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# 1

# INTRODUCTION BASIC ECONOMICS

- The word " Economics" is derived from the Greek word **'Oikonomia'** which means **household management.**
- Economics is a social science that studies how people allocate scarce resources for production , distribution and consumption of goods and services .
- Economics is the "study of how societies use scarce resources to produce valuable commodities and distribute them among different people." **- Paul. A. Samuelson**
- **Economics is about how the society deals with the problem of scarcity.**
- The scarcity of resources indicates that all wants cannot be satisfied. Hence we have to make choices among innumerable wants.

### *What are Economic Activities?*

- Economic activity is the activity of making, providing, purchasing or selling goods or services. Any action that involves producing, distributing or consuming products or services is an economic activity.
- Economic activities exist at all levels within a society. Additionally, any activities involving money or the exchange of products or services are economic activities. For instance, running a small business is a great example of economic activity

### *Macroeconomics, Microeconomics and Mesoeconomics*

- After the Great Depression (during the 1930s) the domain of economics got divided into two broad branches: micro and macro-economics.
- **John Maynard Keynes** is considered the father of macroeconomics.
- The branch came into being after the publication of his seminal work, **The General Theory of Employment, Interest and Money,** in 1936.

| Macroeconomics | Microeconomics |
|---|---|
| Macro means large. Macroeconomics is a branch of economics dealing with the overall working of an economy. | Micro means small. Micro economics is the study of particular markets and segments of the economy. |
| It deals with all the sectors of the economy, national income, inflation, unemployment, international trade etc | It deals with individual unit. |
| Income is the major determinant. | Price is the major determinant |
| It depends on aggregate demand and aggregate supply. | It depends on individual demand and individual supply. |

- ***Mesoeconomics* -** Mesoeconomics can be defined as the intermediary level between macro-economic and micro-economics like study of sectors of economics. **Example:** auto, infrastructure etc.

### *Branches of Economics and their Utility*

- Economics is mainly divided into two parts: macroeconomics, which studies the behavior of the economy as a whole and microeconomics, which studies individual people and businesses.
- Macroeconomics is a branch of economics that studies how an entire economy—the market or other large-scale systems—behaves. It studies economy-wide phenomena such as inflation, price levels, economic growth rate, national income, GDP and changes in unemployment.
- Microeconomics is the study of individual and decisions to allocate production, exchange and consumption resources. Microeconomics studies prices and production in single market as well as the interaction of different markets, whereas macroeconomics studies economy-wide aggregates.

- In addition to the two perspectives (macroeconomics and microeconomics), economics has many other branches, each specializing in a different area of study.
- ***Behavioral Economics*** – This branch of economics investigates the effects of social, psychological, cognitive and emotional factors on economic decisions. It primarily employs microeconomics.
- ***Ecological Economics*** – It is the study of the relationship between the economy and the environment, as well as the methods for achieving sustainable development.
- ***Environmental Economics*** – It is concerned with the development and management of natural resources. It primarily employs microeconomics.
- ***Health Economics*** – It is the study of the economy of health and health care. Microeconomics is the main focus.
- ***Information Economics*** – It is the study of how information and information systems influence the economy and economic decisions. It primarily employs microeconomics.
- ***International Economics*** – It is the study of how economic relations between countries, specifically trade, investment and labour flow, affect economies. It can use microeconomic models, but it is primarily concerned with macroeconomic aggregates.
- ***Labour Economics*** – It is the study of wages, labour employment and labour (job) markets. It also employs many tools from microeconomics, but it may also include macroeconomic analysis.
- ***Monetary Economics*** – It is the study of means of payment(money etc.) markets.
- ***Population Economics*** – It is the study of demography using economic tools, as well as the relationship between the economy and the population.
- ***Public finance*** – It is the study of the government's role in the economy, including public spending, taxes and the deficit.
- ***Urban Economics*** – It studies cities using economic tools such as transportation, housing and crime.

## *What is an Economy?*

- **Economy** indicates a geographical area's or country's economic condition, status and activities.
- Economy is economics in action.
- It is a still-frame picture of the economic activities.
- A country, a company and a family all have their economies.
- It is popularly used in case of countries—Indian economy, the US economy, the Japanese economy etc.

| Basis for comparison | Economics | Economy |
|---|---|---|
| Meaning | Economics is the science and art of decision-making, regarding the use of scarce resources, under the conditions of scarcity, to attain maximum satisfaction. | When a country or a geographical region is defined in the context of its economic activities, it is known as an economy or economic system. |
| What is it? | Theory and Principle | Practical application of Economics |
| Determines | How do human beings make decisions when resources are scarce? | How resources are allocated among different members of society? |
| Focuses on | The way in which economic agents behave and interact and how economies work. | The way in which a country's economic affairs are organized and conducted. |

## *Sectors of Economics*

- Economic activities in a country/economy are broadly divided into three main sectors.
  1. ***Primary Sector-*** Primary sector companies are typically engaged in economic activity that utilizes the Earth's natural resources, which are sold to consumers or commercial businesses. For examples, Mining and quarrying, Fishing, Agriculture, Forestry, Hunting etc.
  2. ***Secondary Sector-*** The secondary sector produces goods from the natural products within the primary sector. It's also called manufacturing sector. The secondary

sector includes the following business activities: Automobile production, Textile, Chemical engineering, Aerospace, Shipbuilding, Energy utilities etc.

3. ***Tertiary Sector-*** It's also known as service sector. The tertiary sector provides services to businesses and consumers by selling the goods that are manufactured by companies in the secondary sector. The types of services provided by the tertiary sector include: Transportation and distribution, electricity distributions, Restaurants, Education, Communication, Tourism, Insurance and Banking, Healthcare services, Legal services etc.

### *Apart from the above mentioned sectors of economy, two more sectors are recognised in the contemporary world*

1. ***Quaternary Sector-*** These are specialised tertiary operations in the 'Knowledge Sector,' therefore thus require their own classification.
   - The intellectual side of the economy is the quaternary sector. It is the procedure that allows entrepreneurs to innovate and increase the economy's service quality.
   - This category includes employees who work in office buildings, elementary schools and university classrooms, hospitals and doctors' offices, theatres, accounting and brokerage firms.
   - Quaternary activities, like other tertiary functions, can be outsourced.
2. ***Quinary Sector-*** The quinary sector is the segment of the economy that makes the highest-level decisions.
   - This includes the government, which is in charge of enacting legislation. It also includes the most powerful decision-makers in industry, trade and education.
   - These are services that focus on the development, reorganisation interpretation of new and existing ideas, as well as data interpretation and the use and evaluation of new technology.
   - Senior business executives, government officials, research scientists, financial and legal consultants and other professionals in this category are often referred to as 'gold collar' professionals.

### *Why did India shift from the primary sector to the services sector and not the secondary sector?*

- A country's normal economic path is from agrarian to industrial to a service economy, but India has jumped ahead of the curve from agrarian to service economy.
- Diversification towards services has been a notable element of India's recent prosperity, with the services sector accounting for the majority of GDP.
- India has become a prominent services exporter thanks to its success in software and IT-enabled services (ITeS).
- Other factors for the country's quick expansion in the service industry include well-educated and vast human resources, fluency in English and the availability of cheap labour.
- On the other hand, low growth in the Secondary sector can be attributed to:
  - The License Raj
  - Restrictions on foreign investment
  - Lack of measures to promote private industry
  - Power deficit
  - Stringent labour laws
  - Lack of skilled labour

- Delays in land acquisition and environmental clearances
- Import of cheap manufactured goods etc.

- Despite its low per capita income, India's percentage of GDP from services is approaching the worldwide norm. However, unlike the global average, the contribution of services to employment was much lower.
- Because the manufacturing sector is labour-intensive, greater emphasis on manufacturing through initiatives such as 'Make in India' would help to remedy this anomaly and increase employment in line with GDP growth.

## *Differences between Primary, Secondary and Tertiary Sector*

| Primary Sector | Secondary Sector | Tertiary Sector |
|---|---|---|
| It is known as the agricultural and allied sector. | It is known as the manufacturing sector. | It is known as the service sector. |
| This sector provides raw materials for goods and services. | This sector transforms one good into another by creating more utility from it. | The tertiary sector provides useful services for the primary and secondary sectors. |
| The primary sector is unorganized and uses traditional techniques. | The secondary sector is organized and uses better methods of production. | This sector is well organized and uses modern-day logistics techniques to perform its functions. |
| Activities in this sector consist of agriculture, forestry and mining. | It includes manufacturing units, small scale units, large firms and multinational corporations. | Banking, insurance trade and communications come under this sector. |
| In most developing nations such as India, this sector is where a large section of the workforce is employed, in comparison to developed nations. | The employment rate is in equilibrium as a specialized set of skills is required to find employment in this sector. | This sector's employment share has increased in the ensuing years. |

## *On the Basis of Work Condition*

### *Organised Sector*

- In this industry, employment terms are set and consistent and employees are guaranteed work and social security.
- It can also be characterised as a sector that is registered with the government and is subject to a variety of laws. The organised sector includes schools and hospitals.
- Workers in the organised sector have more job security. They are only required to work a set amount of hours. If they work longer hours, the company must compensate them with overtime pay.

### *Unorganised Sector*

- A home-based worker, a self-employed worker or a wage worker in the unorganised sector is considered an unorganised worker, as is a worker in the organised sector who is not covered by any of the welfare schemes listed in Schedule-II of the Unorganized Workers Social Security Act, 2008.
- Due to the transient and seasonal nature of employment and the dispersed placement of businesses, wage-paid labour in this sector is typically non-unionized.
- Low wages, insecurity irregular employment and a lack of protection from legislation or trade unions characterise this industry.
- The unorganised industry relies primarily on labour-intensive and locally developed technology.
- Workers in the unorganised sector are so dispersed that the legislation's execution is woefully inadequate and ineffective. In this industry, there are few unions to function as watchdogs.
- However, as compared to the organised sector, the unorganised sector makes a significant contribution to national income.
  - It contributes more than 60% of national income, whereas the organised sector contributes about half of that, depending on the industry.

### *On the Basis of Assets Ownership*

### *The Public Sector*

- The government owns the majority of the assets in the sector and it is the segment of the economy responsible for providing various governmental services.
- The public sector does not exist solely to make money. Governments raise funds through taxes and other means to cover the costs of the services they provide.

### *The Private Sector*

- Asset ownership and service delivery are in the hands of private individuals or organisations in the private sector.
- It is also known as the citizen sector and it is administered by private persons or groups, usually for profit and is not governed but regulated by the government.
- The private sector's activities are guided by the desire to make money. We must pay money to these persons and companies in order to obtain such services.

### *Types of Economy Systems*

Economy systems are the way that are adopted by governments of particular countries for the distribution of resources along with services and goods. Such deal is dependent on production factors – capital, labour, physical resources, entrepreneurs and information resources.

1. **Capitalist economy:**
   - Capitalism is an economic system based on the private ownership of the means of production and their operation for profit.
   - In this economy, the production of all the goods and services is dependent on the demand and supply in the market.
   - It is also known as a market economy.
   - Examples of Capitalist economies are Switzerland, United Kingdom, United States, Ireland etc.
2. **Socialist economy:**
   - In a socialist country the government determines what products are to produced in accordance with the requirements of the society.
   - It is also known by other names such as State Economy, Command Economy, Centrally Planned Economy.
   - Prices are determined by the Central Planning Authority.
3. **Mixed economy:**
   - It is a system that combines aspects of both capitalism and socialism.
   - It is also known as a dual system.
   - It protects private property and allows a level of economic freedom in the use of capital.
   - But it also allows for governments to interfere in economic activities in order to achieve social aims.
   - Most of the countries today have a mixed economic system with the existence of both public services as well as private industries.

**Differences between Capitalist, Socialist and Mixed Economies**

| Parameters | Capitalist economy | Socialist economy | Mixed economy |
|---|---|---|---|
| Ownership of property | Private ownership | Public ownership | Both private and public ownerships |
| Price determination | Prices are determined by the market forces of demand and supply. | The Central Planning Authority determines prices. | The Central Planning Authority, as well as demand and supply, determine prices. |
| Motive of production | Profit motive | Social welfare | In the private sector, profit is the motivating factor, while in the public sector, welfare is the motivating factor. |
| Role of government | No role | Complete role | Full role in the public sector and limited role in the private sector |
| Competition | Exists | No competition | Exists only in the private sector |
| Distribution of income | Very unequal | Quite equal | Considerable inequalities exist |

### *What is Keynesian Economics?*

- Keynesian economics is a "demand-side" theory that focuses on short-run changes in the economy.
- Keynes' theory was the first to distinguish between the study of individual economic behaviour and markets and the study of broad national economic aggregate variables and constructs.
- Based on his theory, Keynes advocated for increased government spending and lower taxes in order to stimulate demand and lift the global economy out of depression.
- Since labour demand curves slope downward like any other normal demand curve, Keynesian economics challenges the notion held by some economists that lower wages can restore full employment.

### *Associated Factors & Principles - Keynesian Economics*

Keynesian economic theory's central tenet is that government intervention can stabilise the economy. The following are the underlying principles of this supposition:

- Economic decisions made by the government public and the private sector have an impact on demand.
- Wages and prices react slowly to changes in supply and demand.
- Changes in demand have the greatest short-term impact on output and employment.
- Unemployment is unfavourable because it is subject to the whims of demand.
- To reduce the volatility of the business cycle, an active stabilisation policy is required.
- Unemployment is more important than inflation.

### *Implementation of Keynesian Economics in India*

- The government has made numerous efforts to come out of the vicious cycle of low economic growth.
- But what is really needed is a systematic application of Keynesian philosophy, which was once used to free the American economy from the clutches of the 1929 Great Depression.
- One of the guiding principles of this philosophy is that fiscal expenditure, rather than fiscal prudence, should be the guiding principle of any slowing economy.
- Fiscal spending will inject more money into the economy, increasing consumer purchasing power and as a result, increasing consumer demand for industrial goods via the multiplier effect.
- In the case of India, one such programme that works on this principle is the implementation of the MNREGA programme.
- Similarly, the current government can make significant investments in the FMCG, infrastructure and construction sectors.
- These industries will help the situation in two ways.
    - Primarily, these sectors have enormous potential for the nation's overall economic growth because they have the potential to directly address the problem of structural bottlenecks in the economy.
    - Secondly, these sectors have a high potential for job creation.
- According to Keynes, the export sector plays an important role because it is one of the major constituents of aggregate demand.
    - What is required here is an increase in productivity rather than an increase in output.
    - 'Make in India' is one such initiative launched by the government to address this issue.
- Domestically, imparting necessary skills for labour force training is critical and internationally, there is a need to smooth out the restrictions of India's overall external barriers.
- In this case, the government must carefully manipulate the international forum in order to remove obstacles such as GSP and import tariff barriers, among others.

- Without a doubt, the Keynesian philosophy was designed primarily for developed economies, but it also has some utility for the developing world and it is precisely in this space that the Indian economy must move its elbow.

### *Keynesian Philosophy during Covid 19*

- A post-corona world resembles a shattered, devastated and fragmented post-World War World – Politically, Economically and Socially.
- It was in this context that Keynesian economics emerged as a new avatar of capitalism.
- It is encouraging that the government's financial stimulus packages to provide some relief to the agricultural sector, MSMEs, street vendors, NBFCs, DISCOMs and real estate sector are very much in line with Keynesian economics, as the government intends to spend more, build more agro-infrastructure and put more money in the hands of the people.
- India's unemployment rate remains high with no signs of improvement. Poverty is rapidly increasing and the rural-urban divide is widening.
- At the moment, the private sector lacks both the capacity and the desire to fill this void.
- In any case, due to our country's dire and unique socio-economic conditions, it would take far more than private sector initiative to get the country back on track.
- This is the time that the government must step in.

### *Law of Demand & Supply*

- According to the law of demand, as prices rise, buyers demands less of an economic good.
- According to the law of supply, at higher prices, sellers will supply more of an economic good.
- These two laws interact to determine the actual market prices and volume of goods traded on a market.
- Several independent factors can influence the shape of market supply and demand, influencing both the prices and quantities observed in markets.

### *Law of Demand*

- According to the law of demand, if all other factors remain constant, the higher the price of a good, the fewer people will demand that good. In other words, as the price rises, so does the quantity demanded.
- Buyers purchase less of a good at a higher price because as the price of good rises, so does the opportunity cost of purchasing that good.
- As a result, people will naturally avoid purchasing a product that requires them to forego the consumption of something else that they value more.
- Consumers demand less quantity of goods at higher prices and more at lower prices.

### *Demand Elasticity*

- Demand elasticity or price elasticity of demand refers to the degree to which rising prices translate into falling demand. For example,
- The demand elasticity of corn is one if a 50% increase in corn prices causes a 50% decrease in corn demand.
- The demand elasticity is 0.2 if a 50% increase in corn prices only reduces the quantity demanded by 10%.
- For products with more elastic demand, the demand curve is shallower (closer to horizontal) and for products with less elastic demand, the demand curve is steeper (closer to vertical).
- A new demand curve must be drawn if a factor other than price or quantity changes.
- Assume that the population of a region explodes, increasing the number of mouths to feed. In this scenario, even if the price remains constant, more corn will be demanded, causing the curve in the graph below to shift to the right (D2).
- Other factors, such as changes in consumer preferences, can also cause the demand curve to shift.
- If cultural shifts cause the market to prefer quinoa over corn, the demand curve will shift to the left (D3).

- If consumer income falls, reducing their ability to purchase corn, demand will shift to the left (D3).
- If the price of a substitute increases from the consumer's point of view, consumers will buy corn instead and demand will shift right (D2).
- If the price of a supplement, such as charcoal for grilling corn, rises, demand will shift to the left (D3).
- If the future price of corn is higher than the current price, demand will temporarily shift to the right (D2), because consumers will be more inclined to buy now before the price rises.

### *Exceptions to Law of Demand*

- There are some exceptions to the rules that govern the relationship between goods prices and demand. A Giffen good is one of these exceptions.
- This is a staple food, similar to bread or rice, for which there is no viable substitute.
- In short, when the price of a Giffen good rises, demand rises and demand falls when the price falls.
- The demand for these goods is increasing, which contradicts demand laws.
- As a result, the typical response (rising prices causing a substitution effect) will not apply to Giffen goods and the price increase will continue to push demand.

### *Law of Supply*

- The law of supply is a microeconomic law that states that, all else being equal, as the price of a good or service rises, so will the quantity of goods or services offered by suppliers and vice versa.
- According to the law of supply, as the price of an item rises, suppliers will try to maximise their profits by increasing the quantity offered for sale.
- In contrast to the law of demand, the supply relationship has an upward slope. This means that as the price rises, so will the quantity supplied.
- The supply curve slopes upward because suppliers can choose how much of their goods to produce and later sell.
- However, at any given time, the supply that sellers bring to market is fixed and sellers simply face the decision of selling or withholding their stock from a sale; consumer demand sets the price and sellers can only charge what the market will bear.

### *Equilibrium*

- The equilibrium price, also known as a market-clearing price, is the price at which the producer can sell all of the units he wants to produce and the buyer can buy all of the units he wants to buy.
- It is easy to see how an upward-sloping supply curve and a downward-sloping demand curve will intersect at some point.
- At this point, the market price is sufficient to entice suppliers to bring to market the same quantity of goods that consumers are willing to pay for at that price.
- Supply and demand are in equilibrium.
- The precise price and amount at which this occurs are determined by the shape and position of the respective supply and demand curves, both of which are influenced by a variety of factors.

### *Examples of Law of Supply*

- When college students realise that Computer Engineering jobs pay more than English Professor jobs, the supply of computer Engineering majors will increase.
- When consumers begin to pay more for cupcakes than for donuts, bakeries will increase their cupcake output while decreasing their donut output in order to increase their profits.
- When your employer pays time and a half for overtime, you increase the number of hours you are willing to work.

### *Law of Demand and Supply – Significance*

- The Law of Demand and Supply is critical because it assists investors, entrepreneurs and economists in understanding and forecasting market conditions.

- For example, a company launching a new product may purposefully attempt to raise the price of the product by increasing consumer demand through advertising.
- At the same time, they may try to raise their prices even further by deliberately limiting the number of units they sell in order to reduce supply.
- In this scenario, supply would be reduced while demand would be increased, resulting in a higher price.
- Together with the Law of Supply, the Law of Demand helps us understand why things are priced the way they are and to identify opportunities to buy perceived under-priced (or sell perceived overpriced) products, assets or securities.
- For example, a company may increase output in response to rising prices caused by a surge in demand.

## *Drawbacks*

- Unemployment is caused by a lack of demand for goods.
- During the Great Depression, factories sat idle and workers were laid off because there was insufficient demand for those products.
- In the case of Giffen goods, when the price of a Giffen good rises, demand rises and demand falls when the price falls. For example, staple food, similar to bread or rice, for which there is no viable substitute.
- The demand for these goods is increasing, which contradicts demand laws.
- ***Prestigious Goods:*** Demand for goods of prestige like gold, demand may not decrease even if there is rise in price. They are purchased and consumed because of their high prices.
- ***Hobbies:*** The law of demand is not applicable in the case of goods of hobbies like ticket collection and collection of historical and archaeological materials. The things are collected even by paying more and more price.
- ***Addiction:*** In case of goods and addiction like alcohol, tobacco, drugs etc the demand does not decrease even if there is an increase in price. Instead of the operation of law of demand consumers purchase more units even if there is a rise in price.
- ***Future Prices:*** When the price of rice rises and the seller expects the price to rise further in the future, supply will decrease because the seller will be induced to withhold supplies in order to sell later and earn larger profits.
- ***Agricultural Output:*** The law of supply may not apply in the case of agricultural commodities because production cannot be increased all at once in the event of a price increase.
- ***Subsistence Farmers:*** The law of supply may not apply in underdeveloped countries where agriculture is dominated by subsistence farmers.
- ***Factors other than price are not constant:*** The law of supply is stated with the assumption that factors other than the commodity's price remain constant.

***Question:*** Consider the following statements: Other things remaining unchanged, market demand for a good might increase if [UPSC 2021]

1) Price of its substitute increases
2) Price of its complement increases
3) The good is an inferior good and income of the consumers increases
4) Its price falls

Which of the above statements are correct?

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

***Question:*** Which of the following policy steps a government usually takes to boost demand and support the economy in deflationary situations?

1) Lowering interest rates together with cutting direct taxes
2) Emphasising savings and enhancing salaries
3) Increasing government expenditure
4) Going for tapering of fiscal stimulus

Select the answer using the code given below:

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

# 2 ECONOMIC GROWTH AND DEVELOPMENT

## *What is Economic Growth?*

Economic growth can be defined as an increase in the value of goods and services produced in an economy over a period of time. This value calculation is done in terms of % increase in GDP or Gross Domestic Product.

Economic growth is calculated in real terms where the effects of variation in the value of goods and services due to inflation distortion are also accounted for.

## *Factors influencing Economic Growth*

1. ***Human resources–*** this is a major factor that is responsible for boosting the economic growth of a country. The rate of increase in the skills and capabilities of a workforce ultimately increases the economic growth of a country.
2. ***Infrastructure development -*** Improvements and increased investment in physical capital such as roadways, machinery and factories will increase the efficiency of economic output by reducing the cost.
3. ***Planned utilization of natural resources –*** Proper use of available natural resources like mineral deposits helps boost the productivity of the economy.
4. ***Population growth –*** An increase in the growth of the population will result in the availability of more human resources which in turn will increase the output in terms of quantity. This is also an important factor that influences economic growth.
5. ***Advancement in technology –*** Improvement in technology will affect the economic growth of a country positively. The application of advanced technology will result in increased productivity of labor and economic growth will advance at a lower cost.

**Q. Economic growth in country X will occur if**
**(UPCS Prelims-2013)**

(a) There is technical progress in the world economy
(b) There is population growth in X
(c) There is capital formation in X
(d) The volume of trade grows in the world economy

## *What is Economic Development?*

The term economic development can be explained as the process by which the economic well-being and quality of life of a nation, community or particular region are improved according to predefined goals and objectives.

Economic development is a combination of market productivity and the welfare values of the nation.

## *Factors affecting Economic development*

1. ***Infrastructural improvement-***Development in the infrastructure improves the quality of life of people. Therefore, an increase in the rate of infrastructural development will result in the economic development of a nation.
2. ***Education–*** Improvement in literacy and technical knowledge will result in a better understanding of the usage of different equipment. This will increase labor productivity and in turn, will result in the economic development of a nation.
3. ***Increase in the capital–*** Increase in capital formation will result in more productive output in an economy and this will affect the economic development positively.

**Difference between Economic Growth & Economic Development**

| Economic growth | Economic development |
|---|---|
| Increase in market output results in economic growth | Economic development can be measured in terms of welfare values and market output |
| It is a quantitative concept | It is a qualitative concept |
| Economic growth is uni-dimensional | Economic development is multidimensional |
| This is one of the major concern of developed countries | This is a major concern of developing countries |
| Economic growth is independent of the development | Economic development can only happen if economic growth takes place. |
| Indicators of Economic growth<br>• Real GDP<br>• Real per capita income | Indicators of economic development<br>• Human Development Index<br>• Physical Quality of Life Index<br>• Net Economic Welfare (NEW) |

## *Meaning and Definition of Underdevelopment*

Underdevelopment is low level of development characterized by low real per capita income, wide-spread poverty, lower level of literacy, low life expectancy and underutilisation of resources etc.

The state in underdeveloped economy fails to provide acceptable levels of living to a large fraction of its population, thus resulting into misery and material deprivations. We need to note here that underdevelopment is a relative concept but it sustains absolute poverty.

## *Underdevelopment is a Relative Concept*

The concept of underdevelopment is a relative one because it is the comparison of quality of life between the economies that differentiates them in underdeveloped and developed.

## *Underdevelopment Sustains Absolute Poverty*

Although, concept of underdevelopment is a relative concept but it sustains absolute poverty. Absolute poverty refers to the state of poverty wherein the people fail to fulfil even their basic needs in terms of food, clothing and shelter. In fact, they are a class of people who are always striving to survive. Thus, underdevelopment and absolute poverty go together or underdevelopment sustains absolute poverty.

## *Characteristics of Underdeveloped Economies*

It is difficult to find an underdeveloped economy representing all the representative characteristics of underdevelopment. While most of them are poor in nature, they have diverse physical and human resources, socio-political conditions and culture. Some of the common characteristics displayed by most of the underdeveloped countries in the world are as follows:

1. ***Low Per Capita Income***
   - Almost all underdeveloped countries of the world show low per capita income in comparison to developed countries of the world.
2. ***Slow Growth Rate of Per Capita Income***
   - Low per capita income and slow growth rate of per capita income are characteristics of these countries.
3. ***Economic Inequalities***
   - High inequality of income and wealth is another common feature of underdeveloped countries. In these countries, large percentage of national income is shared by a small segment of the society while a large segment of the society gets barely enough to survive. Economic inequality exists even in developed countries but it is not as much as found in underdeveloped countries.
4. ***Low Level of Living***
   - Level of living in the underdeveloped countries is low because of low per capita income. Low level of living of the people of underdeveloped countries is also reflected in Human Development Index prepared by the United Nation Development Programme (UNDP). HDI of developed countries is very high whereas for underdeveloped countries it is very low.
5. ***Low Rate of Capital Formation***
   - Rate of capital formation is very low in underdeveloped economies due to low income levels and high incidence of poverty.
6. ***Backward Techniques of Production***
   - Underdeveloped economies use outdated technology for production. Lack of capital leads to less spending on research and development.
7. ***High Growth Rate of Population and Dependency Burden***
   - These countries are characterised by high growth rate of population and high dependency burden.
8. ***Low Productivity of Labour***
   - Underdeveloped economies are characterised by low labour productivity due to low level of skill set.

9. ***Underutilisation of Natural Resources***
   - Natural resources are underutilised in underdeveloped economies. Their capability to exploit them is very low.

10. ***Large Scale Unemployment***
    - Large scale unemployment is another characteristic feature of underdeveloped countries.

11. ***Dominance of Agriculture***
    - Large section of people in underdeveloped economies depends on primary sector for employment. But the primary sector is not well-developed in those countries.

12. ***High Incidence of Poverty***
    - Low per capita income results in high incidence of poverty in underdeveloped economies.

13. ***Infrastructural Backwardness***
    - Economic infrastructure and social infrastructure are almost at their bottom level in underdeveloped countries.

14. ***Low Volume of Foreign Trade***
    - Underdeveloped countries export primary products like, agricultural goods, minerals, petroleum oil etc. and import finished products, especially consumer goods. Terms of trade are grossly unfavourable to underdeveloped countries.

## *Non-Economic Factors Affecting the Economic Growth*

### *Political Factors*

- Political stability and strong administration are critical to modern economic growth.
- A stable, strong and efficient government, honest administration, transparent policies and their efficient implementation foster investor confidence and attract domestic and foreign capital, resulting in faster economic development.

## *Social and Psychological Factors*

- Social factors include **social attitudes, social values and social institutions,** which change as education expands and cultures shift from one society to the next.
- Modern ideology, values and attitudes result in new discoveries and innovations, as well as the rise of new entrepreneurs.
- Outdated social customs limit occupational and geographical mobility, posing a barrier to economic development.

## *Education*

- It is now widely acknowledged that education is the primary means of development. Greater progress has been made in countries where education is widely available.
- Education is important in human resource development because it increases labour efficiency and removes mental barriers to new ideas and knowledge, which contributes to economic development.

## *Desire for Material Betterment*

- The desire for material advancement is a necessary prerequisite for economic development.
- Societies that place focus on self-satisfaction, self-denial and faith in fate, limit risk and enterprise, causing the economy to stagnate.

## *Physical Quality of Life Index*

- Morris David Morris created the Physical Quality of Life Index (PQLI) for the Overseas Development Council in the mid-1970s.
- It was formed in response to unhappiness with the use of GNP as a development indicator.
- PQLI is a step forward, but it still suffers from the same issues as other attempts to quantify quality of life.
- It has also been chastised since infant mortality and life expectancy are so closely related. The United Nations Human Development Index is a more generally used metric of happiness.
- The Physical Quality of Life Index (PQLI) is an effort to quantify a nation's overall standard of life.
- The number is calculated by taking the average of three facts and figures: basic literacy rate, newborn fatality rate and their life span at one year, all of which are evenly valued on a 0 to 100 scale.

- It was discovered in the middle of the 1970s by Morris David Morris for the International Technical Committee as one of a number of metrics produced in response to discontent through the use of GNP as a proxy for economic growth.
- While the Physical Quality of Life Index may be considered an improvement, it shares the basic difficulties associated with quantifying the quality of life. Additionally, it has been questioned due to the substantial overlapping between newborn mortality.
- ***Life expectancy rate*** represents the average number of years that an individual is predicted to live. According to the 2011 census, the average age in India is 66.8 years.
- ***Infant mortality*** is the number of newborns that die during the first year of infancy for every 1000 births. According to the 2011 census, it is 47 per 1000 people.
- ***Basic literacy rate:*** Any individual above the age of seven who can read and comprehend in at least one language is deemed educated. According to the 2011 census, it stands at 74.04 per cent in India.
- Each of the aforementioned criteria is scored on a scale of 1 to 100, with 1 being the poorest performance and 100 representing the highest performance. The Physical Quality of Life Index is then computed by comparing these three parameters and allocating equal merit to each.

## Advantages of PQLI

- The advantages of PQLI are that it aids in comprehending the economy's overall wellbeing and the effectiveness with which its welfare measures are executed. This assists the government in implementing remedial measures.
- The technique used to calculate the Physical Quality of Life Index is universally accepted. As a result, it may be used to compare nations, which enables comparatively impoverished countries to take remedial action, which is one of the advantages of PQLI.
- The three metrics, namely life expectancy, infant mortality and literacy, all accurately reflect the country's population wellbeing. A nation that scores well on all three parameters is considered to have a successful economy. It is another advantage of PQLI.
- The Physical Quality of Life Index evaluates the country's sharing of income. A nation cannot have a high life expectancy, a long life expectancy or a low newborn mortality rate unless a significant proportion of its inhabitants gain from economic progress.

## Disadvantages of PQLI

- The Physical Quality of Life Index overlooks a variety of elements that affect one's quality of life, including job, housing, justice, life expectancy rate and state pensions.
- The Physical Quality of Life Index is an arithmetic mean of the literacy rate, infant mortality and life expectancy rate, with each element receiving equal weighting. However, it is hard to see why all elements should be given equal weight.
- The Physical Quality of Life Index does not account for a country's economy changing structurally.

## Human Development

- Human development can be defined as **the process of enhancing people's freedoms and opportunities and improving their well-being.**
- Human development focuses on improving the people's live rather than assuming that economic growth will lead to greater wellbeing for all.
- Economic growth is **seen as a means to development**, rather than an end in itself.

## Approaches to Human Development

1. Income
2. Basic Needs
3. Capability
4. Welfare

## Income

- This approach is one of the oldest approaches to human development. Human development is seen as linked to income.
- The idea is that the level of income reflects the level of freedom an individual has.
- Higher the level of income, the more is the level of human development.

## Welfare Approach

- This approach **looks at human beings as beneficiaries or targets of all developmental activities.**
- The approach argues for **higher government expenditure on education, health and basic amenities.** People are **not participants but only passive recipients.**
- The government is solely responsible for increasing levels of human development by maximizing expenditure on welfare.

## Basic Needs Approach

- This approach was **initially proposed by the International Labor Organization** (ILO).
- **Six basic needs** i.e. health, education, food, water supply, sanitation and housing were identified.
- The **question of human choices is ignored** and the emphasis is on the provision of basic needs of specific sections.

## Capability Approach

- This approach is associated with **Prof. Amartya Sen.**
- **Building human capabilities** in the areas of **health, education** and access to resources is the key to increasing human development.

> **Q. Increase in absolute and per capita real GNP do not connote a higher level of economic development, if**
>
> **(UPCS Prelims-2018)**
>
> (a) Industrial output fails to keep pace with agricultural output.
>
> (b) Agricultural output fails to keep pace with industrial output.
>
> (c) Poverty and unemployment increase.
>
> (d) Imports grow faster than exports.

## Measuring Human Development

## Human Development Index (HDI)

- Published by **the United Nations Development Programme (UNDP) on an annual basis,** it is a statistical tool used to measure a **country's overall achievement** in its social and economic dimensions.
- The **social and economic dimensions** of a country are based on the **health** of people, their level of **education** attainment and their standard of living.
- First report was published in 1990.
- The human development approach, developed by the economist **Mahbub Ul Haq, is anchored in the Nobel laureate Amartya Sen's work on human capabilities.** It had **the purpose** "to shift the focus of development economics from national income accounting to people centered policies".
- **HDI is broken down into four tiers–**
  1. Very high human development
  2. High human development
  3. Medium human development
  4. Low human development
- HDI measures average success of a country in three basic dimensions of human development:
  - A long and healthy life
  - Access to knowledge
  - A decent standard of living

## Human Development Report 2021-22

According to the **Human Development Report 2021-22,** India's rank on the **Human Development Index (HDI)** has slipped from 130 in 2020 to 132 in 2022, in line with a global fall in HDI scores in the wake of the **Covid-19 pandemic**.

- **Goal:** The goal is to contribute toward the expansion of opportunities, choice and freedom.
- **Theme:** The theme for Human Development Report 2021-22 is Uncertain Times, Unsettled Lives: Shaping our Future in a World in Transformation.

- **Indian Perspective:**
  - **Human Development Index:** India's HDI value stood at 0.633 in 2021, which was lower than the world average of 0.732. In 2020, too, India recorded a decline in its HDI value (0.642) in comparison to the pre-Covid level of 2019 (0.645).
  - **Life expectancy:** In 2021, India's life expectancy at birth was recorded at 67.2 years.
  - **Schooling:** Expected years of schooling at 11.9 years, mean years of schooling at 6.7 years,
  - **Gross National Income:** The gross national income per capita stood at USD 6,590.
  - **Gender Inequality Index:** India has been ranked 122 on the Gender Inequality Index.

## *Gender Development Index:*

- GDI measures disparities in the HDI by gender. or India, the GDI value for 2021 is 0.490.
- The key HDI metric where women seem to lag behind men the most is the income per capita.

## *Gender Inequality Index:*

- GII presents a composite measure of gender inequality using three dimensions:
  - Reproductive health,
  - Empowerment and
  - The labour market.
- In GII, India is at the 122nd rank.

## *Multidimensional Poverty Index (MPI):*

- MPI captures the multiple deprivations that people in developing countries face in their health, education and standard of living.
- As of 2022, India had more than **228 million who are suffering from multi-dimensional poverty.**
- **Globally 1.2 billion people are living under multidimensional poverty.**

## *Planetary pressures-adjusted Human Development Index:*

- It adjusts the HDI for planetary pressures in the Anthropocene to reflect a concern for intergenerational inequality, similar to the Inequality-adjusted HDI adjustment - which is motivated by a concern for intragenerational inequality.
- The PHDI value can be interpreted as the **level of human development adjusted by carbon dioxide emissions per person** (production-based) and material footprint per person to account for excessive human pressure on the planet.

**Q. The Multi-dimensional Poverty Index developed by Oxford Poverty and Human Development Initiative with UNDP support covers which of the following?**

**UPCS Prelims-2011**

1. Deprivation of education, health, assets and services at household level
2. Purchasing power parity at national level
3. Extent of budget deficit and GDP growth rate at national level

Select the correct answer using the codes given below:

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

## *World Happiness Report 2022*

- The World Happiness Report 2022 was published by the **United Nations Sustainable Development Solutions Network.**
- Published since 2012, the World Happiness Report is based on two key ideas:
  - **Happiness or life evaluation** measured through opinion surveys and
  - **Identifying key elements** that determine well-being and life evaluation across countries.
- The report **usually ranks 150 countries** based on several factors such as real GDP per capita, social support, healthy life expectancy, freedom to make life choices, generosity and perceptions of corruption.
  - This year, the report ranked 146 countries.
- Every year, each variable measures a populated-weighted average score on a scale of 0-10 that is tracked over a period of time and further compared with other countries.

- This year, countries which ranked in the top 10 last year, moved upwards and downwards.

### *What about the Performance of the Countries?*

- Top Performers:
  - **Finland** has been named the **world's happiest country** for the fifth year running followed by **Denmark**.
  - The biggest gains in happiness have taken place in **Serbia, Bulgaria and Romania.**
- Worst Performers:
  - Afghanistan was ranked as the unhappiest nation, followed by Lebanon, Zimbabwe, Rwanda and Botswana respectively.
- India's Performance:
  - India saw a marginal improvement in its ranking, jumping three spots to 136, from 139 a year ago.

### *Inclusive Growth*

- Inclusive growth means economic growth that creates employment opportunities and helps in reducing poverty.
- It means having access to essential services in health and education by the poor. It includes providing equality of opportunity, empowering people through education and skill development.
- It also encompasses a growth process that is environment friendly growth, aims for good governance and helps in creation of a gender sensitive society.
- As per OECD (Organisation for Economic Co-operation and Development), inclusive growth is economic growth that is distributed fairly across society and creates opportunities for all.

### *Elements of Inclusive Growth*

#### Skill Development

- Harnessing the demographic dividend will depend upon the employability of the working age population, their health, education, vocational training and skills. Skill development plays a key role here.
- India is facing a dual challenge in skill development:
  - First, there is a paucity of highly trained workforce
  - Second, there is non-employment of conventionally trained youths
- According to the Economic Survey 2017, over 30% of youth in India are NEET (Not in education, employment or training).
- Similarly, UNICEF 2019 reports states that at least 47% of Indian youth are not on track to have the education and skills necessary for employment in 2030. According to OECD, 31% of youth in India are NEET category.

#### Financial Inclusion

- Financial Inclusion is the process of ensuring access to financial services to vulnerable groups at affordable costs.
- Financial inclusion is necessary for inclusive growth as it leads to the culture of saving, which initiates a virtuous cycle of economic development.

#### Technological Advancement

- The world is moving towards an era of Industrial Revolution 4.0. These technological advancements have capabilities to both decrease or increase the inequality depending on the way these are being used.
- Several initiatives have been taken by the government, eg. Digital India Mission, so that a digitally literate population can leverage technology for endless possibilities.
- Technology can help to combat other challenges too, eg:
  - **Agriculture-** Modern technology can help in making an agro-value chain from farmer to consumer more efficient and competitive.
  - **Manufacturing-** Technology can resolve the problems of finance, procuring raw materials, land and linkages with the user market. GST was made possible only with the help of sound technology.
  - **Education-** Innovative digital technologies can create new forms of adaptive and peer learning, increasing access to trainers and mentors, providing useful data in real-time.

- **Health-** Technologies could transform the delivery of public health services - extend care through remote health services
- **Governance-** Technology can cut down delays, corruption and inefficiency in the delivery of a public service

### Economic Growth

- India is among the fastest-growing major economies in the world. However, currently Indian economy is facing slowdown due to both cyclic and structural challenges.
- However, the target of becoming a $ 5 trillion economy by 2024-25 can allow India to reduce inequality, increase social expenditure and provide employment to all.

### Social Development

- It means the empowerment of all marginalised sections of the population like SC/ST/OBC/ Minorities, women and transgenders.
- Empowerment can be done by improving institutions of the social structure i.e. hospitals especially primary care in the rural areas, schools, universities etc.
- Investment in social structures will not only boost growth (by fiscal stimulus) but will also create a healthy and capable generation to handle future work.

## *Challenges in achieving Inclusive Growth*

### Poverty

- As per the Multidimensional Poverty Index (MPI), India lifted 415 million people between 2005-06 and 2019-21, with the poorest regions, groups and children, reducing poverty fastest. India demonstrates the clearest pro-poor pattern at the sub-national level.
- Still, despite the massive gans, 373 million Indians continue to experience acute deprivations. Additionally, 8.8% of the population lives in severe multidimensional poverty and 19.3% of the population are vulnerable to multidimensional poverty.

### Unemployment

- As per the **Periodic Labour Force Survey (PLFS) of NSSO 2022-21,** the unemployment rate among the urban workforce was 6.7%, while the unemployment rate for the rural workforce was 3.37% totaling the total unemployment rate at 4.2%.
- The quality and quantity of employment in India are low due to illiteracy and due to over-dependence on agriculture.
- The quality of employment is a problem as more than 80% of people work in the informal sector without any social security.
- Low job growth is due to the following factors:
  - Low investment
  - Low capital utilization in industry
  - Low agriculture growth

### Agriculture Backwardness

- Around 45% of people in India have agriculture-related employment but its contribution to the Indian GVA is 18.8% in the year 2021-22 which lead to widespread poverty
- Issues in agriculture are as follows:
  - Declining per capita land availability
  - A slow reduction in the share of employment
  - Low labour productivity
  - Decline in agriculture yield due to climate change, land degradation and unavailability of water
  - Disparities in growth across regions and crops

### Issues with Social Development

- Social development is one of the key concerns for inclusive growth. But it is facing some problems such as:
  - Significant regional, social and gender disparities
  - Low level and slow growth in public expenditure particularly in health and education
  - The poor quality delivery system
  - Social indicators are much lower for OBC, SC, ST and Muslims
  - Malnutrition among the children - India ranks 107$^{th}$ in Global Hunger Index-2022

#### Regional Disparities

- Regional disparities are a major concern for India. Factors like the caste system, gap between rich and poor etc. contribute to the regional disparities which create a system where some specific groups hold more privileges over others.
- Some of the regional disparities problems are as follow:
  - In terms of literacy rate, Kerala is the most literate state with 93.1% literacy, on the other hand, literacy rate of Bihar is only 63.82%
  - In terms of per capita income, Goa's per capita income is Rs 4, 55, 654 in 2021 while per capita income of Bihar is roughly one-tenth of that ie Rs 46, 292.

> **Q. Which of the following can aid in furthering the Government's objective of inclusive growth?**
> **(UPCS Prelims-2012)**
>
> 1. Promoting Self-Help Groups
> 2. Promoting Micro, Small and Medium Enterprises
> 3. Implementing the Right to Education Act
>
> Select the correct answer using the codes given below:
>
> (a) 1 only (b) 1 and 2 only
> (c) 2 and 3 only (d) 1, 2 and 3

### *Measuring Inclusive Growth*

#### Inclusive Development Index (IDI)

- In the Inclusive Development Index (IDI) compiled by the World Economic Forum (WEF), India ranked 62$^{nd}$ out of 74 emerging countries and was among the least inclusive countries in Group of 20 (G-20) countries.
- The IDI is based on the idea that most people base their country's growth not on GDP but by their own standard of living.
- It gives a measure of inequality based on three parameters: :
  - Growth and development
  - Inclusion
  - Inter-generational equity and sustainability.
- India also did not make it to the top 10 most inclusive emerging and developing economies, where its neighbours Nepal, China and Sri Lanka made a mark.
- India performed its best in terms of "intergenerational equity and sustainability", ranking 44$^{th}$, for which credit can be attributed to its demographic dividend.

### *Social Progress Index (SPI)*

- It is an aggregate index of social and environmental indicators which includes the following:
  - Basic human need
  - Foundation of well being
  - Opportunity
- Limitation of other indices:
  - **GDP:**
    - It does not include non-market activities.
    - Excludes factors like environment, equality etc
  - **Gini Coefficient:**
    - Only income inequalities are included and other inequalities like social inequality, equality of opportunities etc are ignored.
  - **Gross Happiness Index:**
    - Ignores gender neutrality, education etc
  - **HDI:**
    - The unequal distribution of wealth is ignored.
- Benefits of SPI:
  - SPI measures the outcomes of the government measures rather than money spent. It also takes account of efficiency by which money spent by the government has been used.
  - It is more comprehensive.

### *Global Slavery Index*

- It is released by the Walk Free Foundation of Australia.
- Modern Slavery means a situation where one person has taken away another person's freedom, to control their body so that they can be exploited.
- Factors responsible for modern slavery:
  - Absence of rights

- Lack of physical safety
- Access to necessities such as health care, education, food etc
- Pattern of migration
- Government actions to reduce modern slavery:
- India has worked in the right direction by criminalizing trafficking, slavery, forced labor, child prostitution and child marriage.

## *Measures taken by India to achieve Inclusive Growth*

- Several schemes are being implemented by the government for inclusive growth which includes the following:
    - Mahatma Gandhi National Rural Employment Guarantee Act Scheme (MGNREGA)
    - Prime Minister's Employment Generation Programme (PMEGP)
    - Mudra Bank scheme
    - Pt. Deen Dayal Upadhyaya Grameen Kaushalya Yojana (DDU-GKY)
    - Deendayal Antyodaya Yojana- National Urban Livelihoods Mission (DAY-NULM)
    - Sarva Siksha Abhiyan (SSA)
    - National Rural Health Mission (NRHM)
    - Bharat Nirman
    - Swachh Bharat Mission
    - Mission Ayushman
    - Pradhan Mantri Jan Dhan Yojana
- Government is working with NGOs and International groupings in policy making eg:
    - DISHA Project is being implemented in partnership with UNDP for creating employment and entrepreneurship opportunities for women in India.
- NITI Aayog's Strategy for New India @75 has the following objectives for the inclusive growth:
    - To have a rapid growth, which reaches 9-10% by 2022-23, which is inclusive, clean, sustained and formalized.
    - To leverage technology for inclusive, sustainable and participatory development by 2022-23.
    - To have an inclusive development in the cities to ensure that urban poor and slum dwellers including recent migrants can avail city services.
    - To make schools more inclusive by addressing the barriers related to the physical environment (e.g. accessible toilets), admission procedures as well as curriculum design.
    - To make higher education more inclusive for the most vulnerable groups.
    - To provide quality ambulatory services for an inclusive package of diagnostic, curative, rehabilitative and palliative care, close to the people.
    - To prepare an inclusive policy framework with citizens at the center

Q. Pradhan Mantri Jan-Dhan Yojana' has been launched for

**(UPCS Prelims-2015)**

(a) Providing housing loan to poor people at cheaper interest rates

(b) Promoting women's Self-Help Groups in backward areas

(c) Promoting financial inclusion in the country

(d) Providing financial help to the marginalized communities

# 3 NATIONAL INCOME

## National Income

- National Income is **the total value of all final goods and services produced by the country in certain year.** The growth of National Income helps to know the progress of the country.
- In other words, the total amount of income accruing to a country from economic activities in a year's time is known as national income.
- National Income **includes payments made to all resources in the form of wages, interest, rent and profits.**

## Background of National Income

- A first rough estimate of National Income was done by Dadabhai Naoroji for 1867-68; published in his book Poverty and Unbritish rule in India (famous for its Drain of Wealth theory).
- The first scientific estimate made by Prof V K R V Rao (1931-32).
- The Indian government estimated the National Income for the first time in 1948-49 through the Ministry of Commerce.
- National Income Committee was set up in 1949 (Chairman – Dr. P C Mahalanobis).
  - P. C. Mahalanobis was also the chairman of Indian Statistical Institute.
- Currently, the National Statistical Office (NSO) estimates National Income.
  - It publishes National Accounts Statistics annually.
  - Under the Ministry of Statistics and Programme Implementation.
  - Now, CSO has been merged with the National Sample Survey Organization to form the National Statistical Organization.

## NATIONAL INCOME ACCOUNTING (NIA)

- National Income Accounting is a **method or technique used to measure the economic activity in the national economy as a whole.**
- It is the bookkeeping system which measures the level of economic activity in a given time period
- NIA **sets rules and definition to measure aggregate economic activity** and tries to summarise the performance of the economy.

## NIA is predominantly done for:

- **Policy Formulation:** It helps in comparing the estimates of the past from the future and also forecast the growth rates in future. For example, if a country has a GDP of Rs. 103 Lakh which is 3 Lakh rupees higher than the last year, it has a growth rate of 3 per cent.
- **Effective Decision Making:** To estimate the contribution of each of the sectors of the economy. It helps the business to plan for production.
- **International Economic Comparison:** It helps in comparing the level of development of countries and provides useful insight into how well an economy is functioning and where money is being generated and spent. One can compare the standard of living of different nations and its growth rate.

## Applications'of NIA

- **Indicates the performance of the economy** signifying the economy's strength and failures
- It **helps to find out structural changes in the economy.** E.g. - Proportional share of primary sector is declining and tertiary sector is proportionately increasing since late 1990.
- It helps in **assessing the current standard of living**
- **Helps in comparison among nations** with respect to national income, per capita income.
- Data help in making suitable changes in policy and approaches to achieve rapid economic development

## *Problems Faced in The Estimation of National Income*

1. **Conceptual problems:** What should be included or excluded in NI?
    - eg. which activities of foreign firms or the govt should be considered productive?
    - Services of household – not included as there is no income, no price and no market for service rendered for the household work done.
    - Domestic servants are to be included- but quantifying becomes difficult.
    - Farm products kept for self-consumption are to be estimated by guess.
    - Output from vegetables grown from home garden or terrace garden –not included as there is no accurate estimate for the produce.
2. **Practical or Statistical problems:**
    - Small shopkeepers, casual workers etc **don't keep a proper record** of their income/expenditure.
    - Non-market activities (self- consumption) are tough to estimate.
    - Reliable information is not available due to illiteracy
    - Statistical staff is untrained and inefficient
    - Large regional diversity – language , customs – create a problem in computing the estimates
    - Issue with multiple counting

## *Problems in Calculating*

- Black money outside the estimates.
- Non monetisation such as barter system in rural areas are kept out of transaction
- Household services like care economy not included
- Social service ,voluntary and charitable work ignored.
- Environmental cost

## *Measurement of National Income*

There are three methods to measure national income:

| Methods to Measure National Income | |
|---|---|
| **S.No** | **Measurement Method** |
| 1. | Income Method |
| 2. | Production (Value-Added) Method |
| 3. | Expenditure Method |

## *Measurement of National Income – Income Method*

Estimated by adding all the factors of production (rent, wages, interest, profit) and the mixed-income of self-employed.

1. In India, one-third of people are self-employed.
2. This is the 'domestic' income, related to the production within the borders of the country

## *Measurement of National Income - Production Method*

Estimated by adding the value added by all the firms.

Value-added = Value of Output – Value of (non-factor) inputs

1. This gives GDP at Market Price (MP) – because it includes depreciation (therefore 'gross') and taxes (therefore 'market price')
2. To reach National Income (that is, NNP at FC)
    - Add Net Factor Income from Abroad: GNP at MP = GDP at MP + NFIA
    - Subtract Depreciation: NNP at MP = GNP at MP – Depreciation
    - Subtract Net Indirect Taxes: NNP at FC = NNP at MP – NIT

## *Measurement of National Income – Expenditure Method*

The expenditure method to measure national income can be understood by the equation given below:

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

Where Y = GDP at MP, C = Private Sector's Expenditure on final consumer goods, G= Govt's expenditure on final consumer goods, I= Investment or Capital Formation, X = Exports, I= Imports, X-M = Net Exports

Any of these methods can be used in any of the sectors - the choice of the method depends on the convenience of using that method in a particular sector

### *Findings and projections:*

- India's **GDP at Constant (2011-12) Prices grew 5.4 per cent in the third quarter (Q3) of 2021-22,** way less than the 8.4 per cent growth for the preceding three months.
- The growth in **Real GDP or Gross Domestic Product (GDP) at Constant (2011-12) Prices** in the year 2021-22 is estimated at 8.9 percent as compared to a contraction of 6.6 percent in 2020-21.
- It projected the **nominal GDP growth for 2021-22 at 19.4 per cent.**

### *GDP:*

- Gross Domestic Product (GDP) is the **total value of goods and services produced in a country in one year.**
- GDP refers to the value of goods produced within the geographical territory of a country **irrespective of whether they are produced by citizens or foreigners.**
- It is **not to be confused with Gross National Product or GNP,** which takes into account the value of goods produced by a country's residents regardless of whether they live inside the **country or abroad.**

### *Formula for Calculating GDP:*

There are three different ways that economists and statisticians can calculate a country's GDP and they should all, theoretically, produce the same number:

1. **Expenditures:**This is the value of everything that is purchased within the country plus that country's net exports to other countries.
2. **Income:** This is the income of all the individuals and businesses within the country. Also called domestic income.
3. **Production:** This is the market value of everything that is produced within the country.

### *This is calculated using the formula:*

**GDP=consumption (C) + investment (I) + government spending (G) + (exports (X) - imports (M)).**

### *Types of GDP:*

There are four different types of GDP and it is important to know the difference between them, as they each show different economic outlooks.

**1. Nominal GDP**

Nominal GDP is **calculated with inflation (i.e without removing the effect of rising prices)**. The prices of goods and services are calculated at current price levels. It is defined as a GDP measure, expressed in absolute terms. The raw GDP data, before inflation adjusted is called Nominal GDP. It includes all the changes in the prices of finished goods and services that took place in one year due to inflation or deflation.

**2. Real GDP**

Real GDP is a calculation of GDP that is adjusted for inflation (removing the effect of rising prices). The prices of goods and services are calculated at a constant price level, which is usually set by a predetermined base year. Real GDP is considered the **most accurate portrayal of a country's economy** and economic growth rate. It exclusively **considers the production and free from price changes or currency fluctuations.**

GDP deflator is a factor by which Nominal GDP is adjusted to calculate Real GDP. It adjusts gross domestic product by removing the effect of rising prices. It shows how much an economy's GDP is really growing.

**Formula is :**

**GDP Deflator = (Nominal GDP / Real GDP ) * 100**

**3. Actual GDP**

Actual GDP is the measurement of a country's economy at the current moment in time.

**4. Potential GDP**

Potential GDP is a calculation of a country's economy under ideal conditions, like a steady currency, low inflation and full employment.

### *Nominal GDP and Real GDP*

| Parameters | Nominal GDP | Real GDP |
|---|---|---|
| Meaning | The aggregate financial business value manufactured within a country is known as nominal GDP. | The measure of GDP was modified according to the changes in the general price level. |
| What is it? | Inflation without GDP | Inflation-adjusted GDP |
| Communicated in | Present year prices | Beginning year prices or regular prices |
| Worth | High | Low |
| Uses | Compares different quarters of a particular year | Compares two or more financial years |
| Financial growth | Analysing is not easy | Measures economic growth in an excellent manner |

### *What is GDP deflator?*

- The GDP deflator, also called implicit price deflator, is a measure of inflation.
- It is the ratio of the value of goods and services an economy produces in a particular year at current prices to that of prices that prevailed during the base year.
- This ratio helps show the extent to which the increase in gross domestic product has happened on account of higher prices rather than increase in output.
- GDP price deflator measures the difference between real GDP and nominal GDP. Nominal GDP differs from real GDP as the later doesn't include inflation, while the former does.
- As a result, nominal GDP will most often be higher than real GDP in an expanding economy.
- The formula to find the GDP price deflator:

**GDP price deflator = (nominal GDP ÷ real GDP) x 100**

### *Why GDP deflator is a better measure of inflation than CPI / WPI?*

Since the deflator covers the entire range of goods and services produced in the economy - as against the limited commodity baskets for the wholesale or consumer price indices - it is seen as a more comprehensive measure of inflation.

- A consumer price index (CPI) measures changes over time in the general level of prices of goods and services that households acquire for the purpose of consumption.
- However, since CPI is based only on a basket of select goods and is calculated on prices included in it, it does not capture inflation across the economy as a whole.
- The wholesale price index basket has **no representation of the services sector** and all the constituents are only goods whose prices are captured at the wholesale/ producer level.
- Changes in consumption patterns or introduction of goods and services are automatically reflected in the GDP deflator.
- This allows the GDP deflator to absorb changes to an economy's consumption or investment patterns. Often, the trends of the GDP deflator will be similar to that of the CPI.
- Specifically, for the GDP deflator, the 'basket' in each year is the set of all goods that were produced domestically, weighted by the market value of the total consumption of each good.
- Therefore, new expenditure patterns are allowed to show up in the deflator as people respond to changing prices. The theory behind this approach is that the GDP deflator reflects up-to-date expenditure patterns.
- **Drawback:** GDP deflator is available only on a quarterly basis along with GDP estimates, whereas CPI and WPI data are released every month.

### *Gross National Product (GNP):*

- Gross National Product is the total measure of the flow of goods and services at market value resulting from current production during a year in a country, including net income from abroad.

**GNP= GDP + Net income from abroad(X-M) , where X= Export, M= Import**

- If the value of (X-M) is negative then, GDP > GNP

**Net National Product (NNP):**

- Net national  is considered a true measure of national product or income. It is defined as GNP minus depreciation or capital consumption allowance or wear and tear.

**NNP = GNP – Depreciation**

- Unlike GDP, GNP, net National Product (NNP) may also be categorized as:

1. **NNPmp (Net National Product at market price)** : Net national product at market prices is net value of final goods and services evaluated at market prices in the course of one year in a country.
2. **NNPfc (Net National Product at factor cost):** Net national product at factor cost is the net output evaluated at factor prices. It includes income earn by factors of production through participation in the production process such as wages and salaries, rents profits etc. **NNP at factor cost is also called National Income.**

**NNPmp = NNPfc – S + (IT+ GS)**

**or,**

NNPmp = NNPfc – subsidies + (indirect tax+ surpluses from government enterprises)

**NNPfc = NNPmp + S - (IT+ GS)**

**or,**

NNPfc = NNPmp + subsidies - (indirect tax+ surpluses from government enterprises)

Normally, NNP at market prices is higher than NNP at factor cost because indirect taxes exceed government subsidies. However, NNP at market prices can be less than NNP at factor cost when government subsidies exceed indirect taxes.

**Q. In the context of Indian Economy, consider the following statements : (Prelims 2011)**

1. The growth rate of GDP has steadily increased in the last five years.
2. The growth rate in per capita income has steadily increased in the last five years.

Which of the statements given above is/are correct?

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

***Some other concepts of National Income:***

**Private income**

Private income is income obtained by private individuals from any source, produce or otherwise and retained income of corporations. It can be obtained from NNP at factor cost by making certain additions and deductions.

**Private Income = National income (NNP at factor cost) +Transfer Payments + Interest on Public Debt – Social Security – Profits and Surpluses of Public Undertakings.**

**Personal Income**

- Personal income is the total income received by the individuals of a country from all sources before direct taxes in one year. Personal income is never equal to the national income because the former includes the transfer payments whereas they are not included in national income. Personal income is derived from national income by deducting undistributed corporate profits, profit taxes and employee's contributions to social security schemes. Personal income is differs than private income actually it is less than private income because it excludes undistributed corporate profits.

**Personal Income = National Income – Undistributed Corporate Profits – Profit Taxes – Social Security Contributions + Transfer Payments + Interest on Public Debt.**

**Disposable Income**

Disposable income or personal disposable income means the actual income which can be spent on consumption by individuals and families. The whole of the personal income cannot be spent on consumption, because it is the income that accrues before direct taxes have actually been paid. Therefore, in order to obtain disposable income, direct taxes are deducted from personal income. Thus

**Disposable Income=Personal Income – Direct Taxes**

But the whole of disposable income is not spent on consumption and a part of it is saved. Therefore, disposable income is divided into consumption expenditure and savings. Thus

| Disposable Income = Consumption Expenditure + Savings. |
|---|

If disposable income is to be deduced from national income, we deduct indirect taxes plus subsidies, direct taxes on personal and on business, social security payments, undistributed corporate profits or business savings from it and add transfer payments and net income from abroad to it.

| Thus Disposable Income = National Income – Business Savings – Indirect Taxes + Subsidies – Direct Taxes on Persons – Direct Taxes on Business – Social Security Payments + Transfer Payments + Net Income from abroad. |
|---|

**Real income**

Real Income is the income expressed in terms of a general level of prices of a particular year taken as base year. National income in terms of money at current prices does not indicate the real state of the economy. So the concept of real income has been propounded to rectify such illusions. This is also known as National Income at constant prices.

| Real NNP = NNP for the Current Year × Base Year Index (100) / Current Year Index |
|---|

Suppose 1990-91 is the base year and the national income for 1999-2000 is Rs. 20,000 crores and the index number for this year is 250. Hence, Real National Income for 1999-2000 will be = 20000 x 100/250 = Rs. 8000 crores. This is also known as national income at constant prices.

**Per Capita Income**

The average income of the people of a country in a particular year is called Per Capita Income for that year.

| **Per Capita Income for 2011 = National Income for 2011 divided by Population in 2011** |
|---|

This concept enables us to know the average income and the standard of living of the people.

But it is not very reliable due to unequal distribution of national income which exists in every country.

## *What is the difference between Current Price and Constant Price?*

| Current Price vs Constant Price | |
|---|---|
| GDP at current price is the GDP unadjusted for the effects of inflation and is at current market prices. | GDP at constant price is the GDP adjusted for the effects of inflation. |
| **Synonyms** | |
| GDP at current price is also referred to as nominal GDP. | GDP at constant price is also referred to as real GDP. |
| **Formula** | |
| GDP at current price is calculated as (GDP = C + G + I + NX). | Nominal GDP / Deflator is used to calculate GDP at constant price. |
| **Use** | |
| GDP at current price is not used much since it can be misleading due to the effects of inflation. | GDP at constant price is widely used as a reliable economic measure since it considers the actual increase in economic activity. |

## *Base year*

- The base year is a benchmark concerning which the public record figures like total national output (GDP), gross homegrown saving and gross capital development are determined. Base year prices are considered constant as that structure is the base for comparison of two or more figures. It is allotted the value of 100 as an index. The previous series changed the base from 2004-05 to 2011-12. During **Modi Govt**, GDP base year was **2004-05.**
- In 2015, PM Modi changed GDP base year to 2011-12. Then, Modi govt. updated / re-adjusted GDP figures as per the new base year.
- The (new) GDP-data thus **re-produced for 2005-2011** is called "Back series" data.

## *Transfer payments*

Transfer payments - is the payment by the government in grants, allowances, pensions etc to people such as pensioners, widows, sick or unemployed people or others with little or no income. Transfer payment doesn't involve a return of any productive service from the beneficiaries to the government.

**Q. Consider the following statements regarding India's GDP data: (Prelims-2021)**

1. The National Statistical Office (NSO) is mandated to prepare national accounts as well as publish biannual estimates of the national product.
2. India's economy for the first time in the last decade saw a negative quarterly growth rate in (April-June) Q1 of 2020-21.

Which of the statements given above is/are correct?

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

## *Green GDP*

- Green GDP is a term used for expressing GDP after adjusting for environment degradations.
- Green GDP is an attempt to measure the growth of an economy by subtracting the costs of environmental damages and ecological degradations from the GDP
- The concept was first initiated through a System of National Accounts.
- The System of National Accounts (SNA) is an accounting framework for measuring the economic activities of production, consumption and accumulation of wealth in an economy during a period of time. When information on economy's use of the natural environment is integrated into the system of national accounts, it becomes green national accounts or environmental accounting.
- The process of environmental accounting involves three steps viz. Physical accounting; Monetary valuation; and integration with National Income/Wealth Accounts.
- Physical accounting determines the state of the resources, types and extent (qualitative and quantitative) in spatial and temporal terms.
- Monetary valuation is done to determine its tangible and intangible components.
- Thereafter, the net change in natural resources in monetary terms is integrated into the Gross Domestic Product in order to reach the value of Green GDP.

## *National Statistical Office (NSO)*

- The National Sample Survey Office (NSSO) merged with the Central Statistical Office (CSO) to form the National Statistical Office (NSO). On 23rd May 2019, the Government of India has approved the **merger of NSSO and CSO.**
- The National Sample Survey Office **(NSSO)**, formerly called the National Sample Survey Organisation was the **largest organization in India conducting periodic socio-economic surveys.**
- Earlier known as the Central Statistics Organisation of India, **CSO** is responsible for the **coordination of statistical activities in India** and evolving and maintaining statistical standards.
- NSO is headed by the **Ministry of Statistics and Programme Implementation (MoSPI).**

**Q. Consider the following statements:**

1. Real GDP measures an economy's total goods and services in a given year, taking into account changes in price levels.
2. Real GDP can never be more than the nominal GDP.

Which of the statements given above is/are correct?

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

## *History of Central Statistical Organization (CSO)*

Central Statistical Organization (CSO) was headed by a Director-General who was assisted by two additional director generals and four deputy director generals, joint directors and other official staff. The CSO was headquartered in Delhi. The CSO is the final organisation for the coordination of statistical activities in the country. The activities of CSO included:

- National Income Accounting;
- Conduct of Annual Survey of Industries;
- Economic Census and follow-up surveys
- Compilation of index of industrial production and consumer price indices;
- Human Development Statistics;
- Gender Statistics;
- Imparting training in official statistics;
- Five-Year Plan Work

Presently, these two organizations - NSSO and CSO are merged to form a new organization National Statistical Office (NSO) that will presumably be responsible for all the tasks hitherto done by CSSO and NSO.

**Q. The national income of a country for a given period is equal to the: (Prelims 2013)**

(a) Total value of goods and services produced by the nationals
(b) Sum of total consumption and investment expenditure
(c) Sum of personal income of all individuals
(d) Money value of final goods and services produced

# 4

# UNEMPLOYMENT, POVERTY AND INEQUALITY

## *Unemployment*

- Unemployment is a circumstance in which a person who is actively looking for a job is unable to find work.
- Unemployment is seen as a significant indicator of the economy's health.
- The **unemployment rate,** which is calculated by dividing the number of jobless persons **(unemployed who are willing to work)** by the total number of people in the labour force, is the most used measure of unemployment.
- "Unemployed, not wanting to work and not actively looking for a job" refers to someone who is **not employed, is not willing to work or is not interested in engaging in any economic activity.**
- This category typically includes **students, stay-at-home moms, retirees and people** who are unemployed.

## *Types of Unemployment*

Unemployment can be grouped into various types based on the nature of work, the structure of the economy, the nature of the seasons, technological advancements in an economy etc. Various types of unemployment are discussed below.

### *Frictional Unemployment*

- It is when there is least amount of unemployment prevailing in an economy due to workers quitting their previous jobs and searching for new jobs.
- One of the major causes of occurrence of frictional unemployment is **lack of information about the availability of jobs and non-willingness of mobility** on the part of workers (it means workers are not willing to travel to a distant place or a new state for employment).
- A frictionally unemployed person remains unemployed for a **very brief period of time.**

### *Cyclical Unemployment*

- It occurs during the **cyclical trends of booms and recessions** of a business cycle.
- This type of unemployment occurs mainly **due to either deficiency or fall in effective demand from consumers** which in turn leads to a fall in production and low demand for labour.
- This type of unemployment occurs for a long period of time and workers remain unemployed during the entire phase of slowdown.
- The unemployment crisis due to the 2008 financial crisis is an example of cyclical unemployment.

### *Voluntary Unemployment*

- It is when workers are **either not seeking work or are in transition** from one job to another.
- Voluntary unemployment is present all the time in an economy.
- As there will always be some workers, who quit their previous jobs in search of new ones.

### *Involuntary Unemployment*

- It is when **workers are actively seeking employment and are willing to work but are unable to get work.**
- Involuntary unemployment happens in an economy during the time of depression and **decreases** in aggregate demand for goods and services.

### *Structural unemployment*

- It refers to a situation that arises as a result of a **change in the structure** of the economy.
- For instance, when an economy transforms itself from a **labour-intensive to a capital intensive economy,** structural unemployment happens due to the mismatch of skills.

- As a result, workers who do not know how to operate the new and advanced technologies will be removed.
- This type of unemployment happens as the current workers do not have the skills required by their employers.

### *Seasonal Unemployment*

- This happens **during specific seasons of the year**. It is more prevalent in sectors and occupations such as agriculture, holiday resorts etc., where production activities take place only in some seasons.
- Therefore, they offer employment for only a certain period of time in a year.
- People **engaged in seasonal activities** may remain unemployed during the off-season

### *Open Unemployment*

- It is a condition where **people have no work to do.** It is also known as **naked unemployment.**
- Here individuals are able to work and are also willing to work but there is no work for them.
- It is frequently found in larger cities and is less frequent in villages. Most of such individuals come from villages in search of jobs or might originate in cities themselves.
- Such employment can be seen and counted in terms of the number of such persons. Hence it is called open unemployment.

### *Under-employment*

- It is a scenario where employed people are **contributing to production less than they are capable of.**
- Underemployment is a measure of the total number of people in an economy who are unwillingly working in low-skill and low-paying jobs or only part-time because they cannot get full-time jobs that use their skills.
- ***There are two types of underemployment:*** Visible underemployment is underemployment in which an individual works fewer hours than is necessary for a full-time job in their chosen field. Due to the reduced hours, they may work two or more part-time jobs in order to make ends meet.
- The second type of underemployment is invisible underemployment. It refers to the employment situation in which an individual is unable to find a job in their chosen field. Consequently, they work in a job that is not commensurate with their skill set and, in most cases, pays much below their customary wage.

### *Disguised Unemployment*

- It occurs when a person is the one who seems to be employed but actually he is not. His/Her contribution to the total output is either zero or negligible.
- When more individuals are engaged in a job than the number actually required it leads to a state of disguised unemployment.
- It is mostly seen in rural areas such as in agricultural activities

### *Vulnerable Employment*

- This means, people, **working informally, without proper job contracts** and thus get deprived of any legal protection. These persons are regarded as unemployed since records of their work are never maintained. It is one of the main types of unemployment in India.

### *Technological Unemployment*

- It is unemployment that occurs as a result of the loss of jobs due to changes in technological developments.
- According to World Bank data, the proportion of jobs threatened by automation in India is 69% on a year-on-year basis.

## *Measurement of Unemployment in India*

Various approaches have been used for measuring unemployment based on methods by the National Sample Survey Office (NSSO). These include:

- **Usual Status Approach:** This method considers only those persons as unemployed. That has had no gainful work for a major time during the 365 days preceding the date survey.

- **Weekly Status Approach:** This method considers only those persons as unemployed who did not have gainful work even for an hour on any day of the week preceding the date of the survey.
- **Daily Status Approach:** In this method unemployment status of a person is measured for each day in a reference week. A person having no gainful work even for one hour in a day is described as unemployed for that day.
- **Unemployment rate:** The unemployment rate is the number of people unemployed divided by the working population/people working in the labor force.

| **Unemployment rate = (Unemployed Workers / Total labor force) × 100** |
|---|

- **LFPR:** The **labor force participation rate (LFPR)** is a measure undertaken to evaluate the working-age population in an economy.
  - The participation rate estimates the total number of people who are currently employed or are in the search of a job.
- **Worker Population Ratio:** The worker population ratio is defined as the ratio of a country's working population to its population multiplied by 100. Symbolically,

| **Worker population ratio = Total number of Workers / Total Population ×100** |
|---|

### *Causes of Unemployment*

- Despite India's GDP growth is at about 7-8%, it did not translate into the creation of more employment opportunities for the labour force.
- Preference for large scale industry after independence and the new industrial policy of the 1990s resulted in the decline of small scale industries.
- The joint family system is more prevalent in rural areas and encourages disguised unemployment.
- Various factors such as family loyalty, which people avoid migrating to far-off areas of work. Lower mobility causes greater unemployment.
- The education curriculum is mostly theory-oriented which leads to a mismatch between vocational training and the current economic environment.
- An increase in population is the major reason for increasing unemployment in the country.
- Despite agriculture being the biggest employer in the country contributing to approx 45% of employment, it contributes only 18.8% to the country's GVA.
- Skill deficit between the employment opportunities available and the skills.
- The industrial sector in India has not achieved the desired level of growth. Agriculture still remains the biggest employer in the country.
- Decreasing capital investment and therefore a subsequent decrease in industrial growth that in turn provides employment to the labour force.

### *Jobless Growth*

- Jobless growth is a dominant issue in the Indian economy because of the decreasing window from when the demographic dividend becomes the demographic burden.
- There is the involvement of a greater population in the agriculture sector even though the sector contributes very little to the overall GDP of the country.
- The tertiary sector contributes the largest to the overall GDP of India, however, the job creation by this sector are mostly of formal type due to which inclusion of informal workforce in this sector is reduced.

### *Recent trends regarding Unemployment in India*

- India's unemployment rate reached a high of 8 %in a data released in Dec 2022 according to the Centre for Monitoring Indian Economy (CMIE). A decreasing trend started emerging even before the economic activity was impacted by the new Covid 19 restrictions.
- The unemployment rate has risen to 8% whereas the rate in urban areas is 8.96%. Rural unemployment is 7.55%.

- India's Labor Participation Rate (LPR) decreased from more than 46% in 2016 to 41.6% in 2021.
- Therefore, approximately 60% of the working population was either inactive or not looking for a job and hence dropping out of the labour market.

### Labor Force Participation Rate

- It is an important metric when the **economy is not growing or witnessing recession**.
- The labor force participation rate (LFPR) is a measure undertaken to evaluate the working-age population in an economy.
- The participation rate estimates the total number of people who are currently employed or are in the search of a job.
- People who are not looking for a job such as full-time students, homemakers, individuals above the age of 64 etc are not a part of this data set.

### Significance of Labor Force Participation Rate

- During a recesssion, the labor force participation rate mostly decreases.
- During the time of recession, the economic activity is low which results in fewer jobs across the country.
- When jobs are less, people do not take extra efforts to focus on employment which eventually leads to a lower participation rate in the economy.
- The Labour force participation rate helps to **understand the unemployment rate in the economy.** Consistent analysis of the unemployment rate in the economy is essential.
- A higher labor force participation is a good sign for the economy whereas if it is on the lower side, it can also act as a warning sign for any economy.

### Worker population ratio

- The worker population ratio is defined as the ratio of a country's working population to its population multiplied by 100. Symbolically,

**Worker population ratio = Total number of Workers / Total Population ×100**

- If the ratio is higher, it means that the engagement of people is greater.
- If this ratio is medium or low, it means that a very high proportion of the population is not involved directly in economic activities.

**Q. What is the formula to know the unemployment rate?**

(a) Total number of unemployed/total labour force X 100
(b) Total labour force / Total number of unemployed x 100
(c) Total number of unemployed/total labour force x 1000
(d) Total labour force/Total number of unemployed x 1000

**Q. Periodic Labour Force Survey consists of**

1. Quarterly employment survey
2. Quarterly unemployment survey
3. The survey of urban areas only
4. The survey is done on the basis of households

**Choose the correct option:**

(a) 1 and 2 (b) 1, 2 and 4
(c) 2, 3 and 4 (d) All of the above

## Poverty in India

**Poverty** is a **multidimensional phenomenon** in which an individual or a group **lacks the financial means and necessities for a basic level of living.** Poverty also includes poor health and education, a lack of access to safe drinking water and sanitation, a lack of physical security, a lack of voice lack of capacity and chance to improve one's life. **According to the Tendulkar Poverty line method, 20.8% of the Indian population was still in poverty in 2020.**

### What is Poverty?

- **Poverty is defined as a state or condition in which an individual or a group lacks the financial means and necessities for a basic level of living.**
- Poverty is defined as a situation in which one's **earnings from work are insufficient** to meet fundamental human requirements.
- Poverty, according to the World Bank, is a severe lack of well-being that has various dimensions. Low earnings and the inability to obtain the essential commodities and services required for a dignified existence are examples of poverty.

- The World Bank defined poverty as **individuals living on less than $2.15 per day** which is called the International Poverty Line.
- In India, the National poverty threshold is given by the Tendulkar Committee.
- Poverty also includes poor health and education, a lack of access to safe drinking water and sanitation, a lack of physical security, a lack of voice and a lack of capacity and chance to improve one's life.
- **In 2011, 21.9 percent** of India's population was living below the **national poverty threshold.**
- **In 2018, about 8.9%** of the world's workers and their families were living on less than $1.90 per day (International Poverty Line).

## Types of Poverty

Poverty can be divided into two categories:

- **Absolute Poverty:** When a household's income falls below the level required to **sustain basic living standards** (food, shelter, housing). This condition allows comparisons between countries as well as throughout time.
  - The **"dollar a day" poverty line,** first proposed in 1990, quantified absolute poverty according to the criteria of the world's poorest countries. The **World Bank raised it to $1.90 per day in October 2015** and later raised it to dollar 2.15 in sept 2022.
- **Relative Poverty:** It is defined from a **social perspective as a living standard** that is lower than the economic standards of the surrounding population. As a result, it is a measure of income disparity.
  - In most cases, relative poverty is defined as the percentage of the population earning less than a certain percentage of median income.

## Poverty Line

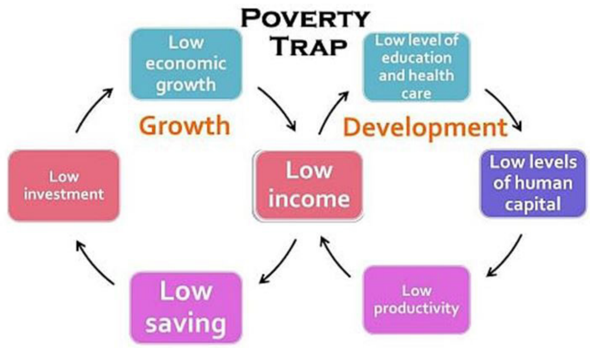
- Poverty **levels are defined as a level of income or spending** below which it is reasonable to conclude that someone is poorer than the rest of society.
- It is a measure of income or consumption spending that distinguishes the poor from the rest of the population.
- The **Tendulkar Committee** proposed a poverty level of **Rs 29 per person per day in urban areas and Rs 22 per person per day in rural areas.**
- There are two reasons for choosing a poverty line.
  - To **create policies** that are tailored to the needs of the poor.
  - To determine if government programmes have been successful or unsuccessful over time.

## Poverty Estimation in India

- Poverty estimation in India is done by the **NITI Aayog task force using data from the National Sample Survey Office** under the Ministry of Statistics and Programme Implementation to calculate a poverty line **(MoSPI)**.
- In India, poverty lines are calculated primarily on **consumption expenditure rather than income levels.**
- **Consumer expenditure surveys** conducted by the National Sample Survey Organization are used to determine poverty. A poor household is defined as one that spends less than a certain amount each month.
- The **poverty ratio, which is the ratio of the number of poor to the total population stated as a percentage,** is used to determine the prevalence of poverty. It's also referred to as the head-count ratio.
- **The Alagh Committee (1979)** established a poverty level based on an adult's daily calorie requirement of **2400 and 2100 calories,** respectively, in rural and urban areas.
- **Following that, the poverty estimation was done by other committees, including the Lakdawala Committee (1993), Tendulkar Committee (2009) and Rangarajan Committee (2012).**
- According to the **Rangarajan committee report (2014),** the poverty line is set at **Rs. 1407 per capita in urban areas and Rs. 972 in rural regions (monthly consumption).**

## *Causes of Poverty in India*

- **Population Explosion:** India's population has been continuously increasing throughout the years. It has risen at a **pace of 2.2 percent per year for the past 45 years,** implying that around 17 million people are added to the country's population each year. This has a significant impact on the demand for consumer products.
- **Low Agricultural Productivity:** The agriculture sector's low productivity is a key source of poverty. Low productivity can be caused by a variety of factors. It is primarily due to **fragmented and subdivided landholdings, a lack of cash, illiteracy about modern farming technologies,** the use of conventional farming practices, wastage during storage and other factors.
- **Inefficient Resource Utilization:** The country suffers from underemployment and **hidden unemployment, notably in the agricultural sector.** Low agricultural output and a drop in living standards have resulted as a result of this.
- **Economic Progress at a Slow Pace:** India's economic development has been slow, particularly in the first 40 years of independence before the LPG reforms in 1991.
- **Price Increases:** The country's price increases have been consistent, adding to the **burden carried by the poor.** Although a few people have profited, the lower-income groups have suffered as a result and are unable to meet even their most basic needs.
- **Unemployment:** Unemployment is another element that contributes to poverty in India. As the world's population grows, so does the number of people looking for work. However, the expansion of opportunities is insufficient to meet the demand for jobs.
- **Lack of Capital and Entrepreneurship:** In the absence of capital and entrepreneurship, the economy suffers from a lack of investment and employment creation.
- **Social Issues:** In addition to economic factors, social factors obstruct India's poverty eradication efforts. The laws of inheritance, the caste system and certain customs, to name a few, are all obstacles in this regard.
- **Colonial Exploitation:** For nearly two centuries, the British colonisation and authority over India **de-industrialized** the country by destroying its traditional handicrafts and textile industries. Colonial policies reduced India to a simple source of raw materials for European businesses.
- **Climatic Factors:** Bihar, UP, MP, Chhattisgarh, Odisha, Jharkhand and other states in India account for the majority of the impoverished. Natural catastrophes like floods, disasters, earthquakes and cyclones frequently strike these states, wreaking havoc on agriculture.
- **Poverty Trap:** A poverty trap is **created when an economic system requires a significant amount of capital to escape poverty**. When individuals lack this capital, they may also find it difficult to acquire it, creating a self-reinforcing cycle of poverty.




## *Lorenz Curve and Gini Coefficient*

- The distribution of income in an economy is represented by the **Lorenz Curve** and the **degree of income inequality** is measured through the **Gini Coefficient.**
- One of the five major and common macroeconomic goals of a government is the equitable (fair) distribution of income.
- The Lorenz Curve (the actual distribution of income curve), a graphical distribution of wealth developed by **Max Lorenzin 1906,** shows the proportion of income earned by any given percentage of the population. The line at the 45º angle shows perfectly equal income distribution, while the other line shows the actual distribution of income. The further away from the diagonal, the more unequal the size of the distribution of income.

### *What is Engel's Law:*

- A version is that the poorer a family, the greater the proportion of the total outgo which must be used for food.
- The proportion of the outgo used for food, other things being equal, is the best measure of the material standard of living of a population.
- Engel's Law is a 19th century observation that as household **income increases, the percentage of that income spent on food declines on a relative basis.**
- This is because the amount and quality of food a family can consume in a week or month is fairly limited in price and quantity.
- As food consumption declines, luxury consumption and savings increase in turn.
- **For example,** a family that spends 25% of their income on food at an income level of $50,000 will pay $12,500 on food. If their income increases to $100,000, it is not likely that they will spend $25,000 (25%) on food, but will spend a lesser percentage while increasing spending in other areas.

### *Gini Coefficient*

- The Gini Coefficient, which is derived from the Lorenz Curve, can be used as an indicator of economic development in a country.
- The Gini Coefficient measures the degree of income equality in a population.
- The Gini Coefficient can vary from 0 (perfect equality) to 1 (perfect inequality).
- A Gini Coefficient of zero means that everyone has the same income, while a Coefficient of 1 represents a single individual receiving all the income.

### *Global Hunger Index 2022*

Global progress in GHI 2022 is stagnant – Globally, the progress against hunger has largely stagnated in recent years, with a global score of 18.2 in 2022 as compared to 19.1 in 2014, there is only a slight improvement. However, the 2022 GHI score is still considered "moderate".

  - Causes for stagnation in this progress –
  - Conflicts among countries,
  - **Climate change**
  - The economic **fallout of the Covid-19 pandemic**
  - **Russia-Ukraine war,** which has increased global food, fuel and fertiliser prices and is expected to "worsen hunger in 2023 and beyond.

- Top performers in GHI 2022 – **Belarus, Bosnia & Herzegovina, Chile, China and Croatia** are the top five countries in GHI 2022.
- Worst Performers in GHI 2022 – **Chad, Democratic Republic of Congo, Madagascar, Central African Republic and Yemen** are the countries ranked at the bottom of the index.
- As per the data, there are 44 countries that currently have "serious" or "alarming" hunger levels.

### *India's Performance in Global Hunger Index 2022*

India ranks 107th out of 121 countries in the GHI 2022 rankings. With a score of 29.1, India has a level of hunger that is serious.

- India has slipped 6 positions from its 2021 rank of 101.
- According to the latest data, India has the highest child wasting rate of all countries covered in the GHI.
- India is ranked behind most of its neighbouring countries. Their ranks are given below:
  - Pakistan – 99th
  - Sri Lanka – 64th
  - Nepal – 81th
  - Bangladesh – 84th
- The only country in **South Asia** that performs worse than India on the index is Afghanistan with 109th rank.
- India has seen improvement in child stunting and child mortality between 2014 and 2022:
  - Child stunting has declined from 38.7% to 35.5%.
  - Child mortality has also dropped from 4.6% to 3.3%.

- India performance in undernourishment – Prevalence of undernourishment has also risen in the country from **14.6% in 2018-2020 to 16.3% in 2019-2021.**
  - It implies that **224.3 million people in India (out of 828 million globally)** are considered undernourished.
- India performance in child wasting – India's **child wasting rate (low weight for height), at 19.3%, is worse than the levels recorded in 2014** (15.1%) and even 2000 (17.15%).

## *Schemes for Poverty Alleviation*

### *Integrated Rural Development Programme (IRDP)*

- The Community Area Development Programme (CADP), Drought Prone Area Programme (DPAP), Small Farmer Development Agency (SFDA) and Marginal Farmers and Agricultural Labourers Agency (MFALA) were merged into the Integrated Rural Development Programme (IRDP) by the Janta government in 1978-79.
- The central government's **National Common Minimum Programme** (NCMP) reaffirms the key importance of villages to the country's overall development and commits to striving to develop rural communities.
- IRDP's major goal is to **eliminate poverty, hunger and unemployment** in rural India.
- The integrated rural development initiative was initially limited to 2000 blocks out of the country's total of 5004 development blocks.

### *Jawahar Gram Samridhi Yojana (JGSY)*

- The programme has been reorganised, streamlined and expanded upon the previous **Jawahar Rozgar Yojana.**
- It was established on **April 1, 1999,** with the goal of improving the lives of the rural poor by providing them with additional useful employment.
- This includes the establishment of the framework, the creation of local resources and, in this vein, the commercial era.
- JGSY public awareness campaign in towns, particularly those with a large BPL population. This entails rethinking the arrangement at a higher (public) level in order to assess its natural value.
- The government's Jawahar Gram Samridhi Yojana is being implemented entirely at the gram panchayat level.
- Subsidies will be sent directly to Gram Panchayats, including State Mail Accounts to **District Rural Development Agencies** (DRDAs)/ Zila Parishads (ZPs).
- The importance of the country's framework in the development of the town's economy cannot be overstated.
- The **Central and State Governments** have started a number of initiatives to build the country's structure. The public works programme has also made a significant contribution to this direction.

### *Rural Housing – Indira Awaas Yojana*

- To meet the goal of **"Housing for All"** by 2022, the erstwhile rural housing scheme Indira Awaas Yojana (IAY) was redesigned as PMAY-G on 1 April 2016.
- **Ministry Involved: Ministry of Rural Development**
- By the end of March 2022, provide a pucca house with basic facilities to all rural families who are homeless or living in kutcha or dilapidated structures.
- To assist rural residents living below the poverty line (BPL) in constructing housing units and upgrading existing unserviceable kutcha homes through the provision of a full grant.
- **Beneficiaries:** Members of the SC/ST communities, freed bonded labourers and non-SC/ST categories, widows or next-of-kin of deceased defence personnel, ex-servicemen and retired paramilitary personnel, disabled persons and minorities.
- Beneficiaries are chosen through a three-stage validation process involving the Socio-Economic Caste Census 2011, Gram Sabha and geotagging.

- **Cost Sharing:** The cost of unit assistance are split in the ratio of 60:40 between the central and state governments in plain areas and 90:10 in North Eastern and hilly states.

### *Food for Work Programme*

- The National Food for Work Program was inaugurated with the cooperation of the Ministry of Rural Development and state governments.
- The National Food for Work Initiative is a pay employment programme aimed at alleviating rural poverty.
- The programme is being launched in 150 of the country's most impoverished areas with the goal of increasing the generation of supplementary wage jobs.
- The programme is open to all rural poor people who need to work for a living and want to conduct manual, unskilled labour. Food is offered to the states at no cost.
- In February 2006, this programme was absorbed into the Mahatma Gandhi National Rural Employment Guarantee Act MGNREGA.

### *National Old Age Pension Scheme (NOAPS)*

- "The State shall, within the limits of its economic capacity and development, make effective provision for securing the right to work, to education and to public assistance in cases of unemployment, old age, sickness and disablement and in other cases of undeserved want," according to **Article 41** of the Indian constitution.
- **IGNOAPS** (Indira Gandhi National Old Age Pension Scheme): IGNOAPS is open to anybody above the age of 60. Individuals between the ages of 60 and 79 receive a pension of Rs.200 per month, while those aged 80 and up receive a pension of Rs.500 per month.
- It was first introduced in 2007 as part of the National Social Assistance Program (NSAP).
- The NSAP initially had the following three components:-

    1. **National Old Age Pension Schemes (NOAPS) -** Providing social security to senior citizens below BPL.
    2. **National Family Benefit Scheme (NFBS) -** This assistance is provided in case of the death of any bread earner of the family. A lump sum amount of Rs 20000/- is given to the bereaved household.
    3. **National Maternity Benefit Scheme (NMBS)-**All Pregnant Women and Lactating Mothers (PW&LM), excluding those who are in regular employment with the Central Government or the State Governments or PSUs or those who are in receipt of similar benefits under any law for the time being in force.

### *Benefits under the Scheme*

Beneficiaries receive a cash benefit of Rs. 5,000 in three instalments on fulfilling the following conditions:

- Early registration of pregnancy
- Ante-natal check-up
- Registration of the birth of the child and completion of the first cycle of vaccination for the first living child of the family.

### *Sampoorna Gramin Rozgar Yojana (SGRY)*

- A scheme developed by the Indian government with the goal of providing productive employment to the destitute people of rural India.
- The **Panchayati Raj institutions (PRIs)** were in charge of implementing the initiative.
- On **September 25, 2001,** the Sampoorna Grameen Rozgar Yojana was established, combining the provisions of the Employment Assurance Scheme (EAS) and the Jawahar Gram Samridhi Yojana (JGSY).
- The initiative is self-targeting in nature, with the goal of providing jobs and food to those living in rural areas who are poor.

### *NRLM - National Rural Livelihood Mission (Deendayal Antyodaya Yojana)*

- DAY-NRLM has been launched under the **Ministry of Rural Development** with an aim to reduce rural poverty by providing them with employment opportunities.

- It also involves **building strong community institutions** and mobilizing them to build strong self-help groups.
- Features:
  - **Universal Social Mobilisation:** Minimum of one woman from each identified rural poor family will be brought under the Self Help Group (SHG) network within a giver time framework.
  - **Participatory Identification of Poor (PIP):** PIP is a community-driven process where CBOs identify poor people in the village themselves. This list is confirmed by Gram Sabha.
  - **Revolving Fund (RF) and Community Investment Fund (CIF):** These are granted to the poor and their institutions for strengthening them.
  - **Financial Literacy:** It also promotes financial literacy among the poor.
  - **Livelihoods:** It promotes the existing livelihood of the poor in farm and non-farm sectors and also builds skills for the job market outside.

### *Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA) 2005*

- The Mahatma Gandhi National Rural Employment Guarantee Act, which is previously known as the National Rural Employment Guarantee Act was introduced on 7th September 2005. The act is for generating employees and social security in India. The act aims to cover all districts of India except the district which have a 100% urban population.
- Objectives:
  - It provides 100 days of guaranteed wage employment to rural unskilled labour
  - The main aim of the MGNREGA scheme is to provide a source of livelihood for the economically weaker section of the society.
  - It helps to grow economic security
  - It takes initiative to decrease the number of migration of labour from rural to urban areas
  - MGNREGA scheme helps proactively the weaker section of society.
  - The scheme will strengthen the Panchayati Raj across India.

### *National Urban Livelihood Mission*

- **DAY-NULM** was launched in the year 2013 by restructuring the **Swarna Jayanti Shahari Rozgar Yojana** with an aim to benefit the urban poor including the urban homeless. It is implemented under the **Ministry of Housing and Urban Affairs.**
- Features:
  - It was launched in 2013 by restructuring the Swarna Jayanti Shahari Rozgar Yojana.
  - It will cover all district's headquarter towns and all the other towns with a population of 1 lakh or more as per the Census 2011.
  - Primarily, NULM will target the urban poor, which will also include the urban homeless.
  - Funding for NULM will be shared between the Centre and the States in the ratio of 75:25.
  - For North Eastern and the Special Category States, the ratio for fund sharing will be 90:10.

### *Pradhan Mantri Kaushal Vikas Yojana (PMKVY)*

- It is a flagship scheme with the aim of providing an **industrial skillset to the unemployed or dropout youth.**
- This scheme targets **10 million youth (2016-2020)** who will get the desired skill set so that they can earn their livelihood.
- **National Skill Development Corporation (NSDC)** is the implementing agency of Pradhan Mantri Kaushal Vikas Yojana (PMKVY) which is further under the guidance of the Ministry of Skill Development and Entrepreneurship.
- **Any youth (between the age group of 15-29** years) with Indian nationality is eligible to apply for the scheme. However, the main focus is given to either college/school dropouts or unemployed individuals.

## *Pradhan Mantri Jan Dhan Yojana (PMJDY)*

- PMJDY means Pradhan Mantri Jan Dhan Yojana is a Prime Minister's wealth scheme for the Indian People. Some people also know it as a financial inclusion of Country.
- Key Pillars:
  - **Branch and banking correspondent (BC)** banking services are available to everyone.
  - Every qualified adult would receive a basic savings bank account with **Rs. 10,000 overdraft limits**
  - **Program on Financial Literacy:** To encourage people to save, utilise ATMs, become ready for credit, acquire insurance and pensions and use basic mobile phones for banking.
  - **Credit Guarantee Fund** was established to provide banks with some protection against defaults.
  - On accounts created between August 15 2014 and January 31 2015, there is accident insurance of up to Rs. 1,00,000 and a life cover of Rs. 30,000 (For the unorganised sector, there is a pension system).
  - **RuPay Card Coverage:** For PMJDY accounts created after August 28, 2018, the free accidental insurance cover on RuPay cards has been enhanced from Rs. 1 lakh to Rs. 2 lakhs.
  - **Overdraft (OD)** facilities have been improved: the OD limit has been quadrupled from Rs 5,000 to Rs 10,000 and the OD limit has been increased to Rs 2,000.
  - The upper age restriction for OD has been raised from 60 to 65 years.

## *Pradhan Mantri Awas Yojana – Gramin (PMAY-G)*

- The scheme was launched for social welfare to provide necessary housing facilities for the low households in India. PMAY-G was established in line with the government's commitment to delivering by **2022 "Housing in all rural areas."**
- Ministry Involved: **Ministry of Rural Development**
- By the end of March 2022, provide a pucca house with basic facilities to all rural families who are homeless or living in kutcha or dilapidated structures.
- To assist rural residents living below the poverty line (BPL) in constructing housing units and upgrading existing unserviceable kutcha homes through the provision of a full grant.
- **Beneficiaries:** Members of the SC/ST communities, freed bonded labourers and non-SC/ST categories, widows or next-of-kin of deceased defence personnel, ex-servicemen and retired paramilitary personnel, disabled persons and minorities.
- Beneficiaries are chosen through a three-stage validation process involving the Socio-Economic Caste Census 2011, Gram Sabha and geotagging.
- **Cost Sharing:** The cost of unit assistance are split in the ratio of 60:40 between the central and state governments in plain areas and 90:10 in North Eastern and hilly states.

## *Pradhan Mantri Awas Yojana – Urban (Housing For All)*

- The PMAY program intends to provide housing to all by 2022. It offers central assistance to all the implementing agencies, Central Nodal agencies and the Urban Local Bodies for the following.
- **In-situ rehabilitation:** Redeveloping the existing slum areas to build pucca houses with basic amenities.
- **Affordable housing in partnership:** Government offers financial assistance for housing in collaboration with the public and private sectors.
- **Credit Linked Subsidy:** Beneficiaries are to receive a loan worth Rs. 6 Lakh at an interest of 6.5% for 20 years.
- **Subsidy for the beneficiary-led individual house:** Government provides central assistance of Rs. 1.5 Lakh to the beneficiaries belonging to the EWS category.

## *National Food Security Act (NFSA)*

- Public Distribution System (PDS) is now governed by provisions of the National Food Security Act, 2013 (NFSA)
- This act encompasses the **Midday Meal Program, the Integrated Child Development Services Program** and the Public Distribution System. Furthermore, the NFSA 2013 recognises maternity benefits.
- The Act provides coverage for nearly 2/3$^{rd}$ of the country's total population, based on Census 2011 population estimates.
- 75% of rural and 50% of urban population is entitled to receive highly subsidized food grains under two categories i.e **Antyodaya Anna Yojana(AAY) households and Priority Households (PHH).**
- Stata/UT wise coverage is determined by the erstwhile Planning Commission which is now NITI Aayog on the basis of the 2011-12 Household Consumption Expenditure Survey of NSSO. Many states use the Socio-Economic Caste Census (SECC) data for the identification of beneficiaries.
- The Act entitles 35 kg of food grains as per **Antyodaya Anna Yojana Households** per month, whereas **5kg of food grains per Priority Households per person.**
- The eldest woman of the beneficiary household (18 years or above) is considered 'Head of Family' for the purpose of issuing ration cards.

## *Gram Swaraj Abhiyan (GSA)*

- "Sabka Sath, Sabka Gaon, Sabka Vikas" is the focus of the campaign.
- Its main goal is to promote social harmony, raise awareness about government pro-poor initiatives, reach out to poor households to enrol them and solicit feedback on various welfare programmes.
- The Gram Swaraj Abhiyan assists over **2.55 lakh Panchayati Raj Institutions (PRIs)** in developing governance capabilities through inclusive local governance and maximising the use of available resources.
- The scheme's implementation and monitoring activities are broadly aligned with the **Sustainable Development Goals** (SDGs), with a focus on Panchayats identified under **Mission Antyodaya and Aspirational districts identified** by NITI Aayog.
- This scheme will apply to all States and UTs in the country, as well as rural local government institutions in non-Part IX areas where Panchayats do not exist.
- It will create an institutional structure for PRI capacity building at the national, state and district levels, complete with adequate human resources and infrastructure.
- Priority will be given to national issues that have the greatest impact on excluded groups, such as poverty, primary health care, nutrition, immunisation and so on.
- Schemes include central components- **National Plan of Technical Assistance, Mission Mode Project on e-Panchayat** and incentivisation of Panchayats and State Components.

## *Pradhan Mantri Adarsh Gram Yojana (PMAGY)*

- The **Pradhan Mantri Adarsh Gram Yojana (PMAGY)** aims to integrate the development of selected villages with more than **50% Scheduled Caste (SC)** population by implementing existing schemes of the Central and State Governments in a convergent manner and utilising gap-filling funds provided as Central Assistance.
- The scheme was launched on a pilot basis in **2009-10** for the **integrated development of 1000 villages in five states:** Himachal Pradesh (Northern Region), Bihar (Eastern Region), Rajasthan (Western Region), Tamil Nadu (Southern Region) and Assam (North-Eastern Region).
- It was expanded in **2015 to include another 1500 villages** in Assam, Uttar Pradesh, Madhya Pradesh, Karnataka, Punjab, Odisha, Jharkhand, Chhattisgarh.
- Construction of village roads, community halls/meeting places, community toilets,

drainage works, installation of hand pumps, solar-powered street lights, drinking water scheme, programmes are undertaken under PMAGY in the identified States.

- Advisory Committees would be established at the Central and State levels to provide overall guidance and monitoring of the Scheme. The Union Minister of Social Justice and Empowerment would chair the Central Advisory Committee.

## *Pradhan Mantri Khanij Kshetra Kalyan Yojana (PMKKKY)*

- **Pradhan Mantri Khanji Kshetra Kalyan Yojana** is an All India scheme for all the tribals who have been affected by the mining operations which take place in the mining area. It was launched on 17th September 2015.
- Most of the **Scheduled Tribe people are inhabited in the mining areas.** And they are located in the regions according to the **Fifth Schedule of the Constitution.** And this help to the tribals will be done through the Funds which are generated by the **District Mineral Foundation (DMF's).**
- Objectives:
  - To improve and protect the health, natural environment and economic condition of the tribal people.
  - Provide the affected Tribal people with a lot of opportunities that benefit them from the vast minerals which are extracted from their inhabited areas.
  - To start welfare programs in the mining areas which are being affected. Also, these programs will go hand in hand with the existing schemes of the Central and State Governments.
  - To lower the impact of before and after mining work on the people. Also, to safeguard the environment in which the tribals are living.
  - To ensure the livelihood of the affected tribals in the mining area is long term and sustainable.

## *SVAMITVA scheme*

- **SVAMITVA (Survey of Villages and Mapping with Improvised Technology in Village Areas)** is a joint initiative of the **Ministry of Panchayati Raj, State Panchayati Raj Departments, State Revenue Departments and the Survey of India.**
- Its goal is to grant rural residents the **right to document their residential properties** so that they can use them for economic purposes.
- The plan is to use **drone technology** to survey land parcels in **rural inhabited areas.**
- The survey will be conducted in stages across the country between 2020 and 2025.
- The scheme would be a stepping stone towards achieving **Gram Swaraj** in its true sense and making rural India Atmanirbhar by facilitating the monetisation of properties and enabling bank loans, reducing property-related disputes and comprehensive village level planning.

## *Transformation of Aspirational Districts*

- The 'Transformation of **Aspirational Districts'** program intends to effectively transform the districts.
- Transformation of Aspirational Districts Program intends to **rapidly and adequately** change a portion of India's most underdeveloped regions.
- It will **distinguish zones of quick improvement,** measure progress and rank areas.
- Objectives:
  - It aims to **effectively and quickly transform** and evolve some of India's most underdeveloped districts.
  - It will identify areas of immediate improvement, rank districts and measure progress.

## *National Rurban Mission (NRuM)*

- On 22 February 2016, Prime Minister Narendra Modi inaugurated the **National Rurban Mission (NRuM)** in Rajnandgaon district of Chhattisgarh.

- The mission, also titled **“Shyama Prasad Mukherjee Rurban Mission”** (SPMRM), aims to spur economic, social and infrastructure growth in rural areas by developing a cluster of **300 Smart Villages** in the coming three years across our country in the first phase.
- Depending upon the betterment of the scheme, many more clusters will be identified. The project was announced in the Union Budget of 2014-15.
- NRuM is implemented by the **Union Ministry of Rural Development.**

## *Pradhan Mantri Gram Sadak Yojana (PMGSY)*

- **Pradhan Mantri Gram Sadak Yojana** is a scheme implemented by the Ministry of Rural Development. The scheme was launched in the year 2000.
- The main objective of the scheme is to construct all-weather roads connecting all the unconnected habitations.
- The scheme is **sponsored fully by the central government.** There is also an up-gradation component in the program that will further ensure full connectivity from market to farms. Since the inception of the scheme, the World Bank has been in its support.
- The third phase of the Pradhan Mantri Gram Sadak Yojana proposed to consolidate road length of **1,25,000 Km.**
- In Jammu and Kashmir, under PMGSY, more than 1800 roads of length, greater than, 11,000 kilometres and 84 bridges have been constructed.
- The road to **Kainthgali from supply** more provides an all-weather road to a well-known pilgrimage centre. The place is visited by lacs of tourists every year.
- The roads will connect major routes, **GrAMs**, hospitals and schools.

## *Sansad Adarsh Gram Yojana (SAGY)*

- Saansad Aadarsh Gram Yojana (SAGY) is a village development venture under which every Member of Parliament (MP) is responsible to build up the physical and socio-economic infrastructure in three villages each by 2019.
- The plan expects to create a total of eight 'Adarsh Villages' or 'Model Villages' by 2024.
- Objectives:
  - To work and chart the progress that leads to the comprehensive development of the recognized Gram Panchayats.
  - Improving the way of life and personal growth of all areas of the populace by improving the fundamental infrastructure, upgrading the human standard of living, making higher efficiency, giving better jobs, lessening differences and advancing social capital.
  - Producing models of development at the local level
  - To create good governance in Villages.
  - To motivate nearby Village Panchayats to focus on their development.

## *National Social Assistance Programme (NSAP)*

- The National Social Assistance Program is a health program that is controlled by the Ministry of Rural Development. This program is being executed in the rural ranges as well as urban zones.
- The National Social Help Program makes a difference for those in need by paying them each month in the form of social pensions.
- NSAP stands for National Social Assistance Program. NSAP was propelled on 15$^{th}$ August 1995.
- The National Social Assistance Program puts forward a significant step towards the attainment of the Directive Principles in Articles 41 and 42 of the Structure recognizing the parallel duty of the Central and the State Governments within the matter.
- In specific, Article 41 of the Structure of India directs the State to supply open help to its citizens in case of unemployment, old age, ailment and disablement and in other cases of undeserved need inside the constraints of its financial capacity and development.

## NITI Aayog task force on Poverty Elimination

- According to the decision made at the first meeting of the Governing Council of **NITI Aayog** on February 8, 2015, held under the chairmanship of **Prime Minister Narendra Modi,** NITI Aayog established a task force on poverty eradication in India on March 16, 2015, under the chairmanship of Arvind Panagariya.
- The current poverty estimates are based on the methodology recommended in 2009 by an expert group chaired by **Suresh D Tendulkar.**
- Those whose daily consumption of goods and services exceeds Rs 33.33 in cities and Rs 27.20 in villages are not poor, according to the Tendulkar committee methodology.
- According to statistics, only 22% of the people in the country are classified as poor.
- Members include one **NITI** member, a **CEA**, experts and secretaries from relevant ministries. **Parallel Task Forces** were to be established in each State/Union territory.

## Economic Inequality

- Economic inequality is the unequal distribution of income and opportunity between different groups in society.

## Types of Economic Inequality

- There are three main types of economic inequality:

### Income Inequality

- Income inequality is the extent to which income is distributed unevenly in a group of people.

### Income

- Income is not just the money received through pay, but all the money received from employment **(wages, salaries, bonuses etc.), investments,** such as **interest on savings accounts and dividends from shares of stock, savings, state benefits, pensions (state, personal, company)** and rent.
- Household income before tax that includes money received from the social security system is known as gross income. Household **income including all taxes and benefits is known as net income.**

## Pay Inequality

- A person's pay is different to their income. Pay refers to payment from employment only. This can be on an hourly, monthly or annual basis, is typically paid weekly or monthly and may also include bonuses. Pay inequality therefore describes the difference between people's pay.

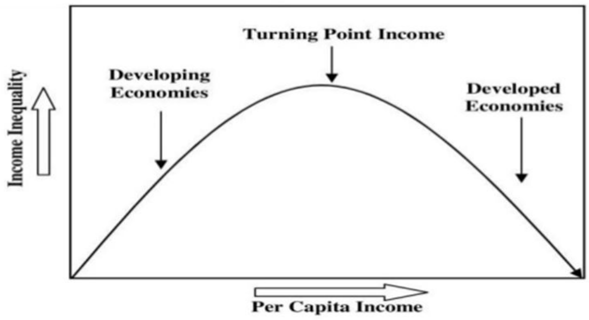
## Wealth Inequality

- Wealth refers to the total amount of assets of an individual or household. This may include financial assets, such as bonds and stocks, property and private pension rights. Wealth inequality therefore refers to the unequal distribution of assets in a group of people.

## Measures of Economic Inequality in India

**Kuznets Curve**

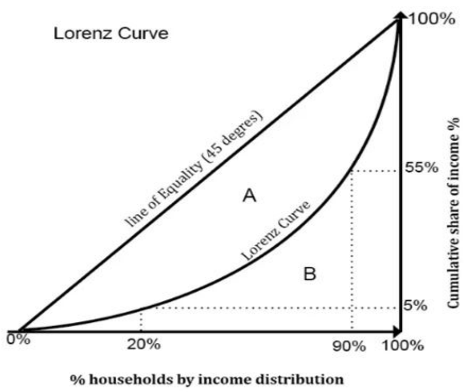
- Kuznets Curve is used to demonstrate the hyzpothesis that **economic growth initially leads to greater inequality, followed later by the reduction of inequality.** The idea was first proposed by American economist Simon Kuznets.
- As economic growth comes from the creation of better products, it usually boosts the income of workers and investors who participate in the first wave of innovation. The industrialization of an agrarian economy is a common example. This inequality, however, tends to be temporary as work ers and investors who were initially left behind soon catch up by helping offer either the same or better products. This improves their incomes.



**Lorenz Curve**

- The Lorenz curve is a way of showing the distribution of income (or wealth) within an economy. It was developed by Max O. Lorenz in 1905 for representing wealth distribution.
- The Lorenz curve shows **the cumulative share of income from different sections of the population.**
- The **further away from the bisector the curve is, the greater the inequality.**
- If there was perfect equality – if everyone had the same salary – the poorest 20% of the population would gain 20% of the total income. The poorest 60% of the population would get 60% of the income.
- The Lorenz Curve can be used to calculate the Gini coefficient - another measure of inequality.

Diagram of Lorenz curve




- In this Lorenz curve, the poorest 20% of households have 5% of the nation's total income.
- The poorest 90% of the population holds 55% of the total income. That means the richest 10% of income earners gain 45% of total income.
- In this example, there has been a reduction in inequality – the Lorenz curve has moved closer to the line of equality.
- The poorest 20% of the population now gain 9% of total income
- The richest 10% of the population used to gain 45% of total income but now only get 25% of total income.

## *Gender Inequality Index*

- The GII is an inequality index **released by UNDP.** It measures gender inequalities in three important aspects of human development-
  - **Reproductive Health,** measured by maternal mortality ratio and adolescent birth rates;
  - Empowerment, measured by proportion of parliamentary seats occupied by females and proportion of adult females and males aged 25 years and older with at least some secondary education; and
  - **Economic status,** expressed as labour market participation and measured by labour force participation rate of female and male populations aged 15 years and older.
- The GII is built on the same framework as the IHDI-to better expose differences in the distribution of achievements between women and men.
- It measures the human development costs of gender inequality. Thus the higher the GII value the more disparities between females and males and the more loss to human development.

# 5 INDIAN PLANNING

## Economic Planning

- **Economic planning** is a **resource allocation method** based on a strategy for addressing a restricted maximizing problem with an iterative solution.
- In contrast to the market process, planning is a system for allocating resources between and within organizations.
- Since the introduction of planning into the world of economics, economists have come up with a variety of definitions. However, many of them think that **H. D. Dickinson's** formulation is the most important.
- According to him, economic planning is **"the making of major economic decisions - what and how much is to be produced and to whom it is to be allocated by the conscious decision a determinate authority, on the basis of a comprehensive survey of the economic system as a whole".**

## Types of Economic Planning

### Planning by Direction and Planning by Inducement

- **Planning by direction,** which is an inherent feature of socialist society, involves the **complete absence of a laissez-faire system.** One central authority plans directs and executes according to predetermined economic priorities under this style of economic planning.
- **Planning by Inducement,** on the other hand, is **more democratic in nature. It entails market manipulation for the sake of planning.** Although there is no obligation, planning by enticement employs some persuasion techniques.
  - Enterprises have production and consumption independence under this sort of planning. However, the state uses rules and methods to manage and regulate these freedoms.

### Financial Planning & Physical Planning

- Resource allocation in **financial planning is done in terms of money** and it is **critical to eliminate supply and demand misalignments.** As a result, it is critical in maintaining a supply-demand balance and regulate inflation in order to achieve economic stability in the country.
- The allocation of resources in **physical planning is done in terms of persons, machinery and materials.** To guarantee that bottleneck situation are avoided during the execution of the plan, an overall assessment of the available resources is conducted. It is regarded as a method of long-term planning.

### Indicative Planning & Imperative Planning

- The operation and execution of plans are based on the principle of decentralization in indicative planning. The private sector is neither entirely regulated nor directed to accomplish the plan's objectives under this style of planning. However, it is projected to meet those goals. The government assists the private sector in this endeavor but does not direct it in any way.
- In **imperative planning,** on the other hand, the **government has complete control over all economic operations.** The government has complete control over the production factors. Even the private sector is required to follow the government's strict policies and choices.

### Rolling Plans & Fixed Plans

- Every year, three plans are set up and implemented as part of a rolling plan. The **first is an annual plan, which involves planning**

**for a single year; the second is a 5-year plan; and the third is a 15-year plan,** which includes bigger goals and objectives that are aligned with prior year planning.

- **A fixed plan, in contrast to a rolling plan, refers to preparing for a specific length of time, such as four, five or ten years ahead.** It provides specific goals and objectives that must be completed in a specific time frame. Unless there is an emergency, the annual objectives are met (those listed in the fixed plan).

### Centralized & Decentralized Planning

- Planning is considered a limiting prerogative of the **central planning authority under the centralized planning system.** The plan's formulation, as well as its objectives, targets and priorities, are completely the responsibility of this authority. There is no economic liberty and all economic planning is controlled by bureaucrats.
- Decentralized planning, on the other hand, refers to the **execution of a plan from the ground up.** The central planning body formulates the plan in conjunction with the various administrative entities for the central and state schemes in this style of **planning. The plan for district and village levels is created by the state planning authority.**

## Economic Planning

### Economic Planning in India

- Sir M. Visvesvaraya, a civil engineer and ex-dewan of the state of Mysore, published "The Planned Economy of India" in 1934, which was the first attempt to establish economic planning in India.
- The **Planning Commission, which was replaced by NITI Aayog on January 1, 2015,** is responsible for economic planning in India.
- The NITI Aayog (National Institution for Transforming India) was founded with the intention of accomplishing long-term development goals through cooperative federalism.
- The history of economic planning in India is interesting, from the formation of NITI Aayog through the replacement of the Planning Commission's 5-Year Plan with a **15-Year Vision document.**

### Bombay Plan

- With the support of a few economists, India's major businessmen, including JRD Tata and GD Birla, devised the **Bombay Plan in 1944.**
- The industrialists were a diverse group, with some **having strong ties to the Congress (Birla, Thakurdas and Lalbhai).**
- Despite their friendship with Gandhiji, they did not support his mass-mobilization politics.
- Despite their differences, they were **united in their opposition to Nehru's command economy model,** which he called "socialist."
- The Bombay Plan envisioned the government playing a significant role in the economy and the **creation of a Central Planning Authority.**
- In the 1940s, the intellectual atmosphere in the West was favorable to a large state role in the economy, therefore a group of industrialists pushed for such a broad role for the state in the economy.
- Indian industrialists likewise believed that they lacked the financial muscle to undertake large-scale projects, therefore the government was forced to take action.

### Gandhian Plan

- Gandhiji was **never a supporter of centralization, industrialization or state control over the economy.** In his opinion, **agriculture should be prioritized and decentralization and self-contained settlements should be encouraged.**
- These qualities were proposed as part of the Gandhian agenda. The strategy was to concentrate on agriculture and industry, but only agri-based small and cottage businesses. Because they are reliant on agriculture.
- The **NPC, on the other hand, was opposed to this idea and an impasse was avoided**

**when Nehru reassured the Gandhians that industrialization would not come at the expense of cottage enterprises.** This plan also stressed public engagement, which was absent from the NPC plan, which focused on constructing a power structure and establishing a top-down planning system.

- India's planning system was **designed to fulfill socio-economic objectives.** However, planning was primarily focused on achieving economic goals (growth, poverty reduction, job creation and so on), while social goals were left to the political process to address. As a result, issues such as reservations in school and employment, land reforms and inter-caste marriages are not covered by planning.

## *People's Plan*

- **M. N. Roy drafted the People's Plan in 1945,** which was created by the **Indian Federation of Labour's Post-War Re-Construction Committee.**
- The People's **Plan emphasizes consumer products manufacturing** in the industrial sector. It is suggested that because a major portion of the community's need for basic goods is continually unmet, the goal of the planned economy in the industry must be to meet that demand first.
- In a planned economy, the **People's Plan places a high value on railways, roads and shipping.** As a result, it urges the quick construction of communication and transportation infrastructure to cope with the increased movement of commodities and traffic between cities and dry regions.

## *Sarvodaya plan*

- After the reports of the National Planning Committee (NPC) and the government's commitment to the five-year plans, the famous socialist leader **Jaiprakash Narayan** devised a single blueprint for India's planned development, the **Sarvodaya Plan,** which was published in **January 1950.**
- The Gandhian techniques of constructive works by the community and **trusteeship**, as well as the Sarvodaya concept of **Acharya Vinoba Bave,** the prominent Gandhian constructive worker, were important influences on the scheme.
- The plan also advocated for a Luddite approach to technology and was skeptical about the use of foreign technologies.

## *Planning Commission*

- The Planning Commission of India was a government institution that, among other things, **formulated India's Five-Year Plans.** The planning commission was tasked with ensuring that everyone had the opportunity to work in the community's service.
- The Planning Commission was **directly responsible to India's Prime Minister.** It was founded on March 15, 1950, under the chairmanship of Prime Minister Jawaharlal Nehru. The Planning Commission was established by the Central/Union Government and was **not established by the Constitution or statute.**
- In March 1950, the Government of India passed a resolution establishing the Planning Commission. The **government's main goals were to push a quick rise in Indians' living standards through profitable exploitation of the country's resources**, increased output and providing chances for everyone to work in the service of society.
- The Planning Commission was tasked with evaluating all of the country's resources, enhancing precious resources, **making plans for the most productive and balanced use of resources** and determining priorities. The first Chairman of the Planning Commission was Pandit Nehru.

## *Background*

- The first Five-Year Plan was started in 1951 and Five-Year Plans were developed until 1965 when the conflict with Pakistan caused a gap. Drought for two years in a row, rupee depreciation, general price increases and resource depletion disrupted the planning process and the $4^{th}$ Five-year plan began in 1969, after three **Annual Plans from 1966 to 1969.**

- Due to changing political circumstances and instabilities at the Centre, the 8th Plan was not introduced in 1990 and the years 1990-91 and 1991-92 were given Annual Plans. After the government began its **economic liberalisation initiatives in 1992, the 8th Plan was ultimately launched.** The focus of the first eight Plans was on a growing public sector with enormous expenditures in heavy and fundamental industries, but following the publication of the **Ninth Plan in 1997, the focus turned away from heavy industries** and toward the idea that planning should be most suggestive in character.

## *Composition of Planning Commission*

- **Chairman –** Prime Minister; presided over the meetings of the Commission
- **Deputy Chairman –** de facto executive head (full-time functional head);
  - Was in charge of drafting and submitting the draft Five-Year Plan to the Cabinet of Ministers.
  - The Central Cabinet appointed him for a defined term and he held the position of a Cabinet Minister.
  - Without the ability to vote, he or she might attend cabinet sessions.
- **Part-time members –** Some Central Ministers
- **Ex-officio members –** Finance Minister and Planning Minister

## *Functions of Planning Commission*

- Make an **assessment of the nation's capital, material and human resources,** including technical personnel and look into ways to improve these resources for the nation's development.
- **Prepare a plan** for the most efficient and balanced use of the country's resources.
- Define the stages in which the Plan shall be implemented, as well as the resources required to complete each stage;
- Determine the **causes that impede economic development** and the circumstances that, in light of the current social and political environment, should be established to ensure the Plan's successful execution.
- Determine the **type of machinery required for each step of the Plan** to be completed successfully in all aspects;
- Regularly **assess the success made in implementing the Plan** at all phases and offer any policy or measure corrections or changes that such an assessment may find essential;
- Make **interim or supplementary recommendations** to enable it to carry out the responsibilities entrusted to it or based on a review of current economic conditions, policies, measures and development plans or a study of specific problems that the Central or State Governments may refer to it.

## *Why was the Planning Commission dissolved?*

- In contrast to the Commission, which imposed five-year plans and assigned resources to meet specified economic targets, **promoters of the new National Institution for Transforming India (NITI) argue it will work more like a think tank or forum.**
- The **leaders of India's 29 states** and seven union territories will be **represented at NITI Aayog.** However, the full-time team, which includes a deputy chairman, CEO and experts, will report directly to the Prime Minister, who will serve as Chairman.
  - It differs from the National Development Council's planning commission, which used to report to it.
- The major difference between the NITI Aayog and the Planning Commission's **approaches to planning** is that the former will encourage increased state participation, whereas the latter will took a **top-down approach with a one-size-fits-all plan.**
- The Planning Commission's duty was to formulate broad policy and serve as an advisory body.
  - The NITI Aayog would be in **charge of allocating resources to states based on their requirements.**
- Policy planning, which was the responsibility of the Planning Commission, had minimal direct input from the states.

- The states were involved indirectly through the National Development Council; this will not happen again in the NITI Aayog.

**Question: Consider the following statements:**
**[UPSC 2004]**

1. The highest deciding body for planning in India is the Planning Commission of India.
2. The Secretary of the Planning Commission of India is also the Secretary of the National Development Council.
3. The Constitution includes economic and social planning in the Concurrent List in the Seventh Schedule of the Constitution of India.

Which of the statements given above is/are correct?
(a) 1 and 2 (b) 2 and 3
(c) 2 only (d) 3 only

## *National Development Council*

- The National Development Council (NDC) is the country's "highest decision-making authority" on development issues
- The National Development Council is one of India's most important planning institutions.
- It represents the **federal approach to planning** and serves as a check to ensure that the planning system is really national in scope.
- One of the most important decisions it made was the **introduction of "special category" States (as part of the Gadgil-Mukherjee exercise)** and the criteria for deciding whether a State could acquire the designation and corresponding financial support from the Centre.
- A **Cabinet resolution established the National Development Council.**
- It was once made up of the Prime Minister, the State Chief Ministers and members of the Planning Commission. Pandit Jawahar Lal Nehru, India's first Prime Minister, remarked at the NDC's first meeting on November 8-9, 1952, that the NDC is mainly a platform for **"intimate cooperation" between State governments and the Centre** for all national development responsibilities.
- On October 7, 1967, the NDC was reorganised and its tasks were specified based on suggestions from the Administrative Reforms Commission.
- **The Prime Minister, the Union Cabinet Ministers, Chief Ministers of all States and Union Territories and Members of the Planning Commission made up the reformed NDC.**
- The government **intends to scrap** the **Nehruvian legacy: the National Development Council (NDC).**
    - The Cabinet will take up its closure and will also pass a resolution transferring its powers to the Governing Council of the NITI Aayog.

**Question: Consider the following statements:**
**[UPSC 2013]**

1. The National Development Council is an organ of the Planning Commission.
2. The Economic and Social Planning is kept in the Concurrent List in the Constitution of India.
3. The Constitution of India prescribes that Panchayats should be assigned the task of preparation of plans for economic development and social justice.

Which of the statements given above is/are correct?
(a) 1 only (b) 2 and 3 only
(c) 1 and 3 only (d) 1, 2 and 3

**Comparison between NITI Aayog and NDC**

| Parameter | NITI Aayog | National Development Council |
|---|---|---|
| **Purpose** | A policy think tank and a government advisory organisation. | The country's highest decision-making authority on development issues and is a Planning institution. |
| **Composition** | The Governing Council of NITI Aayog comprises the Hon'ble Prime Minister of India; Chief Ministers of all the States and Union Territories with the legislature; Lt Governors of other UTs; Ex-Officio Members; Vice Chairman, NITI Aayog; Full-Time Members, NITI Aayog; and Special Invitees. | The Prime Minister, the Union Cabinet Ministers, Chief Ministers of all States and Union Territories and Members of the Planning Commission |
| **Formation** | By Executive resolution | By cabinet resolution |
| **Function** | To actively monitor and evaluate the implementation of programmes and initiatives | To prescribe guidelines for the formulation of the National Plan, including the assessment of resources for the Plan |

> **Q. The Government of India has established NITI Aayog to replace the [UPSC 2015]**
> (a) Human Rights Commission
> (b) Finance Commission
> (c) Law Commission
> (d) Planning Commission

## *Five Year Plan*

### *First Five Year Plan*

- It was established under the leadership of **Jawaharlal Nehru from 1951 to 1956.**
- It was based on the **Harrod-Domar model**, but with some modifications.
- Its main focus was on the country's agricultural development.
- This plan was a success, with a 3.6% growth rate (more than its target of 2.1%).
- At the conclusion of this strategy, the country had five IITs.

> **Q. Who among the following constitute the National Development Council? [UPSC 2013]**
> 1. The Prime Minister
> 2. The Chairman, Finance Commission
> 3. Ministers of the Union Cabinet
> 4. Chief Ministers of the States
>
> Select the correct answer using the codes given below:
> (a) 1, 2 and 3 only (b) 1, 3 and 4 only
> (c) 2 and 4 only (d) 1, 2, 3 and 4

### *Second Five Year Plan*

- It was established between **1956 and 1961,** under **Jawaharlal Nehru's leadership.**
- It was created using the P.C. Mahalanobis Model from 1953.
- Its main focus was on the country's industrial development.
- This plan fell short of its target growth rate of 4.5%, achieving 4.27% instead.
- However, many experts rejected this idea and India suffered a payment problem in 1957 as a result.

### *Third Five Year Plan*

- It was created between 1961 and 1966, under Jawaharlal Nehru's leadership.
- The plan is also known as the **'Gadgil Yojna,'** after **D.R. Gadgil, the Deputy Chairman of the Planning Commission.**
- The plan's principal goal was to make the **economy self-sufficient. Agriculture was emphasized,** as was the improvement in wheat production.
- India was involved in two wars during the implementation of this plan: (1) the Sino-India conflict of 1962 and (2) the Indo-Pakistani war of 1965.
- These battles exposed our economy's weaknesses and moved attention to the defense industry, the Indian Army and price stabilization (India witnessed inflation).
- Due to wars and drought, the plan failed. The target growth rate was 5.6%, but the actual rate was only 2.4%.

### *Plan Holidays*

- From **1966 to 1969,** the government announced three annual plans known as Plan Holidays in response to the failure of the previous plan.
- The **Indo-Pakistani and Sino-Indian wars** were the primary causes of the plan's cancellation, resulting in the failure of the third Five-Year Plan.
- Annual plans were made during this period and agriculture, its related sectors and the industry sector were given equal attention.
- In order to boost the country's exports, the government announced a rupee devaluation.

### *Fourth Five Year Plan*

- Under the leadership of Indira Gandhi, it lasted from **1969 to 1974.**
- This plan had two primary objectives: expansion with stability and gradual self-sufficiency.
- 14 major Indian banks were nationalized during this period and the Green Revolution began. The 1971 Indo-Pakistani War and the Bangladesh Liberation War occurred.
- One of the Plan's major goals was to implement family planning programs.
- This plan failed, with a growth rate of only 3.3% compared to the aim of 5.7%.

### *Fifth Five Year Plan*

- It lasted from **1974 to 1978.**

- The Garibi Hatao, employment, justice, agricultural output and defense were all prioritized in this plan.
- In 1975, the Electricity Supply Act was changed, a Twenty-Point Program was started, the Minimum Needs Programme (MNP) was established and the Indian National Highway System was established.
- This plan was overall successful, with a growth rate of 4.8% vs the aim of 4.4%.
- The freshly elected Moraji Desai government put an end to this scheme in 1978.

### *Rolling Plan*

- The Rolling Plan had effect from 1978 to 1990, following the end of the fifth Five-Year Plan.
- The Rolling Plan was rejected by Congress in 1980 and a new sixth Five-Year Plan was introduced.
- Under the Rolling plan, three plans were introduced:
  1. This plan was for the current fiscal year's budget;
  2. It was for a definite number of years- 3, 4 or 5 years;
  3. It was a long-term perspective plan- 10, 15 or 20 years.
- The plan has various advantages, including the ability to change targets and the ability to adapt projects, allocations and other aspects of the plan to the economy of the country. This indicates that if the aims can be changed each year, it will be difficult to meet the goals and the market will become unstable.

### *Sixth Five Year Plan*

- Under the leadership of Indira Gandhi, it lasted from **1980 until 1985.**
- The plan's main goal was to achieve economic liberalization by eliminating poverty and creating technological self-sufficiency.
- It was built on Yojna investment, infrastructure changes and a growth model trend.
- Its target growth rate was 5.2%, but it really grew at 5.7%.

### *Seventh Five Year Plan*

- It lasted from 1985 to 1990 and Rajiv Gandhi was the Prime Minister during that time.
- This plan's aims include the creation of a self-sufficient economy, possibilities for gainful employment and technological advancement.
- With a focus on 'food, work and productivity,' the Plan planned to increase foodgrain output, increase employment possibilities and raise productivity.
- The private sector was given precedence over the public sector for the first time.

### *Annual Plans*

- Because of the volatile political climate in the country's capital, the Eighth Five-Year Plan could not be implemented.
- For the years **1990-91 and 1991-92,** two annual programs were established.

### *Eighth Five Year Plan*

- It lasted from **1992 to 1997, with P.V. Narasimha Rao** as its leader.
- The development of human resources, such as employment, education and public health, was given primary importance in this strategy.
- The New Economic Policy of India was launched by the Narasimha Rao government during this plan.
- Rapid economic growth (highest annual growth rate so far - 6.8%), high growth in agriculture and allied sectors and manufacturing sector, growth in exports and imports and improvement in trade and current account deficit were some of the significant economic outcomes during the eighth plan period. Despite the fact that the public sector's portion of total investment had fallen to around 34%, a strong growth rate was attained.
- This plan was a success, with an annual growth rate of 6.8% compared to the aim of 5.6.%

### *Ninth Five-Year Plan*

- Under the leadership of **Atal Bihari Vajpayee, it lasted from 1997 to 2002.**
- The plan's main goal was **"Growth with Social Justice and Equality."**

- It was launched on the $50^{th}$ **anniversary of India's independence.**
- This strategy fell short of its 6.5% growth target, achieving a rate of 5.6% instead.

### *Tenth five-year plan*

- It lasted from **2002 to 2007, with Atal Bihari Vajpayee and Manmohan Singh as its leaders.**
- The goal of this strategy was to double India's per capita income in the next ten years.
- It aimed to get the poverty rate down to 15% by 2012.
- Its goal growth rate was 8.0%, but it only reached 7.6%.

> **Q. Inclusive growth as enunciated in the Eleventh Five Year Plan does not include one of the following:**
> (a) Reduction of poverty
> (b) Extension of employment opportunities
> (c) Strengthening of capital market
> (d) Reduction of gender inequality

### *Eleventh Five-Year Plan*

- It lasted from **2007 to 2012 and Manmohan Singh was the Prime Minister during that time.**
- C. Rangarajan was in charge of preparing it.
- The main focus of the conference was **"rapid and more inclusive growth."**
- It grew at an annual pace of 8%, compared to a projection of 9% growth.

### *Twelfth Five-Year Plan*

- It lasted from **2012 to 2017, with Manmohan Singh as its head.**
- The main focus of the conference is "Faster, More Inclusive and Sustainable Growth."
- Its target growth rate was set at 8%.

> **Q. In the context of India's Five Year Plans, a shift in the pattern of industrialization, with a lower emphasis on heavy industries and more on infrastructure begins in**
> (a) Fourth Plan (b) Sixth Plan
> (c) Eighth Plan (d) Tenth Plan

### *NITI Aayog - Historical Background*

- The **Government of India constituted NITI Aayog** to envisage the vision of "Maximum Governance, Minimum Government". **It replaced the Planning Commission,** which had been instituted in 1950. This step was taken to better serve the needs and aspirations of the people.
- The Planning Commission was **established as a body to direct investment activity** in a country.
- The Planning Commission of India had **two major responsibilities**: to implement the five-year plan and to offer financial assistance to the state.
- An important evolutionary change, NITI Aayog acts as the quintessential platform of the Government of India to bring the States to act together in national interest and thereby fosters cooperative federalism.

### *NITI Aayog - Functions*

- NITI Aayog acts to allow States to deepen their policy engagement with the Central Government.
- The **Aayog planned to come out with three documents:** 3-year action agenda, 7-year medium-term strategy paper and 15-year vision document.
- **NITI Aayog is meant to serve as a state-of-the-art resource centre for research on policy innovations, propagate a culture of high-quality monitoring and evaluation as well as promote collaboration between policymakers and researchers.**
- In a paradigmatic shift from the command and control approach of the past, NITI Aayog accommodates diverse points of view in a collaborative, rather than confrontation, setting. In the spirit of federalism, NITI's own policy thinking is shaped by a bottom-up approach rather than a top-down model.
- **Need for NITI Aayog:** The majority of the criticism directed at the planning commission was that it imposed its development strategy on nations without their active participation and without taking into account their social and economic differences. The planning commission adopted a one-size-fits-all answer.
- **Aim of NITI Aayog:** Promoting the

involvement of Indian state governments in the economic policy-making process via a bottom-up strategy to accomplish Sustainable Development Goals and strengthen cooperative federalism.

- **NITI Aayog is based on the seven pillars of effective governance.**
- Pro-people: it fulfills the aspirations of society as well as individuals
- **Pro-activity:** in anticipation of and response to citizen needs
- **Participation:** involvement of the citizenry
- **Empowering:** Empowering, especially women in all aspects.
- **Inclusion of all:** inclusion of all people irrespective of caste, creed and gender
- **Equality:** Providing equal opportunity to all especially for youth
- **Transparency:** Making the government visible and responsive

## *Two Hubs of NITI Aayog*

- **At the core of NITI Aayog's creation are two hubs:**
- Team India Hub; and
- Knowledge and Innovation Hub.
- The Team India Hub leads the engagement of states with the Central government, while the Knowledge and Innovation Hub builds NITI's think-tank capabilities.

## *Organisation of NITI Aayog*

- The **Prime Minister is the ex-officio Chairman** of the Aayog.
- A full-time organizational setup consists of a **Vice-Chairperson.**
- Three full-time members.
- Two part-time members from leading Universities or Research Organisations.
- **Four ex-officio members** of the Union Council of Ministers which is to be nominated by the Prime Minister.
- A **Chief Executive Officer** with the **rank of Secretary** to the Government of India who looks after administration.
- A Secretariat as deemed necessary.

## *Composition of NITI Aayog*

- Prime Minister of India is the Chairperson
- **The Governing Council** includes Chief Ministers of all States and Lt. Governors/ Administrators of the Union Territories.
- Regional Councils will be created to address particular issues and possibilities affecting more than one state. **These will be formed for a fixed term**. It will be convened by the Prime Minister. It will consist of the Chief Ministers of States and Lt. Governors of Union Territories. These will be chaired by the Chairperson of the NITI Aayog or his nominee.
- **Special invitees:** Eminent experts, specialists with relevant domain knowledge, which will be nominated by the Prime Minister.

## *The objective of NITI Aayog*

- To evolve a shared vision of national development priorities, sectors and strategies with the active involvement of States.
- To foster cooperative federalism through structured support initiatives and mechanisms with the States on a continuous basis, recognizing that strong States make a strong nation.
- To develop mechanisms to formulate credible plans at the village level and aggregate these progressively at higher levels of government.
- To ensure, in areas that are specifically referred to, that the interests of national security are incorporated in economic strategy and policy.
- To pay special attention to the sections of our society that may be at risk of not benefiting adequately from economic progress.
- To design strategic and long-term policy and program frameworks and initiatives and monitor their progress and their efficacy. The lessons learnt through monitoring and feedback will be used for making innovative improvements, including necessary mid-course corrections.
- To provide advice and encourage partnerships between key stakeholders and national and international like-minded think tanks, as well as educational and policy research institutions.

- To create a knowledge, innovation and entrepreneurial support system through a collaborative community of national and international experts, practitioners and other partners.
- To offer a platform for the resolution of inter-sectoral and inter¬ departmental issues in order to accelerate the implementation of the development agenda.
- To maintain a state-of-the-art resource centre, be a repository of research on good governance and best practices in sustainable and equitable development as well as help their dissemination to stakeholders.
- To actively monitor and evaluate the implementation of programs and initiatives, including the identification of the needed resources so as to strengthen the probability of success and scope of delivery.
- To focus on technology up-gradation and capacity building for the implementation of programs and initiatives.
- To undertake other activities as may be necessary in order to further the execution of the national development agenda and the objectives mentioned above.

### *Aspirational Districts Programme of NITI Aayog*

- It aims to quickly and effectively transform some of the most underdeveloped districts of the country.
- **Launched** in January 2018.
- The broad contours of the program are Convergence (of Central & State Schemes), Collaboration (of Central, State level 'Prabhari' Officers & District Collectors) and Competition among districts driven by a Mass Movement or Jan Andolan.
- With States as the main drivers, this program will focus on the strength of each district, identify low-hanging fruits for immediate improvement, measure progress and rank districts.
- Selection of districts
  - NITI Aayog Identified: 117 Aspirational districts based upon composite indicators.
- **Indicators:**
  - Health & Nutrition (30%),
  - Education (30%),
  - Agriculture & Water Resources (20%),
  - Financial Inclusion and Skill Development (10%) and
  - Basic Infrastructure (10%).

### *Achievements and Initiative of NITI Aayog*

- Measuring performance and ranking States on outcomes in critical sectors and ensuring that the growth process of India must be inclusive. India's growth process remains inclusive.
- The Governing Council of NITI Aayog has **promoted Zero Budget Natural Farming.**
- The concept of **a village storage scheme has been developed.** Similarly, the Dhaanya Lakshmi Village Storage Scheme was suggested in the Union Budget 2021, although it has yet to be implemented.
- **Promoting the adoption of frontier technology like Artificial Intelligence, blockchain, the Methanol economy** etc.
- Promote entrepreneurial and innovation ecosystem: Atal Innovation Mission, which established Atal Tinkering Labs in India, has already done commendable work in improving the innovation ecosystem in India, Global Entrepreneurship Summit 2017 – Women First: Prosperity for All, Women Entrepreneurship Platform.
- **Launch a mission "Explore in India"** by revamping minerals exploration and licensing policy.
- **NITI Aayog Identified:** 117 Aspirational districts based upon **composite indicators**.

### *How far NITI Aayog different from Planning Commission*

- It has a **structure similar to the Planning Commission, but its functions will be limited to only acting as a policy think-**tank relieving it of the two more functions viz., the allocation of funds to the States and project evaluation of the Ministers that the Planning Commission used to perform.

- Evidence-informed policy and practice could provide the NITI Aayog with a distinct and effective approach to meet its mandate. It is an **approach that aims to integrate the best available scientific evidence into the design of public policies.**

## *Challenges in NITI Aayog*

- To achieve these in practice will require the NITI Aayog to overcome the two key challenges.
- Access high-quality researchers in multiple disciplines who can partner with policymakers.
- Creating a willingness among policymakers to learn from evidence.
- There are other many challenges ahead for NITI Aayog, the most significant of which is bringing all stakeholders on board to fully realize the aspirations of the common man and bring development to the village level by enacting policies that are people-centric or it will simply be old wine in new bottles.
- NITI Aayog has **no powers in granting discretionary funds to states,** which renders it toothless to undertake a transformational intervention.
- It acts as an **advisory body only** that advises the government on various issues without ensuring the enforceability of its ideas.

## *Millennium Development Goals*

The United Nations in September 2000 made all its members follow a Millennium Development goal that had a series of eight time-bound targets that were supposed to be attained within a time period of fifteen years. The eight targets under the Millennium Development Goal are as mentioned below:

1. To eradicate extreme poverty and hunger
2. To achieve universal primary education
3. To promote gender equality and empower women
4. To reduce child mortality
5. To improve maternal health
6. To combat HIV/AIDS, malaria and other diseases
7. To ensure environmental sustainability
8. To develop a global partnership for development

In 2015, a final report was handed over to the UN, stating the positive impact of the Millennium Development goal based on the eight factors and also on the maternal mortality rate. Once the 15-year target of MDG was attained, the responsibility for the development based on the 17 targets based Sustainable Development Goal.

## *Sustainable Development Goals*

The Sustainable Development Goals are a set of seventeen pointer targets that all the countries which are members of the UN agreed to work upon for the better future of the country..

The documentary screened at the Rio+20 conference – "Future We Want" presented the idea of a post-2015 development agenda. Sustainable Development Goals (SDGs) is an intergovernmental agreement formulated to act as post-2015 Development agenda, its predecessor being Millennium Development Goals.

It is a group of 17 goals with 169 targets and 304 indicators, as proposed by the United Nation General Assembly's Open Working Group on Sustainable Development Goals to be achieved by 2030. Post negotiations, agenda titled "Transforming Our World: the 2030 agenda for Sustainable Development" was adopted at the United Nations Sustainable Development Summit. SDGs is the outcome of the Rio+20 conference (2012) held in Rio De Janerio and is a non-binding document.

The 17 goals under the Sustainable Development Goals are as mentioned below:

1. End poverty in all its forms everywhere.
2. End hunger, achieve food security and improved nutrition and promote sustainable agriculture.
3. Ensure healthy lives and promote well being for all at all stages.
4. Ensure inclusive and equitable quality education and promote lifelong learning opportunities for all.
5. Achieve gender equality and empower all women and girls.

6. Ensure availability and sustainable management of water and sanitation for all.
7. Ensure access to affordable, reliable, sustainable and modern energy for all.
8. Promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all.
9. Built resilient infrastructure, promote inclusive and sustainable industrialisation and foster innovation.
10. Reduce inequalities within and among countries.
11. Make cities and human settlements inclusive, safe, resilient and sustainable.
12. Ensure sustainable consumption and production pattern.
13. Take urgent actions to combat climate change and its impact.
14. Conserve and sustainably use the oceans, seas and marine resources.
15. Protect, restore and promote sustainable use of terrestrial ecosystems, sustainably managed forests, combat desertification and halt and reverse land degradation and halt biodiversity loss.
16. Promote peaceful and inclusive societies for sustainable development, provide access to justice for all and build effective, accountable and inclusive institutions at all levels.
17. Strengthen the means of implementation and revitalise the global partnership for sustainable development.

## *Sustainable Development Goals in India*

India's record in implementing Sustainable Development Goals

- Mahatma Gandhi National Rural Employment Guarantee Act (MNREGA) is being implemented to provide jobs to unskilled labourers and improve their living standards.
- National Food Security Act is being enforced to provide subsidized food grains.
- The government of India aims to make India open defecation free under its flagship programme Swachh Bharat Abhiyan.
- Renewable energy generation targets have been set at 175 GW by 2022 to exploit solar energy, wind energy and other such renewable sources of energy efficiency and reduce the dependence on fossil fuels.
- Atal Mission for Rejuvenation and Urban Transformation (AMRUT) and Heritage City Development and Augmentation Yojana (HRIDAY) schemes have been launched for improving the infrastructure aspects.
- India has expressed its intent to combat climate change by ratifying the Paris Agreement.

# 6 MONEY

## Meaning of Money

- Money is a commonly accepted medium of exchange.
- Money is anything that can be generally accepted as payment for goods and services or settlement of debts.
- Money is the most liquid (it is easy to sell in the market like gold, silver etc.) of all assets in the sense that it is universally acceptable and hence can be exchanged for other commodities very easily.

## EVOLUTION OF MONEY

1. **Barter System**
   - Money as a medium of exchange was not used in early human history since households were self-sufficient and there was little exchange of goods.
   - Whatever exchange occurred between the households was done through barter or the exchange of goods for other goods.
   - As there was no common unit of account and medium of exchange, the barter system did not allow for direct purchases of goods.
   - The problem with a barter system is that in order to obtain a specific good or service from a supplier, one must also have a good or service of equal value that the supplier desires.
   - In other words, in a barter system, the exchange can occur only if two transacting parties have a **double coincidence of wants.**
   - The likelihood of a double coincidence of wants is quite low and making the exchange of goods and services rather difficult.
   - To solve the problems of barter trade, early humans devised a payment and exchange system that allows the direct purchase of goods using any instrument that has the following characteristics:
     - Unit of account
     - High Liquidity
     - Possible to store
     - It must be desired by all (It should have high demand)
     - It is easily exchangeable (Medium of Exchange)
2. **Commodity Money**
   - In the beginning, there were only a few commodities that were required by everyone.
   - Commodities such as **arrows, bows and seashells,** which are mostly used for hunting, became the first form of medium of exchange and thus acted as money.
   - When early humans transitioned from hunting to agriculture in the second stage of evolution, animals such as **cattle, goats and sheep** became a medium of exchange and acted as money.
   - Since commodities have limitations such as a lack of a standard unit of account, limited supply and natural factors etc. their use was limited and was eventually replaced by other forms of money.
3. **Metallic Money**
   - Commodity money evolved into metallic money as human civilization progressed.
   - Metals such as **gold, silver, copper** and others were used because they could be easily handled and quantified. It was the primary form of money for the majority of recorded history.
   - With the passage of time and technological advancements, the hard form of gold and silver was replaced by a coinage system (gold and silver coins) that was widely used as money.

4. **Paper Money**
   - It was discovered that transporting gold and silver coins was both inconvenient and dangerous. As a result, the invention of paper money marked a watershed moment in the evolution of money.
   - The country's **central bank** regulates and controls paper money (RBI in India).
   - At the moment, a large portion of the money is made up of **currency notes** or paper money issued by the central bank.
5. **Credit Money**
   - The emergence of credit money occurred almost concurrently with the emergence of paper money.
   - People keep a portion of their cash in bank deposits, which they can withdraw at their leisure via cheques.
   - The cheque (also known as credit money or **bank money**) is not money in and of itself, but it serves the same functions as money.
6. **Plastic Money**
   - Plastic money, such as credit and debit cards, is the most recent type of money. They intend to do away with the need to carry cash when conducting transactions.
7. **Mobile Payments**
   - Mobile payments are payments made for goods or services using a portable electronic device such as a cell phone, smartphone or tablet.
   - Money can also be sent to friends and family members using mobile payment technology.
   - **Paytm, PhonePe, Google Pay** and so on are increasingly competing for retailers to accept their platforms for point-of-sale payments.
8. **Cryptocurrency**
   - A cryptocurrency is a type of digital asset that is based on a network that is distributed across many computers.
   - Because of their decentralized structure, they can exist independent of governments and central authorities.
   - Cryptocurrencies are not widely accepted as money, owing to their lack of legal tender status.
   - El Salvador, on the other hand, became the first country in the world to accept bitcoin as legal tender in June 2021.

## *WHAT IS FIAT MONEY?*

- Paper money acted as money (Legal tender) because they are guaranteed by the national governments.
- Fiat money is legally recognized to settle all debts & payments within territorial jurisdiction.
- Fiat money gives central banks greater control over the economy because they can control how much money is printed.
- When fiat money is backed by gold or silver standard, it's called "representative money" and when central bank promises "to pay bearer the sum of this many rupees", currency becomes an "anonymous bearer bond with zero interest"
  - Examples→ US dollar, Indian Rupee, Euro etc.
- In India, two entities issue fiat money –
  - Government of India under the Coinage Act, 1909 issues all coins and Rs.1 note; while
  - RBI Act, 1934 empowers RBI to issue the remaining bank notes and RBI central board is empowered to make recommendation to government of India to withdraw any notes from circulation.
- This is called "Demonetization" and was done thrice in India after independence

## *WHAT IS NOT FIAT MONEY?*

- Money without government legal backing
- Superstores plastic coins, cards & coupons
- Shares, Bonds, Debentures, G-Sec, T-bill
- DD, Cheques, Credit Card, ATM card
- Bitcoin & other Digital currency

## *BANK MONEY*

- Backed by Central bank of the country viz.
- Cheque, Bank Draft, NEFT, RTGS, Credit cards & Debit cards.

## *BENEFITS OF BANK MONEY*

- Transaction could be settled on the spot, result in time saving.
- Option of the Deferred payment
- Easy to transfer over long distance. Exact amount can be transferred (No change problem)
- Hard to counterfeit or make duplicate
- Can be freezed if card is stolen via. KYC (Know Your Customer) norms
- Legally recognized for high value payment.

## *FIDUCIARY MONEY*

- Fiduciary money is that money which is accepted as a medium of exchange because of the trust between the payer and the payee.
  - Example of Fiduciary money is Cheques, Banknotes etc.

## *SIGNIFICANCE OF MONEY*

- It serves as a **medium of exchange;** it can be used to purchase any commodity.
- It serves as a **measure of value** or account of a unit. Every commodity has a monetary value that can be expressed in terms of money.
- It acts as a **store of value.**
- It serves as a standard mode for **deferred payments.** It can be used to settle future monetary obligations. As an example, a loan obtained today is paid back in installments.
- It is the most liquid of all assets because it is universally accepted and thus easily exchanged for other commodities.
- It also has an opportunity cost. Instead of keeping a specific cash balance, you can earn interest on it by putting it in a fixed deposit with a bank.
- Money provides consumers and businesses with some very basic and practical advantages.
- Money's main advantage is that it increases an economy's efficiency by **lowering transaction costs.**
- When people can use money instead of bartering, the economy becomes more specialized and has a better division of labor.
- Money facilitates exchange and promotes trade.
- Money provides incentives to people to work hard and satisfy their wants.
- Money helps producers to earn profits and reinvest the profit to generate more income and employment.
- Money in the form of wages increases the productivity of labor in the economy.

## *CREATION OF MONEY*

- **Money supply–** It is all the currency and other liquid instruments in a country's economy on the date measured.
- The money supply is roughly composed of both cash and deposits that can be used almost as easily as cash.
- Money supply will change if the value of any of its components such as Consumer Unit (CU), Demand Draft (DD) or Time Deposits changes.
- For simplicity, use the most liquid definition of money, viz. M1 = CU + DD, as the measure of money supply in the economy.
- Various actions of the monetary authority, RBI and commercial banks are responsible for changes in the values of these items.
- The preference of the public for holding cash balances vis-́a-vis deposits in banks also affects the money supply.

**1. CURRENCY DEPOSIT RATIO (CDR)**

- The currency deposit ratio (CDR) is the ratio of money held by the public in currency to that they hold in bank deposits

$$\boxed{CDR = CU/DD}$$

- It reflects people's preference for liquidity. It is a purely behavioural parameter which depends, among other things, on the seasonal pattern of expenditure.
- For example, (CDR) increases during the festive season as people convert deposits to cash balance for meeting extra expenditure during such periods.

**2. RESERVE DEPOSIT RATIO**

- Reserve Deposit Ratio (RDR) is the **proportion of the total deposits** commercial banks keeps as reserves.

- Reserve money consists of two things –
  1. Vault cash in banks and
  2. Deposits of commercial banks with RBI.
- Banks hold a part of the money, that people keep in their bank deposits as reserve money and loan out the rest to various investment projects.
- Banks use this reserve to meet the demand for cash by account holders.
- However, RBI requires commercial banks to keep reserves in order to ensure that banks have a **safe cushion of assets to draw** on when account holders want to be paid.
- RBI uses various policy instruments to bring forth a healthy RDR in commercial banks.
- The first instrument is the **Cash Reserve Ratio** which specifies the fraction of their deposits that banks must keep with RBI.
- There is another tool called **Statutory Liquidity Ratio** which requires the banks to maintain a given fraction of their total demand and time deposits in the form of **specified liquid assets.**
- Apart from these ratios RBI uses a certain interest rate called the Bank Rate to control the value of RDR.
- Commercial banks can borrow money from RBI at the **bank rate** when they run short of reserves.
- A high bank rate makes such borrowing from RBI costly and, in effect, encourages the commercial banks to maintain a healthy RDR.

## 3. COMMERCIAL BANKS

- Commercial Banks **accept deposits from the public and lend out this money** to interest earning investment projects.
- The rate of interest offered by the bank to deposit holders is called the **'borrowing rate'** and the rate at which banks lend out their reserves to investors is called the **'lending rate'.**
- The difference between the two rates, called 'spread', is the profit that is appropriated by the banks.
- Deposits are broadly of two types – demand deposits, payable by the banks on demand from the account holder, e.g. current and savings account deposits and **time deposits,** which have a fixed period to maturity, e.g. fixed deposits.

**Q. The main functioning of the banking system is to (CDS-2013)**

A. Accept deposits and provide credit
B. Accept deposits and subsidies
C. Provide credit and subsidies
D. Accept deposits, provide credit and subsidies

**Q. Which of the following is not included in the assets of a commercial bank in India?**

A. Advances
B. Deposits
C. Investments
D. Money at call and short notice

| Function of Commercial Banks | |
|---|---|
| **Primary** | Accepting deposit and Providing loans |
| **Secondary** | Collection and payment of various items e.g. Cheques, Bills Purchase and sell of securities & remittance of money Purchase and sell of foreign exchange Acting as executors and trustees of wills & underwriting of shares Lockers facility & Travellers' cheque and letter of credit |

## *VALUE OF MONEY*

- By value of money, we mean the **purchasing power of money.**
- **Purchasing Power** is the amount of goods or services that can be purchased with a **unit of currency.**
- When the value of money rises i.e. its purchasing power increases, the general price level falls and vice versa. This means the **value of money is inverse of the general price level.**
- For instance, at a point of time, Rs. 10 were able to purchase 2 packets of biscuits, but on another times it can buy only one packet because of erosion of purchase power of that currency. This also results in increased purchase power of biscuit packet, it became Rs.7.

## *DEMAND FOR MONEY*

- Money is the most liquid of all assets in the sense that it is universally acceptable and hence can be exchanged for other commodities very easily.
- On the other hand, it has an opportunity cost. If, instead of holding on to a certain cash balance, you put the money in a fixed deposits in some bank you can earn interest on that money.
- Total demand for money in an economy is composed of transaction demand and speculative demand. Demand for money balance is thus often referred to as liquidity preference.
- People desire to hold money balance broadly for following motives-
  1. Transaction Motive
  2. Precautionary Motive
  3. Speculative Motive

**1 TRANSACTION MOTIVE**

- The principal motive for holding money is to purchase goods and services in day to day life and carry out transactions
- The transaction demand for money in the economy is fraction of the total volume of transactions in the economy over the unit period of time.
- The total value of annual transactions in an economy includes transactions in all intermediate goods and services and is clearly much greater than the nominal GDP.
- An increase in nominal GDP implies an increase in the total value of transactions.

**2. SPECULATIVE MOTIVE**

- When people wish to hold money rather than buying assets/bonds/risky investment. An individual may hold her wealth in the form of landed property, bullion, bonds, money
- Different people have different expectations regarding the future movements in the market rate of interest based on their private information regarding the economy.
- Speculative demand for money is inversely related to the rate of interest can be thought of as an opportunity cost or 'price' of holding money balance.
- Eg. If interest rates are high and people expect interest rates to fall, then there is likely to be greater demand for buying bonds and less demand for holding money. If interest rates fall, then the price of bonds will rise.

**3. PRECAUTIONARY MOTIVE**

- The precautionary demand for money is the act of holding real balances of money for use in an emergency situation.
- As receipts and payments cannot be perfectly foreseen, people hold precautionary balances to minimize the potential loss arising from a contingency.
- The precautionary demand is dependent on the size of income, the availability of credit and the rate of interest.

## *OPPORTUNITY COST OF MONEY*

- Opportunity cost refers to a benefit that a person could have received, but gave up, to take another course of action. Stated differently, an opportunity cost represents an alternative given up when a decision is made. Opportunity cost is also called the economic cost.
- Opportunity Cost = Return of Most Lucrative Option – Return of Chosen Option.
- As per microeconomics, opportunity cost is zero for free goods such as Air and common goods such as fish / grazing land.
- For public goods such as street light and defence, opportunity cost is involved (Government could have spent that much money on street lights rather than on military). Opportunity cost is not zero in case of public goods.

**Q. If a commodity is provided free to the public by the government, then:**

A. The opportunity cost is zero.

B. The opportunity cost is ignored.

C. The opportunity cost is transferred from the consumers of the product to the taxpaying public.

D. The opportunity cost is transferred from the consumers of the product to the government.

## *DETERMINANTS OF MONEY DEMAND*

- ***The prevalent price level –*** High interest rate or price level will reduce demand for money and vice versa.
- ***Inflation level in an economy–***Inflation level reduces demand for money because people prefer to save instead of expenditure because of price rise.
- ***Real income (Real GDP) –*** Real income is how much money an individual or entity makes after accounting for inflation.
- ***Disposable income–***Higher the disposable income, there will be higher tendency to spend more.
- ***Innovation level*** in an economy.

## *MONEY SUPPLY (MONETARY AGGREGATES)*

- The supply of money is a total stock of money in circulation among the public at a particular point of time.
- The measures of money supply in India are classified into four categories M1, M2, M3 and M4 along with M0.
- The classification of money supply was introduced in April 1977 by Reserve Bank of India.
- The term 'the supply of money' is synonymous with such terms as 'money stock', 'stock of money', 'money supply' and 'quantity of money'. The supply of money at any moment is the total amount of money in the economy.
- The supply of money is the product of Money Multiplier (M) and the amount of high-powered money or the reserve money.

**1. RESREVE MONEY (M0)**

- **Reserve Money (M0):** It is also known as High-Powered Money, monetary base, base money etc.
- Reserve Money is the monetary base of the economy.
- **Reserve Money (M0) =** Currency in circulation + Bankers' Deposits with the RBI + 'Other' deposits with the RBI.
- 'Other' deposits with RBI comprise mainly:
- deposits of quasi-government; other financial institutions including primary dealers,
- balances in the accounts of foreign Central Banks and Governments,
- Accounts of international agencies such as the International Monetary Fund

**2. NARROW MONEY (M1)**

- In banking terminology, M1 is called narrow money as it is **highly liquid** and banks cannot run their lending programmes with this money.
- M1 = Currency with the Public + Demand Deposits with the Banking System + 'Other' deposits with the RBI.
- M2 = M1 + Savings Deposits of Post-office Savings Banks

**3. BROAD MONEY (M3)**

- The money component M3 is called broad money. With this money (which lies with banks for a known period) banks run their lending programmes.
- M3 = M1 + Time Deposits with the Banking System.
- **M4 = M3 + All deposits with Post Office Savings Banks (excluding National Savings Certificates).**
- M3 and M4 are known as broad money.

## *HIGHEST LIQUIDITY TO LOWEST LIQUIDITY*

- M1 ⇒ CURRENCY + DEMAND DEPOSITS + OTHER DEPOSITS
- M2 ⇒ M1 + POST OFFICE (ONLY SAVINGS)
- M 3⇒ M1 + TIME DEPOSITS
- M4 ⇒ M3 + POST OFFICE (TOTAL)

**4. HIGH POWER MONEY**

- The **total liability of the monetary authority** of the country, RBI, is called the monetary base or high powered money.
- It consists of currency (notes and coins in circulation with the public and vault cash of commercial banks) and **deposits** held by the Government of India and commercial banks with RBI.
- If a member of the public produces a currency note to RBI the latter must pay her value equal to the figure printed on the note.

- Similarly, the **deposits are also refundable by RBI on demand** from deposit-holders. These items are claims which the general public, government or banks have on RBI and hence are considered to be the liability of RBI.
- In general, therefore, this liability **must be backed by an equal value of assets** consisting mainly, gold and foreign exchange reserves. In practice, however, most countries have adopted a **'Minimum Reserve System'.**
- By definition, money supply is equal to currency plus deposits – M = CU + DD = (1 + CDR)DD
- where, CDR = CU/DD.
- Assume, for simplicity, that treasury deposit of the Government with RBI is zero. High powered money then consists of currency held by the public and reserves of the commercial banks, which include vault cash and banks' deposits with RBI. Thus,
- H=CU+R=CDR.DD+RDR.DD=(CDR + RDR)DD
- The **Currency Issued By The Central Bank** is called 'high power money' because it is **generally backed by supporting 'reserves'** and its **value is guaranteed by the government** and it is the source of all other forms of money.
- In India, there are two sources of high power money supply:
    - RBI
    - Government of India
- The RBI issues currency notes of rupees 2, 5, 10, 20, 50, 100, 200, 500 and 2000 denominations which RBI calls as the 'Reserve Money'.
- The RBI issues currency of one rupee notes and coins including coins of smaller denominations on behalf of the Government of India which accounts for around 2 per cent of the total high power money.

| RESERVE BANK OF INDIA | |
|---|---|
| **LIABILITIES** | **ASSETS** |
| Notes in circulation | Foreign currency assets |
| Notes held in banking dept | Bill purchases and discounts |
| Deposits | Collaterals by commercial banks |
| Other liabilities | Loan and advances<br>Rupee securities Gold coin bullion |

## *MONEY MULTIPLIER*

- The money multiplier is **maximum amount of broad money that could** be created by commercial banks for a given fixed amount of base money and reserve ratio.
- Its value is determined in ratio of total money supply to the stock of the high-powered money in an economy.
- **M**– stock of money, **H**-stock of high powered money
- Clearly, its **value is greater than 1.**
- The Currency Deposit Ratio (CDR) and Reserve Deposit Ratio (RDR) plays an important role in determining money multiplier.
- **CDR** = C/DD ratio of the total deposit kept by commercial banks.
- **RDR** is the proportion of the total deposit kept by commercial banks.
- The money multiplier (M) is the inverse of the Reserve Requirement (R)
- M = 1/R
- Monetary base is the sum of currency in circulation and bank reserves.

## *FACTORS AFFECTING VELOCITY OF MONEY*

- **Income distribution-** Poor people immediately use their money. So, money in the hands of poor money has higher velocity.
- **Business cycle-** During booming period, production of goods and services increases, so there is higher demand for goods and services which leads to higher economic transactions so, higher velocity and vice versa
- If more people use EMI loans for purchase, it will result in higher velocity of money.
- **Developed countries** have higher velocity of money, because of higher spending pattern and confidence in Government social-security.
- A **boom** refers to a period of increased commercial activity within a business, market, industry or economy as a whole.

### *Money supply will decrease if: –*

- **Higher Taxation -** as it will reduce money in the market.

- **Sale of Government Securities (G-sec)-** peoples will purchase this, so it will reduce money supply.
- **Deficit financing** by government will increase money supply, so the level of inflation also increases.
- **Business cycle** is fluctuations in economic activity that an economy experiences over a period of time. Business cycles are generally measured using the rise and fall in the real gross domestic product (GDP) or the GDP adjusted for inflation. It is also known as the **economic cycle or trade cycle.**

## *FACTORS AFFECTING MONEY SUPPLY*

- **Monetary Base -** A monetary base is the total amount of a currency that is either in general circulation in the hands of the public or in the commercial bank deposits held in the central bank's reserves. If there is more of reserve money in the system, money supply would increase and vice versa.
- **Monetary policy -** RBI's dear (tight) money policy reduces money supply in market. However, RBI's cheap money policy increases money supply in market.
- **People's choice-** When people deposit higher portion of their income in banks, it results in decreased money supply.
- **Fiscal policy-** Fiscal policy deals with the government policy concerning changes in the taxation and expenditure overheads and components.
- **Business cycle-** In boom cycle, money supply increases and in depression cycle, the money supply decreases.
- Money multiplier

**Q. Which of the following measures would result in an increase in the money supply in the Economy? (CSE-2012)**

1. Purchase of G-Sec from the public by the Central Bank.
2. Deposit of currency in commercial banks by the public.
3. Borrowing by the government from the Central Bank.
4. Sale of government securities to the public by the Central Bank.

**Codes:**

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

## *DETERMINANTS OF MONEY SUPPLY*

- **Reserve Ratio–** higher reserve ratio (e.g. CRR, SLR, Repo rate) reduces the available money with bank to lend, so it reduces money supply and vice versa.
- **The Level of Bank Reserves–** higher bank reserves reduces the available money with bank.
- **Public's Desire to Hold Currency and Deposits–** higher deposits by public reduces money supply in the market.
- **Money Multiplier-** this refers to how an initial deposit can lead to bigger final increase in the total money supply.
- **Interest rates-** higher interest rates discourages the borrowings by people from the bank. So it reduces money supply.

## *Banking System Liquidity*

- Banking System Liquidity is defined as readily available cash that banks require to meet short-term business and financial needs.
- If the banking system is a net borrower from the RBI under Liquidity Adjustment Facility (LAF), then the system liquidity is said to be in deficit.
- If the banking system is a net lender to the RBI, the system liquidity is said to be in surplus.
- During Deficit situation, banks seek funds from Reserve Bank of India to serve the credit demands from the businesses and individuals.
- ***Indication:*** The liquidity deficit indicates that business sentiments and activities are on the rise and they require funds from the financial institutions to further expand their activities.
- ***LAF:*** It is an action by the RBI through which it injects or absorbs liquidity into or from the banking system.
- This system offers banks the opportunity to borrow money through repurchase agreements or repos or to make loans to the RBI via reverse repo agreements.
- This arrangement is effective in managing liquidity pressures and assuring basic stability in the financial markets.

- The RBI introduced the LAF because of the Narasimham Committee on Banking Sector Reforms (1998).

### *Possible Reasons for current Banking System Liquidity deficit*

- Increase in the bank credit
- Advance corporate tax payments
- Intervention of the RBI into the forex market to stem the fall in the rupee against the US dollar
- Incremental deposit growth is unable to keep pace with credit demand
- Capital spending of the government

### *Impact of Banking System Liquidity Deficit on Consumers*

- **Rise in deposit rates:** The condition would increase the yields of government securities and depositors may expect increase in interest rates on their fixed deposits and others.
- **Rise in loan rates:** Banks will increase their repo-linked lending rates (as they have to borrow more from RBI) and the marginal cost of funds-based lending rate (MCLR), to which all loans are linked to.
- A rise in the repo rate will increase cost of funds.

### *What is Liquidity Trap?*

A liquidity trap is not only related to or restricted to economic investments and bonds. Instead, it has a significant impression on the other sides of the economy. As for businesses, they are expected to have the minimum chances of getting hired because consumers are offering the pettiest cash on products; instead, they tend to reserve that cash.

The most crucial thing to remember is the respective out-turn on stocks and bond markets to understand the liquidity trap.

- The Liquidity Trap also significantly affects the Financing in equity because people are uncertain about the production of businesses soon or in the future. It diminishes the cash flow of these production businesses, eventually affecting the finance in the equity.
- Seen the circumstances of a liquidity trap, ordinary people want the interest rates to rise from nil levels with time; therefore, they tend to reduce their investment in the bond charges.
- People do not favour financing money in the market or bonds due to fear of capital losses and tend to hoard the cash as much as possible.

## *VARIOUS TERMS FOR CURRENCIES*

- **HARD CURRENCY**
  - It is the international currency in which the highest faith is shown and is needed by every economy.
  - It is strongest currency of the world, one which has a high level of liquidity.
  - Basically, the economy with the highest as well as highly diversified exports, that are compulsive imports for other countries (high-level technology, defence products, lifesaving medicines and petroleum products) will also create high demand for its currency in the world and becomes the hard currency. It is always scarce.
  - Meanwhile, by late 2015, the IMF allowed the SDR to be denominated in the Chinese 'Yuan'–paving the way for a new hard currency to be implemented in 2016.

### *SOFT CURRENCY*

- A term used in the foreign exchange market which denotes the currency that is easily available in any economy in its forex market.
- For example, rupee is a soft currency in the Indian forex market.
- It is basically the opposite term for the hard currency.

### *HOT CURRENCY*

- Hot currency is a term of the forex market and is a temporary name for any hard currency.
- Due to certain reasons, if a hard currency is exiting an economy at a fast pace for the time, the hard currency is known to be hot.
- As in the case of the South East Asian crisis, the US dollar had become hot.

### *HEATED CURRENCY*

- A term used in the forex market to denote the domestic currency which is under enough pressure (heat) of depreciation due to a hard currency's high tendency of exiting the economy (since it has become hot). It is also knownas currency under heat or under hammering.

### *CHEAP CURRENCY*

- A term first used by the economist J. M. Keynes (1930s). If a government starts re-purchasing its bonds before their maturities (at full-maturity prices) the money which flows into the economy is known as the cheap currency, also called cheap money. In the banking industry, it means a period of comparatively lower/softer interest rates regime.

### *DEAR CURRENCY*

- This term was popularized by economists in early 1930s to show the opposite of the cheap currency. when a government issues bonds, the money whichflows from the public to the government or the money in the economy in general is called dear currency, also called as dear money.
- In the banking industry, it means a period of comparatively higher/costlier interest rates regime.

### *Helicopter money:*

- It is an unconventional **monetary policy tool,** which involves **printing large sums of money and distributing it to the public,** to stimulate the economy during a recession (decline in general economic activity) or when interest rates fall to zero.
- Under such a policy, a central bank "directly increases the money supply and, via the government, distribute the new cash to the population **with the aim of boosting demand and inflation.".**
- The term was coined by American economist Milton Friedman. It basically denotes a helicopter dropping money from the sky.

### *CURRENCY IN INDIA*

- In India, the paper currency was first issued during British East India Company rule.
- The first paper currency issued in India was the Rs. 1 note.
- The first paper notes were issued by the private banks such as Bank of Hindustan and the presidency banks during late $18^{th}$ century.

### *CURRENCY CIRCLE*

- After the 1861 Act, the Government of India had the monopoly to issue paper notes in India.
- The lack of mobility, lack of development and lack of education resulted in a major issue in redemption of these notes.
- Consequently, there were only some areas (such as major cities and nearby areas) in various parts of country, where the paper notes of Indian government were legal tenders. These areas were called "Currency Circles".

### *Currency chests*

Currency chests are branches of selected banks authorised by the RBI to stock rupee notes and coins.

### *Who determines the number of notes and coins to be printed?*

- The responsibility for managing the currency in circulation is vested in the RBI.
- The Central bank advises the Centre on the number of notes to be printed, the currency denominations, security features and so on. The number of notes that need to be printed is determined using a statistical model that takes the pace of economic growth, rate of inflation and the replacement rate of soiled notes.
- The Government has, however, reserved the right to determine the amount of coins that have to be minted.

### *Role of currency chests:*

- The RBI offices in various cities receive the notes from note presses and coins from the mints. These are sent to the currency chests and small coin depots from where they are distributed to bank branches.

- The RBI has set up over 4,075 currency chests all over the country. Besides these, there are around 3,746 bank branches that act as small coin depots to stock small coins.

### *What is Legal Tender Money?*

- Any form of payment recognised by a government that is used to pay debts or financial obligations, such as tax payments, is considered legal tender.
- Legal tender laws effectively prohibit the use of anything other than existing legal tender in the economy as money.
- By law, the legal denomination of a country's currency must be accepted as a medium of exchange and payment for a money debt.
- While all denominations of circulating paper money are usually legal tender, the denomination and amount of coins acceptable as legal tender vary by country.
- The **RBI Act of 1934,** which grants the Central Bank the sole authority to issue banknotes, states that **"every banknote shall be legal tender in payment for the amount expressed therein in any place in India."**
- The acceptance or rejection of legal tender status is significant because paper money derives all of its value from the government's acceptance of it.
- **The RBI and the government issue legal tender money in the form of currency notes or coins. When this legal tender status is withdrawn, the process is known as demonetization.**
- Legal tender performs the economic functions of money as well as a few other functions, such as making monetary policy and manipulation of currency possible.
- Meanwhile, some currencies, most notably the US dollar, are considered legal tender in countries that do not issue their own currency.
- For example, Ecuador, which does not have its own currency, has accepted the US dollar as legal tender since 2000.

### *Types of Legal Tender Money*

- **Limited Legal Tender Money**
  - This is a type of money that can be used to pay off a debt up to a certain amount, after which a person can refuse to accept the payment and no legal action can be taken against them.
  - In India, coins are only legal tender in limited quantities.
- **Unlimited Legal Tender Money**
  - In this form of money, it is possible to pay off any amount of debt.
  - A person who refuses to accept this money
  - may face legal action.
- In India, paper notes/currency are unlimited legal tender.

### *Legal Tender Money – Significance*

- Market participants use it to perform the following functions of money in the economy: **a medium of indirect exchange, a unit of account, a store of value and a deferred payment standard.**
- Having a legal tender allows for flexibility in the money supply and using a single currency eliminates the transaction costs associated with using multiple competing currencies.
  - Imposing legal tender is one method of achieving a **single currency.**
- **Monetary policy** is also made possible by legal tender.
- From the standpoint of the issuer, legal tender allows the issuer to manipulate, debase and devalue the currency in order to obtain **seigniorage** and facilitates the issuance of fiduciary media by the banking system to meet trade needs.
- The revocation of legal tender status is significant because paper money derives all of its value from the government's acceptance of it.

### *Legal Tender Money – Limitations*

- The loss of a currency's legal tender status can have an impact on citizens' personal finances as well.
- In the short term, it may also disrupt the smooth flow of day-to-day business.

- With many large economies bracing for a full-fledged war on tax evasion, many countries are considering withdrawing legal tender status from their high-value notes.
    - All of this strengthens our case for going cashless and switching to plastic/ electronic banking.

## Present Legal Tender in India

- Currency notes in the Mahatma Gandhi series in denominations of **Rs.5, Rs.10, Rs.20, Rs.50, Rs.100, Rs.500 and Rs.2,000 are currently in circulation.**
- Furthermore, coins with denominations of 50 paise, Rs 1, Rs 2, Rs 5 and Rs 10 in a variety of sizes, themes and designs are in circulation.

## What is Cryptocurrency?

- A cryptocurrency is a type of **digital asset** that is based on a network that is distributed across many computers.
- Because of their **decentralized structure**, they can exist independent of governments and central authorities.
- **Blockchain and related technology,** according to experts, will disrupt many industries, including finance and law.
- The **benefits** of cryptocurrencies include cheaper and faster money transfers, as well as decentralized systems that do not fail at a single point.
- Cryptocurrency **disadvantages** include price volatility, high energy consumption for mining activities and use in criminal activities.
- **Cryptocurrencies are not widely accepted as money, owing to their lack of legal tender status.**
- El Salvador, on the other hand, became the first country in the world to accept bitcoin as legal tender in June 2021.

## Evolution of Cryptocurrency

- **Bitcoin**, the first decentralized cryptocurrency, was created in 2009 by a presumably anonymous developer named **Satoshi Nakamoto**.
- Subprime mortgage crisis and recession in 2008-2009 resulted in **Quantitative Easing** (the introduction of new money into the money supply by a central bank) of the dollar in the United States, which increased dollar supply and eroded dollar purchasing power.
- Banks charge fees for online transfers, credit card transactions and ATM withdrawals.
- From the creation of **Bitcoin in 2009** to the present day, cryptocurrencies have grown in popularity all over the world.
- The gains made by this sector since the onset of the Covid-19 pandemic in January 2020 have been astounding; the "**crypto market"** has grown by more than **500%**.

## Bitcoin

- It is an electronic or digital currency that operates on a peer-to-peer basis. It is decentralized, with no centralized authority in charge.
- Bitcoins can be digitally sent to anyone with a bitcoin address anywhere in the world. One person may have multiple addresses for various purposes such as personal, business and so on.
- Satoshi Nakamoto proposed bitcoin, a mathematically-proofed electronic payment system.
- A bitcoin is not printed currency, but rather a **non-reputable** (assurance that no one can deny the legitimacy of something) record of every transaction that it has been through. All of this is part of a massive ledger known as the blockchain.
- Since no authority controls or tracks the generation of the coins, the system is designed in such a way that the network keeps a foolproof record of every transaction as well as tracking the issuance of the currency sent without either side knowing the identity of the other Bitcoins is 'mined' using computing power in a distributed network.
- It is the first example of a new type of currency known as cryptocurrency.

## Cryptocurrency – Concept

- Cryptocurrencies are digital or virtual currencies that rely on cryptographic systems to function.

- They make it possible to make secure online payments without the use of third-party intermediaries.
- The term "crypto" refers to the encryption algorithms and cryptographic techniques used to protect these entries, such as elliptical curve encryption, public-private key pairs and hashing functions.
- Cryptocurrencies can be mined or bought on cryptocurrency exchanges.
- They are also used for cross-border transfers to a limited extent.

### *Types of Cryptocurrency*

- Bitcoin is still the most traded and covered cryptocurrency.
- Many other cryptocurrencies, known as **"altcoins,"** have been launched in the aftermath of Bitcoin's success. Some of the well-known altcoins are:
  - Solana
  - Litecoin
  - Ethereum
  - Cardano
  - Peercoin
  - Namecoin
- By November 2021, the total value of all cryptocurrencies in existence had surpassed $2.1 trillion, with Bitcoin accounting for approximately 41% of the total value.

### *Legality of Cryptocurrency*

- Cryptocurrencies are not backed by any government or private organization. As a result, making a case for their legal status in various financial jurisdictions around the world has been difficult.
- It doesn't help that cryptocurrency has mostly operated outside of most existing financial infrastructure.
- Cryptocurrency's legal status has implications for its use in daily transactions and trading.
- The **Financial Action Task Force (FATF)** recommended in June 2019 that cryptocurrency wire transfers be subject to the requirements of the Travel Rule, which requires AML compliance.
- **El Salvador** is the only country in the world to accept Bitcoin as legal tender for monetary transactions as of December 2021.
- The **Payment Services Act of Japan** declares Bitcoin to be legal property.
- **China** has prohibited cryptocurrency exchanges and mining within its borders.
- In the **European Union,** cryptocurrencies are legal.

### *Cryptocurrency - Significance*

- Cryptocurrencies represent a new, **decentralized money paradigm.**
- Centralized intermediaries, such as banks and monetary institutions, are not required in this system to enforce trust and police transactions between two parties.
- Thus, a cryptocurrency-based system eliminates the possibility of a single point of failure, such as a large bank, triggering a global crisis, such as the one triggered in 2008 by the failure of institutions in the United States.
- Cryptocurrencies promise to make it **easier to transfer funds** between two parties without the need for a trusted third party such as a bank or credit card company.
- Cryptocurrency transfers between two transacting parties are faster than traditional money transfers because they do not use third-party intermediaries.
- **Profits** can be made from cryptocurrency investments. The value of cryptocurrency markets has skyrocketed.
- It is a less expensive option when compared to other online transactions.
- The transfer of funds is completed with minimal processing fees.

### *Cryptocurrency - Limitations*

- Cryptocurrencies, while claiming to be an anonymous form of transaction, are actually pseudonymous. They leave a digital trail that agencies can decipher.
- Cryptocurrencies have grown in popularity among criminals as a tool for nefarious activities such as **money laundering and illegal purchases.**

- Cryptocurrencies have also become popular among hackers, who use them to carry out ransomware attacks.
- **In theory, cryptocurrencies are supposed to be decentralized, with their wealth distributed among many parties via a blockchain. In practice, ownership is extremely concentrated.**
- One of the misconception regarding cryptocurrencies is that anyone with a computer and an internet connection can mine them.
  - Mining popular cryptocurrencies, on the other hand, necessitates a significant amount of energy, sometimes equivalent to that consumed by entire countries.
- While **cryptocurrency blockchains** are extremely secure, other crypto repositories, such as exchanges and wallets, are vulnerable to hacking.
- **Price volatility** affects cryptocurrencies traded on public markets. Bitcoin's value has gone through rapid ups and downs.
- Some economists believe that cryptocurrencies are a passing fad or **speculative bubble.**

## *Cryptocurrency in India*

- The RBI issued a circular in 2018 prohibiting all banks from dealing in cryptocurrencies. In May 2020, the Supreme Court ruled that this circular was unconstitutional.
- The government recently announced the introduction of a bill, **Cryptocurrency and Regulation of Official Digital Currency Bill, 2021,** to create a sovereign digital currency while simultaneously prohibiting all private cryptocurrencies.
- The funds invested in Indian blockchain start-ups account for less than 0.2 percent of the total amount raised by the sector globally.
- The current cryptocurrency approach makes it nearly impossible for blockchain entrepreneurs and investors to gain significant economic benefits.

## *Way Forward*

- **Regulation** is required to prevent serious problems, to ensure that cryptocurrencies are not misused and to protect unsuspecting investors from excessive market volatility and potential scams.
- The regulation must be clear, **transparent and coherent a**nd it must be animated by a vision of what it seeks to achieve.
- A legal **and regulatory framework** must define crypto-currencies as securities or other financial instruments under applicable national laws and identify the regulatory authority in charge.
- Rather than outright prohibiting cryptocurrencies, the government should regulate their trading by instituting stringent KYC norms, reporting and taxation.
- To address concerns about transparency, information availability and consumer protection, steps such as record keeping, inspections, **independent audits, investor grievance redressal** and dispute resolution may be considered.
- Cryptocurrencies and Blockchain technology have the potential to **rekindle the entrepreneurial spirit in India's startup ecosystem** by creating job opportunities at all levels, from blockchain developers to designers, project managers, business analysts, promoters and marketers.

## *What is NPCI?*

The National Payments Corporation of India (NPCI) serves as an umbrella body for the operation of retail payment in India. This organization was established by the **Reserve Bank of India** along with the Indian Bank's Association. NPCI was incorporated in December 2008 and was centrally promoted by the Reserve Bank of India. The Certificate of Commencement of Business was issued in April 2009.

Presently, NPCI is promoted by ten major promoter banks:

- State Bank of India
- Punjab National Bank

- Canara Bank
- Bank of Baroda
- Union Bank of India
- Bank of India
- ICICI Bank
- HDFC Bank
- Citibank
- HSBC

## *Who are the regulatory members of NPCI?*

Headquartered in Mumbai, the National Payments Corporation of India is an organization registered under section 8 of the Companies Act 2013.

The regulating board of NPCI consists of the following members:

- Biswamohan Mahapatra as the Non-Executive Chairman
- Nominees from the Reserve Bank of India (RBI)
- Nominees from ten core promoter banks.
- Currently, Dilip Asbe is the current managing director and chief executive officer of NPCI.

## *Objectives of NPCI*

The National Payments Corporation of India (NPCI) was under the support of the Reserve Bank of India (RBI) and Indian Banks' Association (IBA) with an aim of consolidating and integrating various systems into nation-wide uniform and standard business process that can be used as a retail payment system. Another major objective of NPCI was facilitating an affordable payment system that can help the common people during financial inclusion.

Under the PSS Act, 2007 as per the authorisation of RBU, NPCI can operate the following payment systems:

1. National Financial Switch (NFS)
2. Immediate Payment System (IMPS)
3. Affiliation of RuPay Cards (debit cards/ prepaid cards) issued by banks and co-branded credit cards issued by non-banking financial companies (NBFCs) or any other entity approved by the RBI.
4. National Automatic Clearing House (ACH)
5. Aadhaar Enabled Payments System (AEPS)
6. Operation of Cheque Truncation System

## *Products of NPCI*

Some of the current products that were launched under the National Payments Corporation of India are discussed below:

1. **RuPay:** It is a domestic card scheme of India that has a magnetic stripe along with an EMV chip. The card is now accepted at all ATMs and has been issued by 300 cooperative banks and Regional Rural Banks (RRBs) in India.
2. **National Common Mobility Card:** Also known as Rupay Contactless card, it is a contactless payment technology that allows cardholders to use their card in the contactless payment terminals without the need to physically swipe or insert the card.
3. **Bharat Interface for Money (BHIM):** Bharat Interface for Money (BHIM) is a mobile payments application based on NPCI's Unified Payments Interface (UPI). It provides the facility to easily send or receive money from other customers using the UPI.
4. **Unified Payments Interface (UPI):** Unified Payments Interface (UPI) was introduced on 11$^{th}$ April 2016 as an instant inter-bank payment system. This payment system was developed to provide a mobile platform for instant transfer of funds between two bank accounts.
5. **Bharat Bill Payment System:** The Bharat Bill Payment System is an initiative taken by NPCI along with the Reserve Bank of India (RBI) for payment of all bills which will provide an interoperable and accessible bill payment service to its customers.

National Payments Corporation of India is an initiative of the Reserve Bank of India and the Indian Banks' Association. Its Immediate Payment Service (IMPS) has enabled India to become the leading country in the world in real-time payments in the retail sector.

## What is Digital Payment in India?

- Digital payments are transactions that happen online or through other digital platforms without a physical exchange of money. This indicates that both the payer and the payee exchange money via electronic means.
- To encourage and promote digital payments in India, the government has been implementing a number of actions. The government intends to establish a "digitally empowered" economy that is "Faceless, Paperless, Cashless" as part of the "Digital India" campaign. Digital payments come in a variety of forms and ways.

## Types of Digital Payments in India?

The Government of India's main initiative, the Digital India program, aims to make India into a knowledge-based society and economy. One of the purported roles of Digital India is to be faceless, paperless and cashless.

A variety of digital payment methods are offered in an effort to encourage cashless transactions and make India a society that uses less cash.

## Debit/Credit Cards

- As an alternative to cash payments, Indians frequently utilize debit/credit cards, prepaid cards or banking cards. In 1981 andhra Bank introduced the country's first credit card. Cards are preferred for a variety of factors, including but not exclusive to mobility, convenience, safety and security.
- This is the only type of digital payment that is widely used for both online and offline transactions. Nowadays, numerous applications like Cred, Square etc. are released solely for managing card transactions.

## Unstructured Supplementary Service Data

For those portions of India's population without access to reliable banking and internet services, USSD was introduced. By simply calling *99# on any necessary feature phone, USSD enables mobile banking transactions to be completed without the need for an internet connection.

Prepaid GSM cell phones frequently use USSD to check the available balance. The vendor's "check balance" application conceals from the user the specifics of the USSD protocol.

When a user engages in an activity that costs money on some pay-as-you-go networks, such as Tesco Mobile, they receive a USSD message containing their updated balance. Additionally, USSD can be used to send PIN codes or one-time passwords, as well as to replenish the SIM card's balance.

## Digital Wallet

A digital wallet often referred to as an e-wallet, is a software program, internet service or electronic device that enables two parties to conduct electronic transactions in exchange for products and services and digital currency units.

This can involve utilizing a computer to make online purchases or a smartphone to make in-person purchases. Prior to any transactions, funds can be added to the digital wallet; alternatively, the digital wallet can be connected to a person's bank account.

Additionally, users' driver's licenses, health cards, loyalty cards and other IDs may be kept in their wallets. Near field communication allows the credentials to be wirelessly transferred to a merchant's terminal (NFC).

## Prepaid Cards

A bank-issued pre-loaded debit card, typically single-use or reloadable for numerous uses, is known as a bank prepaid card. It differs from a typical debit card in that the latter can only be used once and is always connected to your bank account. A prepaid bank card may or may not be covered by this.

Any customer with a KYC-compliant account can generate a prepaid card by going to the bank's website. The most typical uses of these cards are as corporate gifts, reward cards or one-use cards for gifting.

## Point of Sale

The moment and location where a retail transaction is finished are referred to as the point of sale (PoS) or point of purchase (PoP). The merchant determines the customer's balance due at the point of sale, notifies them of it, may create an invoice for them (which might be a printout from the cash register) and informs them of their payment alternatives.

Because it is also a point of return or client order, the point of sale is frequently referred to as the point of service. Software for PoS terminals could additionally provide capabilities for further functionality, such as warehousing, CRM or inventory management.

### *Internet Banking*

Customers of a specific bank are given the option to perform transactions and engage in other financial activities online through internet banking, sometimes referred to as e-banking or online banking, on the bank's website. To make or receive payments online and to access a bank's website, which is known as Internet Banking, you need a reliable internet connection.

The majority of Indian banks have now made their internet banking services available. It has grown to be one of the most widely used methods for making purchases online. In India, there is a virtual banking option available on every payment gateway. Some of the most popular methods for doing transactions via internet banking are NEFT, RTGS or IMPS.

### *Mobile Banking*

A bank or other financial institution's mobile banking service enables its customers to carry out financial transactions remotely using a mobile device, like a smartphone or tablet. It uses software, sometimes referred to as an app, offered by the financial institution for the purpose, unlike related internet banking.

Typically, mobile banking is accessible around-the-clock. Some financial organizations have restrictions on which accounts can be accessed using mobile banking and set a dollar threshold for the value of transactions. The presence of an internet or data connection for the mobile device is necessary for mobile banking.

### *Micro ATMs*

Business Correspondents (BC) use a micro ATM to provide consumers with crucial financial services. These Correspondents will act as a "micro ATM" for quick transactions, they might even be local business owners. They will employ a system that only requires your fingerprint for authentication to allow you to transfer money using your bank account that is linked to your Aadhaar.

With the help of micro ATMs, banks can connect remotely to their main banking system. This device has a fingerprint scanner built right into it. In other terms, a micro ATM is a portable point-of-sale device used to disburse cash in areas where bank facilities are inaccessible. Micro ATMs are a type of doorstep mobile banking arrangement combined with a mobile ATM device, comparable to point of sale (PoS) terminals.

### *National Electronic Funds Transfer:*

- NEFT is a nation-wide payment system facilitating one-to-one funds transfer. Under this Scheme, individuals, firms and corporates can electronically transfer funds from any bank branch to any individual, firm or corporate having an account with any other bank branch in the country participating in the Scheme.
- There is no limit – either minimum or maximum – on the amount of funds that could be transferred using NEFT.
- However, the maximum amount per transaction is limited to Rs. 50,000/- for cash-based remittances within India and also for remittances to Nepal under the Indo-Nepal Remittance Facility Scheme.

### *RuPay Card Scheme:*

- The name, derived from the words 'Rupee and 'Payment', emphasises that it is India's very own initiative for Debit and Credit Card payments.
- The card can also be used for transactions in Singapore, Bhutan, UAE, Bahrain and Saudi Arabia.

### *Real Time Gross Settlement*

- RTGS is an electronic fund transfer method through which money is sent on a 'real time' basis without any delays.

- RTGS allows the money sent by the remitter to immediately reach the beneficiary as and when the money transfer transaction is initiated.
- 'Gross Settlement' refers to the processing of transactions on an individual basis and not in a batch wise system.
- Minimum amount that can be sent via RTGS mode is Rs.2 lakh and has no maximum limit.
- RTGS is not a 24x7 facility and is available only during working hours of banks.

### *Unified Payments Interface*

- It is an advanced version of Immediate Payment Service (IMPS)- round–the-clock funds transfer service to make cashless payments faster, easier and smoother.
- UPI is a system that powers multiple bank accounts into a single mobile application (of any participating bank), merging several banking features, seamless fund routing & merchant payments into one hood.
- National Payments Corporation of India (NPCI) launched UPI with 21 member banks in 2016.

### *Bharat Bill Payment System*

- The Bharat bill payment system is driven by National Payments Corporation of India (NPCI).
- It is a one-stop ecosystem for payment of all bills providing an interoperable and accessible "Anytime Anywhere" bill payment service to all customers across India with certainty, reliability and safety of transactions.

### *Aadhaar enabled Payment System*

- AePS is developed by the National Payments Corporation of India (NPCI) that allows people to carry out financial transactions on a Micro-ATM by furnishing just their Aadhaar number and verifying it with the help of their fingerprint/iris scan.
- With the help of this payment system, funds can be transferred from one bank account to another simply through their Aadhaar numbers.
- This system adds another layer of security to financial transactions as bank details would no longer be required to be furnished while carrying out these transactions.

### *What is Payment & Settlement Systems Act 2007?*

- The Payment and Settlement Systems Act, 2007 (PSS Act), which was passed into law in December 2007, governs the payment and settlement systems in India.
- Beginning on August 12, 2008, the Payment and Settlement System Act and the regulations created under it went into force.
- A payment system cannot be started or operated in India by anyone other than the Reserve Bank of India (RBI) without RBI authorization, according to Section 4 of the PSS Act.
- Since then, the Reserve Bank has authorized operators of payment systems for prepaid payment instruments, card programs, cross-border inbound money transfers, ATM networks and centralized clearing arrangements.
- **Payment & Settlement Introduction in India:**
    - As long as there have been commodities and services, there has also been a demand for payments and settlements.
    - The barter system, which facilitated exchange through products and/or services, was the first Payment and Settlement System (PSS) that was known to have existed.

### *What is e-rupee?*

- ***Definition:*** RBI defines the Central Bank Digital Currency (CBDC) as the digital form of currency notes issued by a central bank. It is a sovereign or entirely independent currency issued by the central bank (in this case, RBI), in accordance with the country's monetary policy.
- ***Legal Tender:*** Once officially issued, CBDC will be considered as a medium of payment and legal tender by all three parties - citizens, government bodies and enterprises. Being

government-recognised, it can be freely converted to any commercial bank's money or notes.

- RBI is not in favour of e-rupee with interest. Because people might withdraw money from banks and convert it to digital rupee - causing banks to fail.

- **Difference with Crypto currencies:** The underlying technology of crypto currency can underpin parts of the digital rupee system, but the RBI has not decided on this, yet. However, cryptocurrencies like Bitcoin or Ethereum are 'private' in nature. Digital rupee on the other hand, will be issued and controlled by the RBI.
- **Global Scenario:** As of July 2022, 105 countries were exploring CBDC. Ten countries have launched CBDC, the first of which was the Bahamian Sand Dollar in 2020 and the latest was Jamaica's JAM-DEX.

### *What is RBI's Plan for CBDC?*

- **Types of CBDC:** On the basis of usage and the functions performed by the digital rupee and considering the different levels of accessibility, CBDC can be demarcated into two broad categories - general purpose (retail) (CBDC-R) and wholesale (CBDC-W).
  - Retail CBDC is an electronic version of cash primarily meant for retail transactions. It will be used by all - private sector, non-financial consumers and businesses. However, the RBI has not explained how e-rupee can be used in merchant transactions in the retail trade.
  - Wholesale CBDC is designed for restricted access to select financial institutions. It has the potential to transform the settlement systems for financial transactions undertaken by banks into government securities (G-Sec) segment, inter-bank market and capital market more efficiently and securely in terms of operational costs, use of collateral and liquidity management.
- ***Structure:***
  - A token based CBDC would be a bearer instrument like banknotes, the person receiving a token will verify that his ownership of the token is genuine. A token-based CBDC is viewed as a preferred mode for CBDC-R as it would be closer to physical cash.
  - An account-based system would require maintenance of records of balances and transactions of all holders of the CBDC and indicate the ownership of the monetary balances. In this case, an intermediary will verify the identity of an account holder. This system can be considered for CBDC-W.
- Available in online and offline mode: The offline functionality as an option will allow CBDC to be transacted without the internet and thus enable access in regions with poor or no internet connectivity.
  - However, the RBI feels in the offline mode, **the risk of 'double-spending' will exist** because it will be technically possible to use a CBDC unit more than once without updating the common ledger of CBDC.

### *Model for Issuance:*

- In the direct model, the central bank will be responsible for managing all aspects of the digital rupee system such as issuance, account-keeping and transaction verification.
- An indirect model would be one where the central bank and other intermediaries (banks and any other service providers), each play their respective role. The central bank will issue CBDC to consumers indirectly through intermediaries and any claim by consumers will be managed by the intermediary.

### *What are the advantages of e-rupee?*

- Reduction in operational costs involved in physical cash management, fostering financial inclusion, bringing resilience, efficiency and innovation in the payments system.
- Provide the public with uses that any private virtual currencies can provide, without the associated risks.

### *What are the issues related to CBDC in India?*

- ***Cyber Security:*** CBDC ecosystems may be at a similar risk of cyber-attacks that the current payment systems are exposed to.
- ***Privacy issue:*** The CBDC is expected to generate huge sets of data in real time. Privacy of the Data, concerns related to its anonymity and its effective use will be a challenge.
- ***Digital divide and financial illiteracy:*** The NFHS-5 also provides data segregation based on the rural-urban divide. Only 48.7% of rural males and 24.6% of the rural females have ever used the internet. So, CBDC may wide gender-based hurdle in financial inclusion along with digital divide.

### *Way Forward*

- Technical clarity must be ensured to decide on the underlying technologies that can be trusted to be safe and stable.
- To make CBDC a successful initiative and movement, RBI must address the demand side infrastructure and knowledge gap to increase its acceptance in rural areas for wide base.
- The RBI must proceed cautiously, remaining mindful of the various issues, the design considerations and the implications surrounding the introduction of the digital currency.

### *Merchant Discount Rate*

- Merchant Discount Rate (alternatively referred to as the Transaction Discount Rate or TDR) is the sum total of all the charges and taxes that a digital payment entails.
- Simply put, it is a charge to a merchant by a bank for accepting payment from their customers in credit and debit cards every time a card gets swiped in their stores.
- Similarly, MDR also includes the processing charges that a payments aggregator has to pay to online or mobile wallets or indeed to banks for their service.

### *Who will bear the MDR costs?*

- If customers don't pay and merchants don't pay, some entity has to pay for the MDR costs.
- In her speech, the FM has said that RBI and Banks will absorb these costs from the savings that will accrue to them on account of handling less cash as people move to these digital modes of payment.
- Necessary amendments are being made in the Income Tax Act and the Payments and Settlement Systems Act, 2007 to give effect to these provisions.

### *Issues surrounding*

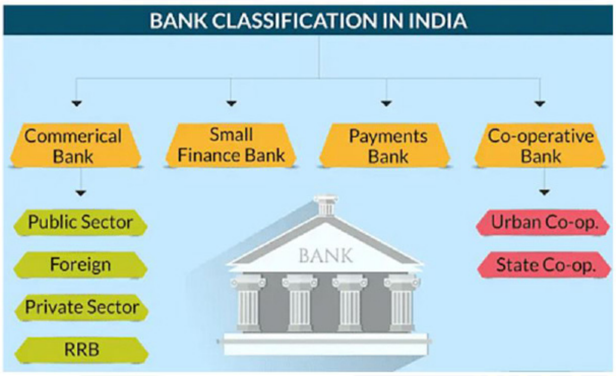
- Contrary to public perception, the MDR has not been made zero.
- The FM's decision has just shifted its incidence on to the RBI and banks.
- However, if banks pay for the MDR it will adversely affect their likelihood to adopt the digital payments architecture.
- Moreover, many payments providers apprehend that the banks will find a way of passing on the costs to them.
- In turn, this will negatively impact the health of a sector that needs nurturing.

# 7 BANKING IN INDIA

## *What Is a Bank?*

- A bank is a financial institution that is licensed to accept checking and savings deposits and make loans.
- Banks also provide related services such as individual retirement accounts (IRAs), certificates of deposit (CDs), currency exchange and safe deposit boxes.
- There are several types of banks including retail banks, commercial or corporate banks and investment banks.
- Banks are regulated by the country's central bank—in India, the **RBI (Reserve Bank of India)**. **The banking sector in India** truly reflects a mixed economy, with public, private and foreign banks.

## *Types of Banks*




### 1. Commercial Banks

- Any banking organisation that deals with the deposits and loans of businesses is referred to as a commercial bank.
- Commercial banks issue bank checks and drafts and accept term deposits.
- Through instalment loans and overdrafts, commercial banks also serve as moneylenders.
- Commercial banks also provide a variety of deposit accounts, including checking, savings and time deposits.
- These institutions are run for profit and are owned by a group of people.

**Commercial Banks are further divided into the following:**

#### (i) Public Sector Banks

- These are banks in which the Government of India owns a majority stake.
- SBI, Bank of India, Canara Bank and other public sector banks are examples.

| Bank of Maharashtra | Indian Bank |
|---|---|
| Bank of Baroda | Punjab & Sind Bank |
| Bank of India | Punjab National Bank |
| Canara Bank | State Bank of India |
| Central Bank of India | Union Bank of India |
| Indan Overseas Bank | UCO Bank |

#### (ii) Private Sector Banks

- The majority of a bank's share capital is held by private individuals. These banks are set up as limited-liability corporations.
- Private sector banks include **ICICI Bank, Axis Bank, HDFC and others.**

| List of Private Sector Banks | |
|---|---|
| Axis Bank | IndusInd Bank |
| Bandhan Bank | Jammu and Kashmir Bank |
| City Union Bank | Karnataka Bank |
| Dhanlaxmi Bank | Kotak Mahindra Bank |
| DCB Bank | Karur Vysya Bank |
| Federal Bank | Lakshmi Vilas Bank |
| HDFC Bank | Nainital Bank |
| ICICI Bank | RBL Bank |
| IDFC Bank | South Indian Bank |
| IDBI Bank | Tamilnad Mercantile Bank |
| YES Bank | |

#### (iii) Regional Rural Banks

- Regional Rural Banks were established in accordance with the provisions of an Ordinance promulgated on September 26, 1975 and the **RRB Act, 1976,** with the goal of ensuring adequate institutional credit for agriculture and other rural sectors.

- RRBs can only operate in the areas that have been designated by GoI as covering one or more districts in the state.
- RRBs are jointly owned by GoI, the relevant State Government and Sponsor Banks; the issued capital of an RRB is divided among the owners in the proportions of **50%, 15% and 35%**, respectively.

### (iv) Foreign Banks

- These banks are registered and have their headquarters in another country, but they have branches in our country.
- Foreign banks in India include HSBC, Citibank, Standard Chartered Bank and others.

## 2. Small Finance Banks (SFBs)

- The Small Finance Bank (SFB) is a private financial institution that primarily undertakes basic banking activities such as deposit acceptance and lending to unserved segments such as small business units, small and marginal farmers, micro and small industries and unorganised sector entities, but without any geographical restrictions, unlike Regional Rural Banks or Local Area Banks.
- Small Finance Banks were established in response to an announcement made in the Union Budget 2014-2015, which was presented on July 10, 2014.
- On November 27, 2014, the RBI issued guidelines for the licencing and regulation of SFBs.
- On September 16, 2015, the RBI decided to grant "in-principle" approval to ten applicants to establish small finance banks in order to advance the financial inclusion agenda.
  - Au Financiers (Jaipur), Capital Local Area Bank (Jalandhar), Disha Microfin (Ahmedabad), Equitas Holdings (Chennai), ESAF Microfinance and Investments (Chennai), Janalakshmi Financial Services (Bengaluru), Janal (Bengaluru), RGVN (Northeast) Microfinance (Guwahati), Suryoday Micro Finance (Navi Mumbai), Ujjivan Financial Services (Bengaluru) and Utkarsh Micro Finance (Varanasi).
- The above-mentioned banks were chosen from a pool of 72 applicants. Customers' deposits will be accepted by small finance banks.
- In addition, unlike payments banks, small finance banks will be permitted to lend money to individuals.
- Microfinance institutions make up the majority of those who have received the 'in-principle' approval.
- As a result, the majority of small finance bank customers will be small and medium enterprises and small businesses.
- These banks will now be able to provide MSMEs and SMEs with secured and legal loans, bringing them into the financial system.

| List of Small Finance Banks | |
|---|---|
| Au Small Finance Bank Ltd. | Jana Small Finance Bank Ltd. |
| Capital Small Finance Bank Ltd. | North East Small FinanceBank Ltd. |
| ESAF Small Finance Bank Ltd. | Suryoday Small Finance Bank Ltd. |
| Equitas Small Finance Bank Ltd. | Utkarsh Small Finance Bank Ltd. |
| Fincare Small Finance Bank Ltd. | Ujjivan Small Finance Bank Ltd. |

## 3. Payment Banks

- A payment bank is a distinct type of bank that performs only the limited banking functions permitted by the Banking Regulation Act of 1949.
- Acceptance of deposits, payments and remittance services, internet banking and acting as a business correspondent for other banks are examples of some oftheactivities.
- They are initially permitted to **collect deposits of up to Rs 1 lakh per individual.**
- They can help with money transfers as

well as sell insurance and mutual funds. Furthermore, they can only issue ATM/ debit cards, not credit cards.

- They are not permitted to establish subsidiaries to provide non-banking financial services. More importantly, they are not permitted to engage in any lending activities.
- On February 15, 2015, the RBI published a list of entities that had applied for a payments bank licence. There were 41 entitieswho hadapplied.
- To evaluate the licence applications, an **External Advisory Committee (EAC)** led by Nachiket Mor wasformed.
- The government has decided that India Post will run a payments bank using its extensive network.
- On July 6, 2015, the external advisory committee, led by Nachiket Mor, submitted its findings. The applicant entities' financial records and governance issues were scrutinised.
- Payment banks' goal is to bring unbanked people into the fold of formal banking while also accelerating financial inclusion.
- The spread of banking will also help the poor become financially literate and aid in the fight against poverty.
- The RBI's establishment of payment banks is a significantstep. People in rural areas will be reached by payment banks.
- Payments banks will ensure that more money enters the banking system.
- Various banks, including big banks like SBI, are looking to expand their rural reach and payments banks will help them achieve this goal.
- The Reserve Bank of India granted "in-principle" permission to the following entities to establish payment banks:
  - Nuvo Aditya Birla, Airtel M Commerce Services, Cholamandalam Distribution Services, Department of Posts, FINO PayTech, National Securities Depository, Reliance Industries, Dilip Shanghvi - Sun Pharmaceuticals, Paytm, Tech Mahindra, M-Pesa (Vodafone M-Pesa),
- Out of the above mentioned, three of them have surrendered their licences - The first was Chalomandalam Distribution Services, followed by Dilip Shanghvi, Sun Pharmaceuticals and the most recent, Tech Mahindra.
- The "in-principle" licence is valid for 18 months, during which time the entities must meet the requirements.
- They are not permitted to engage in banking activities during this time.
- After determining that the conditions have been met, the RBI will consider granting full licences under **Section 22** of the **Banking Regulation Act of 1949.**
- The Payments Bank is proposed to be registered as a public limited company under the Companies Act of 2013 and licenced under Section 22 of the Banking Regulation Act of 1949, with specific licencing conditions limiting its activities to accepting demand deposits and providing payments and remittance services.
- It will be governed by the provisions of the Banking Regulation Act of 1949, the Reserve Bank of India Act of 1934, the Foreign Exchange Management Act of 1999, the Payment and Settlement Systems Act of 2007.
- With differentiated banks entering the banking space, the biggies such as SBI, ICICI Bank and others are feeling the heat. These banks will only operate in specific areas.

**4. Co-operative Banks**

- A cooperative bank is a financial entity that is owned and operated by its members, who are also its customers.
- Co-operative banks are frequently formed by people who belong to the same local or professional community or who share a common interest.

- Co-operative banks typically offer a wide range of banking and financial services to their members (loans, deposits, banking accounts etc).
- They offer a limited range of banking services and specialise in agricultural products.
- Cooperative banks are the primary financiers of agricultural activities, small-scale industries and self-employment.
- **Cooperative banks operate on the principle of "no profit, no loss."**
- Anyonya Co-operative Bank Limited (ACBL) is India's first co-operative bank, headquartered in **Vadodara, Gujarat.**

### *Co-operative Banks can further be divided into the following:*

**(i) Urban Cooperative Banks**

- The term "Urban Co-operative Banks" refers to primary cooperative banks in urban and semi-urban areas.
- These banks primarily lent to small borrowers and businesses centred on communities, neighbourhoods and workplace groups.
- They primarily finance entrepreneurs, small businesses, industries and self-employment in urban areas, as well as home purchases and educational loans.

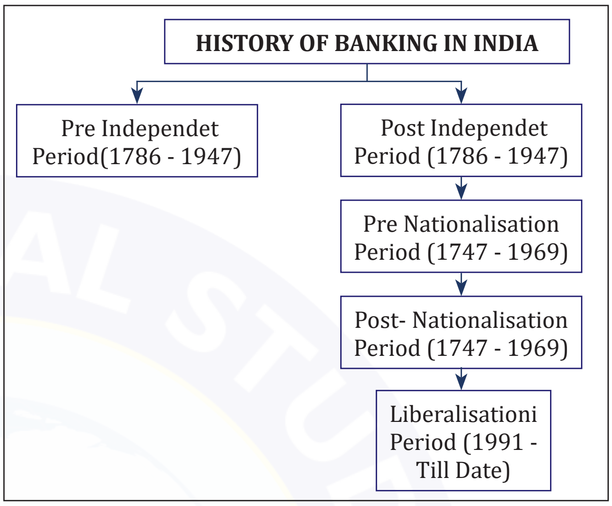
**(ii) State Cooperative Banks**

- A State Cooperative Bank is a federation of the central cooperative bank that serves as the state's custodian of the cooperative banking structure.
- Co-operative banks in rural areas primarily serve agricultural-based activities such as farming, livestock, dairies and hatcheries, among others.
- They also give loans to small-scale businesses, cottage industries and self-employment activities such as artisanship.

## *History of Banking in India*

The banking sector development can be divided into three phases:

- **Phase I:** The Early Phase which lasted from 1770 to 1969
- **Phase II:** The Nationalisation Phase which lasted from 1969 to 1991
- **Phase III:** The Liberalisation or the Banking Sector Reforms Phase which began in 1991 and continues to flourish till date




## *Pre Independence Period (1786-1947)*

- The first bank of India was the "Bank of Hindustan", established in 1770 and located in the then Indian capital, Calcutta. However, this bank failed to work and ceased operations in 1832.
- During the Pre Independence period over 600 banks had been registered in the country, but only a few managed to survive.

Following the path of Bank of Hindustan, various other banks were established in India. They were:

- The General Bank of India (1786-1791)
- Oudh Commercial Bank (1881-1958)
- Bank of Bengal (1809)
- Bank of Bombay (1840)
- Bank of Madras (1843)

During the British rule in India, The East India Company had established three banks: Bank of Bengal, Bank of Bombay and Bank of Madras and called them the Presidential Banks. These three banks were later merged into one single bank in 1921, which was called the "Imperial Bank of India."

The Imperial Bank of India was later nationalised in 1955 and was named The State Bank of India, which is currently the largest Public sector Bank.

Given below is a list of other banks which were established during the Pre-Independence period:

| Pre-Indepence Banks in India | |
|---|---|
| Bank Name | Year of Establishment |
| Allahabad Bank | 1865 |
| Punjab National Bank | 1894 |
| Bank of India | 1906 |
| Central Bank of India | 1911 |
| Canara Bank | 1906 |
| Bank of Baroda | 1908 |

If we talk of the reasons as to why many major banks failed to survive during the pre-independence period, the following conclusions can be drawn:

- Indian account holders had become fraud-prone
- Lack of machines and technology
- Human errors & time-consuming
- Fewer facilities
- Lack of proper management skills

## *Post Independence Period (1947-1991)*

- At the time when India got independence, all the major banks of the country were led privately which was a cause of concern as the people belonging to rural areas were still dependent on money lenders for financial assistance.
- With an aim to solve this problem, the then Government decided to nationalise the Banks. These banks were nationalised under the Banking Regulation Act, 1949. Whereas, the Reserve Bank of India was nationalised in 1949.
- Following it was the formation of State Bank of India in 1955 and the other 14 banks were nationalised between the time duration of 1969 to 1991. These were the banks whose national deposits were more than 50 crores.
- Given below is the list of these 14 Banks nationalised in 1969:

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

In the year 1980, another 6 banks were nationalised, taking the number to 20 banks. These banks included:

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

- Apart from the above mentioned 20 banks, there were seven subsidiaries of SBI which were nationalised in 1959:
  1. State Bank of Patiala
  2. State Bank of Hyderabad
  3. State Bank of Bikaner & Jaipur
  4. State Bank of Mysore
  5. State Bank of Travancore
  6. State Bank of Saurashtra
  7. State Bank of Indore
- All these banks were later merged with the State Bank of India in 2017, except for the State Bank of Saurashtra, which merged in 2008 and State Bank of Indore, which merged in 2010.
- Note: The Regional Rural Banks in India were established in the year 1975 for the development of rural areas in India.

## *Impact of Nationalisation*

There were various reasons why the Government chose to nationalise the banks. Given below is the impact of Nationalising Banks in India:

- This lead to an increase in funds and thereby increasing the economic condition of the country
- Increased efficiency
- Helped in boosting the rural and agricultural sector of the country
- It opened up a major employment opportunity for the people
- The Government used profit gained by Banks for the betterment of the people
- The competition decreased, which resulted in increased work efficiency

This post Independence phase was the one that led to major developments in the banking sector of India and also in the evolution of the banking sector.

### *Liberalisation Period (1991-Till Date)*

- Once the banks were established in the country, regular monitoring and regulations need to be followed to continue the profits provided by the banking sector. The last phase or the ongoing phase of the banking sector development plays a hugely significant role.
- To provide stability and profitability to the Nationalised Public sector Banks, the Government decided to set up a committee under the leadership of Shri. M Narasimham to manage the various reforms in the Indian banking industry.
- The biggest development was the introduction of Private sector banks in India. RBI gave license to 10 Private sector banks to establish themselves in the country. These banks included:

| | |
|---|---|
| 1. Global Trust Bank | 6. IndusInd Bank |
| 2. ICICI Bank | 7. Centurion Bank |
| 3. HDFC Bank | 8. IDBI Bank |
| 4. Axis Bank | 9. Times Bank |
| 5. Bank of Punjab | 10. Development Credit Bank |

The other measures taken include:

- Setting up of branches of the various Foreign Banks in India
- No more nationalisation of Banks could be done
- The committee announced that RBI and Government would treat both public and private sector banks equally
- Any Foreign Bank could start joint ventures with Indian Banks
- Payments banks were introduced with the development in the field of banking and technology
- Small Finance Banks were allowed to set their branches across India
- A major part of Indian banking moved online with internet banking and apps available for fund transfer

Thus, the history of banking in India shows that with time and the needs of people, major developments have been brought about in the banking sector with an aim to prosper it.

## *Bank Nationalisation in India*

### *What is nationalisation of banks?*

- Bank nationalisation can be expressed as a process whereby the national or state government is empowered to **take over the private industry,** organization or even the assets in their hands, which is often called public ownership, through any legislation.

### *Process of bank nationalisation*

- In India, bank nationalisation was started after the government enacted the **RBI (Transfer of public ownership) Act** in order to nationalize the Reserve Bank of India.
- Consequently, **on Jan 1st, 1949, RBI was nationalized.**
- Similarly, in **1955, the Imperial Bank of India underwent nationalization** and later it was named as the State Bank of India which, in the present time, is the largest public sector bank and a D-SIB (Domestic Systematically Important Bank).
- 14 bank nationalisation: Then in the year 1969, 14 of the major commercial banks that were functioning in India, underwent nationalization.
- Bank nationalisation in 1980: In 1980, another 6 banks were nationalized which increased the **total number nationalised banks to 20.**

### *Bank nationalisation: Why needed?*

- Wars with **China (1962) and Pakistan (1965)** put immense pressure on public exchequer.
- Two **successive years of drought** had led to severe food shortages and also compromised national security (PL 480 program).
- **Resultant three-year plan holiday** affected aggregate demand as public investment was reduced.

- India's economic **Growth Barely Outpaced Population** growth in 1960-70s and average incomes stagnated.
- Share of credit disbursement by commercial banks to the industrial sector almost doubled (from 34% to 68%) between 1951 and 1968, whereas **Agriculture Received Less Than 2% Of Total Credit,** despite the fact that more than 70 percent of the population was dependent on it.

### *Bank nationalisation objectives*

- **Priority Sector Lending -** the agriculture sector and its allied activities were the largest contributors to the national income.
- **Nationalisation aimed at mobilizing the savings** of the people to the largest possible extent and to utilize them for productive purposes.
- It also **aimed at reducing inter and intra-regional imbalance** to curb the urban-rural divide.
- Bank nationalisation was directed to **Control Private Monopolies** over financial sectors.
- It was aimed at **Ensuring Socio-Economic Welfare**, which is enshrined in the preamble of the Indian constitution.
- One of the major aims of bank nationalisation was expansion of banking to rural pockets to ensure financial inclusion.
- The step was directed shift banking from 'class banking' to 'mass banking' (social banking).

### *Impacts of bank nationalisation*

- Nationalization of the Banks brought the **public confidence** in the banking system of India.
- After the two major phases of nationalization in India, **80% of the banking sector came under government ownership.**
- After the nationalization of banks, the deposits of the public sector banks in India rose to approximately 800 per cent and advances took a huge jump by 11,000 per cent.
- Government ownership gave the **Public Implicit Faith** and immense confidence in the sustainability of public sector banks.
- Indian banking system **reached even to the remote corners** of the country, thus ensuring financial inclusion.
- **More equitable and prioritized disbursement** of credit to different sectors of economy, particularly to agriculture sector.
- Nationalization of banks led to a **Smooth And Streamlined** Indian growth process, particularly in the period of Green Revolution.

### *Criticism of bank nationalisation*

- **Efficiency and profitability** of banks declined drastically.
- **Issue of NPA** (Non-Profit Assets) became a major roadblock in profitability of banking sector.
- Nationalization of banks led to an interest rate structure that was **incredibly complex** – different rates of interest for different types of loans.
- Nationalization drive led to lesser competition between the public sector and private sectors banks.
- **Bureaucratic attitude and Procrastination** in the functioning of the banking system.
- **Lack of responsibility** and initiative, red–tapism, inordinate delays became common features of nationalized banks.
- Due to unmanageable expansion of these banks, problems like **heavy overdue loans started arising with the increase of economically unviable branches.**
- Political interference led to disbursement of loans to the sectors which **were against the sound banking rules** and this haphazard credit disbursement **weakened the economic viability of these institutions.**

Q. With reference to India, consider the following: [2010]

1. Nationalization of Banks
2. Formation of Regional Rural Banks
3. Adoption of villages by Bank Branches

Which of the above can be considered as steps taken to achieve the "financial inclusion" in India?

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

Q. In the context of independent India's economy, which one of the following was the earliest event to take place? [2009]

(a) Nationalization of Insurance companies
(b) Nationalization of State Bank of India
(c) Enactment of Banking Regulation Act
(d) Introduction of First Five-Year Plan

## *Reserve Bank of India (RBI)*

- The Reserve Bank of India (RBI) is the central institution of the country that manages all major monetary policies of India and handles economic stability and growth. Shaktikanta Das is the present Governor of the Reserve Bank of India.

## *Reserve Bank of India - Historical Background*

- The **Reserve Bank of India was established** on April 1, 1935, in accordance with the provisions of the Reserve Bank of India Act, 1934 based on the **recommendation of Hilton Young Commission** Report (1926) with a share capital of **Rs. 5 crores.**
- The Central Office of the Reserve Bank was initially established in **Kolkata but was permanently moved to Mumbai in 1937**. The Central Office is where the Governor sits and where policies are formulated.
- Though originally privately owned, since its nationalization in 1949, the Reserve Bank is fully owned by the Government of India.
    - **1st Governor of RBI:** Sir Osborne Smith.
    - **2nd Governor of RBI:** Sir James Braid Taylor.
    - **3rd Governor of RBI:** C. D. Deshmukh.

## *Reserve Bank of India - Definition*

- The Reserve Bank of India is the central bank of the country. RBI is a **statutory body.** It is responsible for printing of currency notes and managing the supply of money in the Indian economy.
- The Reserve Bank of India is the highest monetary authority of India.
- It **Also acts as the representative of the Government in the International Monetary Fund** and represents the membership of India.
- RBI has four zonal offices: New Delhi for North, Chennai for South, Kolkata for East and Mumbai for West.
- The Reserve Bank of India has 19 regional offices and 11 sub-offices at present.
- **The Reserve Bank of India's important publication:** Financial Stability Report; Monetary Policy Report; Report on Financial Review.

## *Reserve Bank of India - Preamble*

- The Preamble of the **Reserve Bank of India describes the basic functions of the Reserve Bank** as:
- "to regulate the issue of Banknotes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage; to have a modern monetary policy framework to meet the challenge of an increasingly complex economy, to maintain price stability while keeping in mind the objective of growth."

## *Reserve Bank of India - Composition*

- The Reserve Bank's affairs are governed by a central board of directors. The board is appointed by the Government of India in keeping with the Reserve Bank of India Act. They are appointed/nominated for a period of four years.

**Official Directors**

- **Full-time:** Governor and not more than four Deputy Governors

**Non-Official Directors**

- Nominated by Government: ten Directors from various fields and two government Official
- Others: four Directors - one each from four local boards.
- Shaktikanta **Das is the Governor of the Reserve Bank of India.** There are **three Deputy Governors:** B P Kanungo, Mahesh Kumar Jain and M D Patra.

## *Powers of Reserve Bank of India*

- Powers of RBI – The Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949 have given the RBI wide powers of Supervision and Control over commercial Banks - relating to:

- licensing and establishments,
- branch expansion,
- liquidity of their assets,
- management and methods of working,
- amalgamation (merger)
- reconstruction and liquidation.

### *Functions of the Reserve Bank of India*

- **Banker's Bank:** The RBI has extensive power to control and supervise the commercial banking system under the RBI Act, 1934 and the Banking Regulation Act, 149.
- The Banks are **required to maintain a minimum Cash Reserve Ratio (**CRR) with RBI.
- The RBI provides financial assistance to scheduled banks and state cooperative banks.
- It uses various measures such as **qualitative and quantitative techniques** to regulate credit in the economy. It uses quantitative controls such as bank rate policy, **cash reserve ratio, open market operations etc. Qualitative controls include selective credit control, rationing of credit** etc.
- Enables banks to maintain their accounts with RBI for statutory reserve requirements and maintenance of transaction balances.
- **Regulator:** RBI is the regulator of the Banking & Finance & Money Market.
- **Custodian of foreign exchange reserves:** The RBI functions as the custodian and manager of forex reserves and operates within the overall policy framework agreed upon with the Government of India.
  - The 'reserves' refer to both foreign reserves in the form of gold assets in the Banking Department and foreign securities held by the Issue Department and domestic reserves in the form of 'bank reserves'.
  - It commonly includes foreign exchange and gold, special drawing rights, (SDRs) and International Monetary Fund (IMF) reserve positions.
- **Issue of Currency:** RBI is the sole authority for the issue of currency in India other than one rupee notes and subsidiary coins, the magnitude of which is relatively small. The RBI is also called "Bank of Issue".
- **Controller of credit:** Credit control is generally considered to be the principal function of the Central Bank. By making frequent changes in monetary policy **(like CRR, SLR, Repo Rate and Reverse Repo Rate),** it ensures that the monetary system in the economy functions according to the nation's needs and goals.
- **Lender of last resort:** Lender of the last resort means "Central Bank (RBI) helps all the commercial and other banks in times of financial crises.
  - Note: Under the Section 22 of the RBI Act 1934, RBI has the sole right to issue Bank notes of all denominations except one rupee note.
- The **One Rupees notes** and coins are issued by the Central Government., The Ministry of Finance.

### *Banker to the Government*

**As Bankers to the Govt. RBI performs the following functions:**

- It accepts money, makes payments,s and also carries out their exchange and remittances for the Government.
- It makes loans and advances to the States and local authorities.
- It also sells treasury bills to maintain liquidity in the economy.
- It makes ways and means advances to the Governments for 90 days.
- It acts as an adviser to the Government on all monetary and banking matters.

**Q. Concerning Indian economy, consider the following: (UPSC CSE- 2015)**

1. Bank rate
2. Open Market Operations
3. Public debt
4. Public revenue

**Which of the above is/are component (s) of Monetary Policy?**

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

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

> **Q. An increase in Bank Rate generally indicates: (UPSC CSE- 2013)**
> (a) Market rate of interest is likely to fall.
> (b) Central bank is no longer making loans to commercial banks.
> (c) Central bank is following an easy money policy.
> (d) Central bank is following a tight money policy.

## *Subsidiaries of RBI*

- **What is a Subsidiary:** A subsidiary, subsidiary company or daughter company is a company that is owned or controlled by another company, which is called the parent company, parent or holding company. Do you know how many subsidiaries does the Reserve Bank of India (RBI) has? **There are five fully owned subsidiaries of RBI: DICGC, BRBNMPL, ReBIT, IFTAS and RBIH. RBI has one associate NCFE.** An associate company is one where the parent company holds 20-50% of the stake.
- Earlier National Housing Bank(NHB) was also a subsidiary of RBI. However now RBI has divested its entire stake in NHB and hence **Now it is not a subsidiary of RBI.** It is fully owned by the Government of India now. However, you can read about NHB in this post.

### *Fully owned subsidiaries of RBI :*

1. Deposit Insurance and Credit Guarantee Corporation of India(DICGC)
2. Bharatiya Reserve Bank Note Mudran Private Limited(BRBNMPL)
3. Reserve Bank Information Technology Private Limited (ReBIT)
4. Indian Financial Technology and Allied Services (IFTAS)
5. Reserve Bank Innovation Hub (RBIH)

### *Associate of RBI:*

1. National Centre for Financial Education (NCFE) Hence RBI has 5 wholly-owned subsidiaries and 1 associate.

**1. Deposit Insurance and Credit Guarantee Corporation of India (DICGC)**

- **Establishment:** Deposit Insurance and Credit Guarantee Corporation (DICGC) came into existence on **July 15, 1978.**
- DICGC was formed by merging Deposit Insurance Corporation (DIC) and Credit Guarantee Corporation of India Ltd. (CGCI)
- The functions of the DICGC are governed by the provisions of DICGC Act 1961 framed by the Reserve Bank of India.
- **Role of DICGC:** DICGC was established for providing insurance of deposits and guaranteeing of credit facilities. At present, DICGC insures each depositor of a registered insured bank upto a maximum of Rs.5 Lakh for all bank deposits, such as saving, fixed, current, recurring deposits. The credit guarantee scheme of DICGC is presently not operative due to availability of alternative guarantee schemes.
- **Authorised Capital :** Rs 50 Crore.
- **Headquarters:** Mumbai
- **Banks under the purview of DIGCG:** Deposit insurance is compulsory for all banks in the country. Therefore, all public sector banks, private sector banks, local area banks, regional rural banks, small finance banks, payments banks, branches of foreign banks functioning in India, all State, Central and Primary cooperative banks (Urban Cooperative Banks) are registered and insured by the DICGC.
- **Maximum deposit amount insured by the DICGC:** Rs 5 lakh (Principle + Interest)
- If you have deposits with more than one bank, deposit insurance coverage limit is applied separately to the deposits in each bank.
- DICGC has the power to cancel the registration of an insured bank if it fails to pay the premium for three consecutive half-year periods.

### *When does DICGC pays:*

1. If a bank goes into liquidation
2. If a bank is reconstructed or amalgamated / merged with another bank

- Chairman: Dr. M.D. Patra

2. Bharatiya Reserve Bank Note Mudran Private Limited (BRBNMPL)

- **Establishment:** Bharatiya Reserve Bank Note Mudran Private Limited (BRBNMPL) was established by Reserve Bank of India (RBI) as its wholly owned subsidiary on 3rd February 1995. The BRBNMPL has been registered as a Private Limited Company under the Companies Act 1956.
- **Role of BRBNMPL:** To augument the production of bank notes in India to enable the RBI to bridge the gap between the supply and demand for bank notes in the country.
- **Headquarters:** Bengaluru
- **Chairman:** Shri T. Rabi Sankar
- The company manages 2 Presses one at Mysore in Karnataka and the other at Salboni in West Bengal.
- **Extra Info:** Apart from this, RBI has two more printing press both owned by Government of India: Nasik (Maharashtra) and Dewas (Madhya Pradesh)
- Coins are minted in four mints owned by the Government of India. The mints are located at Mumbai, Hyderabad, Calcutta and NOIDA.

3. Reserve Bank Information Technology Private Limited (ReBIT)
   - **Established:** 2016
   - It has been set up by the Reserve Bank of India, for its IT and cybersecurity needs and to ensure cyber resilience of Indian banking.
   - Deliver and manage IT projects of RBI; Assist RBI in performing risk-based supervision of regulated entities; Safeguard RBI assets by detecting and responding to cyber-threats.
   - **Chairman:** Shri. Kiran Karnik
4. Indian Financial Technology and Allied Services (IFTAS)
   - **Function and Role of IFTAS–** Financial Technology and Allied Services (IFTAS) is a wholly-owned subsidiary of the Reserve Bank of India, mandated to design, deploy & support IT-related services to all Banks and Financial Institutions in the country and also to the Reserve Bank of India.
   - It manages & operates the Financial messaging platform (SFMS) that comprising of Real-Time Gross Settlement and National Electronic Funds Transfer.
   - INFINET is also managed by IFTAS.
   - IFTAS operates CLOUD (Indian Banking Community Cloud), the only community cloud in the country, hosting cloud based solutions (Platform, Core, Channel, Corporate etc.) dedicated to the Banking & Financial Community.
   - The IFTAS has taken over the Indian FInancial NETwork (INFINET), Structured Financial Messaging System (SFMS) and the Indian Banking Community Cloud (IBCC) from the IDRBT, effective April 01, 2016.
   - The Director, IDRBT, is the Chairman of The Indian Financial Technology and Allied Services.
   - Chairman of IFTAS: Shri. Vivek Deep
5. Reserve Bank Innovation Hub (RBIH)
   - The RBIH has been registered as a section 8 company under Companies Act 2013 having its **registered office at Hyderabad.**
   - The Reserve Bank of India has set up Reserve Bank Innovation Hub (RBIH) to promote innovation across the financial sector by leveraging on technology and creating an environment that would facilitate and foster innovation.
   - RBIH would be guided and managed by a Governing Council (GC) led by a Chairperson. Shri Senapathy (Kris) Gopalakrishnan, co-founder and former co-Chairman, Infosys, as the first Chairperson of the Governing Council of RBIH. The governing council of RBIH has 9 more members apart from the Chairperson.
   - The Board of Reserve Bank Innovation Hub (RBIH) has appointed Rajesh Bansal as the Chief Executive Officer (CEO) of the RBIH.
6. National Centre for Financial Education (NCFE)

- National Centre for Financial Education (NCFE) is a Section 8 (Not for Profit) Company promoted by
  - **Reserve Bank of India (RBI) [30% stake]**
  - Securities and Exchange Board of India (SEBI), [30% stake]
  - Insurance Regulatory and Development Authority of India (IRDAI) [30% stake] and
  - Pension Fund Regulatory and Development Authority (PFRDA) [10% stake]
- **The objective of NCFE:** To promote Financial Education across India as per the National Strategy for Financial Education (NSFE) of the Financial Stability and Development Council (FSDC). The initial share capital of NCFE is Rs. 100 Crore.
  - Chairman of NCFE: Shri Girraj Prasad Garg

## *National Housing Bank (NHB)*

- Establishment: NHB was set up on July 9, 1988 under the National Housing Bank Act, 1987.
- Role of NHB: To promote a sound, healthy, viable and cost effective housing finance system to cater to all segments of the population and to integrate the housing finance system with the overall financial system.
- Authorised Capital: ₹1,450 crore
- **Owned:** Fully owned by Government of India (100%)
- **Headquarters:** New Delhi
- **NHB RESIDEX–** It is India's first official housing price index, was an initiative of the National Housing Bank (NHB), undertaken at the behest of the Government of India, Ministry of Finance.

> Q. Consider the following statements:
>
> 1. The Governor of the Reserve Bank of India (RBI) is appointed by the Central Government.
> 2. Certain provisions in the Constitution of India give the Central Government the right to issue directions to the RBI in the public interest.
> 3. The Governor of the RBI draws his power from the RBI Act.
>
> Which of the above statements are correct?
>
> (a) 1 and 2 only (b) 2 and 3 only
>
> (c) 1 and 3 only (d) 1, 2 and 3

> **Q. Consider the following statements:**
>
> **The Reserve Bank of India's recent directives relating to 'Storage of Payment System Data', popularly known as data diktat, command the payment system providers that:**
>
> 1) They shall ensure that entire data relating to payment systems operated by them are stored in a system only in India
> 2) They shall ensure that the systems are owned and operated by public sector enterprises
> 3) They shall submit the consolidated system audit report to the Comptroller and Auditor General of India by the end of the calendar year
>
> Which of the statements given above is/are correct?
>
> (a) 1 only (b) 1 and 2 only
>
> (c) 3 only (d) 1, 2 and 3

## *PUBLICATIONS OF RBI*

1. Report on Trend and Progress of Banking in IndiaAnnually
2. Financial stability report- Half yearly
3. Monetary policy report- Half yearly
4. Report on foreign exchange reserves- Half yearly
5. Bi-monthly Policy Statement
6. Industrial Outlook Survey of the Manufacturing Sector (Quarterly)
7. Consumer Confidence Survey (Quarterly)
8. Report on Financial Review

## *Minimum Reserve System (MRS):*

- To maintain the adequate supply of money in the economy the RBI prints the money as per the Minimum Reserve System. Under the Minimum Reserve System, the RBI has to keep a minimum reserve of Rs 200 crore comprising of gold coin and gold bullion and foreign currencies. Out of the total Rs 200 crores, Rs 115 crore should be in the form of gold coins or gold bullion and rest in the form of foreign currencies.
- The Reserve Bank has monopoly to issue currency notes of all denominations except one rupee notes. Since the one rupee note issued by the Ministry of Finance but distributed by the RBI through currency commercial banks.

## *Meaning of Minimum Reserve System*

- Printing of currency notes in India is done on the basis of Minimum Reserve System (MRS).

This system is **applicable in India since 1956.**

- According to this system, **the Reserve Bank of India has to maintain assets of at least 200 crore rupees all the times. Out of this 200 crore, the 115 cr rupee should in the form of Gold** or gold bullion and rest 85 cr. should be in the form of foreign currencies.
- After maintaining the Minimum reserve the RBI can print any number of currency notes as per the requirement of the economy. Although RBI has to take prior permission from the government.

### *Objectives of Minimum Reserve System (MRS)*

There are many objectives of MRS but a few are;

1. To ensure the confidence of the Indian currency holders that the currency held by them is a legal tender and they will receive the value of the currency held by them.
2. The Minimum Reserve System is a token of confidence to the general public that the Indian government is liable to pay them as per the face value of the notes because the RBI governor promise to the public that "I promise to pay a the bearer a sum of 100/500 rupee."
3. RBI wants to ensure the appropriate supply of currency in the economy through MRS.
4. Through the MRS the RBI accelerate the economic growth of the country without increasing the rate of inflation in the economy.

Due to its widespread benefits the Minimum Reserve System still continues in India. Sole purpose of the Minimum Reserve System is to maintain the money supply in the economy without increasing the inflation and maintain the confidence of the general public in the currency.

### *What is the Banking Regulation Act, 1949?*

- The Banking Regulation Act, 1949 is a law. It regulates the functioning of banks and provides details on several aspects including licensing, management and operations of banks in India. It had been passed as the Banking Companies Act, 1949 and came into force from March 16, 1949. Further the Banking Companies Act 1949 had been changed to the Banking Regulation Act 1949 and being implemented as the same from March 1, 1966.
- It extends to entire India. The provisions of this Act shall be in addition to and not, save as hereunder expressly PROVIDED, in derogation of the Companies Act, 1956 and any other law for the time being in force.

### *Provisions of the Banking Regulation Act, 1949*

- The Act provides a structure under which commercial banking in India is supervised and regulated. The Act supplements the Companies Act, 1956. Primary Agricultural Credit Society and cooperative land mortgage banks are excluded from the Act.

**Several powers are provided by the Act to the Reserve Bank of India:**

- To license banks, have regulation over shareholding and voting rights of shareholders;
- To supervise the appointment of the boards and management;
- To regulate the operations of banks;
- To lay down instructions for audits; control moratorium, mergers and liquidation;
- To issue directives in the interests of public good and on banking policy and impose penalties

### *Amendment to the Banking Regulation Act, 1949*

- Initially, the law was applicable only to banking companies. But in 1965 the Act was amended to form it applicable to cooperative banks under its purview by adding Section 56 to the Act. Cooperative banks, which operate only in one state, are formed and run by the state government. But, licensing is controlled by RBI and also regulates the business operations. The Banking Act was a supplement to the previous acts associated with banking.

- Recently, the Lok Sabha has passed an amendment to the Banking Regulation Act, 1949. The Banking Regulation (Amendment) ordinance is replaced by the bill and to the same effect promulgated in June 2020.
- The amendment will bring cooperative banks under the direct supervision of the RBI and convey them under some of the same governance norms as commercial banks. Without first imposing a moratorium, it will also allow the RBI to amalgamate or reconstruct a stressed cooperative bank. These amendments are proposed so as to guard the interests of the depositors.

### Monetary Policy

- Monetary policy is aprocess implemented by the central bank to manage the money supply in order to achieve specific goals such as limiting inflation, maintaining an appropriate exchange rate, creating jobs and promoting economic growth. Monetary policy entails changing interest rates, either directly or indirectly, through open market operations, reserve requirements or foreign exchange trading.
- Credit policy is a subset of monetary policy because it governs how much and at what interest rate banks extend credit.
- Historically, in India, monetary policy was announced twice a year, once during the slack season (April-September) and once during the busy season (October-March), in accordance with agricultural cycles. However, because monetary policy has become more dynamic, the Reserve Bank of India decided to issue bi-monthly Monetary Policy Statements—once every two months—beginning in 2014, as recommended by the Urjit Patel Committee.

### Types of Monetary Policy

Monetary policy is of the following two types:

- **Expansionary policy–** It increases the total supply of money in the economy by easing its availability by lowering interest rates. It is used to stimulate economic growth.
- **Contractionary policy–** It decreases the total supply of money in the economy by raising interest rates. It is used to reduce pricescaused by an excess of money supply.

### Objective of Monetary Policy

- Monetary policy is concerned with making money available to the market at reasonable rates and in sufficient quantities at the appropriate time in order to achieve:
  - Price stability
  - Accelerating growth of economy
  - Exchange rate stabilization
  - Balancing savings and investment
  - Generating employment
  - Financial stability
- The primary goal of monetary policy is to maintain price stability while keeping growth in mind. Price stability is a prerequisite for long-term growth.
- In order to maintain price stability, inflation must be kept under control.
- Every five years, the Indian government sets an inflation target. The Reserve Bank of India (RBI) plays an important role in the consultation process for inflation targeting. The current inflation-targeting framework in India is flexible.
- RBI get its Mandate to conduct Monetary Policy

### How does the RBI get its Mandate to conduct Monetary Policy?

- The Reserve Bank of India (RBI) is charged with implementing monetary policy. The Reserve Bank of India Act of 1934 expressly mandates this responsibility.
- There have recently been many changes in the way India's monetary policy is formed, with the introduction of the Monetary Policy Framework (MPF), Monetary Policy Committee (MPC) and Monetary Policy Process (MPP).

### Monetary Policy Framework (MPF)

- While the Government of India establishes the **Flexible Inflation Targeting Framework in India,** the Reserve Bank of India (RBI) is in charge of the country's Monetary Policy Framework.
- The amended RBI Act explicitly gives the Reserve Bank the **legislative mandate** to run the country's monetary policy framework.

- The framework aims to set the **policy (repo) rate** based on an assessment of the current and evolving macroeconomic situation, as well as to modulate liquidity conditions in order to anchor money market rates at or near the repo rate.
- Changes in repo rates are transmitted through the money market to the entire financial system, influencing aggregate demand – a key determinant of inflation and growth.
- Once the repo rate is announced, the Reserve Bank's operating framework envisions day-to-day liquidity management through appropriate actions aimed at anchoring the operating target - the weighted average call rate (WACR) – around the repo rate.

### Monetary Policy Committee (MPC)

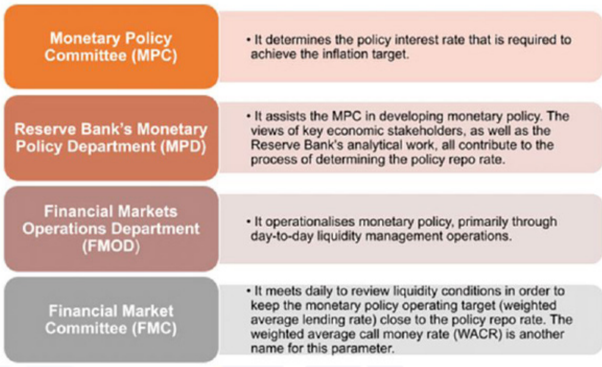
- The Monetary Policy Committee now determines the policy interest rate required to achieve the inflation target in India.
- The MPC is a six-person committee appointed by the Central Government (Section 45ZB of the amended RBI Act, 1934).
- The MPC must meet at least four times per year. The MPC meeting requires a quorum of four members. Each MPC member has one vote and in the event of a tie, the Governor has a second or casting vote.
- Following the conclusion of each MPC meeting, the resolution adopted by the MPC is published.
- The Reserve Bank is required to publish a document called the Monetary Policy Report once every six months to explain:
  - The sources of inflation; and
  - The forecast of inflation for the next 6-18 months.

### Present Monetary Policy Committee

The Central Government constituted the present MPC as under:


- Note: Members referred to at points 4, 5 and 6 above, will hold office for a period of four years or until further orders are issued, whichever is earlier.

### Monetary Policy Process




### Monetary Policy Instruments

- Monetary policy is implemented using a variety of direct and indirect instruments.
  - **Repo Rate**
    - The (fixed) interest rate at which the Reserve Bank provides overnight liquidity to banks in exchange for the government and other approved securities as collateral under the liquidity adjustment facility (LAF).
  - **Reverse Repo Rate**
    - The (fixed) interest rate at which the Reserve Bank absorbs liquidity from banks on an overnight basis in exchange for eligible government securities under the LAF.
  - **Liquidity Adjustment Facility (LAF)**
    - The LAF is made up of both overnight and term repo auctions.
    - The Reserve Bank has gradually increased the proportion of liquidity injected through fine-tuning variable rate repo auctions of various tenors.
    - The goal of the term repo is to help develop the inter-bank term money market, which in turn can set market-based benchmarks for loan and deposit pricing and thus improve monetary policy transmission.

- The Reserve Bank also conducts variable interest rate reverse repo auctions as market conditions dictate.

- **Marginal Standing Facility (MSF)**
  - A facility through which scheduled commercial banks can borrow an additional amount of overnight money from the Reserve Bank by dipping into their Statutory Liquidity Ratio (SLR) portfolio up to a certain limit at a penal rate of interest.
  - This acts as a safety valve for the banking system in the event of unexpected liquidity shocks.
- **Corridor**
  - The corridor for the daily movement in the weighted average call money rate is determined by the MSF rate and the reverse repo rate.
- **Bank Rate**
  - It is the rate at which the Reserve Bank is willing to purchase or rediscount bills of exchange or other commercial papers.
  - Section 49 of the Reserve Bank of India Act, 1934 mandates the publication of the Bank Rate.
  - This rate has been aligned with the MSF rate and, as a result, changes automatically when the MSF rate and the policy repo rate change.
- **Cash Reserve Ratio (CRR)**
  - The average daily balance that a bank is required to maintain with the Reserve Bank as a share of such percentage of its Net demand and time liabilities (NDTL) as specified by the Reserve Bank in the Gazette of India from time to time.
- **Statutory Liquidity Ratio (SLR)**
  - The percentage of NDTL that a bank must keep in safe and liquid assets such as unencumbered government securities, cash and gold.
  - SLR changes frequently have an impact on the availability of resources in the banking system for lending to the private sector.
- **Open Market Operations (OMOs)**
  - These include the outright purchase and sale of government securities for the purpose of injecting and absorbing long-term liquidity, respectively.
- **Market Stabilisation Scheme (MSS)**
  - This monetary management tool was introduced in 2004.
  - Short-term government securities and treasury bills are sold to absorb longer-term surplus liquidity resulting from large capital inflows.
  - The money raised in this manner is kept in a separate government account of the Reserve Bank.

**Q. Consider the following: [CSE-2015]**

(1) Bank rate (2) Open market operations
(3) Public debt (4) Public Revenue

Which of them is/are part of Monetary Policy?

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

**Q. Which of the following statements is/are correct regarding the Monetary Policy Committee (MPC)? [CSE-2017]**

(1) It decides the RBI's benchmark interest rates.
(2) It is a 12-member body including the Governor of RBI and is reconstituted every year.
3) It functions under the chairmanship of the Union Finance Minister.

**Select the correct answer using the code given below:**

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

| Monetary Policy Tool | Description |
|---|---|
| **Quantitative Instruments** | |
| Bank Rate | • It is therate at which the Reserve Bank is willing to purchase or rediscount bills of exchange or other commercial papers.<br>• Section 49 of the Reserve Bank of India Act, 1934 mandates the publication of the Bank Rate.<br>• This rate has been aligned with the MSF rate and, as a result, changes automatically when the MSF rate and the policy repo rate change. |

| | |
|---|---|
| Statutory Liquidity Ratio (SLR) | • The percentage of NDTL that a bank must keep in safe and liquid assets such as unencumbered government securities, cash and gold.<br>• SLR changes frequently have an impact on the availability of resources in the banking system for lending to the private sector. |
| Cash Reserve Ratio (CRR) | • The average daily balance that a bank is required to maintain with the Reserve Bank as a share of suchpercentage of its Net demand and time liabilities (NDTL) as specified by the Reserve Bank in the Gazette of India from time to time. |
| Repo rate | • The (fixed) interest rate at which the Reserve Bank provides overnight liquidity to banks in exchange for the government and other approved securities as collateral under the liquidity adjustment facility (LAF). |
| Reverse Repo Rate | • The (fixed) interest rate at which the Reserve Bank absorbs liquidity from banks on an overnight basis in exchange for eligible government securities under the LAF. |
| Marginal Standing Deposit Facility (MSF) | • A facility through which scheduled commercial banks can borrow an additional amount of overnight money from the Reserve Bank by dipping into their Statutory Liquidity Ratio (SLR) portfolio up to a certain limit at a penal rate of interest.<br>• This acts as a safety valve for the banking system in the event of unexpected liquidity shocks. |
| Long Term Repo Operation (LTRO) | • The repo rate is used to provide funds through the LTRO. This means banks can take out one-year and three-year loans at the same one-day repo interest rate. However, compared to short-term (repo) loans, loans with a longer maturity time (such as one year and three years) normally have a higher interest rate. |
| Open Market Operation (OMO) | • These include the outright purchase and sale of government securities for the purpose of injecting and absorbing long-term liquidity, respectively. |
| Market Stabilisation Scheme (MSS) | • The central bank (RBI) can punish and impose sanctions aon banks for not following the guidelines provided under the monetary policy.<br>• For Instance, the imposition of the Prompt Corrective Action Framework is one such Direct Action measure. |

### *Difference between Quantitative and Qualitative tools*

| Parameter | Quantitative Tools | Qualitative Tools |
|---|---|---|
| Impact | Indirect in nature as any change in these tools may not transmit to the consumer immediately or directly. | Direct in nature as any changes are directly impacting the consumers as the case of requirement of a down payment. |
| Reach | The reach of Quantitative tools is general. They affect money supply in the entire economy and all sectors be it housing, automobile, manufacturing-everything. | The reach of Qualitative tools is selective. It can affect money supply in a specific sector of the economy like automobile or agriculture. |

### *What is Monetary Policy Transmission?*

- Monetary policy transmission is the process by which the central bank's policy action is transmitted in order to achieve the ultimate goals of inflation and growth.
- For instance, if the RBI reduces the policy rates then the benefits of reduced lending rates must be passed on to the customers.
- However the reality is different, the monetary policy was not transmitted to the customers in the internal benchmark era.
- The below table summarises the monetary policy transmission before and after the introduction of External Benchmark Lending Rates.

### *Monetary Policy Transmission Mechanism in India*

- In the Indian context, the repo rate has a significant impact on the momentary policy transmission.
- The repo rate serves as the anchor rate in determining the economy's interest rate (of the banking system).
- Now, how far a change in repo rate can cause a corresponding change in interest rate by banks is dependent on the banking system's financial conditions.
- In this regard, the banking system is central to India's monetary policy transmission.

- In general, there are two steps to the policy transmission mechanism:
  - In the financial markets, there is a transmission from the policy rate to key rates.
  - Transmisson through financial markets to final objectives such as inflation, employment and output.

### Channels of Transmission

- Changes in the central bank's policy rate have a lag effect on the economy through a range of channels, the most important of which are:

### Interest Rate

- Empirical studies suggest that call money rates and interest rates in areas, such as the government debt market, credit market or equities market and the currency market, are bi-directionally related.
- Furthermore, studies have demonstrated that policy rate transmission through this channel is asymmetric, i.e., the level of policy rate transmission varies depending on whether there is a liquidity surplus or a liquidity deficit, with transmission being more successful during the liquidity deficit conditions.
- One reason could be that banks would be more reliant on RBI liquidity during times of constrained liquidity, making them more susceptible to RBI-influenced short-term interest rates.

### Credit

- Even if the role of equities and debt markets has grown in recent years, India remains a banking-dominated economy.
- Because of the high reliance on bank funding, the bank lending and balance sheet channels are particularly crucial for monetary transmission.
- Credit growth appears to have an inverse relationship with policy rate fluctuations in terms of balance sheet implications.
- The annualized growth in nominal and real bank credit was lowered by 2.78 and 2.17 percent, respectively, by a 100 basis point rise in the policy rate.

### Exchange Rate

- Consumption switching between domestic and foreign goods is how the exchange rate channel works.
- In India, this pathway is weak, with some indications of exogeneity. This is due to India's weak integration with global financial markets and the Reserve Bank of India's interference in Forex markets.
- Despite this, it is discovered that currency rate depreciation is a major source of inflation risk.

### Asset Price

- Asset prices, particularly stock prices, react to interest rate changes, according to empirical evidence for India, however, the amount of the influence is minor.
- The asset price transmission channel has improved as the usage of formal finance for real estate acquisition has increased.
- During periods of high inflation, however, consumers have a tendency to shift away from bank savings and toward other types of savings such as gold and real estate, which tend to provide a superior inflation hedge.
- Because these acquisitions are financed through informal channels, they may be less responsive to contractionary monetary policy, weakening India's asset price channel.

### Monetary Policy Transmission - Significance

- The process of monetary policy transmission affects economic growth, prices and other aspects of the economy.
- Due to central banks raising the official interest rate, bank lending rates and bond yields will rise. Changes in the official interest rate are one way for central banks to influence the cost of borrowing for businesses and consumers.
- The discount rates used to compute the present value of cash flows, which are used to estimate the value of securities, are affected by changes in the official interest rate.

- Official interest rate changes have a substantial impact on economic actors' expectations. Economic agents would expect lending to increase as a consequence of lower borrowing costs or asset prices to rise as a result of lower discount rates and expectations of stronger growth if official interest rates were cut.
- Changes in the official interest rate have an impact on exchange rates. When interest rates in a country rise, investment in that country becomes more appealing, all other factors being equal.

### *Challenges to Monetary Policy Transmission*

- Inflexible Funding Costs
  - In India, customer deposits account for the vast majority of funds lent by banks, while market borrowings through the issuance of debentures/commercial papers are insignificant.
  - Because most of these deposits are contracted at fixed rates, the cost of funds is typically fixed.
  - Furthermore, interest rates on small savings remained high when compared to bank rates. This has resulted in a decrease in bank deposits.
  - Because of the lack of funds, banks have been unable to lend at lower deposit rates.
  - Banks will be unable to transmit monetary policy signals at the desired speed and magnitude until and unless this issue is addressed.
- Policy rates are not linked to the market.
  - Because the repo rate is administered by the Monetary Policy Committee, it cannot be considered a market-determined rate.
  - Banks are being asked to link their lending rates to the repo rate, with no regard for the cost of lending funds.

Nearly three-fourths of the outstanding loans are not linked to external benchmarks.

The share of outstanding loans linked to external benchmarks has risen from 2.4% in September 2019 to 28.5 per cent in March 2021.

- High levels of non-performing assets (NPAs)
  - Bank profitability has suffered as a result of the accumulation of large NPAs.
  - As a result, banks keep the weighted average lending rate significantly higher than the marginal lending rate.
- Four Balance Sheet Problems
  - According to Arvind Subramanian, former chief economic advisor, India's economic slowdown is facing a "four balance sheet challenge."
  - This has hampered credit growth in India and, as a result, the greater transmission of monetary policy.

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

(1) Cut and optimize the Statutory Liquidity Ratio
(2) Increase the Marginal Standing Facility Rate
(3) Cut the Bank Rate and Repo Rate

**Select the correct answer using the code given below:**

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

**Q. Which one of the following is not the most likely measure the Government/RBI takes to stop the slide of Indian rupee?**

(a) Curbing imports of non-essential goods and promoting exports
(b) Encouraging Indian borrowers to issue rupee-denominated Masala Bonds
(c) Easing conditions relating to external commercial borrowing
(d) Following an expansionary monetary policy

### *Prompt Corrective Action (PCA)*

With the use of Prompt Corrective Action, the Reserve Bank of India keeps track of the banks with poor financial performance.

- The objective of PCA is to address the issues of the non-performing assets in the banking system of India.
- Prompt Corrective Action needs to inform the depositors and investors when a bank is in crisis.
- The goal of PCA is to prevent the problems from reaching crisis proportions.
- Most importantly, the Prompt Corrective Action assists RBI to monitor the bank's key performance indicators and taking corrective

actions that would help in restoring the bank's financial stability.

- PCA frameworks for Non-Banking Financial Companies comes(NBFCs) will come into effect on October 1, 2022, based on their financial position on or after March 31.

### History of Prompt Corrective Action

- The Reserve Bank of India (RBI) introduced the PCA framework in 2002.
- The Prompt Corrective Action was reviewed in 2017, based on the recommendations of the Financial Sector Legislative Reforms Commission and a working group of the Financial Stability and Development Council on Resolution Regimes for Financial Institutions in India
- In early 2018, there were 12 banks under this framework and among these 11 were Public sector banks.
- As of March, there were only six banks under the PCA framework, due to corrective measures and recapitalization and all six are PCBs.

### Applicability of Prompt Corrective Action

- The Prompt Corrective Action applies to all the banks operating in India. It also includes the foreign banks operating through subsidiaries or branches on breach of risk thresholds of the identified indicators.
- However, the Small Finance Banks and Payment Banks have been removed from the list of lenders where PCA can be initiated.
- Parameters used in the Prompt Corrective Action Framework

### Parameters used in the PCA are given below.

- Capital Adequacy Ratio (CAR)- is used to boost the financial system's stability and protect depositors around the world.
- CET-1 Ratio- it is the percentage of common equity capital, net of regulatory adjustments, to total risk-weighted assets as defined in RBI Basel III guidelines.
- Non-Performing Asset- it's a loan where the interest payment is past due for more than 90 days.
- Tier 1 Leverage Ratio- is the link between a core capital of a bank and total assets.

### How Prompt Corrective Action Framework works?

- The Prompt Corrective Action Framework allows a regulator to place certain restrictions. It can be stopping the payment or increasing the branches in the country or overseas. It also allows placing a cap on the lending limit of a bank to one sector.
- Apart from that, some corrective measures are taken such as:
  - Restructuring operations
  - Special audits
  - Bringing new management
- Superseding the bank's board of directors
- A PCA framework is evoked when certain limitations placed on banks are exceeded. These limitations are based on the levels of capital and assent qualify profitability. When the number of negative returns on assents runs into 4 consecutive years, the restriction is applied.

### Issues with Prompt Corrective Action

- The concerns with the Prompt Corrective Action framework are noted down below.
- It has a bad impact on the rating of a bank and consumer confidence. In long run, it points out concerns about the bank's management and affects the bank's credit history.
- PCA may boost the loss of market share and also decline the position of the Public sector bank, in favor of the Private banks and foreign banks.
- according to the government, Prompt Corrective Action is a barrier to economic growth. That's why the government is advocating friendlier lending regulations.
- The not-so-friendly situation between the RBI and the government may impact India's reputation as an investment destination.

### Internal Benchmark Lending rate (IBLR)

- Lenders usually have an internal rate, which is the benchmark rate. Interest rates on all loans are linked to it.
- For example, a lender's benchmark rate is 6%.
    - It would offer an auto loan 2% higher than the benchmark rate, which will be 8%.
    - Similarly, it may provide personal loans at 8% higher than the benchmark rate or at 14%.
- Initially, RBI focused on making the benchmark rate transparent. It introduced different ways to calculate the benchmark rates which are as follows

| | |
|---|---|
| **Benchmark Prime Lending Rate (BPLR)** | • It was used as a benchmark rate by banks for lending till June 2010. |
| | • Under it, bank loans were priced on the actual cost of funds. |
| **Base Rate** | • Loans taken between June 2010 and April 2016 from banks were on base rate. |
| | • Base rate was the minimum interest rate at which commercial banks could lend to customers. |
| | • Base rate is calculated on three parameters — the cost of funds, unallocated cost of resources and return on net worth. |
| | • Hence, the rate depended on individual banks and they changed it whenever the parameters changed. |
| **Marginal Cost of Lending Rate (MCLR):** | • It came into effect in April 2016. |
| | • It is a benchmark lending rate for floating-rate loans. |
| | • This is the minimum interest rate at which commercial banks can lend. |
| | • This rate is based on four components—the marginal cost of funds, negative carry on account of cash reserve ratio, operating costs and tenor premium. |
| | • MCLR is linked to the actual deposit rates. Hence, when deposit rates rise, MCLR rises and lending rates increases. |

### What were the issues related to Internal Benchmark Lending Rates?

- The problem with the IBLR regime was that when RBI cut the repo and reverse repo rates, banks did not pass the full benefits to borrowers.
    - Repo rate is the rate at which the RBI lends money to the banks for a short term. Here, the central bank purchases security.
- In the IBLR Linked Loans, the interest rate has many internal variables of Bank which prevented the smooth transmission of RBI's Monetary Policy changes.

### About External Benchmark Lending Rate (EBLR)

- RBI mandated the banks to adopt a uniform external benchmark within a loan category, effective 1st October, 2019.
- 4 external benchmarking mechanisms:
    - The RBI repo rate
    - The 91-day T-bill yield
    - The 182-day T-bill yield
    - Anny other benchmark market interest rate as developed by the Financial Benchmarks India Pvt. Ltd.
- Banks are free to decide the spread over the external benchmark. However, the interest rate must be reset as per the external benchmark at least once every three months.
- ***Significance:*** Faster Monetary Transmission + Transparency in Interest rates + Standardisation of fixing interest rate.

### Concerns

- 28.5% of outstanding loans were linked to EBLR during March 2021.
- However, still 71.5% of outstanding loans are Internal Benchmark Lending Rate (IBLR-like base rate and MCLR) linked loans, which continues to impede the monetary policy transmission.

### What is Merger and Amalgamation?

- A merger occurs when two or more companies/entities combine to form either a new company or an existing company that absorbs the other target companies.

- For example, the consolidation of two entities, Tata Steel and the UK-based Corus Group, with the resulting entity being Tata Steel.

- Amalgamation is a type of merger in which two or more businesses combine to form a completely new entity/company.
  - For example, combination of two entities Mittal Steel and Arcelor have formed a new entity. ArcelorMittal
- Any two public sector banking entities may initiate merger talks, but the merger scheme must be finalised by the government in consultation with the central bank and voted on in Parliament.
- The scheme may be modified or rejected by Parliament. Parliamentary approval is also required in the case of a merger between a public sector bank and a private bank.
- Most bank mergers have resulted from the central bank's efforts to safeguard the financial system and depositors' funds.
- Some are also motivated by the need for consolidation and growth.
- Mergers anticipate that weak banks will sell assets, cut costs and close loss-making branches.

### Historical Perspective

- The Banking Regulation Act of 1949 specifies the procedures for bank consolidation.
- The idea of bank mergers has been floating around since 1998, when the M. Narasimham Committee recommended to the government that banks be merged into a three-tiered structure —
  - Three large banks with an international presence at top
  - Eight to ten national banks
  - Large number of regional and local banks.
- In 2014, the PJ Nayak Committee recommended that the government privatise or merge some PSBs.
- The government approved the "merger" of SBI's five associate banks and Bharatiya Mahila Bank (BMB) with SBI in 2017.
- In 2017, the government formed an Alternative Mechanism Panel, led by the Minister of Finance and Corporate Affairs, to investigate merger proposals of public sector banks.

### Reasons for Merger of Banks

- The Indian government believes that a larger bank will be more resilient in the face of adversity.
- A larger bank also has a larger corpus to distribute, which improves the bank's ability to lend to large projects, particularly those in the infrastructure and power sectors.
- The government believes that larger banks will be able to compete more effectively on a global scale, as well as increase their economic efficiency by eliminating similar jobs and lowering lending costs.
- To protect vulnerable PSBs from loss, thereby protecting customers and the financial system.
- Larger banks would also be able to comply with BASEL III standards.
- The formation of larger banks can help to address the problem of credit lending, which is based on the twin balance sheet crisis.

### Current Status of Merger of Banks in India

- The Finance Minister announced the largest consolidation plan for public sector banks (PSBs), merging ten of them into four.
- The Indian government has decided to merge the following banks:
  - Indian Bank and Allahabad Bank (Anchor Bank - Indian Bank).
  - Punjab National Bank, Oriental Bank of Commerce and United Bank will be merged (Anchor Bank - PNB).
  - The Union Bank of India will be merged with Andhra Bank and Corporation Bank (Anchor Bank - Union Bank of India).
  - Canara Bank and Syndicate Bank (Anchor Bank - Canara Bank).
- After consolidation, the total number of PSBs has decreased from 27 in 2017 to 12.

- Previously, Vijaya Bank and Dena Bank merged with Bank of Baroda (BoB) – effective April 1, 2019.
- Following the completion of all merger exercises, India's next-generation PSBs can now be ranked according to their business size, as follows:

| S.No. | Bank Name | PSB Rank by size |
|---|---|---|
| 1. | State Bank of India | Largest |
| 2. | Punjab National Bank | 2nd largest |
| 3. | Bank of Baroda | 3rd largest |
| 4. | Canara Bank | 4th largest |
| 5. | Union Bank of India | 5th largest |
| 6. | Bank of India | 6th largest |
| 7. | Indian Bank | 7th largest |
| 8. | Central Bank of India | 8th largest |
| 9. | Indian Overseas Bank | 9th largest |
| 10. | UCO Bank | 10th largest |
| 11. | Bank of Maharashtra | 11th largest |
| 12. | Punjab & Sind Bank | 12th largest |

## *Merger of Banks – Benefits*

- The consolidation of PSBs aids in the **strengthening of its presence** on a global, national and regional scale.
- Due tothe presence of shared overlapping networks, it has the potential to **reduce operational costs**. And the banks' lending costs will be reduced as their operational efficiency improves.
- All merged banks in a specific bucket share a common **Core Banking Solutions (CBS) platform**, which allows them to synergize technologically.
- Larger banks are better able to raise resources from the market rather than rely on the state exchequer.
- For the benefit of customers, the loan tracking mechanism in PSU banks is being improved.
- As the number of PSBs decreases as a result of the merger process, capital allocation, performance
- milestones and monitoring will become easier for the government.
- Large banks will have **large balance sheets** as a result of the consolidation of PSBs, allowing them to meet the credit needs of the expanding Indian economy.
- It will also strengthen PSBs' ability to raise funds without relying on the state budget.
- Banking entities formed by the merger of PSU banks will be better able to **absorb financial shocks**.
- ***Economies of Scale* -** Bank mergers will result in improved scale efficiency due to increased customer base and market reach.
- A broader range of products and services for customers would result in lower lending capital risk.
- **Enhanced Operational Efficiency -** A synergistic partnership would make the best use of each other›s network, customer base and access to low-cost deposits.
  - Organizational restructuring would improve managerial efficiency while also providing opportunities to learn best practises from each constituent entity.
- **Global Bank -** Stakeholders would have more options if banks were stronger and more globally competitive.

## *Merger of Banks – Challenges*

- The banks that are merging are expected to see a **slowdown in decision making at the top level**, as senior executives of such banks will put all decisions on hold, resulting in a drop in credit delivery in the system.
- The **geographical synergy** between the merged banks is **somewhat lacking** during the merger process. In three of the four mergers, the merged banks only serve one region of the country.
- The move is sound, but the **timing is not ideal**. The economy is already slowing and private consumption and investment are on the decline.
  - As a result, there is a need to boost the economy and increase credit flow in the short term and this decision will impede that credit flow in the short term.
- A complex **merger with a weaker and undercapitalized PSB** would hinder the bank›s recovery efforts because the

weaknesses of one bank could be transferred to the merged entity, causing the merged entity to become weak.

- There would be a number of **human resource issues**, such as difficulty adapting to a new emerging culture, dissatisfaction due to long-distance transfers and so on.
- **Customer retention** would be difficult because customers might be hesitant to bank with a larger parent bank.
- With increased market power, larger banks may engage in **monopolistic behaviour**, ignoring local needs.

### *Merger of Banks – Way Forward*

- Dual regulation of PSBs by the Ministry of Finance and the RBI frequently results in decision paralysis – making consolidation of banks a redundant measure if they are not given the power to act quickly, as PJ Nayak pointed out.
- Before making any significant changes to any emerging architecture, public bank governance must be improved.
- Larger banks provide greater resilience to the banking sector, but ignoring larger red flags such as strong credit appraisal and risk control systems will do little to help create robust banks.
- As a result, it is critical to focus on ensuring a solid foundation for PSBs.

### *What is NABARD?*

- The National Bank for Agriculture and Rural Development was established to meet the credit needs of agriculture and rural development.
- NABARD was envisioned as the **national apex institution** for the entire rural credit system, providing supplemental funding to all rural credit institutions and coordinating their operations.
- NABARD began operations with a share capital of Rs. 100 crores and further Rs. 1400 crores were transferred to it from the **RBI's Agricultural Credit Funds**.

### *Historical Background*

- The importance of institutional credit in boosting the rural economy was obvious to the Government of India from the beginning of its planning process.
- As a result, at the request of the Government of India, the Reserve Bank of India (RBI) formed a **Committee to Review the Arrangements for Institutional Credit for Agriculture and Rural Development (CRAFICARD)** to investigate these critical issues.
- The Committee was established on March 30, 1979, under the chairmanship of **B. Sivaraman**, a former member of the Government of India's Planning Commission.
- The interim report of the Committee, submitted on November 28, 1979, outlined the need for a new organizational device to provide undivided attention, forceful direction and pointed focus to credit-related issues related to rural development.
- Its recommendation was to establish a one-of-a-kind development financial institution to address these aspirations and the formation of**National Bank for Agriculture and Rural Development (NABARD)** was approved by Parliament through**Act 61 of 1981**.
- On **July 12, 1982**, NABARD was established by transferring the agricultural credit functions of the RBI and the refinance functions of the then **Agricultural Refinance and Development Corporation (ARDC)**.
- On **November 5, 1982**, late Prime Minister Smt. Indira Gandhi dedicated it to the service of the nation.
- It was founded with an initial capital of Rs.100 crore and had a paid-up capital of Rs.14,080 crore as of March 31, 2020.
- NABARD today is fully owned by the Government of Indiaas a result of a change in the composition of share capital between the Government of India and the Reserve Bank of India.

## *NABARD – Functions*

### *Financial Functions*

- NABARD provides financial assistance to the farm sector through **refinancing for a variety of agriculture and allied activities** such as minor irrigation, plantation and horticulture, land development, farm mechanization and animal husbandry.
- Commercial banks, state cooperative banks, regional rural banks and state land development banks are eligible for refinancing.
- NABARD is also empowered to extend loans and advances against the security of stocks and **promissory notes**.
- Aside from refinancing, NABARD also makes **short-term loans to State Co-operative Banks and Regional Rural Banks** to fund seasonal agricultural operations, crop marketing and agricultural input purchases.

### *Developmental Functions*

- NABARD engages in a variety of **developmental activities**, including the development of credit plans, the establishment of institutions and the promotion of research and technology.
- It also coordinates rural credit agencies and develops expertise to address agricultural and rural issues.
- NABARD has a **Research and Development Fund (RDF)** to assist and promote agricultural and rural development research, including the provision of research and training facilities.
- NABARD's Central Board is also empowered to establish a **"Reserve Fund"** or any other fund it deems appropriate.

### *Supervisory Functions*

- The **Banking Regulation Act of 1949** gave NABARD the **authority to inspect the operations** of Regional Rural Banks and Co-operative Banks.
- Before the RBI will grant permission to open a new branch, it must receive its recommendation from NABARD.

### *NABARD - Governance*

- A **Board of Directors** governs NABARD›s operations. In accordance with the NABARD Act, the Board of Directors is appointed by the Government of India.
- The Chairperson and other directors (except those elected by shareholders and Central Government officials) will be appointed by the Central Government in consultation with the RBI.
- The Board of Directors may appoint an **Executive Committee** comprised of the prescribed number of directors (referred to as **Executive Directors**).
- The Executive Committee shall perform such functions as the Board may prescribe or delegate to it.
- The **NABARD (Amendment Bill) 2017** which was passed in 2018 allowed the Union Government to increase NABARD›s authorized capital **from Rs. 5,000 crore to Rs. 30,000 crore.**

## *NABARD – Contribution/Achievements*

### *Financial Functions*

- ***Refinance*** - NABARD disbursed ₹1,30,964 crore and ₹92,786 crores for supporting ST and LT financing by banks, respectively, during the year 2020-21.
- ***Short Term Loans*** - Crop loans are extended to farmers for crop production by financial institutions, which support in ensuring food security in the country.
  - During the year 2020-21, NABARD has disbursed ₹95,731 crores for Seasonal Agricultural Operations and ₹11,733 crores for other than seasonal agriculture operations to Cooperative Banks and RRBs.
  - NABARD also introduced a new window of assistance to SFBs and under this facility, Short Term Refinance of ₹49 crores was extended to North East SFB.

- **Long Term Loans -** NABARD's long-term refinance provides credit to financial institutions for a wide gamut of activities encompassing farm and non-farm activities with a tenor of 18 months to more than 5 years.
  - **To address the issue of rural migration and give a boost to agriculture & rural sector post Covid period, NABARD introduced 4 special refinance schemes viz.**
  - **Scheme for PACS as MSC**, Scheme for beneficiaries of the **watershed as well as Wadi project areas**, **Scheme for Water**, **Sanitation and Hygiene (WASH),** and **Scheme for Micro Food Processing activities.**
- ***Special Liquidity Facility -*** NABARD, has disbursed ₹16800 crore to Cooperative Banks, ₹6700 crore to RRBs and ₹2000 crore to NBFC-MFIs to ensure unhindered flow of credit to farmers to carry out harvesting and production activities during lockdown due to which India outperformed in Agriculture production even during the lockdown.
- ***Rural Infrastructure Development Fund* - RIDF** was set up with NABARD in 1995-96 by the Reserve Bank of India out of the shortfall in lending to priority sector by scheduled commercial banks for supporting rural infrastructure projects.
- ***Long-Term Irrigation Fund* -** The Long-Term Irrigation Fund (LTIF) was announced in the Union Budget 2016–17 for fast-tracking 99 identified medium and major irrigation projects, spread across 18 states in mission mode by December 2019.
- Subsequently, the Government of India approved funding for four more projects under LTIF viz;
- Polavaram project in Andhra Pradesh, North Koel project in Bihar and Jharkhand, Relining of Sirhind and Rajasthan Feeder Canal project of Punjab and Shahpur Kandi Dam in Punjab.
- ***Pradhan Mantri Awaas Yojana - Grameen (PMAY-G)* -** NABARD sanctioned an amount of ₹20,000 crores and released ₹19999.80 crores during 2020-21 to the **National Rural Infrastructure Development Agency (NRIDA)** under PMAY-G.
  - The financial assistance was channelized towards PMAY-G, which plans to provide a pucca house, with basic amenities, to all houseless households including those living in kutcha and dilapidated houses, by 2022.
- ***Micro Irrigation Fund (MIF)* -** The objective of the fund is to facilitate State Govts. in mobilizing additional resources for expanding coverage under micro irrigation and incentivizing its adoption beyond provisions of PMKSY-PDMC.
- ***NABARD Infrastructure Development Assistance (NIDA)* -** NABARD Infrastructure Development Assistance (NIDA) offers flexible long-term loans to well-managed public sector entities for financing rural infrastructure.
  - Projects for agriculture infrastructure, rural connectivity, renewable energy, power transmission, drinking water and sanitation and other social and commercial infrastructure are financed under NIDA.
- ***Credit Facility to Federations (CFF)* -** CFF provides short-term credit support to state government entities like agricultural marketing federations, civil supply corporations, dairy cooperatives, /milk unions or federations etc., for procurement, processing and marketing of agricultural commodities, input supply and value and supply chain management.
- ***Dairy Processing and Infrastructure Development Fund (DIDF)* -** The objectives of the scheme are modernization and infrastructure augmentation for milk processing and value addition and to ensure optimum price realization by the primary producers.
- ***Fisheries and Aquaculture Infrastructure Development Fund (FIDF)* -** NABARD will fund the public infrastructure components for various facilities like fishing harbors, fish landing centres, modernized State fish seed farms, modern fish markets, disease diagnostic laboratories, aquatic quarantine facilities and training infrastructure.

- ***Rural Infrastructure Assistance to State Governments (RIAS)*** - NABARD has launched a new product "Rural Infrastructure Assistance to State Governments (RIAS)" with an initial corpus of ₹15000 crores.
    - Under RIAS, NABARD will provide financial assistance to State Governments in Eastern Region, for creating infrastructure that supports rural livelihoods, hinging on **5-J approach – Jan (human being), Jal (Water), Jameen (land), Janwar (livestock) & Jungle (forest).**
- ***Warehouse Infrastructure Fund (WIF)*** - Government of India created Warehouse Infrastructure Fund (WIF) in the year 2013- 14 with NABARD with a corpus of ₹5,000 crores for providing loans to meet the requirements for scientific warehousing infrastructure for agricultural commodities in the country.
- ***Food Processing Fund*** - With a view to promoting food processing industries in the organized sector on a cluster basis, the Government of India instituted the Food Processing Fund (FPF) in NABARD in 2014–15, with a corpus of ₹2,000 crores.
- ***Geo Tagging of Warehouses*** - NABARD took on the onus of creating a web-based Agri-Storage Information System, which not only captures the details of the infrastructure but also captures the Geo-spatial coordinates.
- The **Farmers APP (KisanBhandar)** has been developed for both Android and IOS supporting devices which will be used by Farmers/Traders/Producers to locate the geotagged assets in the vicinity.

## *Development Functions*

- ***Kisan Credit Card Scheme*** - This scheme was launched in 1998 in collaboration with the RBI to provide crop loans.
- ***RuPay Kisan Cards*** - All farmer clients were given RuPay cards in an attempt to bring about a technological change in the rural financial sector.
- ***Watershed Development*** - Cumulatively, as on 31 March 2021, against 3401 watershed development projects sanctioned covering a total project area of 23.43 lakh ha, 1,914 projects have been completed successfully.
- ***Tribal Development*** - Tribal Development Fund (TDF) was set up by NABARD in the year 2003-04 with a corpus of ₹50 crores out of its profit.
    - As on 31 March 2021, a total of 835 projects benefitting 5.60 lakh families spread across 5.33 lakh acre area have been sanctioned.
- ***Climate Change Adaptation Projects*** - NABARD disbursed an amount of ₹0.97 crores during 2020-21 under the Climate change fund for promoting and supporting activities aimed at addressing climate change impacts, adaptation and mitigation measures, awareness generation, knowledge sharing and for facilitating sustainable development.
- ***Umbrella Programme on Natural Resource Management*** - Cumulatively 334 UPNRM projects have been sanctioned across the country covering 10 major natural resource management sectors.
- ***Financial Inclusion*** - As on 31 March 2021, a cumulative amount of ₹4,592.81 crores was sanctioned and an amount of ₹2,527.67 crores was disbursed towards various schemes implemented under FIF (Financial Inclusion Fund) by generating demand for banking services and building payment/ acceptance infrastructure at the ground level.
- ***Microfinance Sector*** - NABARD had launched the **Self Help Group-Bank Linkage Programme (SHG-BLP)** in 1992. The programme has empowered 112.23 lakh Self Help Groups (SHGs) and 13.5 crore rural households in India as on 31 March 2021.
- ***EShakti*** - In a bid to digitize SHGs, project EShakti was launched on 15 March 2015 in 2 districts as a pilot.
    - The Project has enabled the Bankers in providing on line credit to SHGs based on an inbuilt grading system in the portal.
    - It has resulted in an increase in credit linkage with banks from 38% groups to 53% groups as on 31 March 2021.
- ***SHG based Livelihood Interventions*** - For stimulating the micro-entrepreneurship

movement NABARD has launched two skill building and capacity building programmes viz., **Micro-Enterprise Development Programme (MEDP) and Livelihood and Enterprise Development Programme (LEDP).**

- ***Skill Development*** - In tune with GoI's goal, NABARD has developed a structured approach for addressing the skill gap in rural India through demand and outcome-based programmes through multiple stakeholders in skill development ecosystem leading to wage/self-employment.
- ***Marketing Initiatives*** - To support rural producers in the farm and off-farm sector to market their produce effectively, NABARD has been extending support for setting up of **Rural Haats, Rural Marts,** and participation of artisans and craftsmen in National/Regional level Exhibitions and Melas.
- ***Agri-Business Incubation Centres (ABICs)*** - In order to develop a supportive ecosystem for Agri entrepreneurs, NABARD started supporting the setting up of Agri-Business Incubation centre in 2017-18.
  - The policy envisaged extending support to eligible institutions like Agriculture universities/similar institutions for setting up ABICs and meet the eligible operational expenditure for functioning for a period of five years.
  - It is a step towards promoting more agri-startups, Agri/Rural entrepreneurs and enterprises.
- ***Catalytic Capital Fund*** - To support the Agri Start-ups, NABARD has set up a "Catalytic Capital Fund for supporting Rural and Agri Start-ups".
- ***Credit Linked Capital Subsidy Scheme (CLCSS)*** - NABARD is one of the nodal agencies for implementing the Credit Linked Capital Subsidy Scheme (CLCSS) for Technology Upgradation of Micro & Small Enterprises of Government of India.

## *NABARD – Challenges*

- NABARD, as an offspring of the RBI, shares its parent institution's work culture, ethos and development orientation.
  - The breaking of this link (the transfer of the RBI's 0.4 percent equity in NABARD to the Union Government under the NABARD Act 2017) has resulted in a significant disadvantage for both the RBI and NABARD.
  - This has weakened the RBI's ability to play a role or participate in its operations.
  - A strong relationship between the central bank and the development institution will benefit agriculture and rural development at a critical juncture in the country's agrarian crisis.
- The **cost of financing has risen** because NABARD›s market borrowings account for 80% of its resources.
  - Cooperative structures that are member-driven and de-bureaucratized must fill the institutional credit gaps left by commercial banks.
- The **northeastern states** have received a small portion of NABARD credit funds. The northeast receives 1% of credit, trapping farmers in the web of moneylenders.
- Bank penetration in **insurgency-affected states** is low and should be increased.

## *What is Financial Inclusion?*

- Exclusion from the financial system is commonly used to define financial inclusion.
  - If a target group does not have access to mainstream formal financial services such as banking accounts, credit cards, insurance, payment services and so on, they are considered financially excluded.
- **In 2006**, the Government of India formed a committee chaired by **Dr. C. Rangarajan** to study the pattern of exclusion from access to financial services across region, gender and occupational structure, as well as to identify the barriers faced by vulnerable groups in accessing credit and financial services and to recommend steps needed for financial inclusion.
- In January 2008, the committee submitted its report. According to the committee, **financial inclusion** is defined as:

- **The process of ensuring access to financial services and timely and adequate credit where needed by vulnerable groups such as weaker sections and low income groups at an affordable cost.**

- Financial inclusion is achieved when all individuals and businesses have access to and can use a wide range of financial services that are responsibly and affordably provided by sustainable institutions in a well-regulated environment.

## *National Strategy for Financial Inclusion*

- The **Reserve Bank of India (RBI)** has devised a **National Strategy for Financial Inclusion (NSFI)** for the period**2019-2024**.
- It is an ambitious strategy that aims to strengthen the ecosystem for various modes of digital financial services in all **Tier II to Tier VI centres** in order to build the infrastructure needed to transition to a cashless society by March 2022.
- Classification of Centres (Tier-wise):
  - Tier I - 1,000,000 & above
  - Tier II - 50,000 to 99,999
  - Tier III - 20,000 to 49,999
  - Tier IV - 10,000 to 19,999
  - Tier V - 5,000 to 9,999
  - Tier VI - Less than5000

## *Objectives*

- Raise consumer awareness and educate them about financial services, the availability of various types of products and their features.
- A target has been set for every willing and eligible adult who has enrolled in the Prime Minister Jan Dhan Yojana to be enrolled in an insurance scheme and a pension plan by March 2020.
- Changeattitudes in order to transformknowledge into action.
- Make sure that customers understand their rights and responsibilities as financial services customers.
- Increase the reach of banking outlets by March 2020 to provide banking access to every village within a 5-kilometer radius or a hamlet of 500 households in hilly areas.
- By March 2024, every adult should have access to a financial service provider via a mobile device.

## *Stakeholders*

- Financial Consumers
- Banks, Non-banking financial companies (NBFCs) etc.
- Educational Institutions
- Non-Governmental Organizations(NGOs)
- Regulators in the Financial Sector
- Centraland state governments
- International players such as the OECD, G-20 and others.

## *Significance*

- Steps must be taken to strengthen the digital financial services ecosystem, including increased awareness of the use of digital modes of transaction, increased acceptance infrastructure and a safe environment that incorporates consent and privacy principles.
- There is a need to develop a sector-specific action plan to monitor targets and review progress, as well as a strong regulatory and legal framework aimed at protecting customers' interests, promoting fair practises and limiting market manipulations.
- At the moment, financial inclusion policies are aimed at specific sectors such as small and medium-sized businesses, agriculture or specific regions such as aspirational districts.
- The strategy also calls for the **Public Credit Registry (PCR)** to be fully operational by March 2022, so that authorised financial entities can use it to evaluate credit proposals from all citizens.

## *Financial Inclusion – Initiatives*

1. ***Jan Dhan-Aadhar-Mobile (JAM) Trinity***
   - The combination of Aadhaar, PMJDY and an increase in mobile communication has transformed how citizens access government services.

- According to estimates in August 2021, the total number of Jan Dhan scheme beneficiaries was more than 430 million.
- Aadhaar has significantly altered the concept of individual identity, resulting not only in a secure and easily verifiable system, but also in an easy-to-obtain system that will aid in the financial inclusion process.
- The government has also launched a number of flagship schemes to promote financial inclusion and provide financial security in order to empower the country's poor and unbanked citizens.
- The Pradhan Mantri Mudra Yojana, the Stand-Up India Scheme, the Pradhan Mantri Jeevan Jyoti Bima Yojana, the Pradhan Mantri Suraksha Bima Yojana and the Atal Pension Yojana are among them.

2. ***Financial services expansion in rural and semi-urban areas***
   - The Reserve Bank of India (RBI) and NABARDhave launched initiatives to promote rural financial inclusion.
   - These include the establishment of bank branches in remote regions.
   - **Kisan Credit Cards (KCC)** are being issued.
   - **Self-help groups (SHGs)** are linked with banks.
   - Increasing the number of ATMs.
   - **Businesscorrespondent model** of banking.
3. ***Digital Payments Promotion***
   - In comparison to the past, digital payments have become more secure thanks to NPCI's strengthening of the **Unified Payment Interface (UPI).**
   - The Aadhar-enabled payment system (AEPS) allows an Aadhar-enabled bank account (AEBA) to be used at any location and at any time through the use of micro ATMs.
   - The payment system has become more accessible as a result of offline transaction-enabling platforms such as **Unstructured Supplementary Service Data (USSD)**, which allows users to use mobile banking services without the need for an internet connection, even on a basic mobile handset.
4. ***Improving Financial Literacy***
   - **The Reserve Bank of India has launched a project called "Project Financial Literacy."**
     - The project's goal is to disseminate information about the central bank and general banking concepts to a variety of target groups, including school and collegechildren, women, the rural and urban poor, military personnel and senior citizens.
   - **'Pocket Money'** is the flagship programme of the **Securities and Exchange Board of India (SEBI)** and the **National Institute of Securities Markets (NISM)** aimed at increasing financial literacy among school students.
     - The goal is to teach students about the value of money and the importance of saving, investing and financial planning.

## *Financial Inclusion – Significance*

- Financial inclusion enables good financial decision making through financial literacy and qualified advice.
- It also enables access to financial services for all, particularly vulnerable groups such as weaker sections, minorities, migrants, the elderly, micro entrepreneurs and low income groups, at an affordable cost, allowing them to:
  - Manage their finances on a day-to-day basis confidently, effectively and securely;
  - Plan for the future in order to protect themselves from short-term fluctuations in income and expenditure, as well as to create wealth and profit from financial sector developments;
  - Dealing with financial difficulties effectively reduces their vulnerability to the unexpected.
- Various initiatives under financial inclusion have resulted in significant changes in the

last-mile connectivity of financial services to its people.

- Financial inclusion has the potential to reduce poverty and create jobs by providing underprivileged and marginalised sections of society with access to financial resources.
- Previously, private institutions did not engage with the poor on a large scale as customers. This has now changed, with active participation from private players.
  - Payment banks such as paytm, airtel money and jio money have realised that bringing the poor into the financial net benefits their business models as well.
- The integration of the JAM trinity and the **Direct Benefit Transfer (DBT) scheme** has been largely successful.
  - This has resulted in a significant improvement in terms of targeted and accurate payments.
  - It has also aided in the elimination of duplicate entries and the reduction of reliance on cash payments.

## *Financial Inclusion – Challenges*

1. ***Access to Bank Accounts Is Not Universal***
   - Bank accounts provide access to all financial services.
   - However, according to a World Bank report, approximately 190 million adults in India do not have a bank account, making India the world's second largest unbanked population after China.
2. ***Digital Divide***
   - The following are the most common barriers to the adoption of digital technology that could promote financial inclusion:
     - Inadequate availability of appropriate financial products.
     - Inability of stakeholders to use digital services due to a lack of skills.
     - Problems with infrastructure.
     - Low-income customers who cannot afford the technology needed to access digital services.
3. ***Implementation Issues***
   - The Jan Dhan scheme resulted in the creation of a large number of dormant accounts that never saw any banking transactions.
   - All such activities impose costs on the institutions and thus, massive operational costs proved to be detrimental to the overall goal.
   - To avoid these unintended consequences, it is critical that all stakeholders participate in such programmes with proper intent and not just for the sake of participating.
4. ***Economy Is Informal and Cash-Dominated***
   - India has a heavily dominated cash economy, which makes digital payment adoption difficult.
   - Furthermore, the International Labour Organization (ILO) estimates that approximately 81 percent of all employed people in India work in the informal sector.
   - The combination of a huge informal sector along with a high dependence on cash mode of transaction poses an impediment to digital financial inclusion.
5. ***Gender Inequality in Financial Inclusion***
   - According to the 2017 **Global Findex database**, 83 percent of males over the age of 15 in India had a financial institution account in 2017, compared to 77 percent of females.
   - This is due to **socioeconomic factors** such as men having a greater availability of mobile handsets and internet data facilities than women.
6. ***Inadequate Credit Penetration***

- The **lack of information** available to formal creditors **to determine credit worthiness** is one of the main constraints in providing credit to low-income households and informal businesses. As a result, the cost of credit is high.
- As a result, the number of loan accounts per 1,000 adults in India was 154 in 2016. This is quite low when compared to comparable economies such as the BRICS nations.

## *What is MUDRA Bank?*

- The **Micro Units Development Refinance Agency (MUDRA)** Bank is a refinancing institution for micro-finance institutions.
- MUDRA is currently conceived not only as a refinance institution, but also as a **regulator** for **microfinance institutions (MFIs).**
- MUDRA would be in charge of developing and refinancing the micro-enterprise sector by assisting finance institutions that lend to micro/small business entities engaged in **manufacturing, trading and service activities**.
- MUDRA would **collaborate with banks, microfinance institutions and other lending institutions** at the state and regional levels to provide microfinance support to the country›s microenterprise sector.
- The GOI decided that MUDRA would provide refinancing assistance, monitor PMMY data by managing the web portal and facilitate the offering of guarantees for loans made under PMMY.
- MUDRA Bank operates through financing institutions, which in turn connect with last mile lenders such as **Micro Finance Institutions (MFIs), Primary Credit Cooperative Societies, Self Help Groups (SHGs), Non-Bank Financial Companies (NBFCs)** (other than MFIs) and other lending institutions.
- **Microfinance institutions (MFIs)** can become **Member Lending Institutions (MLIs)** of MUDRA (SIDBI) Bank for refinancing and National Credit Guarantee Trustee Company (NCGTC) for credit guarantee.

## *Historical Perspective*

- According to the Government of India, large industries employ only 1.25 crore people in the country, while micro units employ approximately 12 crore people.
- There is a need to focus on the 5.75 crore self-employed people (owners of micro units) who use funds totaling 11 lakh crore, with an average per unit debt of just 17,000 rupees. Capital is essential for small business owners.
- These entrepreneurs rely heavily on local money lenders for their funding needs.
- Given the significance of these enterprises, the Government of India established the **Micro Units Development and Refinance Agency Bank (MUDRA Bank) in April 2015** with the goal of funding these unfunded non-corporate enterprises.
  - This was introduced as the **PMMY (Prime Minister Mudra Yojana).**
- The formation of **MUDRA Bank was announced** in the Union Budget presented by Finance Minister Arun Jaitley for **Fiscal Year 2015-16.**
- As a result, MUDRA was registered as a company under the Companies Act 2013 in March 2015 and as a **non-banking finance institution** with the RBI on April 7, 2015.
- MUDRA was launched on **April 8, 2015,** at Vigyan Bhawan in New Delhi by Prime Minister Narendra Modi.

## *MUDRA Bank – Important Features*

- Under this banking model, micro-enterprises can obtain a loan of up to ten lakh rupees through refinancing (through the Public and private sector banks, NBFCs, MFIs, RRBs, District Banks etc).
- Its products are divided into three finance buckets: **Shishu** (loans up to 50,000), **Kishor** (50,000 to 5 lakh) and **Tarun** (5 lakh to 10 lakh).
- Despite the fact that the scheme covers fruit and vegetable traders, it does not, in general, refinance the agriculture sector.
- This scheme has **no fixed interest rate.** According to the Government of India, banks are currently charging interest rates ranging from Base Rate plus 1% to 7% per annum.
- Loan interest rates are supposed to vary based on the risk involved in the enterprises seeking loans. Except when the loan is linked to another government scheme, there is no general subsidy offered on interest rates.

## *MUDRA Bank – Roles & Responsibilities*

- Developing policy guidelines for micro/small enterprise financing businesses.

- **MFI** registration, regulation, accreditation and rating
- establishing responsible financing practises to prevent indebtedness and ensure proper client protection principles and recovery methods
- Creation of a standardised set of covenants governing last-mile lending to micro/small businesses.
- **Promoting appropriate technology solutions for the lastmile.**
- Creating and implementing a **Credit Guarantee Scheme** to provide guarantees for loans made to micro-enterprises.
- Developing a good architecture for **Last Mile Credit Delivery** to Micro Businesses through the **Pradhan Mantri Mudra Yojana scheme**.

## *MUDRA Bank – Significance*

- According to the government, by March 2020, a total of 22.53 crore loans had been sanctioned since the scheme's inception, with a total loan disbursed of around 11.51 lakh crores.
- Under the scheme, approximately **70% of loan recipients are women**.
- MUDRA **prioritises lending** to enterprises established by **underprivileged sections of society**, particularly those from scheduled caste/tribe groups, first generation entrepreneurs and existing small businesses.
- **There are an estimated 5.77 crore small business units in India, the majority of which are sole proprietorships that operate small manufacturing, trading or service businesses. Sixty-two percent of these are owned by SC/ST/OBC.**

## *MUDRA Bank – Challenges*

- The rise in **non-performing assets** in the case of Mudra loans has been a source of concern for both the government and the RBI.
- According to the Ministry of Finance, net NPAs under Mudra loans increased to 2.88 percent between April and December 2019 (against 2.52 per cent of the same period in 2018).

## *Small Finance Bank vs Payments Bank*

Given below is a tabulated difference, comparing the aspects, guidelines and functions of the given two types of banks in India:

| Small Finance Banks | Payments Bank |
|---|---|
| **Definition** – Small Finance Banks are financial institutions that intend to fund the financial needs of the underprivileged sections through basic banking activities | **Definition** – A Payments Bank is like any other bank, but operating on a smaller scale without involving any credit risk. It can carry out most banking operations but can't advance loans or issue credit cards. |
| Objectives:<br>These have been set up to further financial inclusion by:<br>• supply of credit to small business units; small and marginal farmers; micro and small industries; and other unorganised sector entities | Objectives:<br>The primary objective of setting up payments banks will be to further financial inclusion by providing:<br>• small savings accounts<br>• payments/remittance services to migrant labour workforce, low-income households, small businesses, other unorganised sector entities |
| How many Small Finance Banks are in India?<br>As of December 2021, there are 11 Small Finance Banks in the country:<br>• Au Small Finance Bank Ltd.<br>• Capital Small Finance Bank Ltd<br>• Fincare Small Finance Bank Ltd.<br>• Equitas Small Finance Bank Ltd<br>• ESAF Small Finance Bank Ltd.<br>• Suryoday Small Finance Bank Ltd.<br>• Ujjivan Small Finance Bank Ltd.<br>• Utkarsh Small Finance Bank Ltd.<br>• North East Small Finance Bank Ltd<br>• Jana Small Finance Bank Ltd<br>• Shivalik Small Finance Bank Ltd | How many Payments banks are in India?<br>As of December 2021, there are 6 Payments Bank in India:<br>• Airtel Payments Bank Ltd<br>• India Post Payments Bank Ltd<br>• FINO Payments Bank Ltd<br>• Paytm Payments Bank Ltd<br>• Jio Payments Bank Ltd<br>• NSDL Payments Bank Limited |

| | |
|---|---|
| **Capital Requirement:** The minimum paid-up equity capital for small finance banks is Rs.100 crore | **Capital Requirement:** The minimum paid-up equity capital of the payments bank is Rs.100 crore |
| **Scope of Activities:** • Take up all primary banking activities only in the underserved section | **Scope of Activities:** • ATM/Debit cards can be issued • Credit cards cannot be issued • Mobile banking available |
| **Time Deposit:** Time Deposit such as Fixed Deposit (FD) and Recurring Deposit (RD) are both accepted | **Time Deposit:** These do not accept time deposits like FD and RD |
| **They can offer small loans** | **They cannot offer loans** |
| There is no restriction in the area of operations of small finance banks | The payments bank cannot set up subsidiaries to undertake non-banking financial services activities |
| Capital Small Finance Bank, launched in 2016 was India's first Small Finance Bank | Airtel Payments Bank, introduced in 2016, became India's first entity to receive a payments bank license from RBI |

## *India Post Payments Bank (IPPB)*

- It was launched on September 1, 2018 under the **Department of Posts,** Ministry of Communication
- Its **100% equity** is owned by the Government of India.
- ***Vision:*** To build the most accessible, affordable and trusted bank for the common man in India.
- ***Fundamental mandate:*** To remove barriers for the unbanked and under-banked and reach the last mile leveraging a network comprising 160,000 post offices (145,000 in rural areas) and 400,000 postal employees.
- IPPB's reach and its operating model is built on the **key pillars of India Stack** - enabling Paperless, Cashless and Presence-less banking in a simple and secure manner at the customers doorstep, through a **CBS-integrated smartphone and biometric device.**
- Leveraging frugal innovation and with a high focus on **ease of banking** for the masses, IPPB delivers simple and affordable banking solutions through intuitive interfaces available in **13 languages.**
- IPPB is committed to provide a fillip to a less cash economy and contribute to the **vision of Digital India.**
- India will prosper when every citizen will have equal opportunity to become financially secure and empowered. Their motto stands true - **Every customer is important; every transaction is significant and every deposit is valuable.**

## *Local Area Banks*

- Introduced in India in the year 1996 based on Budget-1996 by the then Finance Minister, Dr. Manmohan Singh.
- Unlike RRBs, they're not set up by Union or State governments or by any special act of the parliament, but by private entities, simply applying to RBI under Banking Regulation Act.
- Each Local Area bank is registered as a public limited company under the Companies Act, 1956. However, they are licensed under the Banking Regulation Act, 1949.
- Earning profit is the main objective of Local Area Banks
- They are Non-Sch. Banks - CRR, SLR, PSL applicable.
- Only RBI regulates them.
- Present in Maximum 3 geographically contiguous districts. only 1 urban centre per district.

## *LEAD BANK SCHEME*

- The Lead Bank Scheme, introduced towards the end of 1969, envisages assignment of lead roles to individual banks (both in public sector and private sector) for the districts allotted to them.
- A bank having a relatively large network of branches in the rural areas of a given district and endowed with adequate financial and manpower resources has generally been entrusted with the lead responsibility for that district.

- Accordingly, all the districts in the country have been allotted to various banks.
- The lead bank acts as a leader for coordinating the efforts of all credit institutions in the allotted districts to increase the flow of credit to agriculture, small-scale industries and other economic activities included in the priority sector in the rural and semi-urban areas, with the district being the basic unit in terms of geographical area.

## *Objectives of the Lead Bank Scheme*

- The main objective was to extend banking facilities to unbanked areas and also to evaluate their physiographic, agro climatic end Socio-economic conditions through economic survey.
- To help in removing regional imbalances through appropriate credit deployment.
- Development of co-operation amongst financial and non-financial institutions, in overall development of the districts were also needed.

## *Function of Lead Bank*

- A monitoring mechanism to periodically assess and evaluate the progress made in achieving the roadmap to provide banking services within the time frame prescribed.
- Identification of Non-banked/under banked areas for providing banking services in a time bound manner with a view to achieving 100% financial inclusion.
- Review of performance of banks under Annual Credit Plan (ACP)
- The flow of credit to priority sector and weaker sections of the society
- Grant of educational loans
- Progress under SHG – bank linkage

## *Advantages of Lead Bank Scheme*

- Lead bank scheme spread the availability of banking facilities all over the country.
- Lead bank Inter link the Commercial and Cooperative banks.
- It helps in more effective Branch Expansion.
- Better relationship between Govt. and Banks.
- Integration of credit activities of banks.
- Bottlenecks in the development of a District can be located and removed.
- Lead Bank Scheme would assist in implementation of the District Plan.

## *Problems in Lead Bank Scheme*

- Confusion regarding the concept of Lead Bank especially for opening branches
- Problems in allotment of Districts.
- Lack of coordination between district planning authorities and banking institutions operating in a district on one side and between NABARD and the Lead Bank on the other.
- Lead bank did not consider the role of co-operatives, which are important source of institutional finance.
- Shift in policies, complexities in operations and issues shifting to the Financial Inclusion.
- Duplication of efforts in credit plan preparation.
- Absence of check and balance.

## *Usha Thorat Committee on Lead Bank Scheme*

- In 2009, Government of India constituted **a High-Power Committee headed by Mrs Usha Thorat, Deputy Governor of the RBI, to suggest reforms in the Lead Bank Scheme.**
- The committee recommended the enhancing the scope of the scheme and suggests a sharper focus on facilitating financial inclusion rather than a mere review of the government sponsored credit schemes.
- Also Private sector banks should be given a greater role in LBS action plans, particularly in areas of their presence.

Enhance the business correspondent model, making banking services available in all villages having a population of above 2,000 and relaxation in KYC (know your customer) norms for small value accounts.

# 8 NON-BANKING SYSTEM OF INDIA

## *Non-Banking Financial Company (NBFC)*

- A non-banking financial company, also known as a non-banking financial institution, provides financial services and products but it is not recognised as a bank with a full banking licence.
- NBFCs are not banks, but their activities include lending and other activities such as providing loans and advances, credit facilities, savings and investment products, trading in the money market, managing stock portfolios, money transfers and so on.
- NBFC Registration is required before NBFC activities can begin.
- Their activities include hiring, leasing, infrastructure finance, venture capital finance, housing finance and so on.
- Deposits can be accepted by NBFC, but only **term deposits** and deposits repayable on demand is not accepted.
- Some examples of well-known NBFCs are Kotak Mahindra Finance, SBI Factors, Sundaram Finance and ICICI Ventures.

## *Criteria for NBFC License*

- The company must be registered in accordance with the Companies Act.
- **The corporation should be either a Limited Company or a Private Limited Company (PLC).**
- The company's **Net Owned Fund** must be at least Rs. 2 crores.
- Following NBFCs are exempted from the requirement of registration with RBI:
  - Venture Capital Fund / Merchant Banking companies / Stockbroking companies registered with SEBI.
  - Insurance Company holding a valid Certificate of Registration issued by IRDA.
  - Nidhi companies as notified under Section 620A of the Companies Act, 1956.
  - Chit companies as defined in clause (b) of Section 2 of the Chit Funds Act, 1982.
  - Housing Finance Companies regulated by National Housing Bank.
  - Stock Exchange or a Mutual Benefit company.

## *Types of NBFCs*

The NBFCs can be categorised under three broad heads:

1. On the nature of their activity
2. On the basis of deposits
3. On the basis of their assets size

The different types of Non-Banking Financial Corporations or NBFCs are as follows:

### *On the basis of deposits*

- Deposit accepting Non-Banking Financial Corporations
- Non-deposit accepting Non-Banking Financial Corporations

### *On the basis of their assets size*

- Systematically Important NBFCs
- Non-systematically Important NBFCs

### *On the nature of their activity*

- Asset Finance Company (AFC)
- Loan Company (LC)
- Mortgage Guarantee Company (MGC)
- Investment Company (IC)
- Systematically Important Core Investment Company (CIC-ND-SI)
- Infrastructure Finance Company (IFC)
- Non-Banking Financial Company: Micro Finance Institutions (NBFC-MFI)
- Infrastructure Debt Fund: Non-Banking Financial Company (IDF-NBFC)
- Non-Banking Financial Company-Factors (NBFC-Factors)
- NBFC-Non-Operative Financial Holding Company (NOFHC)

### *On the basis of their activity*

### *Asset Finance Company (AFC)*

- As its primary business, an AFC is a financial institution that finances various assets for individuals and businesses to support productive/economic activity.
- Automobiles, tractors, machinery, heavy industrial equipment, large power generator sets, earthmoving & material handling equipment, production & farming equipment, self-propelled vehicles and general-purpose industrial machines are examples.
- The income from these should not be less than 60% of the total assets.

### *Loan Company (LC)*

- It is a financial institution that provides loans for a variety of purposes except for AFC.
- The loan is being offered for purposes other than assets, such as working capital finance etc. However, housing finance firms are included.
- Some examples of NBFC – LC are LIC Finance Ltd, PNB Housing Finance Firm and HDFC.

### *Mortgage Guarantee Company (MGC)*

- NBFC-MGCs are financial institutions for which:
  - at least 90% of the business turnover is mortgage guarantee or
- 90% of the gross income is from the mortgage guarantee business, or
- the Net Owned Fund (NOF) is Rs. 100 crores.

### *Investment Company (IC)*

- The primary business of a financial institution is the **acquisition of securities**.
- That is, it collects money from the general public and invests it in various securities and financial products.
- The remaining profit is distributed to shareholders after the company deducts its operational costs from the earned profit.
- Some investment companies include Bajaj Alliance General Insurance Company, IDFC and HDFC mutual funds.

### *Systematically Important Core Investment Company (CIC-ND-SI)*

- **At least 90%** of its total assets are held in the form of investments in shares, stocks, debt or loan group companies.
- Within a period of not more than ten years from the date of issue, **60 percent of the 90 percent should be invested in equity shares** or those that compulsorily convert later in equity shares.
- Does not trade in its investments in group companies' shares, debt or loans, except through block sales for the purpose of dilution or disinvestment.
- It is not engaged in any of the activities listed in **sections 45(c) or 45(f)** of the **RBI Act of 1934.**
- The assets are worth at least **Rs. 100 crore**.
- It accepts government funds.

### *Infrastructure Finance Company (IFC)*

- Infrastructure loans account for roughly 3/4$^{th}$ of the company's total assets.
- Has a Net Owned Fund of at least Rs. 300 crores
- Has a credit rating of at least "A" or a comparable CRAR of at least 15%.
- GMR Infrastructure Ltd., Hindustan Construction Company and other companies are examples.

### *Micro Finance Institutions (NBFC-MFI)*

- NBFC-MFI is a **Non-Deposit Accepting NBFC (ND-NBFC)** with at least 85 percent of its assets in the form of qualifying assets that meet the following criteria:
  - loan disbursed by it to a borrower with an annual income of less than Rs. 60,000 in rural households or less than Rs. 1,20,000 in urban and semi-urban households;
  - the loan amount is not more than Rs. 35,000 in the first cycle and Rs. 50,000 in subsequent cycles;
  - the borrower's total indebtedness is not more than Rs. 50,000;
  - the loan duration is not less than 24 months for loan amounts in excess of Rs. 15,000, with prepayment without penalty;

- the loan is extended without any security,
- The aggregate amount of loans given for income generation is not less than 75% of the total loans given by MFIs and the loan is repayable in weekly, fortnightly or monthly installments at the borrower's discretion.
- Some examples include Bandhan Financial Service Ltd and Ujjivan Financial Service.

### *Infrastructure Debt Fund (IDF-NBFC)*

- IDFs raise funds for long-term infrastructure projects through bonds.
- The bonds are issued in multiple currencies and have a minimum maturity of 5 years for investors.
- It makes it easier for long-term debt to flow into infrastructure projects.
- IDF-NBFCs can only be sponsored by IFC-NBFCs.

### *Non-Banking Financial Company-Factors (NBFC-Factors)*

- This type of NBFC is uncommon in India.
- Such companies usually purchase loans or advances at a heavily discounted rate from lenders and then adjust the debtor's repayment schedule to ensure easy settlement while earning a small profit.
- Normal lending by a bank against the security of receivables etc. is not included.
- A **minimum NOF of Rs. 5 Crore** is required for an NBFC-Factoring company.
- Furthermore, its financial assets in the factoring business should account for at least 75% of its total assets.
- And its income from the factoring business should not be less than 75% of its gross income.

### *NBFC-Non-Operative Financial Holding Company (NOFHC)*

- It is a distinct type of NBFC, consisting of the establishment of a new bank by the promoters.
- It is a non-operative financial holding company that is wholly owned by the company.
- The RBI has granted permission under the applicable regulatory prescription.
- To establish or maintain a bank as well as another financial service.

### *NBFCs not Registered under RBI*

- There are certain businesses that provide financial services but do not need to be registered with the RBI.
- These entities are regulated by other financial sector regulators and are not required to obtain an NBFC License from the RBI in order to avoid dual regulation. They are as follows:

| Type of NBFC | Regulated by |
|---|---|
| Insurance Companies | Insurance Regulatory and Development Authority (IRDA) |
| Housing Finance Companies | National Housing Bank (NHB) |
| Stock Broking Companies | Securities and Exchange Board of India (SEBI) |
| Merchant Banking Companies | Securities and Exchange Board of India (SEBI) |
| Mutual Funds | Securities and Exchange Board of India (SEBI) |
| Venture Capital Companies | Securities and Exchange Board of India (SEBI) |
| Chit Fund Companies | Regulated under Chit Fund Act and by respective State Governments |
| Nidhi Companies | Ministry of Corporate Affairs (MCA) |

### *Difference between Banks and NBFC*

| Basis of Comparison | NBFC's | Banks |
|---|---|---|
| Meaning | They provide banking services to people without holding Bank License | It is government authorized financial intermediary which aim at providing banking services to the public. |
| Regulated under | Companies Act 2013 | Banking Regulation Act 1949 |
| Demand Deposit | Cannot be Accepted | Can be Accepted |
| Foreign Investment | Allowed up to 100% | Allowed up to 74% for Private Sector Bank |
| Payment and Settlement system | Not a part of System | An Integral part of the System |

| | | |
|---|---|---|
| Maintenance of Reserve Ratios | Not Required | Mandatory |
| Deposit Insurance Facility | Not Available | Available |
| Credit Creation | NBFC does not create Credit | Bank create Credit |
| Transaction Services | Cannot be provided by NBFC | Provided by Bank |

## *Regulation of NBFCs*

- **The RBI's Department of Non-Banking Supervision (DNBS) is tasked with regulating and supervising NBFCs in accordance with the regulatory provisions contained in Chapters III B and C and Chapter V of the Reserve Bank of India Act, 1934.**
- The Reserve Bank's Regulatory and Supervisory Framework provides for, among other things, registration of NBFCs, prudential regulation of various categories of NBFCs, the issuance of directions on the acceptance of deposits by NBFCs and sector surveillance through off-site and on-site supervision.
- **Deposit-taking NBFCs** and **Systemically Important Non-Deposit Accepting Companies** face increased regulation and supervision.
- The three main goals of regulation and supervision are as follows:
  - depositor protection
  - consumer protection
  - financial stability.
- In extreme cases, the RBI is also empowered under the RBI Act 1934 to take punitive action, such as:
  - cancelling a Certificate of Registration, issuing prohibitory orders against accepting deposits, filing criminal cases or filing winding-up petitions under the provisions of the Companies Act.
- The Reserve Bank of India (RBI) recently proposed a tighter regulatory framework for Non-Banking Financial Companies (NBFCs) by establishing a **four-tier structure** with a progressive increase in regulatory intensity.
- It has also proposed reducing the classification of non-performing assets (NPAs) of base layer NBFCs **from 180 to 90 days overdue**.
- The proposed framework is intended to **protect financial stability** while allowing smaller NBFCs to continue to operate under light regulations and grow with ease.

## *NBFC – Significance*

- NBFCs play an important role in developing countries like India, where access to bank finance remains a challenge for a large portion of the population and businesses.
- Non-banking financial institutions, including NBFCs in India, provide services to market segments that commercial banks do not serve due to higher risk and lower returns.
- Non-banking financial institutions are an essential part of an economy's financial sector due to their inherent characteristics.

## *NBFC – Criticism*

- The fact that NBFCs are not as heavily regulated as banks adds to the risk. Such a risk was highlighted during the 2008 Global Financial Crisis, when companies' lending practises went unchecked, resulting in a disastrous outcome.
- The IL&FS default and subsequent turbulence in the Indian credit markets in 2018 raised some critical and fundamental questions about the role of NBFCs, their business model and the best regulatory regime for them.

## *What is SIDBI?*

- SIDBI is the country's primary institution for promoting, financing and developing industries in the micro and small-scale sectors.
- It coordinates the activities of other institutions involved in similar activities.
- SIDBI assists MSMEs in obtaining the funds they need to expand, market, develop and commercialise their innovative technologies and products.
- The bank offers several schemes as well as financial services and products to meet the needs of individuals in various businesses.

## *Historical Background*

- The **Industrial Development Bank of India** has served as the apex bank in the field of financing all industries, including small-scale industries, since its inception.

- However, as the financing activities of small-scale industries expanded significantly, the need for a separate apex bank for small-scale industries became apparent.
- As a result, the Small Industries Development Bank of India (SIDBI) was established, taking over IDBI's financing activities for small-scale industries.
- The SIDBI (Small Industries Development Bank of India) was established by a special **Act of Parliament in 1988** and went into effect on **April 2, 1990**.
- The Shares of SIDBI are held by the Government of India and twenty-two other institutions / public sector banks / insurance companies owned or controlled by the Central Government.

## *Role of SIDBI*

- ***Indirect lending*** – It is done through Banks, SFBs, NBFCs, MFI and New Age Fintechs and is based on a multiplier effect/a wider reach in financing the MSME sector.
- ***Direct lending*** – It aims to close existing credit gaps in the MSME sector through demonstrative and innovative lending products that can be scaled up by the credit delivery ecosystem.
- ***Fund of Funds*** – It promotes entrepreneurship by providing funding to emerging startups through the Fund of Funds channel.
- ***Promotion and Development*** - encouraging entrepreneurship and assisting aspiring entrepreneurs in the holistic development of the MSME sector through credit-plus initiatives.
- ***Acts as a facilitator*** through roles such as Nodal Agency for the Government's MSME-oriented Schemes.

## *Financing activities of SIDBI*

SIDBI's financing activities can be divided into two categories:

***1. Direct Assistance***

- ***Project financing*** is available for the establishment of new units as well as the expansion/diversification/ modernization/technology up-gradation of existing units.
- ***Equipment Finance Scheme:*** This scheme provides assistance for the expansion and modernization of existing units.
- ***Technology Development and Modernisation Fund Scheme*** is a new SIDBI scheme that provides assistance to engineering, garments, electrical and electronics, crockery and pottery units, among others.
- ***Bill Financing Scheme:*** Bill financing accounts for the majority of SIDBI's direct assistance
- ***Equity Assistance Scheme:*** SIDBI offers equity assistance to various types of businesses. It provides merchant bankers with lines of credit to close bought-out deals for their small industrial unit clients.
    - Small units receive assistance through the National Equity Fund Scheme. Seed capital is also made available through the **Mahila Udyam Nidhi Scheme** and the Scheme for Employment of Ex-Servicemen.
- ***Venture Capital Scheme:*** SIDBI also provides venture capital assistance through the Venture Capital Fund.
    - SIDBI also invests in the funds of other venture capital firms. SIDBI provides venture capital assistance for projects that are high risk, specialised and import substitutive.
    - The majority of these projects propose to use indigenously developed technology and are promoted by seasoned technical entrepreneurs.
- Some of the Loan Financing schemes under SIDBI are

| Loan Scheme | Loan Amount | Eligibility Criteria |
|---|---|---|
| SIDBI Make in India Soft Loan Fund for MSME (SMILE) | Minimum loan size – Rs.10 lakh for Equipment Finance and Minimum Loan Size for Others – Rs.25 lakh. | New enterprises in the manufacturing and services sector and existing enterprises undertaking expansion. |
| Smile Equipment Finance (SEF) | Minimum loan amount is Rs.10 lakh | MSMEs in existence for at least 3 years and having satisfactory financial position. |

| | | |
|---|---|---|
| Loans under partnership with OEM (Original Equipment Manufacturer) | Up to Rs.1 crore | MSMEs in existence for at least 3 years and having satisfactory financial position. |
| Working Capital (Cash Credit) | Depends upon the financial ability of the applicant | MSME units which are existing customers under SIBDI or of other banks. |
| SIDBI – Loan for Purchase of Equipment for Enterprise's Development (SPEED) | Up to 100% of the machinery cost subject to maximum of Rs.1 crore for New to Bank (NTB) customers and up to Rs.2 crore for existing customers of SIDBI. | MSME units with at least 3 years operations with stable sales and cash profits in immediate past 2 years. |
| SIDBI-Loan for Purchase of Equipment for Enterprise's Development Plus (SPEED PLUS) | Up to 100% of the machinery cost subject to maximum of Rs.2 crore for New to SIDBI customers and up to Rs.3 crore for existing customers of SIDBI. | MSME units with at least 5 years operations with stable sales and cash profits in immediate past 3 years. |
| Top Up Loan For Immediate Purposes (TULIP) | 30% of existing exposure or 20% of net sales subject to maximum of Rs.2 crore | At least 1-year association with SIDBI |
| SIDBI Term-Loan Assistance for Rooftop Solar PV Plants (STAR) | Rs.10 lakh to Rs.3.5 crore | Proof of 2 years of cash profit and satisfactory financial records |
| SIDBI Assistance to Facilitate Emergency Response Against Coronavirus (SAFE) | Up to Rs.50 lakh | For New to bank customer – At least two years of cash profits and account and For existing bank customer – Cash profit in last audited balance sheet and account |
| SIDBI Assistance to Facilitate Emergency Response Against Coronavirus Plus (SAFE PLUS) | Up to Rs.100 lakh | For New to bank customer – At least two years of cash profits and account and For existing bank customer – Cash profit in last audited balance sheet and account |
| Timely Working Capital Assistance To Revitalise Industries In Times Of Corona Crisis (TWARIT) | Up to 20% of total outstanding loans with SIDBI up to Rs.25 crore as of February 29, 2020 | All existing borrower accounts with combined outstanding credit facilities up to Rs.25 crore as of 29.2.2020. |

## Indirect Assistance

- SIDBI provides indirect assistance to industries by:
  - refinancing term loans issued by banks, State Finance Corporations (SFCs) and State Industrial Development Corporations (SIDCs) and
  - rediscounting bills issued by small-scale industries.

## SIDBI – Functions

- Small Industries Development Bank of India **refinances loans** made by PLIs to small-scale industrial units and also provides them with resources.
- It **offers bill discounts and rediscounts**.
- It also aids in the **expansion of marketing channels for SSI (Small Scale Industries)** sector products in both domestic and international markets.
- It provides **factoring, leasing** and other services to small-scale industrial concerns.
- It encourages **employment - oriented industries,** particularly in semi-urban areas, in order to create job opportunities and prevent people from relocating to cities.
- It also initiates steps for **modernization and technological advancement** of existing units.
- In collaboration with commercial banks, it also enables the **timely flow of credit for working capital** as well as term loans to Small Scale Industries.
- It also works with state-level venture funds to promote them.

## SIDBI – Benefits

- ***Custom made -*** SIDBI policies loans based on the needs of your business. If your requirement does not fall into the ordinary and usual category, the Small Industries Development Bank of India can help you get the funding you need.

- ***Dedicated Size -*** Credit and loans are tailored to the size of the company. As a result, MSMEs may be able to obtain various types of loans that are tailored to their specific business needs.
- ***Attractive Interest Rates -*** It has agreements with several banks and financial institutions around the world and may be able to offer low interest rates. The SIDBI has collaborations with the World Bank and the Japan International Cooperation Agency.
- ***Assistance -*** It provides more than just a loan; it also provides assistance and much-needed advice. Its relationship managers assist entrepreneurs in making sound decisions and provide assistance throughout the loan process.
- ***Security Fee –*** Without providing security, businesspeople could receive up to Rs.100 lakhs.
- ***Capital Growth -*** Entrepreneurs could acquire adequate capital for meeting their growth requirements without tampering their ownership of a company.
- ***Equity and Venture Funding -*** It has a wholly owned subsidiary, **SIDBI Venture Capital Limited,** that provides growth capital as equity through venture capital funds that focus on MSMEs.
- ***Subsidies -*** SIDBI offers a variety of schemes with low interest rates and flexible terms. SIDBI has in-depth knowledge and a broader understanding of available schemes and loans, which can assist enterprises in making the best decision for their businesses.
- ***Transparency -*** Its processes and rate structure are open to the public. There are no additional fees.

**Question: Consider the following statements: [2004]**

1) The National Housing Bank the apex institution of housing finance in India, was set up as a whollyowned subsidiary of the Reserve Bank of India

2) The Small Industries Development Bank of India was established as a whollyowned subsidiary of the Industrial Development Bank of India

Which of the statements given above is/are correct?

(a) 1 only (b) 2 only

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

**Question: Which of the following statements is/are correct regarding SIDBI?**

1) It directly gives loans to small scale industrial units.

2) It extends financial support to State Small Industries Development Corporations.

Select the correct codes:

(a) 1 only (b) 2 only

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

## What are Non Performing Assets?

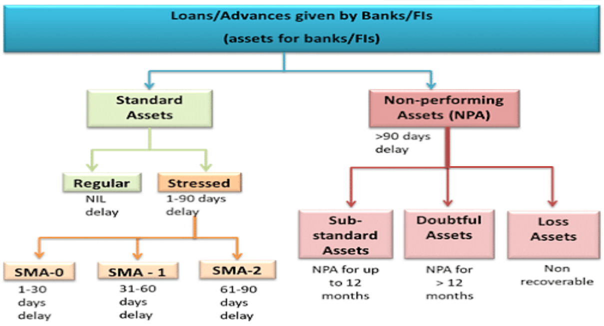
- When an asset no longer generates income for the bank, it is considered a non-performing asset.
- Previously, an asset was classified as a Non-Performing Asset (NPA) based on the concept of "Past Due."
- A 'non-performing asset' (NPA) was defined as a credit for which interest and/or principal instalments have been 'past due' for a specified period of time.
- To move toward international best practices and ensure greater transparency, '90 days' overdue norms for identifying NPAs were made applicable beginning with the fiscal year ended March 31, 2004.
- Commercial loans that are more than 90 days past due and consumer loans that are more than 180 days past due are typically classified as non-performing assets by banks.
- In the case of agricultural loans, NPAs are declared if the interest and/or instalment or principal remain unpaid for two harvest seasons.
  - However, this period should not be longer than two years. Any unpaid loan/ instalment will be classified as NPA after two years.

## Classification of Non Performing Assets

- ***Sub-standard:*** When the NPAs have aged <= 12 months.
- ***Doubtful:*** When the NPAs have aged > 12 months.
- ***Loss assets:*** When the bank or its auditors have identified the loss, but it has not been written off.

**For Example,** consider a commercial loan made on January 1st 2015 with repayment date of interest and principal amount on the 5th of every month. The firm stops its repayment and misses its repayments from January 2016.

- The loan is classified as an NPA if there is no repayment by April 5, 2016.
- If it is not repaid after that it is called a **sub-standard asset** till April 5, 2017.
- If the repayment due is past April 5, 2017, then it is classified as a **doubtful asset.**
- When the bank decides it no longer can recover this commercial loan it is classified as loss assets.




## *NPA problem of Indian Banks*

- The NPA was on a declining trend from FY 2018 due to various initiatives by the Reserve Bank of India and the central government such as the **Insolvency and Bankruptcy Code**, Abolition of previous initiatives like 5:25 rule etc.
- Due to the effects of the coronavirus (COVID-19) epidemic and lockdown, the country was expected to see an increase in **bad loans.**
- The Reserve Bank of India projected three scenarios for the fiscal year 2022 until September 2021 based on the value for September 2020.
- Under the baseline scenario, the GNPA-ratio would reach 13.5 percent, setting a new high.

## *Wilful Defaulter*

- Any entity is considered a wilful defaulter when:
  - The unit has failed to make its payment/ repayment commitments to the lender, despite having the financial means to do so.
  - The unit has failed to meet its payment/ repayment commitments to the lender and has not used the lender's funds for the specific objectives for which they were obtained, instead of diverting the money to other uses.
  - The unit has failed to meet its payment/ repayment commitments to the lender and has syphoned off the funds, such that the funds have not been used for the precise purpose for which credit was obtained, nor are the funds available in the form of other assets with the unit.
- The Banks have to submit the names of the Wilful defaulters to the Reserve Bank of India (RBI) with outstanding loans of more than 25 Lakhs.

## *SARFAESI Act*

- SARFAESI Act of 2002 is ".. an act to regulate securitization and reconstruction of financial assets and enforcement of security interests and to provide for a central database of security interests created on property rights and for matters associated with or incidental thereto,".
- **SARFAESI** is an acronym for Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest.
- It permits banks and other financial institutions to recover loans by **auctioning off the defaulter's residential or commercial assets.**
- Under this act, India's first **Asset Reconstruction Corporation** (ARC), ARCIL, was established.
- **Secured creditors** (banks or financial institutions) have rights to security interest enforcement under **section 13** of the SARFAESI Act, 2002.
- The SARFAESI Act of 2002 will now **apply to all state and multi-state co-operative banks**, according to the Supreme Court of India. Banks can now seize and sell defaulters' properties to recoup their debts, thanks to the Supreme Court's momentous decision.

## *Insolvency and Bankruptcy Code*

- The Insolvency and Bankruptcy Code, 2016 (IBC) is India's bankruptcy law, which aims to unify the existing framework by establishing a single insolvency and bankruptcy law.

- Insolvency is a condition in which a debtor is unable to pay his/her debts.
- Bankruptcy is a legal process that involves an insolvent person or company that is unable to pay its debts.
- It establishes clearer and faster insolvency procedures to assist creditors, such as banks, in recovering debts and avoiding bad loans, which are a major drag on the economy.
- It is an all-encompassing insolvency code that applies to all businesses, partnerships and individuals (other than financial firms).

### *Bad Bank*

- A bad bank is a financial institution that was formed **to purchase the bad loans and other illiquid assets of another financial institution.**
- An organisation with a large number of nonperforming assets will sell them to the bad bank at market value.
- The original institution may be able to clear its balance sheet by transferring such assets to the bad bank, albeit it will still be compelled to take write-downs.
- Instead of a single bank, a bad bank structure may assume the risky assets of a consortium of financial organisations.
- **Grant Street National Bank** is a well-known example of a bad bank. This entity was founded in 1988 to house Mellon Bank's bad assets.
- Outside of the United States, the Republic of Ireland established the **National Asset Management Agency**, a bad bank, in 2009 in response to the country's own financial crisis.

### *Asset Quality Review*

- Inspectors from the Reserve Bank of India (RBI) typically **review bank records** once a year as part of the **Annual Financial Inspection (AFI) process.**
- In 2015-16, however, throughout the months of August and November, a special inspection was carried out. Asset Quality Review (AQR) was the name given to this.
- A small sample of loans is evaluated in a routine AFI to see if **asset classification matches loan repayment** and if banks have made necessary reserves.
- The sample size in the AQR, on the other hand, was substantially larger and most of the large borrower accounts were investigated to see if categorisation complied with prudential standards.
- According to some reports, a list of over 200 accounts was identified and banks were instructed to designate them as non-performing.
- Banks were allocated two quarters to complete the asset classification: October-December 2015 and January-March 2016.
- The main aspect of AQR is that it is a **random check rather than a periodic check**.

### *Recapitalisation of Banks*

- **Recapitalisation of Banks is injecting additional capital into state-owned banks to bring them up to capital adequacy standards.**
- It entails **injecting more capital** into **state-owned banks** in order for them to achieve capital adequacy requirements.
- The requirement for Indian public sector banks to maintain a **Capital Adequacy Ratio (CAR) of 12 per cent** has been underlined by the Reserve Bank of India in line with **BASEL norms**.
- The capital-to-risk-weighted-assets-and-current-liabilities ratio (CAR) is the ratio of a bank's capital to its risk-weighted assets and current liabilities.
- The government injects capital into banks that are short on cash using a variety of instruments.
- Because the government is the largest stakeholder in public sector banks, it is the government's responsibility to increase capital reserves.
- The government injects capital into banks by issuing bonds or buying new shares.
- In 2017, the government had announced an Rs. 2.11 Lakh crore recapitalisation package for the Public sector Banks

**Question : Consider the following statements regarding the "recapitalisation of banks":**

**1: Recapitalisation of Banks is injecting additional capital into banks to bring them up to capital adequacy standards.**

**2: Recapitalisation of Banks is targetted at state-owned banks only.**

Select the correct statements from the codes below:

(a) 1 only (b) 2 only

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

**Question: The term "Prompt Corrective Action" is related to which of the following:**

(a) RBI's intervention strategy to improve bank poor financial health.

(b) Central government's recapitalisation programme of loss-making banks.

(c) Liquidation process of failed banks.

(d) RBI process to regulate fluctuating rupee in the market.

## *What is National Housing Bank?*

- **National Housing Bank** is a **government-owned corporation**. The government took over the NHB from the RBI in 2019 after purchasing the entire stake for Rs. 1,450 crores.
  - The move is in response to the recommendation of the **Narasimham-II committee** report from October 2001.
- NHB raises funds via debt instruments such as bonds, debentures and borrowings.
- Its bonds, which are guaranteed by the Government of India, are eligible securities for commercial banks to use in order to meet the statutory liquidity requirements under the **Banking Regulation Act**.
- Furthermore, it receives external assistance from international organisations such as **USAID and OECF Japan**.
- It accepts deposits through commercial banks' Home Loan Accounts.
- The National Housing Bank refinances **Housing Finance Companies**, which are located throughout the country and account for the majority of the market, followed by Commercial banks, Co-operative banks and Land Development Banks.
- National Housing Bank offers refinancing to housing finance companies at varying rates based on loan size.

## *National Housing Bank – Historical perspective*

- The sub-group on Housing Finance for the **Seventh Five Year Plan (1985-1990)** identified the lack of long-term finance to individual households on a significant scale as a major impediment to housing sector progress and recommended the establishment of a national level institution.
- The Committee of Secretaries considered the recommendation and formed the High-Level Group, chaired by **Dr C. Rangarajan**, the then-Deputy Governor of the Reserve Bank of India, to examine the proposal and recommend the establishment of the National Housing Bank as an autonomous housing finance institution.
- The High-Level Group's recommendations were accepted by the Government of India.
- On February 28, 1987, the Prime Minister of India announced the decision to establish the **National Housing Bank (NHB)** as an apex level institution for housing finance while presenting the Union Budget for 1987-88.
- Following that, the **National Housing Bank Bill**, which provided the legislative framework for the establishment of NHB, was passed by Parliament in the winter session of 1987 and became an Act of Parliament with the assent of the President of India on December 23, 1987.
- The National Housing Policy of 1988 called for the establishment of the NHB as the apex housing institution.
- NHB was established on **July 9, 1988**, under the National Housing Bank Act of 1987.
- The entire **paid-up capital** was contributed by the **Reserve Bank of India**.
- The general supervision, direction and management of NHB's affairs and business are vested in a Board of Directors under the Act.
- **NHB's headquarters is in New Delhi.**

## *National Housing Bank – Objectives*

- To promote a sound, healthy, viable and cost-effective housing finance system capable of serving all segments of the population, as well as to integrate the housing finance system with the overall financial system.

- To encourage the development of a network of dedicated housing finance institutions to adequately serve various regions and income groups.
- To increase resources for the sector and direct them toward housing.
- To make mortgages more affordable.
- To monitor the activities of housing finance companies as per the supervisory powers it derives from the Act.
- To encourage the expansion of the supply of buildable land as well as building materials for housing, as well as to upgrade the country's housing stock.
- Encourage government agencies to become facilitators and suppliers of serviced land for housing.

### *Eligibility Criteria for obtaining refinance from NHB*

- The housing finance company must have a **minimum share capital of Rs. 3 crore** and a **promoter contribution of at least 25%** of the total capital.
- It must be registered as a **public limited company**. Long-term financing for house construction/purchase for residential purposes must account for at least 75% of loans.
- It must not be a subsidiary of any construction firm.
- The top management of the Housing Finance Company should not hold a similar position in the promoters' Construction Company.

### *National Housing Bank – Role & Importance*

- Ensuring adequate financing for housing infrastructure development, as well as a continuous flow of liquidity to various housing finance institutes for timely financing to all income segments.
- Ensure proper regulation and oversight of all housing finance companies operating throughout the country.
- The NHB is also in charge of **auditing such companies**, ensuring their compliance with the relevant guidelines and ensuring that the organisations make credit available at affordable rates in order to provide housing facilities for all.
- The NHB was also created with the goal of increasing the number of housing units in the country.
  - As a result, the National Housing Bank plays an important role in making **land available for housing development** by acting as a facilitator to enable companies in the housing sector to raise funds and smooth the entire function, resulting in increased efficiency and productivity.

### *National Housing Bank – Functions*

- It is primarily in charge of **registering and supervising all Housing Finance Companies (HFCs)**, as well as maintaining surveillance through on-site and off-site mechanisms and coordinating with other regulators.
- Supervision and control of housing companies operating in India under the authority granted by the National Housing Bank Act.
- **Raising funds on a large scale** and refinancing for housing finance companies, cooperative banks and other housing agencies for onward lending to individuals and housing infrastructure companies.
- Regulating and ensuring that housing finance companies meet all **regulatory capital requirements** outlined in the **BASEL guidelines**.
- Assuring that they have a **proper risk management system** in place, as well as good governance practises and so on.

### *National Housing Bank – RESIDEX*

The **NHB RESIDEX** is India's first official housing price index, created by the National Housing Bank (NHB) in response to Ministry of Finance, Government of India directives. A few key points regarding NHB RESIDEX are:

- The NHB RESIDEX was developed with the assistance of a **Technical Advisory Committee (TAC)** comprised of housing stakeholders.
- Since its inception in July 2007, the NHB RESIDEX has been updated on a regular basis until March 2015, with the year 2007 serving as the baseline. During this time, the NHB RESIDEX gradually expanded to cover 26 cities across the country.
- The NHB RESIDEX was initially calculated using market data. However, beginning in 2010, it was based on valuation data obtained from housing finance companies (HFCs) and banks.
- The NHB conducted a review of the processes used to compute the index, as well as the base year, in order to make the RESIDEX more current and in line with the current macroeconomic scenario.
- Following that, a redesigned NHB RESIDEX with broader geographical coverage and a broader scope was released. It was calculated using the fiscal year 2012-13 as the base year and is updated till March 2018.
- With effect from April 2018, a new series of the NHB RESIDEX has been published, with the **fiscal year 2017-18 as the new base year** and is updated up to the current quarter.

**Question: The National Housing Bank was set up in India as a wholly-owned subsidiary of which one of the following? [2007]**

(a) State Bank of India

(b) Reserve Bank of India

(c) ICICI Bank

(d) Life Insurance Corporation of India

**Question: Consider the following statements: [UPSC 2004]**

1) The National Housing Bank the apex institution of housing finance in India, was set up as a wholly-owned subsidiary of the Reserve Bank of India

2) The Small Industries Development Bank of India was established as a wholly-owned subsidiary of the Industrial Development Bank of India

Which of the statements given above is/are correct?

(a) 1 only (b) 2 only

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

# 9 BUDGET AND FISCAL POLICY

## Fiscal Policy

- **Fiscal policy deals with everything regarding the government's income and spending**. From budgeting to taxation, measures of fiscal policy deal with the most important areas of the economy.
- In India, fiscal policy is divided into three parts. **Government receipts, Government expenditures and Public Debt.** The fiscal policy is set by the Ministry of Finance with **assistance from NITI Ayog**.
- Fiscal policy refers to the use of government spending and tax policies to influence economic conditions, especially macroeconomic conditions, including **aggregate demand for goods and services, employment, inflation and economic growth.**
- The major purpose of these measures is to **stabilize the economy**.
- Fiscal policy measures are frequently used in **tandem with monetary policy to achieve these macroeconomic goals**.

## Objectives of Fiscal policy

- **Attainment of full employment:** It is of supreme importance for developing countries to avoid unemployment if not attained full employment. The state, therefore, has to spend on **social and economic overhead** in order to create employment.
- **Price stability**: Fiscal policy measures are deployed to control the inflationary tendencies of the economy.
- **Accelerating the rate of economic development**: Fiscal measures such as taxation, public borrowing and **deficit financing,** etc. are engaged effectively to enhance production, consumption and distribution and thereby increase the **national per capita income**.
- **Optimum allocation of resources: Fiscal policy measures guide public expenditure. Government reallocates resources towards equitability and enhanced social security for the weaker sections. Spending on subsidies, incentives etc are the best examples of such interventions.**
- **Economic stability:** The **budgeting system** should have built-in flexibility so that the **government's income and expenditures** automatically offer a **compensatory effect** on the increase or fall of the nation's income and prevent the economy from external shocks.
- **Capital formation and growth**: Capital formation is crucial to a developing economy. India's fiscal policy has given a lot of **importance to capital formation** in order to bring the country out of poverty. The fiscal policy continues to prioritize investing in capital.

## Tools of Fiscal policy regulations

- **Government Spending**: Government spending can have an **impact on economic output**. Government expenditure can be classed as **Government Final Consumption Expenditure** since it comprises the acquisition of goods and services for the benefit of the community. The government through its spending can redirect its fiscal priorities.
- **Transfer Payments**: Government payments to individuals through social welfare programs, student subsidies and Social Security are referred to as transfer payments.
- **Taxes:** Taxes are a fiscal policy tool since they allow for changes in the economy.

## Components of Fiscal Policy

The components of the Fiscal Policy can be categorized as:

- Government Receipts
- Government Expenditures
- Public Accounts of India

## *Government Receipts*

- The government's income in the form of taxes, interests and earnings on investments, cess and other receipts for services rendered are altogether known as government receipts. This is the total amount of money received by the government from all sources.
- Government receipts are divided into two groups—**Revenue Receipts and Capital Receipts**.
- ***Revenue Receipts***
    - Receipts that neither create liabilities nor reduce assets
    - Revenue Receipts can be subdivided into two: **Tax and non-tax revenues.**
    - Tax revenues are of two types: **direct and indirect taxes**
    - Non-tax revenue sources are **interest and dividend on government investment, cess and other receipts** for services rendered by the government, income through licenses, permits, fines, penalties etc.
- ***Capital Receipts***
    - The government raises funds for its functioning in different ways which are known as capital receipts. These ways could either **incur liabilities to the government or could be by disposing of its assets**. Incoming cash flows is another term used for capital receipts.
    - All kinds of borrowings, loans etc. are treated as debt receipts as the government has to repay this money and, with its interests in some cases.

## *Government Expenditure*

The government's expenditure can be classified into two:

### *Revenue expenditures*

- They are **short-term expenses** used in the current period or typically **within one year.**
- Revenue expenditures include the expenses required to meet the **ongoing operational costs** of the government and thus are essentially the same as operating expenses (OPEX).
- **Ordinary repair and maintenance costs** of state owned assets
- They are **recurring expenses in contrast to the one-off nature of most capital expenditures.**
- Example: **Salaries and employee wages, utilities, rents**, property taxes on government-owned properties etc.

### *Capital Expenditure*

- Investments made by the government in capital to maintain or to expand its business and generate additional revenue.
- **Purchase of long-term assets**, **buying fixed assets, which are physical assets such as equipment.** As a result, capital expenditures are typically for larger amounts than revenue expenditures.
- Example: purchase of factory equipment, purchases for business, other **government purchases like furniture, spending on infrastructure,** etc.

## *Public Accounts of India (Public Debt)*

- The Public Account of India accounts for flows for those transactions where the **government is merely acting as a banker.**
- This fund was constituted under **Article 266 (2) of the Constitution.** It accounts for flows for those transactions where the government is **merely acting as a banker.**
- Examples: **provident funds, small savings,** etc. These funds do not belong to the government, but rather have to be paid back at some time to their rightful owners. Therefore expenditures from the public account are not required to be approved by the Parliament.

## *Fiscal Consolidation*

- The process of fiscal consolidation entails those measures adopted to reduce the fiscal deficit.
- The **crisis imposed by the rising fiscal deficit** and sustainable growth of debt (both at the center and in states) of the late 1990s prompted the government to adopt **institutional measures to control the fiscal deficit**.

- Following are some of the ways through which the government plans to achieve fiscal consolidation:
  1. Better targeting of government subsidies and extending **Direct Benefit Transfer schemes**
  2. Improving the efficiency of tax administration
  3. **Enhancing tax GDP ratio** by **widening the tax base** and minimizing tax concessions and exemptions

## *Funds of Government of India*

The Indian government's funds are kept in three parts, which are listed below:

1. Consolidated Fund of India
2. Contingency Fund of India
3. Public Accounts of India

## *Consolidated Fund of India*

- This is the most important of all accounts of the government.
- This fund is filled by:
  - Direct and indirect taxes
  - Loans taken by the Indian government
  - Returning of loans/interests of loans to the government by anyone/agency that has taken it
  - The government meets all its expenditure from this fund.
  - **The government needs parliamentary approval to withdraw money from this fund.**
  - The provision for this fund is given in Article 266(1) of the Constitution of India.
  - Each state can have its own Consolidated Fund of the state with similar provisions.
  - The Comptroller and Auditor General of India audits these funds and reports to the relevant legislatures on their management.

## *Contingency Fund of India*

- Provision for this fund is made in Article 267(1) of the Constitution of India.
- Its corpus is Rs. 500 crores. It is in the nature of an imprest (money maintained for a specific purpose).
- The Secretary of Finance Ministry holds this fund on behalf of the President of India.
- This fund is used to meet unexpected or unforeseen expenditure.
- Each state can have its own contingency fund established under Article 267(2).

## *Public Accounts of India*

- This is constituted under Article 266(2) of the Constitution.
- All other public money (other than those covered under the Consolidated Fund of India) received by or on behalf of the Indian Government are credited to this account/ fund.
- This is made up of:
  - Bank savings account of the various ministries/departments
  - National small savings fund, defense fund
  - National Investment Fund (money earned from disinvestment)
  - National Calamity & Contingency Fund (NCCF) (for Disaster Management)
  - Provident fund, Postal insurance etc.
  - Similar funds
- The government does not need permission to take advances from this account.
- Each state can have its own similar accounts.
- The audit of all the expenditure from the Public Account of India is taken up by the CAG

The following table summarises the three funds:

| Fund | Consolidated Fund of India | Contingency Fund of India | Public Account of India |
|---|---|---|---|
| Income | Taxes and non-tax revenue | Fixed corpus of Rs. 500 crore | Public money other than those under consolidated fund |
| Expenditure | All expenditure | Unforeseen expenditure | Public money other than those under consolidated fund |
| Parliamentary Authorisation | Required prior to expenditure | Required after the expenditure | Not required |
| Articles of Constitution | 266(1) | 267(1) | 266(2) |

### *Controller General of Accounts (CGA)*

The CGA is the Principal Accounting Adviser to the Government of India. The office is in the Department of Expenditure, Ministry of Finance, GOI.

- CGA is responsible for establishing and maintaining a technically sound Management Accounting System.
- It also prepares and submits the accounts of the Central Government.
- It is also in charge of the exchequer control and internal audits

## *Budget*

### *Budget and Constitutional Provisions*

- According to **Article 112** of the Indian Constitution, the Union Budget of a year is referred to as the **Annual Financial Statement (AFS).**
- It is a statement of the **estimated receipts and expenditure of the Government** in a financial year (which begins on 01 April of the current year and ends on 31 March of the following year). In addition to it, the Budget contains:
  - Estimates of revenue and capital receipts,
  - Ways and means to raise the revenue,
  - Estimates of expenditure,
  - Details of the actual receipts and expenditure of the closing financial year and the reasons for any deficit or surplus in that year and
  - The economic and financial policy of the coming year, i.e., taxation proposals, prospects of revenue, spending programme and introduction of new schemes/projects.
- In Parliament, the Budget goes through **six stages:**
  1. Presentation of Budget.
  2. General discussion.
  3. Scrutiny by Departmental Committees.
  4. Voting on Demands for Grants.
  5. Passing of Appropriation Bill.
  6. Passing of Finance Bill.
- The **Budget Division of the Department of Economic Affairs in the Finance Ministry** is the nodal body responsible for preparing the Budget.

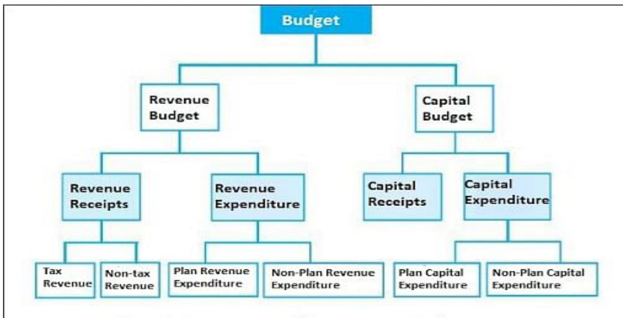
### *Changes Introduced in 2017*

- **Advancement** of Budget presentation to February 1 (earlier presented on the last working day of February),
- **Merger** of Railway Budget with the General Budget and
- Doing away with **plan and non-plan expenditure.**

### *Objectives of Government Budget*

- ***Reallocation of Resources–*** It helps to **distribute resources** keeping in view the **social and economic conditions** of the country.
- ***Reducing Inequalities in Income and Wealth–*** Government aims to bring economic equality by imposing taxes on the elite class and spending the collected money on the welfare of the poor.
- ***Contributing to Economic Growth–*** A country's economic growth is based on the **rate of investment and savings.** Therefore, the budgetary plan focuses on preparing adequate resources for investing in the public sector and raise the overall rate of investments and savings.
- ***Bringing Economic Stability–*** The Budget focuses on avoiding business fluctuations so as to accomplish the aim of ***financial stability.*** Policies such as Deficit Budget (during deflation) and Surplus Budget (during ***inflation***) assist in balancing the prices in the economy.
- ***Managing Public Enterprises–*** Many public sector industries are built for the **social welfare** of the people. The Budget is planned to deliver different provisions for operating such business and imparting financial help.
- ***Reducing Regional Differences–*** It aims to **reduce regional inequalities** by promoting the installation of production units in the underdeveloped regions.

### *Components of Government Budget*




Components of Government Budget

- **Revenue Budget–** It consists of the Revenue Expenditure and Revenue Receipts.
  - **Revenue Receipts** are receipts which **do not have a direct impact** on the assets and liabilities of the government. It consists of the money earned by the government through tax (such as excise duty, income tax) and non-tax sources (such as dividend income, profits, interest receipts).
  - **Revenue Expenditure** is the **expenditure by the government** which does not impact its assets or liabilities. For example, this includes salaries, interest payments, pension and administrative expenses.
- **Capital Budget–** It includes the Capital Receipts and Capital Expenditure.
  - **Capital Receipts** indicate the receipts which lead to a **decrease in assets or an increase in liabilities** of the government. It consists of: (i) the money earned by selling assets (or disinvestment) such as shares of public enterprises and (ii) the money received in the form of borrowings or repayment of loans by states.
  - **Capital expenditure** is used to **create assets or to reduce liabilities.** It consists of: (i) the long-term investments by the government on creating assets such as roads and hospitals and (ii) the money given by the government in the form of loans to states or repayment of its borrowings.

### *Balanced, Surplus and Deficit Budget*

- **Balanced Budget –** A government Budget is assumed to be balanced if the expected expenditure is equal to the anticipated receipts for a fiscal year.
- **Surplus Budget –** A Budget is said to be surplus when the expected revenues surpass the estimated expenditure for a particular business year. Here, the Budget becomes surplus, when taxes imposed, are higher than the expenses.
- **Deficit Budget-** A Budget is in deficit if the expenditure surpasses the revenue for a designated year.

### *Measures of Government Deficit*

There are various measures that capture government Deficit:

- **Revenue Deficit:** It refers to the excess of government's revenue expenditure over revenue receipts.
  - **Revenue Deficit = Revenue expenditure – Revenue receipts**
  - The revenue Deficit includes only such transactions that affect the current income and expenditure of the government.
  - When the government incurs a revenue deficit, it implies that the government is dissaving and is using up the savings of the other sectors of the economy to finance a part of its consumption expenditure.
- **Fiscal Deficit:** It is the gap between the government's expenditure requirements and its receipts. This equals the money the government needs to borrow during the year. A surplus arises if receipts are more than expenditure.

| |
|---|
| Fiscal Deficit = Total expenditure – (Revenue receipts + Non-debt creating capital receipts). |

  - It indicates the total borrowing requirements of the government from all sources.
  - From the financing side:

| |
|---|
| Gross fiscal deficit = Net borrowing at home + Borrowing from RBI + Borrowing from abroad |

  - The gross fiscal deficit is a key variable in judging the financial health of the public sector and the stability of the economy.

- **Primary Deficit:** Primary deficit equals fiscal deficit minus interest payments. This indicates the gap between the government's expenditure requirements and its receipts, not taking into account the expenditure incurred on interest payments on loans taken during the previous years.

| Primary deficit = Fiscal deficit – Interest payments |
|---|

**Question: Which of the following is not an objective of the budget?**
(a) Cutting down bank rates
(b) Paying salaries to government employees
(c) Provision of subsidies
(d) Increasing taxes

**Question: There has been a persistent deficit budget year after year. Which action/actions of the following can be taken by the Government to reduce the deficit?**
(1) Reducing revenue expenditure
(2) Introducing new welfare schemes
(3) Rationalizing subsidies
(4) Reducing import duty
Select the correct answer using the code given below.
(a) 1 only (b) 2 and 3 only
(c) 1 and 3 only (d) 1, 2, 3 and 4

## *Other Types of Budgets*

- **Zero Based Budgeting:** Zero-based budgeting is a method of budgeting in which all expenses are evaluated each time a Budget is made and expenses must be justified for each new period.
  - Zero budgeting starts from the zero base and every function of the government is analysed for its needs and cost. Budget is then made based on the needs
- **Outcome Budget:** Outcome Budget analyses the progress of each ministry and department and what the respected ministry has done with its Budget outlay. It measures the development outcomes of all government programs. It was first introduced in the year 2005.
- **Gender Budgeting:** The gender-budgeting is defined as "gender-based assessment of Budgets, incorporating a gender perspective at all levels of the budgetary process and restructuring revenues and expenditures in order to promote gender equality". It is actually budgeting for gender equity.
  - Through Gender Budget, the Government declares an amount to be spent over the development, welfare, empowerment schemes and programmes for Females.

## *What is Vote on Account?*

- According to **Article 266** of the Constitution, drawing money from the Consolidated Fund of India requires Parliamentary permission. Furthermore, **Article 114 (3)** of the Constitution states that no money can be taken from the **Consolidated Fund** until a law is passed (i.e. Appropriation bill).
- The passage of an appropriation bill is a lengthy process that normally lasts until the end of April. However, the government would require funds to continue its routine operations after March 31st (the end of the financial year).
- To address this practical issue, **Article 116** of the Constitution allows the Lok Sabha to make any grant in advance for expected spending for a portion of the fiscal year, awaiting the conclusion of the vote on grant demands and the adoption of the appropriation bill. This is known as the (vote on account) clause.
- Until 2016, when the Budget was delivered on the last working day of February, the vote on account was commonly employed. The budget presentation date has been moved up to February 1st since 2017. This allowed the government to enact the complete budget in the same fiscal year in less than two months.
- Since 2017, unless there are exceptional circumstances, such as an election year, Vote on Account has not been utilized as a part of the government budgeting process.
- **A 'Vote on Account' is not the same as an interim budget**. An Interim Budget is a comprehensive set of accounts, covering both expenditure and receipts, as opposed to a 'Vote on Account,' which solely deals with the expenditure side of the government's budget.

**Question: Consider the following statements:**

1. The Department of Revenue is responsible for the preparation of the Union Budget that is presented to the Parliament.

2. No amount can be withdrawn from the Consolidated Fund of India without authorization from the Parliament of India.

3. All the disbursements made from Public Account also need authorization from the Parliament of India.

**Which of the statements given above is/ are correct? (UPSC 2015)**

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

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

**Question: Which Article of the Constitution mentions vote on account?**

(a) Article 80 (b) Article 100

(c) Article 116 (d) Article 123

## *What is an Interim Budget?*

- If the administration does not have time to deliver a full budget or if general elections are approaching, it will propose an interim budget to Parliament.
- A complete budget grants the day-to-day government spending authority until the conclusion of the fiscal year (which ends on 31st March).
- If the government is unable to deliver the whole budget before the end of the fiscal year, it will need legislative approval to spend money in the following fiscal year until a new budget is enacted.
- The government approves a **vote-on-account** which will allow the government to pay its administrative expenditures until Parliament debates and adopts the budget (for the entire year) through the interim budget.
- The Interim Budget documents **every detail of the government's expenses and earnings during that period.**

## *What is the Procedure in an Interim Budget?*

- Parliament clears the government's vote-on-account, allowing it to satisfy its obligations until the next Parliament examines and adopts a complete Budget for the remainder of the year.
- The vote-on-account is granted for a period of four months when the government changes due to General Elections rather than a loss of trust vote scenario.
- The government is **constitutionally allowed to make tax changes in the interim budget,** but in every interim budget since Independence, outgoing governments have respected the fact that it is only a custodian for a few months and has refrained from making major changes or introducing new schemes or plans.

## *Occasions on which an Interim Budget was presented in India*

Here are fourteen instances when Interim Budgets were presented in the Parliament:

- By R. K. Shanmukham Chetty on November 26, 1947, after the Constituent Assembly's Budget passed in March 1947 ceased because of partition.
- By C.D. Deshmukh, before the first General Elections, for 1952-53.
- By T. T. Krishnamachari for 1957-58, just before the second general elections.
- By Morarji Desai in 1962-63 and then in 1967-68.
- By Y. B. Chavan for 1971-72.
- By Haribhai M. Patel in 1977. It was the shortest ever interim budget speech and also the first when an interim Budget was presented by a finance secretary and a former bureaucrat By R. Venkataraman for 1980-81 after the Janata government lost power to Congress (I).
- By Yashwant Sinha in 1991 after the fall of the Chandra Shekhar government.
- By Dr. Manmohan Singh — his only interim budget in 1991-92.
- By Yashwant Sinha for 1998-99 during Atal Bihari Vajpayee's government.
- By Jaswant Singh, in the final year of Atal Bihari Vajpayee-led NDA government in 2004-05.
- By Pranab Mukherjee in 2008-09 at the end of UPA's first term.

- By P Chidambaram on February 17, 2014, at the end of UPA's second term.
- By Piyush Goyal in 2019 before the end of PM Narendra Modi-led NDA government's first term.

### What is FRBM Act?

- The Fiscal Responsibility and Budget Management (FRBM) Act, 2003 sets a bar for the government **to lay a foundation of monetary limitations in the Indian Economy**.
- It contributes to the improvement of the management of public funds and **lowers the fiscal deficit** rate as well.
- The FRBM Act also allows for the use of an **escape clause** in times of disaster or national security. In such cases, the government may deviate from its target annual fiscal deficit.

### FRBM Act - Background

- In the 1990s and 2000s, India stood at the **top in borrowing capital**. Indian Economic Status was feeble as it had a high Fiscal Deficit, high Revenue Deficit and the degree of **high Debt-to-GDP** was also lofty.
- In the latter half of 2002-03, the continuous borrowing by the government led to high debt, which critically affected the Indian Economic Status.
- More than half of the borrowed capital was used for the **payments of interest** on the previous loans and had nothing much left for progressive purposes or productivity growth.
- Many economists then warned the government and were made well aware of the strategic conditions that could be the result of this borrowing culture.
- To prevent the country from falling into a debt ambush, they also suggested going "**de-jure**."
- Parliamentarians then pointed out the need for a **systematic regulation** of the government of India on resorting to a high level of borrowing.
- Henceforth, the **Fiscal Responsibility and Budget Management (FRBM) Act** was established in 2003.

### Objectives of the FRBM Act

- The primary objective of the said act was to strike out of revenue deficit and bring the fiscal deficit down.
- It was the first acquaintance of **transparency in the fiscal management system** in the country, ascertaining the ethical dispensation of debt with the passing years, making sure of fiscal solidity in the macroeconomics
- The act is also purposeful in terms of **giving necessary modifications to the Central Bank** while overseeing the expanding economy of India.

### Key features of the FRBM Act

- The FRBM is responsible for **maintaining and placing things in a union budget document** in Parliament every year which is mandatory.
- Items that the government should maintain along with the budget documents are - Specifications of Medium Term Fiscal Policy Statement, Specifications of Macroeconomic Framework Statement and Specifications of Fiscal Policy Strategy Statement.
- It was recommended that all the four fiscal indices which are - Revenue deficit as GDP percentage, Fiscal deficit as GDP percentage, Tax revenue as GDP percentage and total remaining due as GDP percentage, to be shown in the statement of medium-term fiscal policy.

### Recommendations of N.K. Singh Committee

- Replacement of the FRBM Act 2003 with **Debt Management and Fiscal Responsibility Bill, 2017**.
- The **debt to GDP ratio by 2022-23 should be 38.7%** for the central government and 20% for the state governments.
- The fiscal deficit target should be **2.5% of GDP by FY 2022-23.**
- Setting up an autonomous fiscal council that deals with the preparation of multi-year fiscal forecasts, improves fiscal data quality, could advise the government on fiscal matters.

- **Target commitments could deviate** under certain circumstances such as a national calamity, war, agricultural collapse etc.
- The debt path to be followed by each state based on their track record of fiscal health and prudence should be recommended by the 15th Finance Commission.
- Borrowing from RBI should occur when the center is to recover from a temporary shortfall in receipts.
- **Monetary and fiscal policies should complement each other** and help accomplish economic stability and growth.

### *Escape Clause in FRBM Act*

- The **escape clause was recommended by the NK Singh committee** to provide flexibility in situations where the central government can show some flexibility in following fiscal deficit targets under special circumstances.
- FRBM Act was further amended in 2018, where the escape clause enables the government to relax the **fiscal deficit target for up to 50 basis points or 0.5 percent**.
- Under the escape clause, RBI participates directly in the **primary auction of government bonds**, thus formalizing deficit financing.
- It can be applied after formal discussions and advice from the Fiscal Council.
- It exempts the government from sticking to FRBM guidelines in case of **war or a national calamity.**
- It was invoked by Finance Minister Nirmala Sitharaman in 2020 to allow the relaxation of the target and revised it for FY20 to 3.8 percent and pegged the target for FY21 to 3.5 percent.

### *Latest Changes in FRBM Act with Union Budget 2022-23*

- In the Budget speech, the Finance Minister noted that the government aims to reduce the fiscal deficit to below 4.5% of GDP by 2025-26.
- The estimated fiscal deficit for 2022-23 is 6.4% of GDP and the estimated revenue deficit for 2022-23 is 3.8% of GDP.
- In 2021-22, the government had set a budget estimate of 6.8% of GDP for fiscal deficit and 5.1% of GDP for revenue deficit.
- As per the revised estimates, the fiscal deficit is expected to marginally exceed the budget estimate to 6.9% while the revenue deficit is estimated to be lower at 4.7% for 2022-23.
- The primary deficit is estimated to be 2.8% of GDP in 2022-23.
- The interest payments as a percentage of revenue receipts have increased from 36% in 2011-12 to 42% in 2020-21.
- As per the budget estimates, this figure is expected to increase further to 43% in 2022-23.
- Outstanding liabilities constituting the accumulation of borrowings over the years is estimated to decrease marginally to 60% of GDP in 2022-23.

### *What is Fiscal Stimulus?*

- A ‘Fiscal stimulus’ is a set of policies designed by authorities to **jump-start a sluggish economy**.
- To encourage consumer spending, the central bank will **increase the money supply or lower the cost of money** (interest rates).
- A fiscal stimulus involves the government spending more money from its own coffers or lowering tax rates to put more money in consumers’ hands.
- For instance, during the COVID-19 pandemic, the central government announced a **fiscal stimulus package of Rs. 20 Lakh crore.**

### *Features of Fiscal Stimulus*

- It emerged as a tool of optimism during the financial crisis and global recession in advanced economies.
- It could also lead to an increase in the deficit and debt levels of countries, which may operate as a permanent drag for some countries.
- It can lead to deviation from the path of fiscal consolidation and also fiscal deficit.
- When the fiscal stimulus is used to stimulate consumer demand, rather than to create income yielding assets through appropriate investment it can cause inflation due to a high fiscal deficit.

## *Need for Fiscal Stimulus*

- To stimulate economic demand during the unemployment rise, shrinking income and consumer confidence.
- A fiscal stimulus revives business confidence, restarts stalled projects, helps in job creation and **sets off a virtuous cycle of demand and growth**.
- Pandemic induced job losses have resulted in increased rates of unemployment across global economies.
- For better economic growth, wealth creation is essential which can be accomplished by providing a fiscal stimulus.

## *Impacts of Fiscal Stimulus Framework*

- Fiscal stimulus results in a sudden rise in liquidities and can also cause widespread bankruptcies, losses of organisational capital, a steep path towards economic recovery.
- It can result in a liquidity trap in which the rate of interest decreases, there is a liquidity preference as almost everyone prefers holding cash.
- It can result in high inflation.
- Fiscal stimulus involves expenditures on health, food and income support for vulnerable households which can put a strain on the government exchequer.
- It can cause an increase in gross public debt, impact the credit ratings etc and therefore cause deterioration of public finances.

## *Fiscal Stimulus during COVID-19*

- During the pandemic there was an increase in job losses that lead to an increase in unemployment.
- Various sectors of the economy especially the manufacturing sector was badly impacted.
- India offered economic relief packages such as the **Pradhan Mantri Garib Kalyan Yojana worth Rs 1.75 lakh crore** or roughly **0.8% of the GDP.**
- **Atmanirbhar Bharat Abhiyan amounting to Rs. 20 lakh crore** was launched for farmers, cottage industry, MSMEs, labourers, middle class etc.
- Many countries such as Bangladesh and Indonesia etc resorted to expanding their coverage of the cash transfer programmes from pre-COVID-19 levels.
- Some countries such as China, Vietnam etc adopted a dual strategy of providing relief to workers who have been laid off and feeding poor families, while also trying to keep firms afloat.

## *Fiscal Stimulus Vs Monetary Stimulus*

| **Difference between Fiscal Stimulus and Monetary Stimulus** | |
|---|---|
| **Monetary Stimulus** | **Fiscal Stimulus** |
| It is regulated by central banks that focus on low inflation rates to stabilise economic growth by increasing the amount of money available. | It is a government-regulated measure which involves change in government spending and taxation to revive the economy. |
| It is undertaken by central banks to regulate the supply of money in the country. The main tool of a monetary stimulus is interest rates. | The government uses fiscal stimulus packages to influence overall supply and demand by cutting down on taxes, increasing spending and boosting economic growth |
| It reduces marketing interest rates, increases the money supply by injecting more cash into the economy. | It is done by the government through direct spending and increasing hiring to promote employment and growth |
| It puts extra money into the hands of the people during times of recession | They are the last resort to achieve price stability, steady economic growth and promote employment |

**Question: Consider the following statements**

1. Cutting the tax rates.
2. Increasing government spending.
3. Abolishing the subsidies.

In view of the economic recession, which of the above actions can be considered a part of the 'fiscal stimulus' package?

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

**Question: Inflation is caused by?**

(a) Increase in supply of goods
(b) Increase in cash with the government
(c) Decrease in money supply
(d) Increase in money supply

## *What is Public Debt?*

- **Public Debt** is the total amount that includes external debt, internal debt and also total liabilities, borrowed by the government to meet its development expenses.

- It is to be **paid from the Consolidated Fund of India**. It can also refer to the overall liabilities of central and state governments. This is provided under **Article 292** of the Indian Constitution.
- According to the Finance Ministry reports, in FY20, India's total debt burden as a percentage of GDP was 51.6 percent; in FY21, it was 60.5 percent.
- The **debt-to-GDP ratio** demonstrates the country's ability to repay its debt. The debt-to-GDP ratio is frequently used by investors to analyse the government›s ability to service its debt. Increased debt-to-GDP ratios have fueled global economic crises.

### *Reasons for Borrowing/Public Debt*

- The income generated is not sufficient to carry out the required expenditure.
- Presently the **tax part of national income is less than 20%**, hence there is a small share of taxes in the national income.
- There is greater reliance on indirect taxation and therefore most of the pressure falls on lower-class strata.
- **Asymmetrical institutional setup** for taxation for instance complex tax systems with greater tax evasion.
- There is a **gross misuse of public funds** due to corruption, wasteful projects, red-tapism etc.
- In order to **accomplish various government schemes and plans** financial resources are needed.
- Lately, the increase in Public Debt has been mainly due to the following reasons.
  - Total central government debt was increased in both absolute terms and as a percentage of GDP that fiscal year due to **bank recapitalization**.
  - Due to the issuing of **Ujwal Discom Assurance Yojana (UDAY) bonds**, there has been an increase in liabilities of states which have increased during 2015-16 and 2016-17.
  - There is a small share of taxes in national income, most of which comes from indirect taxes.
  - Asymmetric taxation systems with **high tax evasion** because of increased loopholes in the tax system.
  - **Misuse of public funds** due to corruption, bribe and red-tapism the work is completed with great difficulty.

### *Classification of Public Debt*

#### *Internal Debt*

- They are the public debt borrowed from within the country.
- Major sources of funds for internal debt include commercial banks and financial institutions.
- Here the government obtains finance by borrowing and not by creating de novo. It is rarely spent on goods and services.

#### *External Debt*

- It is when debt is taken from individuals and organizations living outside the country.
- Here borrowing is from commercial banks, governments or international financial organizations.

#### *Productive Debt*

- These are those debts that are used to generate income from sources such as railway, plans for electricity, plans of irrigation etc.
- The income generated from such plans can be used for the payment of yearly interest and for the payment of principal. Such debts put pressure on the taxpayer and the government.

#### *Unproductive Debt*

- Such debts are incurred on assets that do not generate income. In such debts at some point, there are losses of interest also.

#### *Redeemable/Terminable Debt*

These are those debts in which the government promises that they would pay back the debt on a fixed date later. These debts are also called terminable debts.

### *Irredeemable Debt/Perpetual Debt*

- These are those debts that are done without any promise to be paid back later.
- When debts are not paid back on time then the governments decide on specific arrangements to pay back the debt such as whether such debts need to be paid back from the taxable income etc.

### *Funded Debt*

Such debts are long term in nature. Payment of these debts is to be done within one year or it can be possible, not to give any promise.

### *Unfunded debts*

Such debts are given for three or six months and their time period is not more than one year such as treasury bonds etc.

### *Short Term Debt*

It is when the government takes debt for a short period. These debts are paid back within a year that is to be taken to complete the tenure of debts.

### *Long Term Debt*

It is when the government takes debt for a long period of time. The period of giving it back is not fixed. In this type of debt, the lender gets regular interest.

### *Advantages of Public Debt*

- It **increases the money supply** that facilitates various industries in the country to increase production which in turn increases the national standard of life.
- It helps to counter various man-made (inflation etc) and natural calamities (floods, landslides etc).
- It is especially helpful for developing countries to **allocate resources in various sectors** of the economy.
- Equitable and suitable distribution of debts take place which **promotes harmony and cooperation in public**.
- Public debts are also regarded as **secure sources of investment**.
- It also helps in various **non-economic benefits** to nations such as better international relations between friendly nations.

### *Disadvantages of Public Debt*

- There is increased **misuse of the resources** of the country as a large part of it is given as interests to foreign nations.
- There is a **fear of going bankrupt** in the near future especially in case of a global economic crisis.
- **Extravagant spending** can happen when resources are available easily. For instance, **Greece had a debt to GDP ratio of 160% in 2009 due to extravagant spending.**
- There can be **international pressure and political interference** in the domestic policies of the debtor nation.
- Increased **burden of repayment on citizens** in the form of increased taxation.
- Slower economic and weak economic development

**Question: A decrease in the tax to GDP ratio of a country indicates which of the following?**

1. Slowing economic growth rates
2. Less equitable distribution of national income

Choose the correct option;

(a) 1 only (b) 2 only

(c) Both 1 and 2 (d) Neither 1 and 2

**Question: Debt financing that can magnify the risk and reward for investment are called as follows:**

(a) Reward risk (b) Derivative

(c) Leverage (d) Investment strategy

10

# TAXATION IN INDIA

## *What is Tax?*

- Tax is a **mandatory contribution to state revenue** that the Indian government levies on worker's income and corporate gains, as well as added to the cost of certain transactions, commodities and services.
- The **government collects taxes on citizens to generate revenue** for business ventures that would improve the country's economy and raise citizens' living standards.
- In our country, the government's **right to levy taxes is derived from the Indian Constitution**, which grants the State and Central governments equal jurisdiction to impose taxes.
- Every tax imposed within the country must be accompanied by an accompaniment law passed by the State Legislature or the Parliament.
- The tax system in India is mainly a three tier system which is based between the Central, State Governments and the local government organizations (such as Municipality and Panchayats).

## *Distribution of Taxation Power*

- Article 246 (schedule VII) of the Indian Constitution, distributes legislative powers including taxation, between the Parliament and the State Legislature. Schedule VII provides for the three lists:
- **List – I** It provides for areas on which only parliament is competent to make laws .
- **List – II** It provides for areas on which only parliament is competent to make laws.
- **List – III** the areas on which both the Parliament and the State Legislature can make laws upon concurently.
- Art 248 mentions that the residual powers of Legislation are vested in the Parliament. It means that Parliament has exclusive power to make any law with respect to any matter not enumerated in list II and III. Such power shall include the power of making any law imposing a tax not mentioned in either of those lists.

> ***Note-*** Separate heads of taxation are provided under List- I & List – II of Seventh Schedule of the Constitution. However, there is no head of taxation in the Concurrent List (It means that Union and the States have no concurrent power of taxation).

- The 73rd and 74th constitutional amendment act have provisions to levy taxes by Panchayats and Municipalities respectively. A State may by law authorise a Panchayat (or Municipality) to levy, collect and appropriate taxes, duties, tolls etc.

## *Method of Taxes*

### *Progressive Tax*

- A Progressive Tax is a tax that **increases with an increase in income**.
- A progressive tax is justified by the fact that **a flat percentage tax would disproportionately affect persons with low earnings**.
- The degree to which a tax structure is progressive is determined by how much of the **tax burden is passed to those with higher incomes**.
- It is common knowledge that the **more money you earn, the more taxes you should pay, thereby contributing to society**.
- If one tax code has a low rate of 10% and a high rate of 30% and another tax code has tax rates ranging from 10% to 80%, **the latter is more progressive**.
- **Income Tax, Luxury Sales Tax, Estate tax and surcharge on net income beyond Rs 50 Lakhs** are a few examples of Progressive tax.

### *Regressive Tax*

- A regressive tax is a tax that is **imposed similarly to all situations, regardless of who is paying it.**

- **People with low incomes are disproportionately affected by regressive taxes** compared to those with higher incomes.
- While taxing everyone at the same rate may be reasonable in some contexts, it is **perceived as unjust in others.**

### *Examples of a regressive tax include:*

- Sales Tax
- Property Tax
- Excise Tax
- Tariff
- Government Fees
- Flat Taxes
- "Sin" Taxes

| Difference Between Progressive Tax and Regressive Tax | |
|---|---|
| **Progressive Tax** | **Regressive Tax** |
| It takes a higher percentage rate from taxpayers who have higher incomes. | It takes a larger part of disposable income from low-wage earners. |
| Direct Taxes are progressive in nature. | Indirect Taxes are regressive in nature. |
| Easy to collect as the taxpayer pays his own tax to the government. | Comparatively tough to collect as the incidence and impact of the tax is not on the same person. |
| Progressive taxes are easy to manipulate in comparison to regressive taxes as they have a direct impact on the income. | Regressive Taxes have wider coverage and a broad base. The taxes cover almost every goods and hence, are tough to manipulate. |
| Example: Income Tax, Luxury Sales Tax | Example: Sales Tax, Property Tax, Sin Tax |

## *Proportional Tax*

- A **proportional tax** is one in which the tax rate stays proportional regardless of the taxpayer's income level.
- In this case, the individual's tax liability is not proportional to his income.
- **Examples** of progressive, regressive and proportional taxes in the table
- People are taxed at the same percentage of their annual income when they pay a proportional tax.
- Supporters of a proportional tax system argue that it encourages taxpayers to earn more by not penalizing them with a higher tax bracket.

| Taxable income (Rs) | Progressive tax (rate) | Regressive tax (rate) | Proportional tax (rate) |
|---|---|---|---|
| 10000 | 10% | 10% (1000 spent as tax) | 20% |
| 30000 | 20% | 10% (3000 spent as tax) | 20% |
| 50000 | 30% | 10% (5000 spent as tax) | 20% |
| Example | Income Tax | Sales Tax | GST |

- Flat tax systems also make filing simpler. Flat tax critics contend that the system unfairly burdens low-wage earners in exchange for reduced tax rates for the wealthy.
- However, critics argue that a progressive tax system is more equitable than a flat tax structure.

### *Example of Proportional Tax*

- All taxpayers under a proportional tax system must pay the same percentage of their income in taxes. If the rate is set at 20%, a taxpayer earning Rs.100,000 will pay Rs.20,000, while a taxpayer making Rs.50,000 will pay Rs.10,000. Similarly, a millionaire would pay Rs.2,00,000 in taxes.
- In India, **GST** is an example of proportional tax. Everyone having food in an A/C restaurant pays a GST of 5% irrespective of the income level or the bill amount.

> ***Note:*** Generally all indirect taxes including GST are regressive taxes as the poor pay a larger sum as tax compared to the middle class and the rich. However, since GST is a flat tax irrespective of income we consider it a proportional tax in the above case.

### *Advantages of Proportional Tax*

- The first and most important advantage of proportional tax is that because everyone pays the same rate of tax, there is **no ambiguity about the rate of taxation**, which leads to clarity in the minds of both taxpayers and tax collectors.
- When it comes to taxes, the majority of people **do not understand the tax rates because there are many slabs and exemptions** associated with those slabs, so having clarity about the rate of taxation makes life easier for taxpayers.

- Another advantage of proportional tax is that it **reduces tax evasion** by the wealthy because when tax rates are high for the wealthy and low for the middle and poor, the wealthy will try every trick in the book to avoid paying taxes and thus proportional tax results in less tax leakage from the system.
- Another advantage of proportional tax is that it is **simple to understand for both tax authorities and tax payers**, resulting in improved implementation by tax authorities and acceptance by taxpayers.

### *Disadvantages of Proportional Tax*

- The most significant disadvantage of proportional taxation is that a large segment of society, namely the **middle and lower classes, feel cheated** because they believe that those who have more money should pay more tax and those who have less money should pay less tax, but because this system keeps tax rates the same for everyone, there is frustration and anger among the majority of people in the country, as **middle- and lower-class people make up 99 percent of the population**.
- Another disadvantage of proportional taxation is that because rich and poor people are taxed at the same rate, it creates a **huge disparity between them, which can lead to resentment, frustration** and, in the worst-case scenario, a revolt by the middle and lower classes against the country's affluent people and government.
- Another disadvantage of proportional tax is that the **government obtains less income than under other tax systems** because the tax rate must be kept low to please the poor and middle class, which leads to a lower tax rate for the wealthy, resulting in a loss of revenue for the country's government.

### *Classification of Taxes*

Taxes are broadly classified into two types:

- Direct Taxes
- Indirect Taxes

### *Direct Tax*

- A direct tax is one that **is levied directly on the taxpayer and paid directly to the government** by those who are subjected to it.
- The **Central Board of Direct Taxes is responsible for levying and collecting direct taxes** as well as formulating other direct tax policies.
- A taxpayer pays a government a direct tax for a variety of reasons, such as **real property tax, personal property tax, income tax or asset taxes, Gift Tax, Capital Gains Tax,** and so on.
- Direct Tax is one of the two main sources of revenue for the government. The indirect tax is the other.
- Every fiscal year, **direct taxes account for roughly half of the government's revenue.**
- To increase revenue, **the government sets direct tax collection targets for each fiscal year.**

## *Examples of Direct Tax*

### *Income Tax*

- **Individuals, Hindu Undivided Families, unregistered businesses and other groups of persons are all subject to income tax.**
- The nature of income tax in India is **progressive**.
- Income from all sources is combined together and taxed according to the individual's income tax slabs.
- Different rates of income tax are charged based on the amount of net income. For instance, an income tax of 10% is charged if net taxable income is between Rs 5 to 7.5 lakhs.
- Where the total income exceeds Rs 50 lakh but does not exceed Rs 1 crore, there is a 10% surcharge on income tax.

| Note: Agricultural Income is not taxed. |
|---|

### *Corporation Tax*

- **It is a tax placed on the profits of corporations and business firms. It is also called Corporate tax.**
- A firm is recognised as a separate entity for tax reasons and hence must pay a separate tax from its owner's personal income tax.

- Companies that are registered in India under the Companies Act 1956, both public and private, are subject to pay corporate tax.
- As of January 2022, Corporation tax is at a rate of 22 per cent for all domestic companies.

### *Minimum Alternate Tax*

- The concept of Minimum Alternate Tax (MAT) was introduced to ensure that **companies with large profits and substantial dividends to shareholders who were not contributing to the government through corporate tax** by taking advantage of the various incentives and exemptions provided in the Income-tax Act **paid a fixed percentage of book profit** as minimum alternate tax.
- As a result, the government charges a Minimum Alternate Tax or MAT, on these businesses as an advance tax. As a result, businesses are required to pay at least a certain amount of tax.
- According to the Income Tax Act, if a company's taxable income is less than a particular percentage of its booked profits, that portion of the book profits is automatically considered taxable income and tax is due.
- As of January 2022, MAT is at a rate of 15 per cent.

### *Capital Gain Tax*

- A **capital gain is any profit or gain derived from the sale of a capital asset.**
- **Profits from the sale of capital are subject to taxation.**
- Land, buildings, houses, jewellery, patents and copyrights are examples of capital assets.
- **Short-term capital asset** — A short-term capital asset is an asset that is held for less than 36 months.
- **Long-term capital asset** — A long-term capital asset is one that has been held for more than 36 months.
- From FY 2017-18 onwards, the 36-month requirement for immovable property (land, building and house property) has been decreased to 24 months.
- For example, if you sell a house property after owning it for 24 months, any income you receive will be considered as long-term capital gain if you sell it after March 31, 2017.
- However, **transportable goods such as jewellery and debt-oriented mutual funds are exempt from this adjustment.** If held for more than 36 months, they will be classified as a long-term capital asset.
- The Capital Gains are charged differently for short term and long term gains based on the income gained.

### *Securities Transaction Tax*

- Securities transaction tax is a **tax on gains made on the domestic stock exchange** on securities such as equities, options and futures.
- It is a **direct tax levied and collected by the central government**.
- **P. Chidambaram**, the former Finance Minister, proposed the Securities Transaction Tax (STT) **in 2004**.

### *Commodities Transaction Tax*

- The commodity transaction tax is **charged on the buyer and seller of exchange-traded non-agricultural commodity derivatives in India.**
- It is **calculated based on the contract's size.**
- **Non-farm items such as metals (gold, silver and copper) and energy products are among the commodities covered by CTT** (crude oil and natural gas).

### *Alternate Minimum Tax*

- **What Minimum Alternate Tax (MAT) is to corporations, Alternate Minimum Tax (AMT) is to limited liability partnerships**.
- Other types of commercial organisations, such as partnership businesses, sole proprietorships and associations of persons, are not subject to this tax.

### *Estate Duty*

- It was first introduced in 1953. **It is imposed on all of a person's property when he or she dies.**

- The deceased person's entire estate is considered his riches and is subject to taxation.
- **Since 1985, the tax has been discontinued.**

## Wealth Tax

- It was first introduced in 1957.
- **It was imposed on individuals, joint Hindu families and businesses who had an excess of net worth.**
- Wef 2015, the tax was abolished.

## Gift Tax

- It was first introduced in 1958.
- **All donations were subject to the gift tax,** with the exception of those made by charitable institutions' government and private enterprises.
- **Since 1998, the tax has been discontinued.**

## Fringe Benefits Tax

- Many corporations provide various bonuses to their employees and keep them beneath their input cost in order to lower the profit on booked entries.
- As a result, profit is reduced, resulting in lower government taxation.
- To counter this, the government enacted the Fringe Benefits Tax (FBT), which is essentially **a tax that an employer must pay in lieu of the benefits provided to his or her employees.**
- It was an attempt to impose a tax on all benefits that were evading the tax.
- In India's 2009 Union budget, the fringe benefits tax was repealed.

## Equalisation Levy / Google Tax

- Equalization Levy (Direct Tax) was introduced in India in 2016, with the intention of taxing the digital transactions i.e. the income accruing to foreign e-commerce companies from India.
- It is aimed at taxing business to business transactions.
- If a foreign company makes profit in India, they have to pay 40% Corporation Tax.
- If an Indian businessman purchases digital advertisement slots in google-ad sense or facebook then those (foreign) e-ad companies are making profit. But earlier, they did not pay tax on that profit, claiming their business activity (of displaying digital-ads) is done outside India on global servers.
- Budget-2016 imposed 6% tax on such income of foreign technology companies.
- Officially called "Equalisation Levy", not part of "Income Tax" or "Corporation Tax" under the Income Tax Act 1961, but a separate levy altogether imposed by the Finance Bill 2016.
- Foreign Company cannot escape it saying we are protected under the Double Taxation Avoidance Agreement (DTAA) in our home country.
- ***GAFA Tax* -** France has implemented tax on large technology companies called Google Apple Facebook Amazon from 1st Jan 2019.

## Dividend Distribution Tax

- A **dividend** is a payment made by a corporation to its stockholders from the company's profits in a given year. **Dividends are income in the hands of shareholders,** and they should ideally be subject to income tax.
- **Dividend distribution tax** is a **tax levied by the Indian government on Indian corporations based on the amount of dividends paid to shareholders.**
- DDT was **first introduced in 1997** and it was regulated under Section 115 O of the Income Tax Act.
- An Indian corporation was required to pay **15 percent of the gross amount of a dividend within 14 days of its declaration**, payment or distribution, according to the regulations. The actual rate increased to 20.5 percent once surcharges and cess were added.
- In the Union Budget of 2018, Finance Minister Arun Jaitley proposed DDT on equity mutual funds.
- The **Finance Minister eliminated the Dividend Distribution Tax in Budget 2020.**
- **As a result, individual investors would be responsible for paying dividend taxes**

**which would be calculated as part of income.**

- The **burden of dividend taxation has now been shifted from corporations to individuals.**

## *Tobin Tax (Robinhood Tax)*

- Nobel recipient American economist James Tobin proposed (1970s) a small tax every time currency is converted into another currency (e.g. from Dollar to Rupee and vice versa). Such tax will discourage short term speculative investment and flight of capital from one country to another. Tobin tax helps stabilizing the global economy and currency exchange rates.
- In India, foreign currency conversions are subjected to (previously Service Tax) now GST.

## *Advance taxation*

- New financial year starts from 1st April 2019 and ends on 31st March 2020.
- Rational → If everyone paid all of their direct taxes at 11:59PM on 31st March 2020, then govt. will face money-shortage for the whole year till 31st March midnight comes.
- Advance Tax mechanism requires people to pay their Income tax and Corporation tax in advanceinstalments on quarterly basis, if their annual tax liability is INR 10,000 or more.

## *Tax Deduction at Source (TDS)*

- Suppose a college pays ₹10,000 to a freelance visiting faculty or a bank/NBFC/post- office pays ₹10,000 as interest to a depositor, then how to ensure that payment- recipient (visiting faculty) reports his income to the tax authorities, otherwise he could avoid paying taxes.
- Hence, Income Tax Act requires such organizations to deduct a portion of the payment at source and deposit it to IT-dept along with PAN card number of the recipient.
- Then, payment-recipient will be forced to file his tax return, to unlock his TDS amount.
- On one side, TDS helps fighting tax evasion but on the other side, TDS also creates hardship for lower middle-class persons, because part of their payment is cut in advance.

## *Presumptive taxation*

- Salaried employees can easily compute their taxable income from their annual salary, & pay income tax.
- Companies hire full time Chartered Accountants to compute their taxable income and pay Corporation tax.
- But self-employed freelance consultants and professionals such as lawyers, doctors, fashion designers etc. face difficulty in keeping such account books. So, for them Income Tax Act has Presumptive Taxation System i.e. their 'income/profit' is computed as "x%" of their gross receipts and on that amount they have to pay income tax (depending on slabs) + applicable cess and surcharges, if any.

## *Tax Collection At Source (TCS)*

- Tax Collected at Source i.e. collected by receiver or payee or seller. e.g. Jeweller selling jewellery would collect TCS and pay to the IT department. Tax payee will have to file tax-return to unlock this amount.
- Budget-2020: Authorized Forex dealers will have to cut 5% TCS while converting Indian Rupee into foreign currency. Similar norms on foreign tour operators.

## Tax refund

- A person is eligible to receive income tax refund from IT-dept if he has paid more tax to the govt than his actual tax liability.
- In above case, Income Tax Department will refund money along with interest.
- Similarly, GST refund can be claimed by an entrepreneur from GSTN web portal.

## *Cess and surcharge*

**Cess and surcharge** are the **taxes levied by the Union Government in order to raise funds for government operations**. Though both Cess and Surcharge add money to the government's revenue, these are **different in many aspects.**

### *Cess*

- A **cess is a tax on tax** in basic terms.
- It is critical to remember that a **cess must only be applied to the purpose for which it is levied.**
- For example, the Indian government collects an education cess and uses it solely for that reason, namely, education.
- Furthermore, this tax is **imposed on all taxpayers**.
- Cess taxes are **paid to the Consolidated Fund of India.**
- Cess is **generally expected to be charged until the government has sufficient purpose** and becomes dormant after the purpose is fulfilled.
- A cess is **different from other taxes such as excise duty and income ta**x as it is levied in addition to the current tax (tax on tax).
- **For example**, a 5% education cess on a 20% percent income tax will make the overall tax 21%. (20% base tax plus 5% (cess) of the 20%).
- Education cess, road cess, infrastructure cess, clean energy cess, Krishi Kalyan cess and Swachh Bharat cess are the **key cesses currently in place.**

### *Types of Cess*

There are various types of cess levied in India. They are:

- Infrastructure Cess
- Krishi Kalyan Cess
- Cess on Exports
- Road and Infrastructure Cess
- Duty on Tobacco and Tobacco Products
- Health and Education Cess on Income Tax
- Swachh Bharat Cess
- Education Cess
- Cess on Crude Oil

### *Surcharge*

- In the case of individuals earning a net taxable salary of more than Rs 1 crore, a surcharge of 10% is levied on tax liability.
- Surcharge at the rate of 5% is levied on domestic corporations if net income is in the range of Rs 1 cr to Rs 10 cr. If the net income exceeds Rs 10 cr, surcharge at the rate of 10% is levied.
- Surcharge at the rate of 2% is levied on foreign corporations if the net income is in the range of Rs 1 cr to Rs 10 cr.
- If the net income exceeds Rs 10 cr, the surcharge is increased to 5%. Marginal relief is given to both domestic and foreign companies in case the net income exceeds Rs 1 cr and Rs 10 cr.
- A surcharge on income tax is a substantial **source of revenue for the government.**
- This money is collected **for whatever purpose the Union Government deems appropriate.**
- It's worth noting that **it only applies to the tax due, not the whole income.**
- This **money is paid to India's Consolidated Fund**, which can be utilised for any purpose.
- A 10 per cent surcharge on a 30 per cent income tax rate, for example, brings the tax burden to 33 per cent.

### *Similarities between Cess and Surcharge*

- Both a cess and a surcharge are levied by the central government.
- Both are collected and deposited in India's Consolidated Fund.
- None of these can be shared by state governments.

### *Difference between Cess and Surcharge*

The difference between cess and surcharge is as follows:

| Cess | Surcharge |
|---|---|
| Cess Rate is Fixed. | The surcharge rate varies as per the brackets in which the people fall. |
| Authorities calculate cess on the surcharge and the total tax. | A surcharge is calculated on the total tax amount only. |
| Cess is levied on everyone. | Only higher income brackets face Surcharge. |
| Cess is used for a specific purpose only. It cannot be used for any other reason. | The surcharge can be used for any reason that the government finds fit. |
| Cess is aimed at public welfare. | Surcharge aims to tax high earning individuals. |

### *Issue of Cess and Surcharge to be included in the tax devolution pool*

- The **Centre is empowered to charge and collect both direct and indirect taxes** under the Union List as part of the allocation of power and duties between the Union and states as provided in the **Seventh Schedule** under **Article 246** of the Constitution.
- This has generated a **massive resource mobilisation imbalance** to the governments' detriment in delivering their committed social expenditure duties.
- The **net proceeds of taxes** (also known as net tax revenue) are calculated by subtracting cesses and surcharges from gross tax revenue, as well as the cost of collection and transfer to the National Disaster Response Fund (NDRF).
- As a result, **a larger pool of cesses and surcharges reduces the overall amount of the divisible taxes**, reducing resource transfer to the states.
- According to the **XV Finance Commission**, states are responsible for more than 62 percent of expenditures but only 37 percent of revenue raising capacity, whereas the central government has 63 percent of revenue raising authority to spend on 38 percent of expenditures.
- **Despite an increase in cesses and surcharges** from Rs 49,628.02 crore in 2010-11 to Rs 3,74,471.14 crore in 2021-22, **the benefits do not filter down to the states because cess and surcharges are not included in the divisible pool**, which is net of taxes.
- Over the years, states have been consistently requesting that the Union government either entirely do away with cesses or if they are continued for a longer term, bring them into the divisible pool.
- States will get a larger part of devolution from the Centre's net proceeds as a result of this inclusion, allowing them to meet their own social, human development and infrastructural responsibilities.
- By bringing about a constitutional amendment, **the fourteenth and fifteenth Finance Commissions suggested that earnings from cesses and surcharges be included in the divisible pool.**

### *Advantages of Direct Tax*

- ***Economic Balance:*** The government creates tax bands depending on an individual's wages and age to achieve economic and social balance. The tax rate is set according to the country's economic position. Individuals are excused in order to balance economic disparities.
- ***Ensures equality:*** Individuals and businesses with larger profits must pay higher taxes to the government in order for the government to assist the poor and vulnerable in society. This maintains economic equilibrium.
- ***Gives Certainty:*** The direct tax provides both the government and the taxpayers with a sense of certainty because the amount of tax that must be paid and collected is known to both the taxpayer and the government.
- ***Addresses inflation issues:*** During periods of high inflation, the government raises taxes in order to limit the demand for goods and services, resulting in a fall in inflation.
- ***Makes Government Accountable:*** Individuals are aware of the need to pay taxes. As a result, he or she is aware of his or her rights and is engaged in the government's use of taxes. This ensures that the government is held accountable.

### *Disadvantages of Direct Tax*

- ***Can be easily evaded:*** Not everyone is eager to pay their taxes. To avoid paying taxes, some are willing to file a fraudulent tax return. Without being held accountable to the law of the state, these people can easily conceal their earnings.
- ***Tax slabs are arbitrary:*** Taxes are set arbitrarily by the Finance Minister if they are progressive. It places a significant burden on the poor if it is proportional.
- ***Obstructs growth:*** High taxes disincentivize people from saving and investing, causing the country's economy to suffer. It obstructs the

growth of businesses and industries, causing them harm.

- ***Inconvenience:*** A direct tax has the significant disadvantage of pinching the taxpayer. When a lump sum is taken from his pocket, he feels a sense of his hard-earned money taken away. As a result, paying direct taxes is quite inconvenient.

## Indirect Tax

- An indirect tax is a **tax that is collected through a middleman from the person who suffers the tax's ultimate economic burden**.
- It is **possible for the taxpayer to transfer it to someone else.**
- The **intermediary prepares a tax return and sends the tax proceeds to the government along with it**.
- In this sense, an **indirect tax differs from a direct tax, which is collected directly by the government** from the individuals (legal or natural) who are subjected to it.
- Indirect taxes are **based on an individual's expenses rather than their income**.
- Indirect taxes are **levied on suppliers of goods and services, but the tax is passed on to the consumers**, who are indirectly paying the tax.

## Advantages of Indirect Tax

- ***Everyone is able to contribute:*** Unlike Income Tax, which is paid by those in particular income groups but not others, Indirect Taxes are paid by everyone who buys a product. People who are not working in India, such as tourists and people from lower socio-economic groups, must pay it because they will purchase goods in some way.
- ***Indirect Taxes are convenient:*** When it comes to collecting indirect taxes, they are incredibly convenient. Taxes might be extremely low and customers do not feel pressured while paying such modest sums. Moreover, they are a price of the cost of goods sold, hence, convenient to pay.
- ***They are unavoidable:*** Because indirect taxes are included in the price of the product, they cannot be avoided. As a result, anyone who purchases the commodity will be subject to the tax.
- ***They cover a wide range:*** Heavy taxation on any one feature of a service or item will be obvious to the consumer and will be a significant hardship. In this case, indirect taxes can be advantageous because they are spread out over a larger number of products and are paid in lower amounts.

## Disadvantages of Indirect Taxes

- ***Indirect taxes have the potential to be regressive:*** Because both the rich and the poor pay the same indirect tax, it can be considered unjust to the poor. Anyone who makes a purchase is subject to indirect tax and while the wealthy may afford to pay it, the poor will be charged the same amount. As a result, indirect taxes may be considered regressive.
- ***They are inflationary in effect:*** Sellers may not always be able to compute and collect the exact fraction of tax that applies to all of the goods they sell. As a result, they purposefully charge more than the tax amount in order to ensure that every buyer pays the indirect tax. However, this has a cumulative effect on rising commodity prices.
- ***They do not raise civic consciousness:*** Indirect taxes do not raise civic awareness because millions are not even aware that they're paying a tax because it is hidden in the price.

## Examples of Indirect Tax

### Customs Duty

- **When commodities are transferred across international boundaries, customs duty is applied as a tariff or tax**.
- Its goal is to safeguard the country's economy.
- Various sorts of duties are imposed under customs rules, including Basic Duty, Countervailing Duty, Protective Duty, Anti-Dumping Duty and Export Duty.
- Import duties are used **not just to generate revenue for the government, but also to regulate commerce.**

- In India, import duties are **calculated on an ad valorem basis**.

## *Sales Tax*

- In India, **a sales tax is a type of tax levied by the government on the sale or purchase of a certain commodity within the country.**
- Sales tax is levied by both the central and state governments.
- **It has now been replaced by IGST.**

## *Excise Duty*

- Excise duty is a **commodities tax in the proper sense** because it is collected **on the manufacturing of products in India rather than the sale of the product.**
- Except for alcoholic drinks and narcotics, the central government imposes an explicit excise levy.
- **It has now been replaced by CGST.**

## *Service Tax*

- **In India, a service tax is levied on all services rendered.**
- In 1994-95, a service tax was imposed on three services: telephone services, general insurance and stockbroking.
- Every year since then, the service net has widened by adding more and more services. We now have a 'negative list' exclusion criterion, where some services are excluded from the tax net.
- In India, the current rate of service tax was 15% before it was **replaced by the Goods and Services Tax.**

## *Value Added Tax*

- The VAT is constructed in such a way that it eliminates distortions.
- As a result, all states and union territories in India have implemented VAT (except UTs of Andaman Nicobar and Lakshadweep).
- The **tax is imposed on a variety of commodities sold in the state and the amount is set by the state.**
- State VAT, which was in effect until July 1, 2017, had replaced the previous Sales Tax of States.
- **It has now been replaced by SGST.**

## *Dividend Distribution Tax*

- A **dividend** is a payment made by a corporation to its stockholders from the company's profits in a given year. **Dividends are income in the hands of shareholders,** and they should ideally be subject to income tax.
- **Dividend distribution tax** is a **tax levied by the Indian government on Indian corporations based on the amount of dividends paid to shareholders.**
- DDT was **first introduced in 1997** and it was regulated under Section 115 O of the Income Tax Act.
- The **Finance Minister eliminated the Dividend Distribution Tax in Budget 2020**.
- **The burden of dividend taxation has now been shifted from corporations to individuals.**

## *GST*

- GST (Goods and Services Tax) is a national indirect tax applied on the manufacture, sale and consumption of goods and services.
- It has supplanted all indirect taxes levied by the central and state governments on goods and services.

**Difference between Direct and Indirect Taxes**

| Parameter | Direct Tax | Indirect Tax |
|---|---|---|
| Meaning | Levied directly on the individuals or corporations. | Levied on one entity but is passed on to the final consumer. |
| Incidence | The incidence and impact of the direct tax fall on the same person. | The incidence and impact of the tax fall on different persons. |
| Nature | Progressive | Regressive |
| Administrative Cost | Higher | Lower |
| Tax Evasion | Possible | Not possible |
| Examples | Income Tax, Wealth Tax, Corporation Tax. | Excise duty, VAT, Entertainment Tax, Customs Duty, GST |

## *Goods and Services Tax (GST)*

Goods and Services Tax (GST) is a comprehensive indirect tax on the manufacture, sale and consumption of goods and services throughout India. GST would replace respective taxes levied by the central and state governments.

### *What is GST?*

- It is a **destination-based** taxation system.
- It has been established by the **101st Constitutional Amendment Act.**
- It is an indirect tax for the whole country on the lines of "**One Nation One Tax**" to make India a unified market.
- It is a single tax on the supply of Goods and Services in its entire product cycle or life cycle i.e. from manufacturer to the consumer.
- It is calculated only in the "**Value addition**" at any stage of goods or services.
- The final consumer will pay only his part of the tax and not the entire supply chain which was the case earlier.
- There is a provision of the **GST Council** to decide upon any matter related to GST whose chairman in the finance minister of India.

### *What taxes at the centre and state level are incorporated into the GST?*

### *At the State Level*

- State Value Added Tax/Sales Tax
- Entertainment Tax (Other than the tax levied by the local bodies)
- Octroi and Entry Tax
- Purchase Tax
- Luxury Tax
- Taxes on lottery, betting and gambling

### *At the Central level*

- Central Excise Duty
- Additional Excise Duty
- Service Tax
- Additional Customs Duty (Countervailing Duty)
- Special Additional Duty of Customs

### *Timeline of GST*

- ***1986:*** Vishwanath Pratap Singh, Finance Minister in Rajiv Gandhi's government, proposed in the Budget a major overhaul of the excise taxation structure. This was similar to GST in a theoretical sense.
- ***2000:*** Initiating discussions on GST, Vajpayee government appoints an Empowered Committee headed by the then finance minister of West Bengal Asim Gupta.
- ***2004:*** Vijay Kelkar, then advisor to the Finance Ministry, recommends GST to replace the existing tax regime.
- ***Feb 28, 2006: GST appears in the Budget speech for the first time.*** Finance Minister Chidambaram sets an ambitious task of implementing GST by April 1, 2010.
- ***Feb 28, 2007:*** Chidambaram said in his Budget speech that the Empowered Committee of finance ministers will prepare a road map for GST.
- ***April 30, 2008***: The Empowered Committee submits a report titled 'A Model and Roadmap Goods and Services Tax (GST) in India' to the government.
- ***Nov 10, 2009***: Empowered Committee submits a discussion paper in the public domain on GST welcoming debate.
- ***Feb 2010***: Government launches project for computerisation of commercial taxes. Finance Minister Pranab Mukherjee defers GST to April 1, 2011.
- ***March 22, 2011***: Constitution Amendment Bill (115th) to GST introduced in the LokSabha
- ***March 29, 2011***: Bill referred to Standing Committee on Finance.
- ***Nov 2012***: Finance Minister and state ministers decide to resolve all issues by Dec 31, 2012.
- ***Feb 2013***: Declaring the government's resolve to introduce GST, the Finance Minister makes provisions for compensation to states in the Budget.
- ***Aug 2013***: The standing committee submits a report to Parliament suggesting improvements. But the bill lapsed as the 15th Lok Sabha was dissolved.
- ***Dec 18, 2014:* Cabinet approval for the Constitution Amendment Bill (122nd) to GST.**
- ***Dec 19, 2014***: The Amendment Bill (122nd) in the LokSabha
- ***May 6, 2015:* The Amendment Bill (122nd) passed by the LokSabha.**

- ***May 12, 2015***: The Amendment Bill presented in the RajyaSabha
- ***May 14, 2015***: The Bill forwarded to a joint committee of Rajya Sabha and Lok Sabha
- ***Aug 2015***: Government fails to win the support of the Opposition to pass the bill in the Rajya Sabha where it lacks sufficient numbers.
- ***Aug 3, 2016:*** **Rajya Sabha passes the Constitution Amendment Bill by a two-thirds majority.**

> *Note: GST constitutional amendment bill needs to* **pass by at least 50% of state legislatures to be implemented. Assam is 1st State to pass the GST bill.**

***1 July 2017:*** GST to be applicable across India.

## *Benefits of GST*

### *For Central and State Governments*

- ***Simple and Easy to administer:*** Because multiple indirect taxes at the central and state levels are being replaced by a single tax "GST". Moreover, backed with a robust end-to-end IT system, it would be easier to administer.
- ***Better control on leakage:*** Because of better tax compliance, reduction of rent-seeking, transparency in taxation due to IT use and an inbuilt mechanism in the design of GST would incentivize tax compliance by traders.
- ***Higher revenue efficiency:*** Since the cost of the collection will decrease along with an increase in the ease of compliance, it will lead to higher tax revenue.

### *For the Consumer*

- The single and transparent tax will provide a lowering of inflation.
- Relief in overall tax burden.
- Tax democracy that is luxury items will be taxed more and basic goods will be tax-free.

### *For the Business Class*

- The ease of doing business will increase due to easy tax compliance.
- Uniformity of tax rate and structure, therefore, better future business decision making and investments by the corporates.
- Removal of cascading effects of taxes.
- Reduction in transactional costs will lead to improved competitiveness.
- Gain to the manufacturers and exporters.
- It is expected to raise the country's GDP by 2% points.

### *GST Council*

- It is the 1st Federal Institution of India, as per the Finance minister.
- It will approve all decisions related to taxation in the country.
- It consists of the Centre, 29 states, Delhi and Puducherry.
- Centre has 1/3rd of voting rights and states have 2/3rd of voting rights.
- Decisions are taken after a majority in the council.

## *Taxes Subsumed by GST*

### *Central taxes that are subsumed under the GST are:*

- Central Excise duty
- Duties of Excise (Medicinal and Toilet Preparations)
- Additional Duties of Excise (Goods of Special Importance)
- Additional Duties of Excise (Textiles and Textile Products)
- Additional Duties of Customs (commonly known as CVD)
- Special Additional Duty of Customs (SAD)
- Service Tax
- Central Surcharges and Cesses so far as they relate to supply of goods and services

### *State taxes that are subsumed under the GST are:*

- State VAT
- Central Sales Tax
- Luxury Tax
- Entry Tax (all forms)
- Entertainment and Amusement Tax (except when levied by the local bodies)

- Taxes on advertisements
- Purchase Tax
- Taxes on lotteries, betting and gambling
- State Surcharges and Cesses so far as they relate to supply of goods and services

### *Commodities kept outside GST*

- The Products and Services Tax (GST) is defined by Article 366(12A) of the Constitution, as amended by the 101st Constitutional Amendment Act, 2016, as a tax on the supply of goods or services or both, except for the supply of alcoholic liquor for human consumption.
- As a result, **alcohol for human use is exempt from GST** under the constitution's definition of GST.
- **Petroleum crude, motor spirit (petrol), high-speed diesel, natural gas and aviation turbine fuel have all been temporarily prohibited.**
- The GST Council will determine the date on which they will be subject to GST.
- Furthermore, **power is exempt from the GST.**
- On imported items, customs duty and IGST will continue to be collected.
- Currently, **petroleum and tobacco products are exempt.**
- **Liquor excise duty, stamp duty and power taxes** are all exempted as well.
- In the case of the aforementioned items, the present taxing structure (VAT and Central Excise) would be maintained.

### *Structure of GST*

- The government has categorised items into five major slabs for different goods and services **- 0%, 5%, 12%, 18% and 28%**. Cesses may be imposed on the items under the highest slab of 28%.
- GST Council examines issues relating to goods, services tax and makes recommendations to the Union and the States on parameters like **rates, exemption list and threshold limits**.
- Necessities and food items are kept at the minimal rates of 0% and 5% and the luxury items and sin goods (such as tobacco, pan masala) are placed at the top bracket rate of 28%.
- Out of 1300 products and 500+ services, the majority of the products are placed in the 12% and 18% tax bracket.

### *Goods and Services Network (GSTN)*

- **GSTN is registered as a not-for-profit company under the Companies Act.**
- It has been **formed to set up and operate the information technology backbone of the GST.**
- While the Central (24.5%) and the state (24.5%) governments hold a combined stake of 49%, the remaining 51% stake is divided among five financial institutions—LIC Housing Finance with 11% stake and ICICI Bank, HDFC, HDFC Bank and NSE Strategic Investment Corporation Ltd with 10% stake each.
- GSTN had awarded Infosys Ltd the contract to develop the hardware and software for GST.
- The idea behind GSTN was to set up an entity that is equidistant from both the Central government and the state governments, as it will advise both the Centre and the states on the information technology network.

### *GST (Compensation to States) Act, 2017*

- As per the **GST (Compensation to States) Act, 2017**, **loss of revenue to the states** on account of implementation of Goods and Service Tax is payable during the **transition period of 5 years**.
- The Act says that the financial year **2015-16 is to be taken as the base year** for calculating compensation amount. The projected **nominal growth rate of revenue** subsumed for a state during the transition period **shall be 14% per annum**.
- The government needs extra revenue to compensate the states and so the **GST Council allowed the centre to impose additional cesses for five years on certain goods** over and above the highest tax bracket of 28%. These goods on which cess will be levied include tobacco products, coal, motor

vehicles, which include all types of cars, personal aircraft and yachts.

## National Anti-Profiteering Authority (NAA)

- The National Anti-Profiteering Authority shall be a **five-member committee** consisting of a **Chairman** who holds or has held a post equivalent in rank to a Secretary to the Government of India; and **four Technical Members** who are or have been Commissioners of State tax or Central tax. Additional Director General of Safeguards shall be the Secretary of the Authority.
- The Authority will determine the method and procedure for determining whether the reduction in rate or the benefit of the **input tax credit** has been passed on by the seller to the buyer by reducing the prices.
- The Authority shall **exist for 2 years** from the date on which the Chairman enters upon his office unless the Council recommends otherwise.
- The GST Council will constitute a Standing Committee and a **state-level Screening Committee on Anti-Profiteering**, Standing Committee comprises officers of the State and Central Government as nominated by it.

## New Compliances under GST

- ***e-Way Bills***
  - e-Way Bills are a type of electronic bill.
  - By introducing "e-way bills," the GST created a centralised system of waybills.
  - This system was started on April 1, 2018, for inter-state goods movement and on April 15, 2018, for staggered intra-state goods transit.
  - Manufacturers, traders and carriers can easily generate e-way bills for items moved from their point of origin to their point of destination using the e-way bill system.
  - Tax authorities gain as well, as this technique reduces time spent at checkpoints and aids in the reduction of tax evasion.
- ***E-invoicing***
  - For enterprises with annual aggregate revenue of more than Rs.500 crore in any previous financial year, the e-invoicing system became effective on October 1, 2020.
  - This system was also extended to those having an annual aggregate turnover of more than Rs.100 crore as of January 1, 2021.
  - Every business-to-business invoice must be assigned a unique invoice reference number by uploading it to the GSTN's invoice registration page.
  - The invoice is checked for accuracy and authenticity by the gateway. It then authorises the use of a digital signature and a QR code.
  - e-Invoicing enables invoice interoperability and reduces data entry errors. Its purpose is to send invoice information directly from the IRP to the GST and e-way bill portals.
  - As a result, it will reduce the need for manual data entry when filing GSTR-1 and will also aid in the preparation of e-way bills.

## Reforms brought about by GST

- ***National Market:*** By combining a large number of Central and State taxes into a single tax, a common national market can be created.
- ***Mitigation of cascading effects:*** The GST significantly reduced the negative consequences of cascading or double taxation, paving the path for a common national market.
- ***Reduced Tax Burden:*** From the perspective of consumers, the main benefit would be a reduction in the overall tax burden on goods.
- ***Increasing the competitiveness of Indian products:*** Due to the entire neutralisation of input taxes across the value chain of manufacturing, the GST is making Indian products more competitive in both domestic and foreign markets.

- GST would be ***easier to manage*** due to its transparency and self-policing nature.

## *Issues regarding GST*

- ***All commodities are not covered:*** Certain taxes, such as those on alcohol and tobacco, are still not covered by the GST.
  - States claim that incorporating them will reduce revenue and deplete a valuable resource.
  - However, some experts believe that the underlying explanation is a political-business alliance and high-profile lobbying.
  - In addition, India's Finance Minister stated in Parliament that a consensus on bringing alcohol and cigarettes under the GST framework is conceivable shortly.
- ***GST Council:*** There are concerns regarding how to identify which things will fall into which tax bracket and the criteria for determining which items will fall into which tax bracket. It could result in lobbying.
  - The Finance Minister has responded by saying that the decision will be made by the GST Council only after full diligence and, most likely, by consensus.
- ***Various tax brackets and rates:*** Due to different tax rates and bands, the conceptual premise that GST stands for "One Nation, One Tax" is currently diluted. In response, the Finance Minister stated that because the target consumers of goods and services have varying capabilities, a system similar to the democratic lines must be implemented, in which higher-value consumers pay greater taxes.
- ***The Central Government has taken away the power of the Parliament to levy taxes:*** The Act gives the government the authority to announce CGST rates, subject to a cap. This means that the government can change rates up to a maximum of 20% without getting Parliament's permission.
  - Parliament and state legislatures levy taxes under the Constitution. Though the plan to set rates through delegated legislation satisfies these criteria, the question remains whether it is proper to do so without first undergoing parliamentary examination and approval.
- ***Confusion over consumption location:*** Under GST, both the state and the federal government can tax services based on where they are consumed. Now the problem occurs because the general guideline for determining the recipient's location is his address on file; yet, there are particular requirements for various services such as telecommunications, real estate, transportation and so on.
  - This means that even if a service is used in numerous jurisdictions, the tax revenue is credited to the state where the beneficiary is registered or where his business is located. This could result in states with more registered offices paying a larger tax.
- ***Anti-Profiteering Clause:*** The government intends to establish an authority to determine whether or not there would be any reduction in tax rates when GST is passed on to consumers by businesses. This notion is not well received by industry and enterprises, who perceive it as a backdoor entry for inspector raj.
  - According to experts, pricing should be established by the market and no government agency should be in charge of setting prices for goods and services.
- ***The issue of the casual taxable person:*** If a person who is registered in one state travels to another state for a brief length of time for a commercial transaction, such as to attend a fair or exhibition, that person must register in that state for that period.

## *Finance Commission (Art. 280)*

- The Finance Commission (FC) is a constitutional body, that determines the method and formula for distributing the tax proceeds between the Centre and states, and among the states as per the constitutional arrangement and present requirements.
- Under Article 280 of the Constitution, the President of India is required to constitute a Finance Commission at an interval of five

years or earlier.

- The 15th Finance Commission was constituted by the President of India in November 2017, under the chairmanship of NK Singh. Its recommendations will cover a period of five years from the year 2021-22 to 2025-26.

## *Vertical Devolution (Devolution of Taxes of the Union to States):*

- It has recommended **maintaining the vertical devolution at 41% -** the same as in its **interim report for 2020-21.**
- It is **at the same level of 42% of the divisible pool** as recommended by the **14th Finance Commission.**
- It has **made the required adjustment of about 1%** due to the changed status of the erstwhile State of Jammu and Kashmir into the new **Union Territories of Ladakh and Jammu and Kashmir.**
- ***Horizontal Devolution (Allocation Between the States):***
  - For horizontal devolution, it has suggested **12.5% weightage to demographic performance, 45% to income, 15% each to population and area, 10% to forest and ecology and 2.5% to tax and fiscal efforts.**
- ***Revenue Deficit Grants to States:***
  - Revenue deficit grants **emanate from the requirement to meet the fiscal needs of the States** on their revenue accounts that remain to be met, even after considering their own tax and non-tax resources and tax devolution to them.
  - Revenue Deficit is **defined** as the difference between revenue or current expenditure and revenue receipts, that includes tax and non-tax.
  - It has recommended post-devolution **revenue deficit grants amounting to about Rs. 3 trillion over the five-year period** ending FY26.
  - The **number of states qualifying** for the revenue deficit grants **decreases from 17 in FY22,** the first year of the award period to 6 in **FY26,** the last year.
- ***Performance Based Incentives and Grants to States:***
  - These grants **revolve around four main themes.**
  - The first is the **social sector,** where it has focused on **health and education.**
  - Second is the **rural economy,** where it has focused on **agriculture and the maintenance of rural roads.**
- The rural economy plays a significant role in the country as it **encompasses two-thirds of the country's population, 70% of the total workforce** and **46% of national income.**
- Third, **governance and administrative reforms** under which it has recommended grants for **judiciary, statistics and** aspirational districts **and blocks.**
- Fourth, it has developed **a performance-based incentive system for the power sector,** which is not linked to grants but provides an important, additional borrowing window for States.
- ***Fiscal Space for Centre:***
  - Total **15th Finance Commission transfers (devolution + grants)** constitutes about **34% of estimated Gross Revenue Receipts** to the Union, **leaving adequate fiscal space** to meet its resource requirements and spending obligations on national development priorities.
  - ***Grants to Local Governments:*** Along with grants for municipal services and local government bodies, it includes **performance-based grants for incubation of new cities** and **health grants** to local governments.
  - In grants for Urban local bodies, **basic grants are proposed only for cities/ towns having a population of less than a million.** For **Million-Plus cities,** 100% of the grants are performance-linked through the **Million-Plus Cities Challenge Fund** (MCF).
  - MCF amount is linked to the performance of these cities in **improving their air**

**quality** and meeting the service level benchmarks for **urban drinking water supply, sanitation and solid waste management.**

### *Criticism*

- **Performance based incentives disincentivizes independent decision-making.** Any conditions on the state's ability to borrow will have an adverse effect on the spending by the state, particularly on development thus, **undermines cooperative fiscal federalism.**
- It **does not hold the Union government accountable for its own fiscal prudence** and dilutes the joint responsibility that the Union and States have.

## Horizontal Devolution Criteria

- ***Population:***
  - The population of a State **represents the needs of the State to undertake expenditure** for providing services to its residents.
  - It is also **a simple and transparent indicator** that has a significant equalising impact.
- ***Area:***
  - The **larger the area, greater is the expenditure requirement** for providing comparable services.
- ***Forest and Ecology:***
  - By taking into account the share of dense forest of each state in the aggregate dense forest of all the states, the share on this criteria is determined.
- ***Income Distance:***
  - Income distance is the **distance of the Gross State Domestic Product (GSDP) of a particular state from the state with the highest GSDP.**
  - To maintain inter state equity, the **states with lower per capita income would be given a higher share.**
- ***Demographic Performance:***
  - It **rewards efforts made by states in controlling their population.**
  - This criterion has been computed by **using the reciprocal of the total fertility ratio of each state,** scaled by 1971 population data.
  - This has been done to **assuage the fears of southern States** about losing some share in tax transfers due to the reliance on the 2011 Census data instead of the 1971 census, which could penalise States that did better on managing demographics.
  - **States with a lower fertility ratio will be scored higher** on this criterion.
  - **The Total Fertility Ratio** in a specific year is defined as the total number of children that would be born to each woman if she/they were to pass through the childbearing years bearing children according to a current schedule of age-specific fertility rates.
- ***Tax Effort:***
  - This criterion has been **used to reward states with higher tax collection efficiency.**
  - It has been computed as the ratio of the average per capita own tax revenue and the average per capita state GDP during the three-year period between 2016-17 and 2018-19.