were provided the Constitutional Status. The characteristic features of the Act are as follows :

(i) It provides three-tier system of *Panchayati Raj* in the country;

(ii) Panchayat elections would be held regularly every five years;

(iii) Reservation of seats for Scheduled Castes, Scheduled Tribes and women (not less than one-third of total seats);

(iv) State Finance Commissions to be set up for making recommendations regarding financial powers of the Panchayats;

(v) District Planning Committee to be constituted to prepare draft development plan for the districts.

Now, Panchayats will have powers and authority to function as institutions of self-Government. Panchayats will do it in the following manner :

(a) They would prepare a plan for economic development and social justice;

(b) Schemes for economic development and social justice in relation to 29 subjects given in the Eleventh Schedule of the Constitution would be implemented by them; and

(c) They would levy, collect and appropriate taxes, duties, tolls and fees in their respective areas.

Constitutional Status : The experts thought that it is needed to enshrine certain basic and essential features of PRI in the Constitution to impart certainty, continuity and strength to them. The Constitution (73rd Amendment) Act, 1992 conferred constitutional status to Panchayats and Government from the village upwards with effect from 24th April, 1993.

There are 30 subjects that are to be assigned to the PRIs under the Eleventh Schedule. Some of the important ones are agriculture and allied areas, minor forest produce, small-scale industries, roads, rural housing, drinking water, non-conventional energy, rural electrification, poverty alleviation programmes, education including primary and secondary schools, health, family, women and children. The problems like lack of uniform structure, dominance of upper castes and vested interests, irregular elections and frequent super-sessions have been solved by the mandatory provisions.

Problems : There are certain problems in the implementation of the Act such as non-empowerment of Gram Sabhas and top-down approach to planning, monitoring and evaluation. Moreover, there may be manipulation of the pattern of reservation for the posts of Adhyakshas. Apart from this delay in constitution of District Planning Committees (DPCs) would bring the process of rural-urban synchronisation to a stand still.

Such problems might hamper the representative character of the PRIs and weaken the instrument of check and balances in the system.

Certain suggestions were made by a Round Table Conference on 'Financing for District Level Development', in 200l as given below :

1. The Centre can give money directly to the district.
2. The categories like the plan/non-plan distinction should be simplified.

3. When a fund transfer takes place to the Panchayat, there should be a mechanism to maintain accountability and transparency. This is not very difficult in today's electronically-linked world of giving publicity to the people of that area.
4. To solve over-engineering of the structure, one has to move, between what items have to be subject to conditionalities and what kind of conditionalities are actually needed. Moreover, what extent of freedom of decision-making should be allowed to which level should also be considered.
5. There is also the issue of a whole set of parallel paraphernalia and agencies which really are not required to be set-up.

Effective decentralisation for development needs the following steps :

- We should train people participating in Panchayats in prioritising issues.
- Members of Panchayats should be trained to put choices before an elected body so that they are in a position to really explain to the chairperson or the Panchayat.

Administrative Powers

1. After preparing the framework for devolution, the State Government, should simultaneously reorganise the existing District Administration.
2. Different line departments should be encouraged by the State Governments to take up appropriate measures to integrate their activities with *Panchayati Raj* System.
3. The three tiers of *Panchayati Raj* should be supported with adequate autonomy in the framework for devolution.
4. The District Rural Development Agency (DRDA) should be integrated with the District Panchayat to ensure harmonious integration of different agencies to the service of common objectives of rural development.
5. State Governments should assign administrative powers between three tiers as per the framework given.
6. Convergence of schemes should be further pursued for local benefit.
7. The State Governments may devolve powers and functions to the three tiers of *Panchayati Raj* vis-a-vis. The 30 items under the Eleventh Schedule.
8. Functionaries and funds may be transferred to the PRIs for implementation of various Schemes.
9. The *Panchayati Raj* Institutions should be allowed to constitute adequate number of Subject Committees covering important items.
10. Institutions/organisations along with the activities to the appropriate tier of Panchayats should be transferred to facilitate smooth functioning of the Panchayati Institutions.
11. Mechanisms for monitoring and supervision of the activities of PRIs may be devised by Strengthening of Audit System, Constituting inter-tier Standing Committee, Social Audit by Gram Sabha, enforcing Transparency in the activities of Panchayats and Constitution of 'Ombudsman' for the purpose.
12. Qualified and trained personnel at all levels to assist PRIs in their day-today Operations should be made the part of devolution package.
13. It may noted that all Class-I posts of *Panchayati Raj* should be filled on deputation basis from the State Cadre. Similarly, Class-II officers may be recruited through the State Public Service Commissions or on deputation basis from the State Cadres. For class-III and lower staff, the recruitment may be at the Regional/District level through an independent Recruitment Board.
14. The Chief Executive Officer (CEO) of the District Panchayat should be an Officer equivalent to the District Collector.

People's Participation In Panchayati Raj Activities

For our purpose, people's participation in the development process means active cooperation and involvement of the general masses in the process of development administration. People's active interest, enthusiasm and cooperation in planning, implementation and evaluation of development programmes at all levels, particularly at the grass-root level is required. India's participatory local self-governance has a feasible and institutional status that can be harnessed to implement people's programmes at the grass root. Eventually, local self governance will be the final route of decentralisation of fund, function and functionaries specially the 29 subject/departments under 73rd CAA, However, this dream of local self governance needs informed and responsible decisions at village level by the electorate in Gram Sabhas. We must not only be aware of the possibility & potential of PRI's but should also be very conscious that we have a long way to go to strengthen the PRI's in Rural India. It is possible if all of us who are involved in rural development take the building of PRI's as a very important tool for developing rural India which constitutes 71% of India's populations. It requires active and responsible participation by the Gram Sabha. This is a big challenge in a country with 34.97% illiterate people and where the literate are either indifferent or driven by vested interests. In his article, "Good Governance through Transparency" (1999), M. Ariz Ahmed has strongly advocated the following :

It may be noted that transparency and people's participation in regulatory and development administration is very important not only in bridging the gap between the administration and the public but also in nation-building, by way of reducing the corruption and complaints against the system. Rural body should not function as machinery but in a humane and purposeful way. Moreover, the strengthening of democracy in its social and economic aspect has to be attained through the participation on the part of the people. At the international level, the UNDP framework for Copenhagen Implementation (1996) outlines the basic goal as sustainable human development, eradication of poverty, job creation and sustainable livelihood, and environment protection and regeneration and advancement of women.

Delivery Mechanism at Local Level by Panchayats

To address different aspects of rural poverty, the Government has brought poverty alleviation programmes. Micro-credit-linked programmes provide a package of services including credit and subsidy to set up micro-enterprises. Apart from this, the scheme of infrastructure development and provision of basic services contribute to the well-being of the rural people. For a successful implementation of these programmes, an appropriate policy framework, adequate funds, and an effective delivery mechanism is needed. Further, an effective delivery system has to ensure people's participation at various stages of the formulation and implementation of the programmes, transparency in the operation of the schemes and adequate monitoring. The following suggestions are made to improve the qualitative impact of these programmes :

1. **Organising the Poor for Greater Participation :** Farmers "co-operatives, *Manila Mandals* and other institutions should perform intermediary functions like awareness generation, credit extension, and so on.
2. **Unity of Plan and Policy :** All over the country, a national plan of action supported by national, regional and block level policies should be evolved and adhered to uniformly.
3. **Emphasis on Coordination Rather than Control :** The PRIs should report their progress and Central/State level co-ordinators should use this feedback to analyse the problems/short comings to suggest necessary policy-changes which means the flow of information should be two-ways.
4. **Schemes to Originate from PRIs and not State/Centre :** The PRIs should be sufficiently equipped to collect their own database, analyse their problems and priorities and formulate their own schemes and programmes to develop their areas.
5. **Simplification of Procedures/Norms :** We should make project planning more scientific and simplified, properly understood and implemented at GP level. Excessive paper work in the name of monitoring should be avoided because it alienates the elected representatives and

gives way to bureaucratisation of programme implementation. Field inspections and result-oriented feedback in terms of number and percentage of village population crossing poverty line should be encouraged.

6. **Adoption of Package Approach :** The help should be provided as a package to ensure achievement of tangible results as seen in Sri Kshetra Dharmasthala Model.

7. **PRIs as Corporate Bodies :** The PRIs should spend Government money yielding returns in the form of revenue generation. We should work out the cost-benefit ratio and internal rate of return and monitor them for all schemes per say.

8. **Focus on HRD :** It may be noted that human development through better education, health nutrition and family planning at local level promotes economic growth as effectively as capital investment in factories. The benefits arising out of mass education outweigh its negative aspects, such as educated unemployed or social tensions.

9. **Creation of Satisfactory Monitoring System to Measure and Regulate Performance during Implementation :** Programme control helps the heads of the departments at the district level to keep the programme functioning as scheduled.

It may be noted that a participatory and result-oriented bureaucracy interacting with an aware and educated population would interact fruitfully to produce a self-reliant village entity in the right spirit of democratic decentralisation for rural development. Our experience has confirmed that the goals of economic growth and poverty reduction can be and often are complementary. Hence, the 73rd Amendment to the Constitution has outlined the country's commitment to rural development through democratic decentralisation system.

1. **PRIs as an End and not the Means :** Under the Act, the Panchayats are being treated as an agency for implementation of rural development programmes and not as units of self-Government. PRIs should reflect the spirit of the Constitutional amendment, which says that Panchayats will function as institutionsof self-Government (Article 243G).

2. **Autonomy of PRIs :** A number of powers have given to the Government officials for inspection and supervision of the Panchayats at different levels in the states. Thus, these bodies will not enjoy institutional autonomy and freedom.

3. **Developing able Leadership :** The leadership available at grass-root level may be developed to influence people to co-operate towards a common goal and to create a situation for collective response. PR Organisation constitutes three important leaders as given below :

   (i) First, elected leaders would derive their authority from the institution of PRI.

   (ii) Second, the bureaucratic leaders derive their authority from the administrative system.

   (iii) Gradually, self-appointed leaders spring up with a reformist approach by persuading people to join them in checking the prevailing malpractice of the above two sets of leaders given.

15.2 Pressure Groups

Pressure groups are voluntary agencies which have a long history of active involvement in the promotion of human welfare and well-being. Lord Beveridge called voluntary agencies "aprivate enterprise for social progress". A pressure group can be described as an organised group that does not put up candidates for election, but seeks to influence Government policy or legislation. They can also be described as 'interest groups", 'lobby groups' or 'protest groups'. Some people avoid using the term 'pressure group' as it can inadvertently be interpreted as meaning the groups use actual pressure to achieve their aims, which does not necessarily happen.

The term pressure group is a very wide definition that does not clearly distinguish between the groups that fall under the term. The aim of all pressure groups is to influence the people who actually have the power to make decisions. Pressure groups do not look for the power of political office for themselves, but do seek to influence the decisions made by those who do hold this political power. Pressure groups provide a means of popular participation in national politics between elections. They are sometimes able togather sufficient support to force Government to amend or even scrap

legislation. Pressure groups also provide a means of participation in local politics between elections. A pressure groups can use a variety of different methods to influence law.

Help in Efficient Programme Implementation : It may be noted that voluntary agencies help in the programme implementation, collaboration and co-ordination with other activities. Moreover, they can be helpful in development through programme implementation in the following ways :

1. They can conduct reviews and assessment of existing development programmes.
2. They can develop innovative programmes.
3. They can provide assistance to develop and/or strengthen local NGO capabilities and activities.
4. Voluntary agencies can ensure that their existing programmes and new initiatives promote full participation by individuals and communities in the planning, implementation and control of the programmes of the area.
5. They can expand their training efforts to respond to the need of primary health Care programmes.
6. They can extend their efforts to develop locally sustainable and appropriate health technologies.
7. Voluntary agencies can help in recognising the essential roles of women in health promotion.
8. They can extend their capacity to work with poor, disadvantaged and remote populations.
9. Voluntary agencies can help in the creation of new and effective methods of health education.

These agencies are increasingly playing the catalysistic role in getting the public policies implemented. In the above discussion, the term 'pressure groups "and various forms of organisations have been used interchangeably. It may be noted there are two types of pressure groups or organisations : Membership Based Organisations (MBOs) and the Non-Government Organisations (NGOs) as discussed below :

Membership Based Organisations (MBOs) : Membership-Based Organisations (MBO) are associations and societies that focus on the common interests of their members. Organisations provide tools and solutions to members to increase their productivity and ensure better service. With the use of the latest internet technology, Milestone Consultants provides advanced web communication channels to professional associations, societies, trade unions and clubs to collaborate and share information. Associations can inform and update their members about news and events through emails, newsletters, blogs, discussion forums, wiki's, and various community sites.

Non-Government Organisations (NGOs) : A non-Governmental Organisation (NGO) is a legally constituted organisation created by natural or legal persons that operates independently from any Government. The term is usually used by Governments to refer to entities that have no Government status. In the cases in which NGOs are funded totally or partially by Governments, the NGO maintains its non-Governmental status by excluding Government representatives from membership in the organisation. The term is usually applied only to organisations that pursue some wider social aim that has political aspects, but that are not overtly political organisations such as political parties. Unlike the term "inter-governmental organisation", the term "non-governmental organisation" has no generally agreed legal definition. In many jurisdictions, these types of organisation are called "civil society organisations" or referred to by other names.

Here, it may be noted that NGOs cannot be substitutes for people's organisations because :

1. They are not uniformly distributed all over the country's area.
2. The success of an NGOs depends on the availability of service-minded people.
3. It is important to note that empowerment of people can come about only when they actually run their own organisations.

Despite the above reasons, NGOs can contribute considerably in building the Membership Based Organisations which in turn need a great deal of financial and moral support for capacity building. It is observed that Membership Based Organisations in India are confined to a few legal forms. Of these, the most prominent are the trade unions registered under the Trade Union Act (1926) and the co-operatives registered under various State Cooperative Acts. MBOs Networks are formed through alliances between MBOs or federations of trade unions, co-operatives and savings and credit groups and organisations.

Case Studies : MBOs - Here is a case study of Self-Employed Women's Association (SEWA) which a union of self-employed women. Established in 1972, this MBO pressurises the bureaucracy at all levels to get the prorammes and schemes (launched by the Central and State Governments) implemented as well as it builds pressure for making policies for the welfare of the weaker sections of self-employed women. To combat injustice at different levels, the strategies adopted are different and range from direct action to dealing with the Government departments through complaints and courts as well as to organising campaigns, workshops, studies and advocacy to influence policy changes. Moreover, SEWA is also actively involved in enhancing the capacities of its members by provision of credit through the SEWA Bank. It provides assistance in housing, sanitation, education and marketing facilities for manufactured products, etc.

NGOs - Society for Technology and Development (STD) takes up economic activity through collective organisation of marginalised sections. In the beginning, it acted as a field station of a Delhi based NGO. In 1990, it was registered as a separate society in 1990. It has set up a production unit for tanning of leather and has a network of traditional leather artisans (mainly flayers) of the area, buying the raw hides from them and processing them at its unit.

Many improvements are needed in voluntary organisations to make them effective for implementation of socio-economic programmes of the country. For example, they need to develop a reasonable personnel policy to attract qualified and stable personnel to implement their programmes. Apart from this, they must work in the area of social action and thereby facilitate social change. There is an urgent need to expand their work in rural areas.

Thus, the role of voluntary organisations vis-a-vis the support of Government for social welfare and development must be defined clearly. Their performance can be enhance through the following:

(i) The policy towards voluntary organisations indicating the relative role of the Government and the voluntary sector, entitlement to funds, etc. should be clear.

(ii) In terms of assets, financial soundness, service conditions to staff, quality of service etc., there is an urgent need to make a serious review of the working of voluntary organisations.

(iii) It may be noted that the Directorates of Social Welfare should equip themselves with facts and figures regarding voluntary organisations, their specialised areas of work, problems faced by them in their day-to-day functioning etc. during any action.

(iv) Certain rules and procedures of recruitment, salary scales and working/service conditions should be followed so that voluntary organisations would get properly qualified persons to man their programmes and schemes.

(v) Moreover, grants must not be released as a matter of routine.

Self-Assessment

1. Choose the correct options:

(*i*) What is the system of governance in the Panchayat Raj set up

(*a*) Single tier system of local self government at the village level

(*b*) Two tier system of local self government at the village and block level

(*c*) Three tier structure of local self government at village, block and district level

(*ii*) Which of the following states has no Panchayat Raj institution

Choose one:

(*a*) Assam

(*b*) Nagaland

(*c*) Tripura

(*d*) Kerala

(*iii*) Which of the following regarding the Panchayat Raj are correct

(*a*) The elections to the panchayats will be held by the election commission

(*b*) There are mandatory reservations for women and weaker sections

Notes

(*c*) The panchayats have a fixed term of 5 years

Choose one:

(*a*) A and b (*b*) B and c

(*c*) All of the above (*d*) none

(*iv*) The recommendation s of the Ashok Mehta committee on Panchayati Raj are

1. Creation of two tier system
2. Compulsory powers of taxation to Panchayat
3. Reservation for SC/ST

Choose one:

(*a*) 1, 2 (*b*) 2, 3

(*c*) All of the above (*d*) None

(*v*) The Balwant Rai Mehta committee was on

Choose one:

(*a*) Democratic decentralization (*b*) Panchayati Raj institution

(*c*) Community development programme

(*vi*) Panchayati raj was first adopted by (in order)

Choose one:

(*a*) Rajasthan, Madhya Pradesh (*b*) Andhra Pradesh, West Bengal

(*c*) Rajasthan, Andhra Pradesh

(*vii*) Which of the following is a committee on Panchayati Raj institution

Choose one:

(*a*) Bal want Rai Mehta Committee (*b*) G.V.K Rao

(*c*) LM singhvi (*d*) Ashok Mehta

(*e*) None of these

15.3 Summary

- Decentralisation is the transfer of authority, responsibility, and accountability from Central to Local Governments. Decentralisation can take various forms, commonly described in public administration terms as deconcentration, devolution, and delegation.
- Democratic local governance is autonomous levels of local Government, vested with authority and resources that function in a democratic manner.
- Democratic decentralisation is the development of reciprocal relationships between central and local Governments and between local Governments and citizens.
- In India, panchayats have been very important in the structure of the Indian villages since the beginning of the history.
- There are 30 subjects that are to be assigned to the PRIs under the Eleventh Schedule. Some of the important ones are agriculture and allied areas, minor forest produce, small-scale industries, roads, rural housing, drinking water, non-conventional energy, rural electrification, poverty alleviation programmes, education including primary and secondary schools, health, family, women and children.
- There are certain problems in the implementation of the Act such as non-empowerment of Gram Sabhas and top-down approach to planning, monitoring and evaluation.

Notes

- For our purpose, people's participation in the development process means active cooperation and involvement of the general masses in the process of development administration. People's active interest, enthusiasm and cooperation in planning, implementation and evaluation of development programmes at all levels, particularly at the grass-root level is required. India's participatory local self-governance has a feasible and institutional status that can be harnessed to implement people's programmes at the grass root.
- It may be noted that transparency and people's participation in regulatory and development administration is very important not only in bridging the gap between the administration and the public but also in nation-building, by way of reducing the corruption and complaints against the system.
- To address different aspects of rural poverty, the Government has brought poverty alleviation programmes. Micro-credit-linked programmes provide a package of services including credit and subsidy to set up micro-enterprises.
- The PRIs should report their progress and Central/State level co-ordinators should use this feedback to analyse the problems/short comings to suggest necessary policy-changes which means the flow of information should be two-ways.
- We should make project planning more scientific and simplified, properly understood and implemented at GP level.
- It may be noted that a participatory and result-oriented bureaucracy interacting with an aware and educated population would interact fruitfully to produce a self-reliant village entity in the right spirit of democratic decentralisation for rural development.
- Pressure groups are voluntary agencies which have a long history of active involvement in the promotion of human welfare and well-being. Lord Beveridge called voluntary agencies "aprivate enterprise for social progress".
- The term pressure group is a very wide definition that does not clearly distinguish between the groups that fall under the term. The aim of all pressure groups is to influence the people who actually have the power to make decisions.
- It may be noted that voluntary agencies help in the programme implementation, collaboration and co-ordination with other activities.
- With the use of the latest internet technology, Milestone Consultants provides advanced web communication channels to professional associations, societies, trade unions and clubs to collaborate and share information. Associations can inform and update their members about news and events through emails, newsletters, blogs, discussion forums, wiki's, and various community sites.
- The term is usually used by Governments to refer to entities that have no Government status. In the cases in which NGOs are funded totally or partially by Governments, the NGO maintains its non-Governmental status by excluding Government representatives from membership in the organisation.
- Despite the above reasons, NGOs can contribute considerably in building the Membership Based Organisations which in turn need a great deal of financial and moral support for capacity building.
- MBOs Networks are formed through alliances between MBOs or federations of trade unions, co-operatives and savings and credit groups and organisations.
- NGOs - Society for Technology and Development (STD) takes up economic activity through collective organisation of marginalised sections.
- Many improvements are needed in voluntary organisations to make them effective for implementation of socio-economic programmes of the country.
- Thus, the role of voluntary organisations vis-a-vis the support of Government for social welfare and development must be defined clearly.

15.4 Key-Words

1. Participation : Engagement: the act of sharing in the activities of a group; "the teacher tried to increase his students' engagement in class
2. Panchayati Raj : The Panchayat is a South Asian political system. 'Panchayat' literally means assembly (yat) of five (panch) wise and respected elders chosen and accepted by the village community. Traditionally, these assemblies settled disputes between individuals and villages. Modern Indian government has decentralised several administrative functions to the village level, empowering elected gram panchayats. Gram panchayats are not to be confused with the unelected khap panchayats (or caste panchayats) found in some parts of India.

15.5 Review Questions

1. Do you think that decentralisation is better alternative to buruaucracy in effective implementation of economic policy ?
2. “An effective delivery system has to ensure People’s participation” Comment.

Answers: Self-Assessment

1. (*i*) (*c*) (*ii*) (*b*) (*iii*) (*c*) (*iv*) (*c*) (*v*) (*c*)
   (*vi*) (*c*) (*vii*) (*d*)

15.6 Further Readings

Books

1. Indian Economy; Gaurav Datt and Aswani Mahajan; S. Chand and Company LTD. Ram Nagar, New Delhi-110055.
2. The Indian Economy; S.K. Ray; Prentic, Hall of India Private Limited New Delhi - 110001.