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General Knowledge Today

Banking & Finance-1: History, Structure & Types of Banking

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Banking & Finance-1: History, Structure & Types of Banking

This document is mainly for Preliminary examination and covers the topics objectively. This content is also useful for some of you who might be appearing in Banking Examinations as well.

Prelims MCQ Topics
Kusidin, Presidency Banks, Imperial Bank of India, Hilton Young Commission, Nationalization of Banks and their impact, Scheduled Versus Non-scheduled banks, Old and New Private Sector Banks, RBI policy towards Foreign Banks, Regional Rural Banks, Different Rural Cooperatives, Unit Banking / Branch Banking, Mixed, Chain, Retail / Wholesale Banking, Social Banking, Narrow Banking, Shadow Banking.

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Part-I : History of Banking

Earliest evidence of Banking in India is found from the period of Vedic Civilization. During those days, loan deeds called rnapatra or rnalekhya were prevalent. Interest rates as well as usury (*Sood Khori* in Hindi) was prevalent in Vedic India. The Vedic word Kusidin refers to an usurer (*Soodkhor* in Hindi) .This term is also found in Manusmriti. Various types of instruments were found in Buddhist, Mauryan and Mughal periods. The Arthashastra of Kautilya mentions presence of bankers during Maurya era. There were instruments in Maurya Era known as "Adesha" which are equivalent to Bill of exchange of current times.

Origin of Modern Banking Industry in India

Who were the indigenous bankers of India?

Since ancient times, businessmen called Shroffs, Seths, Sahukars, Mahajans, Chettis etc. had been carrying on the business of banking. These indigenous bankers included very small money lenders to shroffs with huge businesses, who carried on the large and specialized business even greater than the business of banks.

Which is the first bank of India?

The first bank of India is Bank of Hindustan established in 1770. This bank was established at Calcutta under European management. It was liquidated in 1830-32.

What were the three Presidency Banks? When they were established?

From 1612 onwards, British East India Company had set up various factories or trading posts in India with the permission of the local Mughal emperors. In this process, they had established three presidency towns viz. Madras in 1640, Bombay in 1687 and Bengal Presidency in 1690. East India Company's headquarters moved from Surat to Bombay (Mumbai) in 1687. Three Presidency banks were set up under charters from the British East India Company- Bank of Calcutta, Bank of Bombay and the Bank of Madras. The dates of their establishment were as follows:

- **2 June 1806:** Bank of Calcutta was established in 1806; it was renamed in 1809 as Bank of Bengal
- **15 April 1840:** Bank of Bombay established
- **1 July 1843:** Bank of Madras established

These worked as quasi central banks in India for many years. Since Calcutta was the most active trading port in India, mainly due to the trade of the British Empire; it became a banking center.

What happened with Presidency banks later on?

In 1921, the presidency banks viz. Bank of Bengal, Bank of Bombay and Bank of Madras were amalgamated to form Imperial Bank of India. It was a private entity till that time. In 1955, this

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Imperial Bank of India was nationalized and renamed as **State Bank of India**. Thus, State bank of India is oldest Bank of India among the banks that exist today.

Which is the oldest joint stock bank of India?

A bank that has multiple shareholders is called joint-stock bank. Oldest Joint Stock bank of India was Bank of Upper India that was established in 1863. But this bank failed in 1913. India's Oldest Joint Stock Bank which is still working is Allahabad Bank. It is also known as India's oldest public sector bank. It was established in 1865.

Which were the first banks owned / managed by Indians?

The first Bank with Limited Liability to be managed by Indian Board was Oudh Commercial Bank. It was established in 1881 at Faizabad. This bank failed in 1958. The first bank purely managed by Indians was Punjab National Bank, established in Lahore in 1895. The Punjab national Bank has not only survived till date but also is one of the largest banks in India. However, the first Indian commercial bank which was wholly owned and managed by Indians was Central Bank of India which was established in 1911. So, Central Bank of India is called India's First Truly Swadeshi bank. Its founder was Sir Sorabji Pochkhanawala and its first chairman was Sir Pherozeshah Mehta.

Which was the first bank to open a branch at foreign soil?

Bank of India was the first Indian bank to open a branch outside India in London in 1946 and the first to open a branch in continental Europe at Paris in 1974. Bank of India was founded in September 1906 as a private entity and was nationalized in July 1969. Since the logo of this Bank is a star, its head office in Mumbai is located in Star House, Bandra East, Mumbai.

Origin of Reserve Bank of India

Prior to establishment of RBI, the functions of a central bank were virtually being done by the Imperial Bank of India . RBI started its operations from April 1, 1935. It was established via the RBI act 1934, so it is also known as a statutory body. Similarly, SBI is also a statutory body deriving its legality from SBI Act 1955.

RBI did not start as a Government owned bank but as a privately held bank without major government ownership. It started with a Share Capital of Rs. 5 Crore, divided into shares of Rs. 100 each fully paid up. In the beginning, this entire capital was owned by private shareholders. Out of this Rs. 5 Crore, the amount of Rs. 4,97,8000 was subscribed by the private shareholders while Rs. 2,20,000 was subscribed by central government.

After independence, the government passed Reserve Bank (Transfer to Public Ownership) Act, 1948 and took over RBI from private shareholders after paying appropriate compensation. Thus, nationalization of RBI took place in 1949 and from January 1, 1949, RBI started working as a

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government owned bank.

What was Hilton Young Commission?

Hilton-Young Commission was the Royal Commission on Indian Currency and Finance set up by British Government of India in 1920s. In 1926, this commission had recommended to the government to create a central bank in the country. On the basis of mainly this commission, the RBI act was passed.

Where were the original headquarters of RBI?

Original headquarters of RBI were in Kolkata, but in 1937, it was shifted to Shahid Bhagat Singh Marg, Mumbai.

In which year, Banking Regulation Act was passed ?

Immediately after the independence, the Government of India came up with the Banking Companies Act 1949. This act was later changed to Banking Regulation (Amendment) Act 1949. Further, the Banking Regulation (Amendment) Act of 1965 gave extensive powers to the Reserve Bank of India as India's central banking authority.

Beginning of Banking Reforms and Nationalization of the Banks

The banking sector reforms started immediately after the independence. These reforms were basically aimed at improving the confidence level of the public because in those days, most banks were not trusted by the majority of the people. Instead, the deposits with the Postal department were considered rather safe. Banking sector and Financial sector reforms are not static events but continuous processes happening even today and will keep continuing. Nationalization of Banks, consolidation, diversification and liberalization of the banking industry in the 1980s and 1990s were part of this ongoing process. A few recent events as part of banking sector reforms include:

- Deregulation of interest rates
- Payment banks
- Increased autonomy to banks
- Basel III compatibility of banks
- Regulation of Non-banking Finance Companies etc.

The first major step was Nationalization of the **Imperial Bank of India** in 1955 via **State Bank of India Act.** State Bank of India was made to act as the principal agent of RBI and handle banking transactions of the Union and State Governments.

After that, in a major process of nationalization, seven subsidiaries of the State Bank of India were nationalized via the State Bank of India (Subsidiary Banks) Act, 1959. In 1969, fourteen major private

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commercial banks were nationalized. These 14 banks Nationalized in 1969 are shown in the below table.

List of 14 Banks Nationalized in 1969	
1.	Central Bank of India
2.	Bank of Maharashtra
3.	Dena Bank
4.	Punjab National Bank
5.	Syndicate Bank
6.	Canara Bank
7.	Indian Bank
8.	Indian Overseas Bank
9.	Bank of Baroda
10.	Union Bank
11.	Allahabad Bank
12.	United Bank of India
13.	UCO Bank
14.	Bank of India

The above was followed by a second phase of nationalization in 1980, when Government of India acquired the ownership of 6 more banks, thus bringing the total number of Nationalized Banks to 20. The private banks at that time were allowed to function side by side with nationalized banks and the foreign banks were allowed to work under strict regulation.

What was the impact of Nationalization of Banks?

Nationalization of the Banks brought the public confidence in the banking system of India. After the two major phases of nationalization in India, the 80% of the banking sector came under the public sector / government ownership. After the nationalization of banks, the branches of the public sector banks in India rose to approximately 800 per cent in deposits, and advances took a huge jump by

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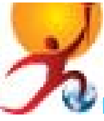

11,000 per cent. Government ownership gave the public implicit faith and immense confidence in the sustainability of public sector banks.

What are financial sector reforms ? Why they are needed?

The financial sector reforms are one of the most important policy agenda of the authorities around the world. There are several reasons for the same.

- Firstly, the reforms are needed to increase the efficiency of financial resource mobilizations and generate higher levels of growth.
- Secondly, financial sector reforms are utmost necessary for the macro-economic stability. India saw its worst economic crisis in the decade of 1980s.

In 1991, India embarked into an era of Economic Reforms which led to liberalization, privatization and globalization of the Indian Economy. The financial sector reforms were an integral part to these reforms.

The financial sector reforms got momentum with the recommendations of various committees such as Chakravarty Committee (1985), Vaghul Committee (1987) and most notably by Narasimham Committee (1991), which is also known as first Narasimham Committee.

What is the importance of year 1991 in banking of India?

Prior to 1991, India was more or less an isolated economy, loosely integrated with the economy of rest of the world. The public sector was born out of a planned economy model, which was underpinned by a Nehruvian-Fabian socialist philosophy.

In 1991, India embarked on the path of liberalization, privatization and globalization. This injected new energy into the slow growing Indian Economy. With reference to Banking sector, it was in this year that the **first Narasimham Committee** gave a blueprint of banking sector reforms. On the basis of these recommendations, the government launched a comprehensive financial sector liberalization programme which included interest rates liberalization, reduction of reserved rations, reduced government control in banking operations and establishment of a market regulatory framework. Another outcome of liberalization was the dismantling of prohibitions against foreign direct investment.

Some more outcomes of reforms that impacted the banking sector were:-

- Steps were taken to move to a market determined exchange rate system, and a unified exchange rate was achieved in the 1990s itself
- The government also released a slew of norms pertaining to asset classification, income recognitions, capital adequacy etc which the banks had to comply with
- Current account convertibility was allowed for the Rupee in accordance with IMF conditions

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- Nationalized banks were allowed to raise funds from the capital markets to strengthen their capital base
- The lending rates for commercial banks was deregulated, thereby freeing them to lend more or as they saw fit
- Also, banks were allowed to fix their own interest rates on domestic term deposits that matures within two years
- Customers were encouraged to move away from physical cash, as RBI issued guidelines to the banks pertaining to the issuance of debit cards and smart cards
- The process of introducing computerization in all branches of banks began in 1993 in line with the Committee on Computerization in Banks' recommendations, which had been submitted in 1989
- FII (Foreign Institutional Investors) were allowed to invest in dated Government Securities
- The Foreign Exchange Management Act (FEMA) was enacted in 1999 and effectively repudiated the Foreign Exchange Regulation Act (FERA) of 1973. FEMA enabled the development and maintenance of the Indian foreign exchange markets and facilitated external trade and payments
- The NSE (National Stock Exchange) began its operations in 1994
- RBI began the practice of auctioning Treasury Bills spanning 14 days and 28 days

Capital index bonds were introduced in India for the first time. The newly adopted policy of liberalization led the RBI to provide licenses to conduct banking operations to some private banks such as ICICI Bank, HDFC Bank etc. The growth of industries and expansion of economic operations also revitalized banking operations, which had to keep up with the demand for various banking operations by the flourishing and even nascent enterprises.

Bankers also responded to the renewed demand from the industrial sector and regular customers. New technology and customer-friendly measures were adopted by bankers to attract and retain customers. The Banking Ombudsman was established, so that consumers could have a forum to address their grievances against banks and the services they provided.

Important Dates in Banking History of India

Timeline of Banking in India	
1770	First bank was established at Cacutta under European Management.
1786	General Bank of India was set up.

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Timeline of Banking in India	
2 June 1806	Bank of Calcutta was established in 1806; it was renamed in 1809 as Bank of Bengal
15 April 1840	Bank of Bombay established
1 July 1843	Bank of Madras established
1861	Paper Currency Act was enacted by British Government of India
1863	Oldest Joint Stock bank of India named Bank of Upper India was established.
1865	Allahabad Bank was established.
1881	Oudh Commercial Bank, the first Bank of India with Limited Liability to be managed by Indian Board was established at Faizabad
1895	Punjab National Bank was established. It was first bank purely managed by Indians.
1911	Central Bank of India, first Indian commercial bank which was wholly owned and managed by Indians, was established. It was called First Truly Swadeshi bank
1921	Three presidency banks viz. Bank of Calcutta, Bank of Bombay and Bank of Madras amalgamated to form Imperial Bank of India
1935	Creation of Reserve bank of India
1949 (January)	Nationalization of Reserve Bank of India
1949 (March)	Enactment of Banking Regulation Act
1955	Nationalization of Imperial Bank of India, which now became State Bank of India
1959	Nationalization of SBI Subsidiaries
1969	Nationalization of 14 major Banks
1971	Creation of Credit Guarantee Corporation
1975	Creation of Regional Rural Banks
1980	Nationalization of 7 more banks with deposits over Rs. 200 Crore

Dates of Establishment of various Banks

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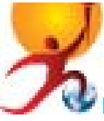

Year / Date	Bank
1786	General Bank of India (First bank established in India)
1790	Bank Of Hindustan which lasted until. 1832.
1839	Union Bank
02 June 1806	Bank of Calcutta
15th April 1840	Bank of Bombay
01st July 1843	Bank of Madras
1863	Bank of Upper India
1865	Allahabad Bank
1881	Oudh Commercial Bank
19th May 1894	Punjab National Bank
1895	Punjab National Bank In Lahore
1904	City Union Bank
1906	Bank of India
12-Mar-06	Corporation Bank
15th August 1907	Indian Bank
1908	Bank of Baroda
01st July 1906	Canara Hindu Permanent Fund (Renamed as Canara Bank in 1910)
21st December 1911	Central Bank of India
1916	Karur Vysya Bank
11-Nov-19	Union Bank of India
26th November 1920	Catholic Syrian Bank

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Year / Date	Bank
1921	Imperial Bank of India by merger of three presidency banks.
11th May 1921	Tamilnad Mercantile Bank Limited
1923	Andhra Bank
1924	Karnataka Bank Limited
1925	Syndicate Bank
1926	Lakshmi Vilas Bank Limited
1927	Dhanlaxmi Bank Ltd
1929	South Indian Bank Limited
23rd October, 1931	Vijaya Bank
1934	Reserve Bank of India
16th Sept 1935	Bank of Maharashtra
1937	Indian Overseas Bank
1938	Jammu & Kashmir Bank
26th May 1938	Dena Bank
19th February 1943	Oriental Bank of Commerce
1943	UCO Bank
1943	United Bank of India
1945	Federal Bank Limited
1954	Nainital Bank Limited
1955	State Bank of India (Imperial Bank of India renamed as SBI)
1985	Kotak Mahindra Bank

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Year / Date	Bank
1994	UTI Bank (Now Axis Bank)
Aug-94	HDFC Bank
1996	ICICI Bank
2003	Yes Bank
2013	Bhartiya Mahila Bank

Key Landmarks in the journey of RBI

- In 1926, the Royal Commission on Indian Currency and Finance recommended creation of a central bank for India.
- In 1927, a bill to give effect to the above recommendation was introduced in the Legislative Assembly, but was later withdrawn due to lack of agreement among various sections of people.
- In 1933, the White Paper on Indian Constitutional Reforms recommended the creation of a Reserve Bank. A fresh bill was introduced in the Legislative Assembly.
- In 1934, the Bill was passed and received the Governor General's assent
- In 1935, Reserve Bank commenced operations as India's central bank on April 1 as a private shareholders' bank with a paid up capital of rupees five crore.
- In 1942 Reserve Bank ceased to be the currency issuing authority of Burma (now Myanmar).
- In 1947, Reserve Bank stopped acting as banker to the Government of Burma.
- In 1948, Reserve Bank stopped rendering central banking services to Pakistan.
- In 1949, the Government of India nationalized the Reserve Bank under the Reserve Bank (Transfer of Public Ownership) Act, 1948.
- In 1949, Banking Regulation Act was enacted.
- In 1951, India embarked in the Planning Era.
- In 1966, the Cooperative Banks came within the regulations of the RBI.
- In 1966, Rupee was devaluated for the first time.
- In 1969, Nationalization of 14 Banks was a Turning point in the history of Indian Banking.
- In 1973, the Foreign Exchange Regulation act was amended and exchange control was strengthened.
- In 1974, the Priority Sector Advance Targets started getting fixed.

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- In 1975, Regional Rural Banks started
- In 1985, the Sukhamoy Chakravarty and Vaghul Committee reports embarked the era of Financial Market Reforms in India.
- In 1991, India came under the Balance of Payment crisis and RBI pledged Gold to shore up reserves. Rupee was devaluated.
- In 1991-92, Economic Reforms started in India.
- In 1993, Exchange Rate became Market determined.
- In 1994, Board for Financial Supervision was set up.
- In 1997, the regulation of the Non Banking Financial Companies (NBFC) got strengthened.
- In 1998, Multiple Indicator Approach for monetary policy was adopted for the first time.
- In 2000, the Foreign Exchange Management Act (FEMA) replaced the erstwhile FERA.
- In 2002, The Clearing Corporation of India Ltd Started operation.
- In 2003, Fiscal Responsibility and Budget Management Act (FRBMA) enacted.
- In 2004, Liquidity Adjustment Facility (LAF) started working fully.
- In 2004, Market Stabilization Scheme (MSS) was launched.
- In 2004 Real Time Gross Settlement (RTGS) started working.
- In 2006, Reserve Bank of India was empowered to regulate the money, forex, G-Sec and Gold related security markets.
- In 2007, Reserve bank of India was empowered to regulate the Payment systems.

Part-II: Structure of Banking

All banks of India can be simply divided into 3 major groups viz. Central Bank (RBI), Scheduled Banks and Non-scheduled Banks. This implies that every bank other than RBI, is either a scheduled bank or a non-scheduled bank.

However, on the basis of functions, there are five broad categories of Banks in India viz. Central Bank (RBI), Commercial Banks, Development Banks (or Development Finance Institutions), Cooperative Banks and Specialized banks.

Scheduled Versus Non-scheduled banks

A bank is called a scheduled bank in India, if it is listed in the second schedule of the RBI Act, 1934. In order to be included under this schedule of the RBI Act, banks have to fulfill certain statutory conditions such as:

- These banks need to have paid up capital and reserves of at least Rs. 0.5 million (50 Lakh)
- They should satisfy the CRAR norms and other prudential norms of RBI
- They should satisfy the RBI that their business is not being conducted in a manner prejudicial

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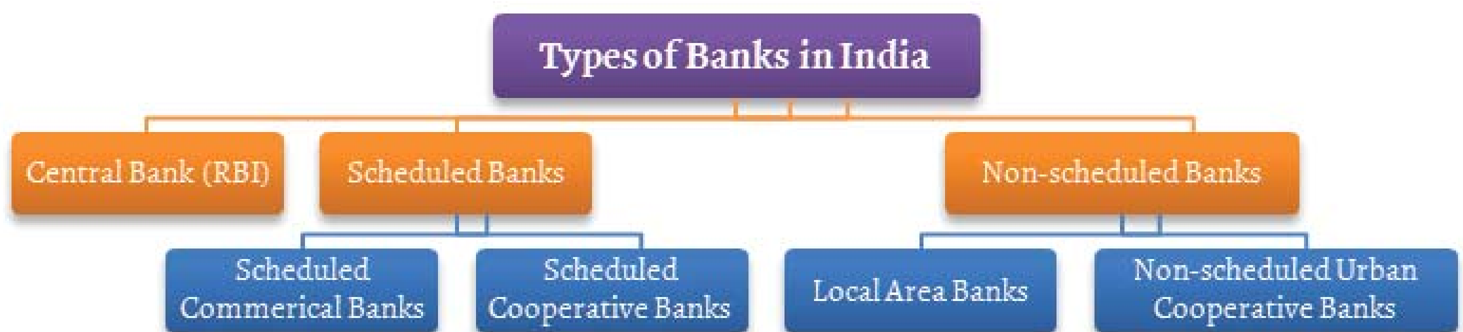
to the interests of its depositors.

In our country all banks are scheduled banks except four Local Area Banks and some Non-scheduled Urban Cooperative Banks. As of February 2015, these four local area banks are:

1. Coastal Local Area Bank Ltd – Vijayawada (Andhra Pradesh)
2. Capital Local Area Bank Ltd – Phagwara (Punjab)
3. Krishna Bhima Samruddhi Local Area Bank Ltd, Mahbubnagar (Andhra Pradesh)
4. Subhadra Local Area Bank Ltd., Kolhapur (Maharashtra)

The scheduled banks are further classified into Scheduled Commercial Banks and Scheduled Cooperative Banks. The basic difference between scheduled commercial banks and scheduled cooperative banks is in their holding pattern. Scheduled cooperative banks are cooperative credit institutions that are registered under the Cooperative Societies Act. These banks work according to the cooperative principles of mutual assistance.

Classification up to this point is displayed in the below graphics.



Different types of Scheduled Commercial Banks

The scheduled commercial banks are those banks which are included in the second schedule of RBI Act 1934 and which carry out the normal business of banking such as accepting deposits, giving out loans and other banking services.

Scheduled Commercial Banks can be further divided into four groups:

- Public Sector Banks: This includes:
    - SBI & Associates
    - Nationalized Banks
    - Other Public Sector Banks
- Private Banks
- Foreign Banks
- Regional Rural Banks

Number of Scheduled Commercial Banks (Public Sector Banks)

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At present, there are 27 Public Sector Banks in India including SBI (and its 5 associates) and 19 nationalized banks. Further, there are two banks which have been categorized by RBI as "Other Public Sector Banks". IDBI and Bhartiya Mahila Bank come under this category. The 19 nationalized banks in India viz. Allahabad Bank, Andhra Bank, Bank of Baroda, Bank of India, Bank of Maharashtra, Canara Bank, Central Bank of India, Corporation Bank, Dena Bank, Indian Bank, Indian Overseas Bank, Oriental Bank of Commerce, Punjab & Sind Bank, Punjab National Bank, Syndicate Bank, UCO Bank, Union Bank of India, United Bank of India and Vijaya Bank.
Further, there are two scheduled commercial banks in India, which have been classified as "other Public Sector Banks". These are IDBI and Bhartiya Mahila Bank.

State Bank of India Group

State Bank of India with its around 17,000 branches and around 200 foreign offices, is India's largest banking and financial services company by assets. With over 2 lakh employees, SBI is banker to millions of Indians. This bank got birth in the British Era. Its first parents were three presidency banks viz. Bank of Calcutta (later Bank of Bengal), Bank of Bombay and the Bank of Madras. In 1921, these three presidency banks were merged in one entity called "Imperial Bank of India". The Imperial Bank of India was nationalized in 1955 and was renamed a State Bank of India. Thus, State bank of India is the oldest Bank of India.
In 1959, there were eight associates of SBI. The current five associate banks of SBI are:

- State Bank of Bikaner & Jaipur
- State Bank of Hyderabad
- State Bank of Mysore
- State Bank of Patiala
- State Bank of Travancore

Apart from the above, the SBI also has seven non-banking subsidiaries viz. SBI Capital Markets Ltd, SBI Funds Management Pvt Ltd, SBI Factors & Commercial Services Pvt Ltd, SBI Cards & Payments Services Pvt. Ltd. (SBICPSL), SBI DFHI Ltd, SBI Life Insurance Company Limited and SBI General Insurance.

Is SBI a nationalized bank?

SBI got birth in the British Era. Its first parents were three presidency banks viz. Bank of Calcutta (later Bank of Bengal), Bank of Bombay and the Bank of Madras. In 1921, these three presidency banks were merged in one entity called "Imperial Bank of India". The Imperial Bank of India was nationalized in 1955 and was renamed a State Bank of India. Thus, although SBI comes under the definition of nationalized banks; yet while classifying the commercial banks in India, RBI puts State Bank of India and its five associates under a separate category (SBI & Associates). Thus, Public Sector

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Scheduled Commercial Banks are of three categories in India viz. SBI & its five associates; 19 Nationalized Banks and two other Public Sector Banks viz. Bhartiya Mahila Bank and IDBI Bank.

Why SBI is put in different category?

This is mainly because SBI group is governed by a different set of laws viz. SBI Act, 1955 and SBI Subsidiary Banks Act, 1959.

Old private banks and new private banks

In private sector banks, most of the capital is in private hands. There are two types of scheduled commercial (private sector) banks in India viz. Old Private Sector Banks and New Private Sector Banks. There are 13 old private sector banks as follows:

1. Catholic Syrian Bank
2. City Union Bank
3. Dhanlaxmi Bank
4. Federal Bank
5. ING Vysya Bank
6. Jammu and Kashmir Bank
7. Karnataka Bank
8. Karur Vysya Bank
9. Lakshmi Vilas Bank
10. Nainital Bank
11. Ratnakar Bank
12. South Indian Bank
13. Tamilnad Mercantile Bank

Out of the above banks, the Nainital Bank is a subsidiary of the Bank of Baroda, which has 98.57% stake in it. Some other old generation private sector banks in India have merged with other banks. For example, Lord Krishna Bank merged with Centurion Bank of Punjab in 2007; Sangli Bank merged with ICICI Bank in 2006; Centurion Bank of Punjab merged with HDFC in 2008. All of these were doing business when RBI came up with its new guidelines on private Banks in 1993.

New Private Sector Banks

The new private sector banks were incorporated as per the revised guidelines issued by the RBI regarding the entry of private sector banks in 1993. At present, there are seven new private sector banks viz. Axis Bank, Development Credit Bank (DCB Bank Ltd), HDFC Bank, ICICI Bank, IndusInd Bank, Kotak Mahindra Bank, Yes Bank.

Apart from the above, there are two banks which are yet to commence operation. These have obtained 'in-principle' licenses from RBI. They are **IDFC** and **Bandhan Bank** of Bandhan Financial

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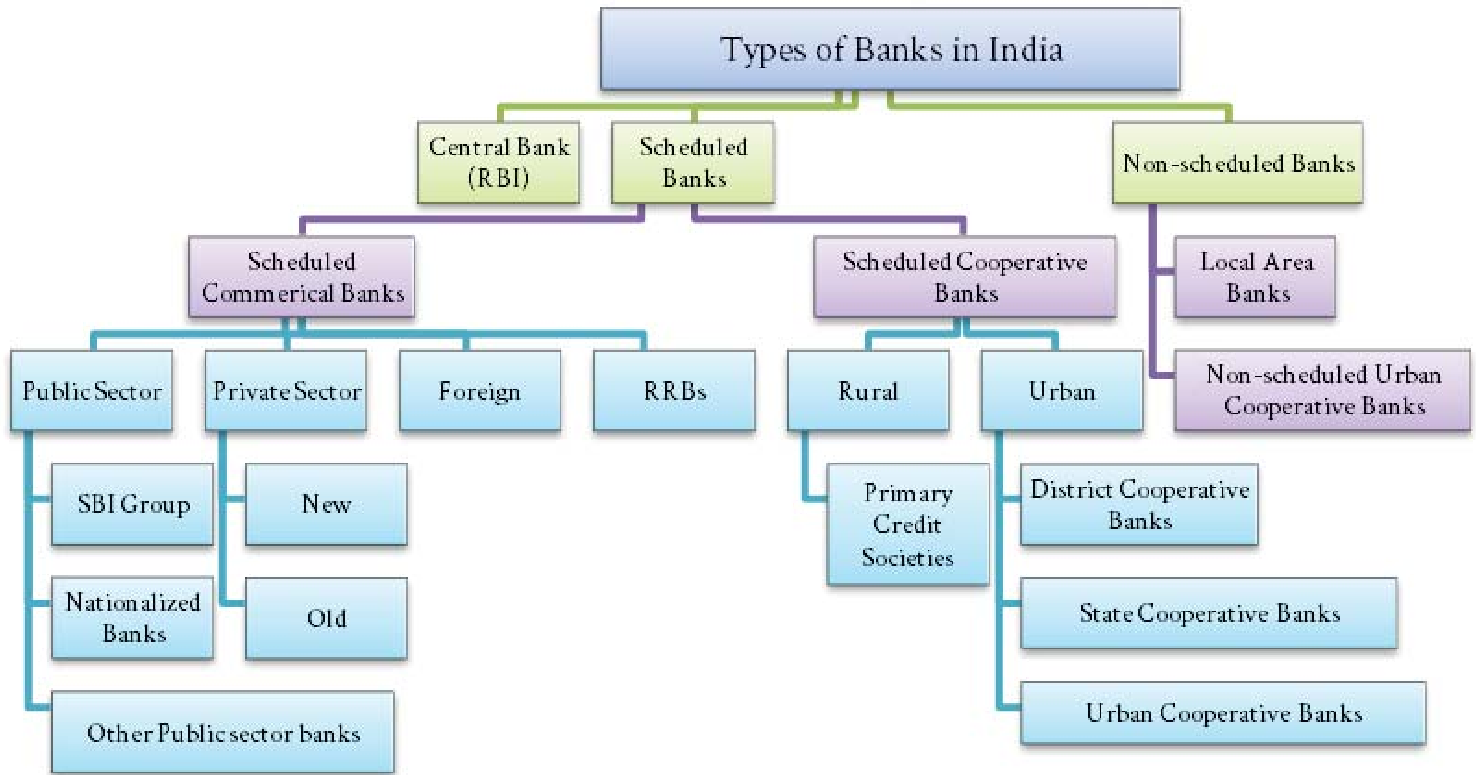
Services. Thus, the whole picture of banking classification is as follows:



Foreign Banks and their branches in India

As of December 2014, there are 43 foreign banks from 26 countries operating as branches in India and 46 banks from 22 countries operating as representative offices in India. Apart from that, few foreign banks have entered into India via the NBFC route. There are 334 foreign bank branches in India.

What is the share of foreign banks in the banking business in India?

Foreign Banks account for less than 1% of the total branch network in the country. However, they account for approximately 7% of the total banking sector assets and around 11% of the profits. Most of the foreign banks in India are niche players and their business is usually focused on trade finance, external commercial borrowings, wholesale lending, investment banking and treasury services. Some other banks are confined to private banking and wealth management.

What is the RBI policy towards Foreign Banks in India?

RBI policy towards presence of foreign banks in India is based upon two cardinal principles viz. reciprocity and single mode of presence.

By reciprocity, it means that overseas banks are given near national treatment in India only if their home country allowed Indian banks to open branches there without much restrictions. By single mode of presence, it means that RBI allows either of the branch mode or a wholly owned subsidiary (WOS) mode in India.

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Some other policy guidelines of RBI towards foreign banks are as follows:

1. Banks have to adhere to mandated Capital Adequacy requirements as per Basel Standard.
2. They should have to meet minimum capital requirement of Rs. 5 billion.
3. They should need to maintain minimum CRAR at 10%
4. Priority sector targets for foreign banks in India is 40%.

Further, the foreign banks have to follow other norms as set by Reserve Bank of India.

Regional Rural Banks

Each RRB is owned by three entities with their respective shares as follows:

- Central Government → 50%
- State government → 15%
- Sponsor bank → 35%

They are different from other commercial banks on the basis of their:

- **Ownership:** as mentioned above, they are owned by three different entities
- **Regulation:** They are regulated by NABARD; which is a subsidiary of RBI. Other banks are regulated by RBI directly.
- **Statutory Background:** RRBs have a separate law behind them viz. Regional Rural Banks Act, 1976.
- **Statutory pre-emptions:** RRBs don't need to maintain CRR and SLR like other banks.

What were the reasons for establishing the Regional Rural Banks?

Regional Rural Banks were started due to the fact that even after nationalization, there were cultural issues which made it difficult for commercial banks, even under government ownership, to lend to farmers. So, basic idea was that such banks will work in rural perspectives and they would bring more and more farmers under the financial inclusion. A separate act was passed to provide them a statutory background.

What were various problems of Regional Rural Banks?

RRBs were conceived as low cost institutions having a rural ethos, local feel and pro poor focus. Every bank was to be sponsored by a "Public Sector Bank", however, they were planned as the self sustaining credit institution which were able to refinance their internal resources in themselves and were excepted from the statutory pre-emptions. However, soon the RRBs were marred by several problems. There was a need to consolidate and recapitalize them. In 1990, there were 196 RRBs in India. This number currently stands at 57 (March 2014) after mergers and amalgamations.

What is the current government's policy on Regional Rural Banks?

The Modi Government has put hold on further amalgamation of the Regional Rural Banks. The

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focus of the new government is to improve their performance and exploring new avenues of investments in the same. Currently, there is a bill pending to amend the RRB Act which aims at increasing the pool of investors to tap capital for RRBs.

Cooperative Banking

A cooperative is jointly owned enterprise in which same people are its customers who are also its owners. Thus, basic difference between scheduled commercial banks and scheduled cooperative banks is in their holding pattern. Scheduled cooperative banks are cooperative credit institutions that are registered under the Cooperative Societies Act. These banks work according to the cooperative principles of mutual assistance.

Indian cooperative structures are one of the largest such networks in the world with more than 200 million members. It has about 67% penetration in villages and fund 46% of the total rural credit. It also stands for 36% of the total distribution of rural fertilizers and 28% of rural fair price shops.

What is history of Cooperative Banking in India?

The idea of cooperatives was first given by Hermann Schulze (1808-83) and Friedrich Wilhelm Raiffeisen (1818-88). In India, the history of Cooperatives begins from 1904 when the Cooperative Credit Societies Act, 1904 led to the formation of Cooperative Credit Societies in both rural and urban areas. The act was based on recommendations of Sir Frederick Nicholson (1899) and Sir Edward Law (1901). The Cooperative Societies Act of 1912, further gave recognition to the formation of non-credit societies and the central cooperative organizations. In independent India, with the onset of planning, the cooperative organizations gained more leverage and role with the continued governmental support.

What is the extent of Urban Cooperative Banking in India?

The structure of cooperative network in India can be divided into two broad segments viz. Urban Cooperative Banks and Rural Cooperatives. Urban Cooperatives can be further divided into scheduled and non-scheduled. Both the categories are further divided into multi-state and single-state. Majority of these banks fall in the non-scheduled and single-state category. Banking activities of Urban Cooperative Banks are monitored by RBI. However, registration and management activities are managed by Registrar of Cooperative Societies (RCS). These RCS operate in single-state and Central RCS (CRCS) operate in multiple state.

Different Rural Cooperatives

The rural cooperatives are further divided into short-term and long-term structures. The short-term cooperative banks are three tiered operating in different states. These are-

- State Cooperative Banks- They operate at the apex level in states

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- District Central Cooperative Banks-They operate at the district levels
- Primary Agricultural Credit Societies-They operate at the village or grass-root level.

Likewise, the long-term structures are further divided into –

- State Cooperative Agriculture and Rural Development Banks (SCARDS)- These operate at state-level.
- Primary Cooperative Agriculture and Rural Development Banks (PCARDBS)-They operate at district/block level.

The rural banking cooperatives have a complex monitoring structure as they have a dual control which has led to many problems. A Forum called State Level Task Force on Cooperative Urban Banks (TAFCUB) has been set-up to look into issues related to duality in control.

- All banking activities are regulated by a shared arrangement between RBI and NABARD.
- All management and registration activities are managed by RCS.

Key features of Cooperative banking in India

A cooperative bank is an institution which is owned by its members. They are the culmination of efforts of people of same professional or other community which have common and shared interests, problems and aspirations. They cater to a services like loans, banking, deposits etc. like commercial banks but widely differ in their values and governance structures. They are usually democratic set-ups where the board of members are democratically elected with each member entitled to one vote each. In India, they are supervised and controlled by the official banking authorities and thus have to abide by the banking regulations prevalent in the country. The basic rules, regulations and values may differ amongst nations but they have certain common features:

- Customer-owned
- Democratic structures
- Profits are mainly pooled to form reserves while some amount is distributed to members
- Involved in community development
- Foster financial inclusion by bringing banking to the doorstep of the lowest segment of society

These banks are small financial institutions which are governed by regulations like Banking Regulations Act, 1949 and Banking Laws Cooperative Societies Act, 1965. They operate both in urban and rural areas under different structural organizations. Their functions are decided by the level at which they operate and the type of people they cater to. They greatly differ from the commercial banking entities.

- These are established under specific acts of cooperative societies operating in different states

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unlike mainstream commercial banks which are mainly joint-stock companies.

- They have a tiered network with a bank at each level of state, district and rural. The state-level bank forms the apex authority.
- Not all sections of banking regulation act are applicable to cooperative banks
- The ultimate motive is community participation, benefit and growth as against profit-maximization for commercial banks.

Major problems of the functioning of the Cooperative Banks in India

- The duality in control by RCS of a state as 'Cooperation' is a state subject. However financial regulatory control by RBI has led to many troubles as there is ambiguity in power structure as there is no clear demarcation.
- Patchy growth of cooperative societies across the map of India. It is said these have grown maximally in states of Gujarat, Maharashtra, Tamil Nadu whereas the other parts of India don't have a heightened presence.
- The state partnership has led to excessive state control and interference. This has eroded the autonomous characters of many of these.
- Dormant membership has made them moribund as there is a lack of active members and lack of professional attitude.
- Their main focus being credit so they have reduced to borrower-driven entities and majority of members are nominal and don't enjoy voting rights.
- Credit recovery is weak especially in rural areas and it has sustainability crisis in some pockets.
- There is a lack of risk management systems and lack of basic standardised banking models.
- There is a widening gap between the level of skills and the increasing computerization of banks.

The government needs to have a serious look into the issues as they did not show an impressive growth in the last 100 years.

Part-III: Types of Banking

What is Branch Banking?

Branch banking involves business of banking via branches. The branches are set up under Section 23 of Banking Regulations Act, 1949. A branch should cater to all banking services and include a specialized branch, a satellite office, an extension counter, an ATM, administrative office, service branch and a credit card centre for the purpose of branch authorization policy. The advantage of branch banking is that it helps in better management, more inclusion and risk diversification. The

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disadvantage of branch banking is that it might encourage outside local influences.

What is Unit Banking?

Unit banking is a system of banking which originated in US. It is a limited way of banking where banks operate only from a single branch (or a few branches in the same area) taking care of local community. In comparison to branch banking, the size of unit banks is very small. Due to small size and due to unit structure; the decision making in unit banks is very fast. The management in unit banks enjoy more autonomy and more discretionary powers. However, due to single units, the risk is not distributed or diversified.

What is Mixed Banking?

Mixed Banking is the system in which banks undertake activities of commercial and investment banking together. These banks give short-term and long-term loans to industrial concerns. The banks appoint experts which give valuable advice on various financial issues and also help gauge the financial health of companies. Industries don't have to run to different places for differential financial needs. They thus promote rapid industrialization. They may however pose a grave threat to liquidity of a bank and lead to bad debts.

What is Chain Banking?

Chain banking system refers to the type of banking when a group of persons come together to own and control three or more independently chartered banks. Each of these banks could maintain their independent existence despite common control and ownership. The banks in the chains were assigned specific functions so there was no loss of profits and overlapping of interests.

What is retail banking?

Retail banking means banking where transactions are held directly with customers and there are no transactions with other banks or corporations. The banks provide all kinds of personal banking services to customers like saving accounts, transactional accounts, mortgages, personal loans, debit and credit cards etc.

It has provided immense benefits to customers who ultimately become loyal customers due to benefits like wide interest spreads, diversified credit risks and stability. However, due to increasing use of new technology, the operational costs for banks have gone up considerably.

What is wholesale banking?

Wholesale banking involves banking services for high net-worth clients like corporate, commercial banks, mid-size companies etc. India has a suitable investment climate and is seen as a favoured investment destination so it has a huge potential for the growth of this vertical of banking. It provides an ease of access to the complete financial portfolio of a client who can easily browse through the same and make suitable allocations, transfers etc.

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It can be equally risky for a firm if all the funds are parked in one place only and there is no diversification of risks.

What is relationship banking?

Relationship banking is a banking system in which banks make deliberate efforts to understand customer needs and offer him products accordingly.

- It helps banks to gather critical soft information about the borrowers, which helps them to determine creditworthiness of such clients.
- Clients too often become responsible and avoid moral hazard behavior.
- However, the banks may discourage borrowers to invest in high risk projects.
- Clients can often renegotiate their loan terms and hence result in inefficient investments for banks.

What is Correspondent Banking?

Correspondent banking prevalent in over 200 countries is a profitable way of doing business by banks in foreign countries in which they don't have physical presence or limited operational permissions. Correspondent banks thus act as banking agent for a home bank and provides various banking services to customers where otherwise the home bank does not operate.

- It helps customers to perform banking operations at ease even in places where their banks don't have physical presence.
- Customers stay loyal to such banks as they get excellent customer service even in foreign lands.

What is universal Banking?

Universal banking is a system of banking under which big banks undertake a variety of banking services like commercial banking, investment banking, mutual funds, merchant banking, insurance etc. It involves providing all these services under one roof by financial experts who can handle multiple financial products easily.

This helps to boost investor confidence and also makes the operations more cost-effective. However, different policy regulations for different financial products makes the operations cumbersome and are a big drawback for banks. Also, if such banks fail, it will lead to a big dip in customer confidence.

What is Social Banking?

Social banking is a concept where banking services are oriented towards mass welfare and financial inclusion of the poor and vulnerable segments of society. RBI has taken some commendable initiatives to make financial inclusion a reality for the remotest segments of Indian population. Some of these are:

- Availability of ICT based Business Correspondent Model for delivery of banking services at

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the doorstep of every household in remote villages.

- 3 year Financial Inclusion Plans for banks. This has been implemented since 2010.
- To cover all villages with a population of over 2000 has been successfully completed by 2012.
- It is mandatory for banks to open 25% of new branches in rural areas which don't have access to formal banking.
- Basic Savings Bank Deposit Account has been introduced for all.
- KYC documentations have been considerably relaxed and simplified for small accounts.

Indian government has thus made the Financial Inclusion as one its topmost priority and has taken many policies and schemes to achieve the same. It has to work on implementation line to make the policies a great success.

What is Virtual Banking?

Virtual banking is performing all banking operations online. This has served as a great revolution in banking market as banks have to continuously struggle for perfection to live up to competition and stay ahead of it. As banks don't have physical offices, they find the options very cost-effective. The banks thus pass these benefits to customers in form of waiving of account fee or higher rates of interest. The trend is catching in Indian markets but some typical fears still grip an average Indian who still places more trust in bank staff with whom they can personally go and talk, rather than relying on machines.

What is Narrow Banking?

The Narrow Banking is very much an antonym to the Universal Banking. Narrow Banking means Narrow in the sense of engagement of funds and not in activity. So, simply, Narrow Banking involves mobilizing the large part of the deposits in Risk Free assets such as Government Securities.

What is Islamic Banking?

Islamic banking is banking or banking activity that is consistent with the principles of sharia and its practical application through the development of Islamic economics.

What is Shadow Banking?

Shadow banking refers to all the non-bank financial intermediaries that provide services similar to those of traditional commercial banks. They generally carry out traditional banking functions, but do so outside the traditional system of regulated depository institutions. Some of these activities include:

- Credit intermediation – Any kind of lending activity including at least one intermediary between the saver and the borrower
- Liquidity transformation – Usage of short-term debts like deposits or cash-like liabilities to finance long-term investments like loans.
- Maturity transformation – Using short-term liabilities to fund investment in long-term assets

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In the Indian financial arena, shadow banks term can be used for Non-Banking Finance Companies (NBFCs). However, NBFCs in India have been regulated by the RBI (Reserve Bank of India) since 1963. Other examples are investment bankers, Money market mutual funds, mortgage companies etc.

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General Knowledge Today

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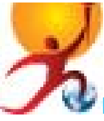

This document is mainly for Preliminary examination and covers the topics objectively. This content is also useful for some of you who might be appearing in Banking Examinations as well.

Prelims MCQ Topics

Functions of RBI, Strucutre of RBI, Board for Financial Supervision, Board for Payment and Settlement Systems (BPSS), Objectives of Monetary policy, Open Market Operations, Liquidity Adjustment Facility (Repo and Reverse Repo), Marginal Standing Facility, SLR, CRR, Bank Rate, Credit Ceiling, Para – banking Activities, Proportional Reserve System and Minimum Reserve System, Ways and means advances (WMA), Statuary Reserves, Lender of the Last Resort (LORL), LERMS.

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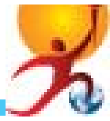

History & Genesis of RBI

Prior to establishment of RBI, the functions of a central bank were virtually being done by the Imperial Bank of India . RBI started its operations from April 1, 1935. It was established via the RBI act 1934, so it is also known as a statutory body. Similarly, SBI is also a statutory body deriving its legality from SBI Act 1935.

RBI did not start as a Government owned bank but as a privately held bank without major government ownership. It started with a Share Capital of Rs. 5 Crore, divided into shares of Rs. 100 each fully paid up. In the beginning, this entire capital was owned by private shareholders. Out of this Rs. 5 Crore, the amount of Rs. 4,97,8000 was subscribed by the private shareholders while Rs. 2,20,000 was subscribed by central government.

After independence, the government passed Reserve Bank (Transfer to Public Ownership) Act, 1948 and took over RBI from private shareholders after paying appropriate compensation. Thus, nationalization of RBI took place in 1949 and from January 1, 1949, RBI started working as a government owned bank.

Hilton Young Commission

Hilton-Young Commission was the Royal Commission on Indian Currency and Finance set up by British Government of India in 1920s. In 1926, this commission had recommended to the government to create a central bank in the country. On the basis of mainly this commission, the RBI act was passed.

Original headquarters of RBI

Original headquarters of RBI were in Kolkata, but in 1937, it was shifted to Shahid Bhagat Singh Marg, Mumbai.

Structure & Functions of RBI

The core structure of RBI includes one Central Board of Directors, two Assistive bodies (BFS and BPSS), four local boards, 33 departments, 19 regional offices and 9 sub-offices.

Main functions of RBI

- To work as monetary authority and implement its Monetary Policy
- To serve as issuer of bank notes
- Serve as banker to central and state governments
- Serve as debt manager to central and state governments
- Provide ways and means advances to the state governments
- Serve as banker to the banks and lender of last resort (LORL) for them
- Work as supervisor and regulator of the banking & financial system

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- Management of Foreign Exchange Reserves of the country
- Support the government in development of the country

Structure and functions of Central Board of Directors in RBI

Central Board of Directors is the top decision making body in the RBI. It is made official directors and Non-official directors.

The Governor and Deputy Governors are the official directors. There is on Governor and maximum 4 Deputy Governors; so maximum number of Official Directors in RBI's Central Board of Directors is five. Governor and Deputy governors are appointed by Central Government. The tenure of service is maximum of 5 years or till the age of 62 whichever is earlier.

Further, there are 16 non-official directors in RBI. Out of them, there are four represent the local Boards located in Delhi, Chennai, Kolkata and Mumbai, thus representing 4 regions of India. Rest 12 are nominated by the Reserve Bank of India. These 12 personalities have expertise in various segments of Indian Economy.

The Central Board of Directors holds minimum 6 meetings every year. Out of which, at least 1 meeting every quarter is held. Though, typically the committee of the central board meets every week (Wednesday).

Assistive bodies in RBI

There are two assistive bodies for Central Board of Directors viz. Board of Financial Supervision (BFS) and Board for Payment and Settlement Systems (BPSS). Both of these are chaired by RBI Governor.

Local Boards

There are four local boards of RBI located in Chennai, Kolkata, Mumbai and New Delhi. These four local boards represent four regions of the country. Members and directors of local boards are appointed by central government for four-year terms. Each of these local boards consists of 5 members who represent regional interests, and the interests of co-operative and indigenous banks.

Departments of RBI

Reserve Bank of India has 33 departments which focus on policy issues in the Reserve Bank's functional areas and internal operations. These are as follows:

1. Consumer Education and Protection Department
2. Corporate Strategy and Budget Department
3. Department of Banking Regulation
4. Department of Banking Supervision
5. Department of Communication
6. Department of Cooperative Bank Regulation

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7. Department of Cooperative Bank Supervision
8. Department of Corporate Services
9. Department of Currency Management
10. Department of Economic and Policy Research
11. Department of External Investments and Operations
12. Department of Government and Bank Accounts
13. Department of Information Technology
14. Department of Non-Banking Regulation
15. Department of Non-Banking Supervision
16. Department of Payment and Settlement Systems
17. Department of Statistics and Information Management
18. Financial Inclusion and Development Department
19. Financial Markets Operation Department
20. Financial Markets Regulations Department
21. Financial Stability Unit
22. Foreign Exchange Department
23. Human Resource Management Department
24. Inspection Department
25. Internal Debt Management Department
26. International Department
27. Legal Department
28. Monetary Policy Department
29. Premises Department
30. Rajbhasha Department
31. Risk Monitoring Department
32. Secretary's Department
33. Central Vigilance Cell

Regional and sub-offices of RBI

There are **19 regional offices and 9 sub-offices of RBI**. Most of the 19 regional offices are located in state capitals. They are shown in the below map:

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Training centres of RBI

The training centres of RBI are as follows:

- The Reserve Bank Staff College, Chennai
- College of Agricultural Banking at Pune
- Zonal Training Centres, located at regional offices, train non-executive staff.
- Apart from that following are RBI funded Research Institutions:
- National Institute of Bank Management (NIBM) : Pune,
- Indira Gandhi Institute of Development Research (IGIDR) : Mumbai
- Institute for Development and Research in Banking Technology (IDRBT) : Hyderabad.

RBI's Subsidiaries

RBI has following subsidiaries

- Deposit Insurance and Credit Guarantee Corporation, DICGC

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- National Housing Bank
- Bharatiya Reserve Bank Note Mudran Private Limited (BRBNMPL)
- NABARD

Board for Financial Supervision (BFS)

Board of Financial Supervision (BFS) is one of the two assistive bodies for Central Board of Directors of RBI, other being Board for Payment and Settlement Systems .

It was established in 1994 and its main function is to undertake consolidated supervision of the financial sector comprising commercial banks, financial institutions and non-banking finance companies. It is chaired by RBI Governor. One of the deputy governors of RBI serves as Vice Chairman BFS. BFS meets typically every month.

Functions of BFS

BFS is working as the main guiding force behind RBI's regulatory and supervisory initiatives. The RBI carries out its functions related to financial supervision under the guidance of BFS. BFS Regulates and supervises commercial banks, Non-Banking Finance Companies (NBFCs), development finance institutions, urban co-operative banks and primary dealers. Some typical functions are:

- Restructuring of the system of bank inspections
- Introduction of off-site surveillance,
- Strengthening of the role of statutory auditors and
- Strengthening of the internal defences of supervised institutions.

Board for Payment and Settlement Systems (BPSS)

BPSS was established in 2005 to regulate and supervise the payment and settlement systems. It is one of the two assistive bodies to Central Board of Directors in RBI (other being BFS). This is also chaired by the Governor of RBI and its members are all the four Deputy Governors and two Non-Official Directors of the Central Board.

Key Functions of BPSS are:

- Lay down policies relating to the regulation and supervision of all types of payment and settlement systems.
- Set standards for existing and future systems
- Approve criteria for authorization of payment and settlement systems
- Determine criteria for membership to these systems, including continuation, termination and rejection of membership.

With regard to the payment and settlement systems, BPSS is the highest policy making body in the country. Electronic, non-electronic, domestic and cross-border payment and settlement systems

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which affect the domestic transactions are regulated by BPSS.

RBI's Monetary Policy

Meaning & Objectives of Monetary policy

Monetary policy refers all those operations, which are used to control the money supply in the economy. The overall objective of the monetary policy is twofold:

1. To maintain economic and financial stability
2. To ensure adequate financial resources for the purpose of development.

These objectives can be further simplified to:

1. Maintaining price stability
2. Adequate flow of credit to productive sectors
3. Promotion of productive investments & trade
4. Promotion of exports and economic growth

Reserve Bank of India announces Monetary Policy every year in the Month of April. This is followed by three quarterly Reviews in July, October and January.

Various tools / instruments of monetary policy

Various instruments of monetary policy can be divided into quantitative and qualitative instruments. Quantitative instruments are those whichdirectly affect the quantity of money supplyin the economy. Qualitative instruments are those which impact the money supply indirectly.

The quantitative instruments are:

- Open Market Operations
- Liquidity Adjustment Facility (Repo and Reverse Repo)
- Marginal Standing Facility
- SLR, CRR
- Bank Rate
- Credit Ceiling etc

On the other hand, qualitative instruments are: credit rationing, moral suasion and direct action (by RBI on banks).

Quantitative Instruments of Monetary Policy

Open Market Operations

Open Market Operations (OMO) refer to the purchase and sale of the Government Securities (G-Secs) by RBI from / to market. The objective of OMO is to adjust the rupee liquidity conditions in the economy on a durable basis. The working of OMOs is defines as below:

- When RBI sells government security in the markets, the banks purchase them. When the

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banks purchase Government securities, they have a reduced ability to lend to the industrial houses or other commercial sectors. This reduced surplus cash, contracts the rupee liquidity and consequently credit creation / credit supply.

- When RBI purchases the securities, the commercial banks find them with more surplus cash and this would create more credit in the system.

Thus, in the case of excess liquidity, RBI resorts to sale of G-secs to suck out rupee from system. Similarly, when there is a liquidity crunch in the economy, RBI buys securities from the market, thereby releasing liquidity. It's worth note here that the market for government securities is not well developed in India but still OMO plays very important role.

Liquidity Adjustment Facility

Liquidity Adjustment Facility (LAF) is the primary instrument of Reserve Bank of India for modulating liquidity and transmitting interest rate signals to the market. LAF was first introduced in June 2000. It refers to the difference between the two key rates viz. repo rate and reverse repo rate. Informally, Liquidity Adjustment Facility is also known as Liquidity Corridor. Under Repo, the banks borrow money from RBI to meet short term needs by putting government securities (G-secs) as collateral. Under Reverse Repo, RBI borrows money from banks by lending securities. These are done by auctions so called "repo auctions" or "reverse repo auctions". Other important points are as follows:

- The repo and reverse repo rates are decided by RBI on its own discretion.
- ONLY Government of India dated Securities/Treasury Bills are used for collateral under LAF as of now.
- While repo injects liquidity into the system, the Reverse repo absorbs the liquidity from the system.
- RBI only announces Repo Rate. The Reverse Repo Rate is linked to Repo Rate and is 100 basis points (1%) below repo rate. RBI makes decision regarding Repo Rate on the basis of prevalent market conditions and relevant factors.
- RBI conducts the Repo auctions and Reverse Repo auctions on daily basis from Monday to Friday except holidays.
- All the Scheduled Commercial Banks are eligible to participate in auctions except the Regional Rural Banks.
- Primary Dealers (PDs) having Current Account and SGL Account (Subsidiary General Ledger Account) with Reserve Bank are also eligible to participate in the Repo and Reverse Repo auctions.

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- Under the Liquidity Adjustment Facility, bids need to be for a minimum amount of Rs.5 crore and in multiples of Rs. 5 Crore thereafter.

Marginal Standing Facility

Marginal Standing Facility is a new Liquidity Adjustment Facility (LAF) window created by Reserve Bank of India in its credit policy of May 2011.

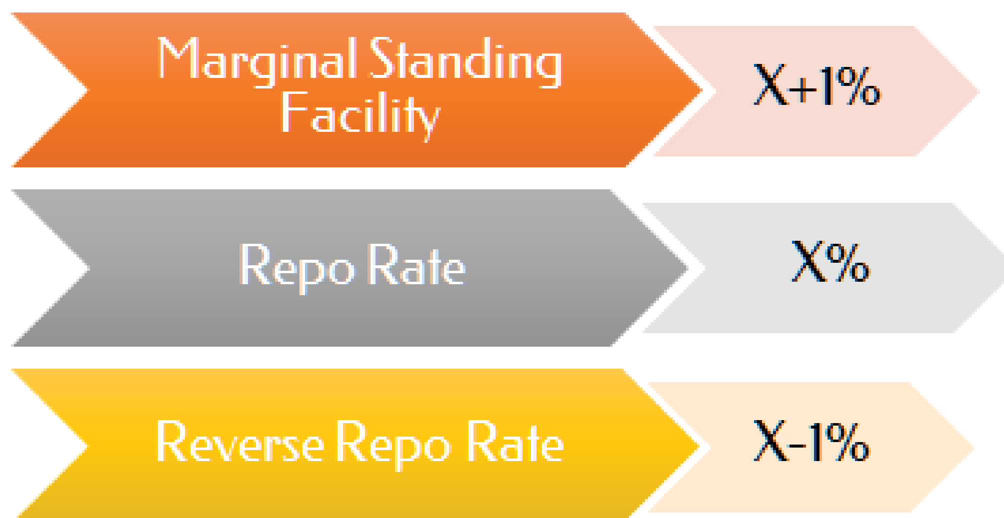
- MSF is the rate at which the banks are able to borrow overnight funds from RBI against the approved government securities.

Banks are already able to borrow from RBI via Repo Rate, then why MSF is needed?

MSF window was created for commercial banks to borrow from RBI in certain emergency conditions when inter-bank liquidity dries up completely and there is a volatility in the overnight interest rates. To curb this volatility, RBI allowed them to pledge G-secs and get more funds from RBI at a rate higher than the repo rate. Thus, overall idea behind the MSF is to contain volatility in the overnight inter-bank rates.

How the rate of interest in Repo, Reverse Repo and Marginal Standing Facility are related to each other?

The rate of interest on MSF is above 100 bps above the Repo Rate. The banks can borrow up to 1 percent of their net demand and time liabilities (NDTL) from this facility. This means that Difference between Repo Rate and MSF is 100 Basis Points. So, Repo rate will be in the middle, the Reverse Repo Rate will be 100 basis points below it, and the MSF rate 100 bps above it. Thus, if Repo Rate is X%, reverse repo rate is X-1% and MSF is X+1%.



Statutory pre-emptions

Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) are called Statutory Pre-emptions. The RBI has been empowered by Banking Regulation Act and RBI act to mandate commercial banks to maintain a certain portion of their Net Demand and Time Liabilities (NDTL)

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in the form of cash with the Reserve Bank [this is called Cash Reserve Ratio (CRR)] and in the form of investment in unencumbered approved securities [this is called Statutory Liquidity Ratio (SLR)].

Statutory Liquidity Ratio (SLR)

The banks and other financial institutions in India have to keep a fraction of their total net time and demand liabilities in the form of liquid assets such as G-secs (Government Securities), precious metals, other approved securities etc. This fraction is called Statutory Liquidity Ratio (SLR).

It is one of the two statutory pre-emptions because it gets its legal sanction from the section 24 (2A) of Banking Regulation Act 1949, which initially mandated for a 23% SLR. To comply with the SLR, the banks can keep any of the following:

- Cash in hand
- Gold owned by the bank
- Balance with RBI
- Net balance in current account
- Investment in Government securities

SLR has to be maintained at the close of business on every day. In the 1980s and 1990s, the SLR was very high (around 38.5%) and the first Narsimham Committee recommended to bring it down from 38.5% to 25%. At present, the SLR is 21.5% (February 2015).

Why SLR is needed?

There are three purposes to keep SLR. These are:

- It is an instrument of credit control
- It works as a cushion against the possibility of bank failures
- It is a conduit for financing government deficits.

We note here that SLR is not very frequently changed; so as an instrument of Credit Control; its role is limited. However, most important function SLR is doing in current times is to "finance the government deficit". As far as its function as a cushion against bank failures is concerned, it is practically meaningless because weak commercial banks are not allowed to fail by the Government/RBI which is guided by the too-big-to-fail doctrine while resolving bank failures.

What is Double Financial Repression?

The Economic Survey 2014-15 pointed out the two side problem being faced by the banks in India. One the asset side, they are forced to keep a huge fraction of their assets in the form of SLR. It does not allow them to invest those assets in better avenues. On the liability side, they have to make huge fraction of their credits to Priority Sector. These two have led to the banks to reel under the so called "Double Financial Repression". The survey recommended to gradually abolish SLR and also bring down mandatory Priority Sector Lending.

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What will happen if SLR is brought down?

As mentioned above, the most important function SLR is doing in current times is to "finance the government deficit". So, if SLR is abolished; the biggest casualty will be on the government borrowing programmes.

Cash Reserve Ratio

The Cash Reserve Ratio is the amount of funds that the banks are bound to keep with Reserve bank of India as a portion of their Net Demand and Time Liabilities (NDTL). This is also a statutory pre-emption because it draws its legality from Banking Regulation Act 1949.

The objective of CRR is to ensure the liquidity and solvency of the Banks.The CRR is maintained fortnightly average basis.

What happens when CRR is reduced?

When CRR is reduced, this means banks have to keep less funds with RBI and they have more funds to deploy in other businesses. When the banks have more money, they would try to lend it, thus increasing money supply in the system, and this might lead to reduction in the interest rates. Further, when money supply increases, too much money chases too few goods and this leads to rise in inflation. So, reducing CRR:

- Increases money supply
- Decreases interest rates on home loans, car loans etc. and in inter-bank market
- Reduces demand for money
- Increases inflation

What happens when CRR is increased?

When RBI increases the CRR, less funds are available with banks as they have to keep larger protions of their cash in hand with RBI. This means that banks will now have less money to play with. Moreover, Reserve Bank does not pay any interest on the CRR balances. Since commercial banks don't earn any interest, the banks are left with an option than to increase the interest rates. If RBI hikes this rate substantially, banks will have to increase the loan interest rates. The home loans, car loans and EMI of floating Rate loans increase. Thus hike in CRR leads to increase of interest rates on Loans provided by the Banks. Reduction in CRR sucks money out of the system causing to decrease in money supply. When money supply decreases, the inflation comes down. In summary, when increasing CRR:

- Decreases money supply
- Increases interest rates on home loans, car loans etc. and in inter-bank market
- Increases demand for money
- Decreases inflation

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Bank Rate

Bank Rate refers to the official interest rate at which RBI will provide loans to the banking system which includes commercial / cooperative banks, development banks etc. Such loans are given out either by direct lending or by rediscounting (buying back) the bills of commercial banks and treasury bills. Thus, bank rate is also known as discount rate. Bank rate is used as a signal by the RBI to the commercial banks on RBI's thinking of what the interest rates should be.

What happens when Bank Rate is increased or decreased?

When RBI increases the bank rate, the cost of borrowing for banks rises and this credit volume gets reduced leading to decline in supply of money. Thus, increase in Bank rate reflects tightening of RBI monetary policy. When RBI decreases the bank rate, the cost of borrowing for banks falls and thus credit volume gets increased leading to surge in supply of money. Thus, decrease in Bank rate reflects loosening of RBI monetary policy.

Difference between Bank Rate and Repo Rate

Bank Rate and Repo Rate seem to be similar terms because in both of them RBI lends to the banks. However:

- Repo Rate is a short-term measure and it refers to short-term loans and used for controlling the amount of money in the market.
- On the other hand, Bank Rate is a long-term measure and is governed by the long-term monetary policies of the RBI.
- In broader term, bank rate is the rate of interest which a central bank charges on the loans and advances that it extends to commercial banks and other financial intermediaries. RBI uses this tool to control the money supply.

Credit Ceiling

Under the credit ceiling, RBI informs the banks to what extent / limit they would be getting credit. When RBI imposes a credit limit, the banks will get tight in advancing loans to public. Further, RBI may also direct the banks to provide certain fractions of their loans to certain sectors such as farm sector or priority sector.

Qualitative instruments of monetary policy

Margin requirements, consumer credit regulation, RBI guidelines, Moral suasion and direct action are the qualitative tools of monetary policy of the RBI.

- **Margin requirements** refers to difference between the securities offered and amount borrowed by the banks.
- Consumer credit regulation refers to issuing rules regarding down payments and maximum maturities of installment credit for purchase of goods.

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- **RBI Guidelines refers to the** oral, written statements, appeals, guidelines, warnings etc. to the banks by RBI.
- Rationing of the credit refers to control over the credit granted / allocated by commercial banks.
- Moral Suasion refers to a request by the RBI to the commercial banks to take certain measures as per the trend of the economy. For example, RBI may ask banks to not to give out certain loans. It includes psychological means and informal means of selective credit control.
- **Direct Action** is taken by the RBI against banks that don't fulfill conditions and requirements. RBI may refuse to rediscount their papers or may give excess credits or charge a penal rate of interest over and above the Bank rate, for credit demanded beyond a limit.

Monetary Policy Stance

Monetary policy stance is based upon the assessment of the macroeconomic and financial conditions and monetary measures taken on the basis of those conditions. The overall objective while taking such instance is to speed up the economic development of the nation and raise the national income and standard of living of the people. The examples of stance taken by RBI via its monetary policy are as follows:

- Immediately after independence, India entered into economic planning era. To contribute in the development of the economy, RBI took such an instance that it not only provides adequate financing and economic growth but also controls inflation. This was called monetary policy stance of "Controlled expansion".
- Similarly, when inflation is high, RBI uses the various policy instruments to reduce the money supply in the economy. To do this, it would raise the Bank Rate, Repo Rate, CRR and SLR. All these would suck he liquidity out of system and bring down too much money chasing too few goods. This would finally bring down inflation. Such instance is called Tight Monetary Policy.
- RBI works as the **monetary authority of India** and thereby operates the monetary policy.

Regulation of Banks

One of the most important functions of RBI is to work as regulator and supervisor of financial system[1]. RBI derives its regulating powers from **Banking Regulation Act 1949.** For other entities, it derives power from the **RBI act 1934**. The objectives of this function are to protect the interest of the depositors and maintain the safety and soundness of the banking and Financial System of the country. At micro level, the regulation and supervision is done by various departments. For example, Department of Banking Operations and Development (DBOD) frames regulations for commercial

banks; while Department of Banking Supervision (DBS) undertakes supervision of commercial banks, including the local area banks and all-India financial institutions. Similarly, Department of Non-Banking Supervision (DNBS) regulates and supervises the Non-Banking Financial Companies (NBFCs), while Urban Banks Department (UBD) regulates and supervises the Urban Cooperative Banks (UCBs). Regulation of Regional Rural Banks (RRBs) and the Rural Cooperative Banks is done by Rural Planning and Credit Department (RPCD); while the supervision of these comes under NABARD.

Key obligations for banks towards RBI

First thing is that to do the banking business, every Bank whether Indian or foreign needs a license from RBI to conduct the banking business. Apart from that they have to:

- To ensure high quality corporate governance, the banks should follow the "fit and proper" criteria for director of banks. This implies that a director bank must have special knowledge in the banking related field. RBI can also appoint additional directors to the board of a banking company.
- Banks need to comply with the statutory pre-emptions viz. CRR and SLR requirements.
- Banks need to adhere to the prudential norms[2]. RBI has also issued guidelines under the Basel II / Basel III for risk management.
- Banks need to maintain public disclosure of relevant information including capital adequacy, asset quality, liquidity, earnings aspects and penalties imposed. This is one of RBI's tool for market discipline.
- Banks need to adhere to KYC norms (Know Your Customer) Anti- Money Laundering (AML) and Combating Financing of Terrorism (CFT) guidelines.
- RBI undertakes annual on-site inspection of banks to assess their financial health and to evaluate their performance in terms of quality of management, capital adequacy, asset quality, earnings, liquidity position as well as internal control systems.
- RBI also analyzes the health of the banks via its OSMOS[3]

How RBI protects the interests of the small depositors and common man?

First, RBI maintains soundness of the entire banking system via its various regulatory tools and norms such as Corporate Governance norms, Fit and proper criteria for directors, statutory pre-emptions, prudential norms, public disclosure roles, Basel guidelines, KYC norms, Anti- Money Laundering (AML) guidelines, Combating Financing of Terrorism (CFT) guidelines, onsite and offsite surveillance etc.

Further, RBI has set up the Deposit Insurance and Credit Guarantee Corporation (DICGC) to

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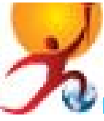

protect the interest of small depositors, in case of bank failure. The DICGC provides insurance cover to all eligible bank depositors up to Rs.1 lakh per depositor per bank.

Para – banking Activities

Parabanking activities are those activities which don't come under the traditional banking activities. Examples of such activities are asset management, mutual funds business, insurance business, merchant banking activities, factoring services, venture capital, card business, equity participation in venture funds and leasing. The RBI has permitted banks to undertake these activities under the guidelines issued by it from time to time.

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 Re. 1 note. The first paper notes were issued by the private banks such as Bank of Hindustan and the presidency banks during late 18th century. In those times, there were Government issued notes also but government had no monopoly in issuing paper notes.
Via the Paper Currency Act of 1861, the British Government of India was conferred the monopoly to issue paper notes in India.

Currency Circles

After the 1861 act, the Government of India had the monopoly to issue paper notes in India. But since making those notes popular was a difficult task in such a vast country; the government entered into agreements with the Presidency Banks to work as authorized agents to promote circulations of the paper notes across length and breadth of British India.
However, there were several limitations. 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".

Controller of Currency

The agreements with the Presidency Banks to promote and popularize the bank notes was terminated in 1867. Subsequently, job of promoting, circulating and redemption of the currency notes was entrusted to Mint Masters, Accountant General and the Controller of Currency. This practice continued till RBI came into existence in 1935.

In which year the currency function moved from Controller of Currency to RBI?

Section 22 of the RBI Act 1934 makes provided that RBI has the sole right to issue Bank notes of all denominations. Thus, on 1 April 1935, 1935, the currency function moved from Controller of Currency to RBI. Today, Reserve Bank is responsible for the design, production and overall management of the nation's currency, with the goal of ensuring an adequate supply of clean and

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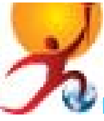

genuine notes. In consultation with the Government, the Reserve Bank routinely addresses security issues and targets ways to enhance security features to reduce the risk of counterfeiting or forgery of currency notes.

Decimalization of Coinage

When India got freedom, the basic unit of Indian currency was 1 Rupee which could be divided into 16 Annas ( ) or 64 pice ( ); pice was old spelling of paise. At that time, lowest denomination of Indian Rupee was Half-Pice, which became obsolete in 1947. At that time, the Government minted One Rupee, Half Rupee, Quarter Rupee, Two Annas, One Anna, Half Anna and One Pice coins.

This 16 Anna and 64 Pice structure remained till 1957, when decimalization of the coinage was done. Henceforth, spelling of "pice" was changed to "Paisa" and 1 Rupee was divided into 100 Paise. This is called Decimalization of Coinage and it took place in 1957. The 100th part of Rupee was now called **Naya Paisa**. The term "naya" was dropped in 1964.

Role of RBI in coins in India

The distribution of Coins is undertaken by RBI as an agent of the Government, (coins are minted by the Government and not by RBI).

However RBI is the only source of legal tender money because distribution of one rupee notes and coins and small coins all over the country is undertaken by the Reserve Bank as agent of the Government.

Current Paper Notes in Circulation

At present, paper currency notes in India are issued in the denomination of Rs. 5, Rs.10, Rs.20, Rs.50, Rs.100, Rs.500 and Rs.1,000. The printing of Rs. 1 and Rs. 2 denominations has been discontinued, though the notes in circulation are valid as per the Coinage Act 2011.

- In February 2015, it was reported that RBI will again put in circulation rupee one notes after a gap of 20 years.

Reserve Bank of India has been authorized to issue notes of Rs. 5000 and Rs. 10000 also. In fact, as per RBI act, RBI can issue any note of any denomination but NOT exceeding Rs. 10,000. The notes denomination is notified by Government and RBI acts accordingly.

Signature on currency notes

Under Section 22 of the Reserve Bank of India Act, RBI has sole right to issue currency notes of various denominations except one rupee notes. The One Rupee note is issued by Ministry of Finance and it bears the signatures of Finance Secretary, while other notes bear the signature of Governor RBI.

Proportional Reserve System and Minimum Reserve System

Originally, the assets of the Issue department were to consist of not less than 2/5th of the Gold or

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sterling securities, provided Gold was not less than Rs. 40 Crores in value. Remaining 3/5th of the assets might be rupee coins. This was called "Proportional Reserve System". In 1956, this system was changed. Now, RBI is required to maintain a Gold and Foreign Exchange Reserves of Rs. 200 Crore of which at least Rs. 115 Crore should be in Gold. This is called Minimum Reserve System. This system continues till date.

Currency Chests

Currency chests are storehouses where bank notes and rupee coins are stocked on behalf of the Reserve Bank. The currency chests have been established with State Bank of India, six associate banks, nationalized banks, private sector banks, a foreign bank, a state cooperative bank and a regional rural bank. Deposits into the currency chest are treated as reserves with the Reserve Bank and are included in the Cash Reserve Ratio.

First printing press in India for bank notes

Currency Note Press (CNP), Nasik, Maharashtra was established in 1928. It was the first printing press for bank notes in India.

Locations of Various Bank Note Press

The **Security Printing and Minting Corporation of India Limited** (SPMCIL) prints the notes. It is a wholly owned company of the Government of India. Its printing presses are located at Nasik (Maharashtra) and Dewas (Madhya Pradesh).

Apart from that, the **Bharatiya Reserve Bank Note Mudran Pvt. Ltd** (BRBNMPL), a wholly owned subsidiary of the Reserve Bank, also has set up printing presses. The presses of BRBNMPL are located at Mysore in Karnataka and Salboni in West Bengal.

Security Printing and Minting Corporation of India Limited (SPMCIL) has 4 mints for coin production located at Mumbai, Noida, Kolkata and Hyderabad.

Legal Tenders

One Rupee Note and One Rupee coins are legal tenders for **unlimited amounts.** 50 Paisa coins are legal tender for any sum not above Rs. 10. The coins of smaller than 50 paisa value are legal tenders of a sum below Re. 1.

Star Series Notes

The Star series notes are currently issued in Rs. 10, 20, 50 and Rs. 100. These notes are issued to replace the defected printed notes at the printing press. They have an additional character of a star and the bundles are NOT in series. Rest all the features are same.

Languages on currency notes

The amount of a banknote is written on it in 17 languages out of 22 official languages of India. The languages are Assamese, Bengali, Gujarati, Kannada, Kashmiri, Konkani, Malayalam, Marathi,

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Nepali, Oriya, Punjabi, Sanskrit, Tamil, Telugu and Urdu.

Issue Department and Currency Departments of RBI

RBI has a separate department called issue department whose assets and liabilities are kept separate from the Banking Department. Currency Management function of Reserve Bank is carried out at the "Department of Currency Management" located at Central Office Mumbai. There are 19 Issue offices. RBI authorizes selected branches of Banks to establish Currency Chests and Coin Deposits. At present there is a network of 4281 Currency Chests and 4044 Small Coin Deposits.

RBI as Banker of Government

For Central Government

As per the RBI Act, 1934, Central Government entrusts the Reserve Bank with all its money remittance, exchange and banking transactions in India and the management of its public debt. The Government also deposits its cash balances with the Reserve Bank. Further, note that the central government is required to maintain a minimum cash balance with the Reserve Bank. Currently, this amount is Rs. 10 crore on a daily basis and Rs.100 crore on Fridays, as also at the end of March and July. These provisions are as per the administrative arrangements (not as per any legislation).

For state governments

In case of state governments, RBI works has their banker only when a particular state enters into such agreement with RBI. Currently, the Reserve Bank acts as banker to all the State Governments in India, **except Jammu & Kashmir and Sikkim.** It has limited agreements for the management of the public debt of these two State Governments.

Banking of Individual Ministries

RBI used to handle banking of individual ministries in past. Currently,every ministry has been given a public sector bank to manage its operations. But still RBI functions for the ministries for which it is **nominated** to do so.

Central Accounts Section

Reserve Bank of India maintains the Principal Accounts of Central as well as State Governments at its Central Accounts Section, Nagpur. It has put in place a well structured arrangement for revenue collection as well as payments on behalf of Government across the country. A network comprising the Public Accounts Departments of RBI and branches of Agency Banks appointed under Section 45 of the RBI Act carry out the Govt. transactions.

Banks that conduct Government Business in India

At present all the public sector banks and three private sector banks viz. ICICI Bank Ltd., HDFC Bank Ltd. and Axis Bank Ltd. act as RBI's agents. Only authorized branches of Agency banks can conduct Govt. business.

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RBI works as Debt Manager of Government

RBI helps both the central government and state governments to manage their public debt, float new loans, issue and retirement of rupee loans, interest payment on the loan and operational matters about debt certificates and their registration. RBI's debt management policy aims at minimizing the cost of borrowing, reducing the roll-over risk, smoothening the maturity structure of debt, and improving depth and liquidity of Government securities markets by developing an active secondary market.

Ways and means advances (WMA)

Whenever there is a temporary mismatch in the cash flow of the receipts and payments of the State Governments, RBI provides them Ways and Means Advances (WMA). This also comes under debt management works of RBI.

RBI as banker to other banks

RBI is bank of all banks in India. As a banker of banks, RBI:

- Enables smooth and swift clearing and settlements of inter-bank transactions
- Provides efficient means of funds transfer for all banks
- Enables banks to maintain their accounts with RBI for statutory reserve requirements and maintenance of transaction balances
- Acts as lender of last resort (LORL)

Reserve Bank maintains current account of all other banks and provides them facility to maintain cash reserves and also to carry out inter-bank transactions. RBI provides the Rea Time Gross Settlement System (RTGS) facility to the banks for inter-bank transactions.

Statuary Reserves

As per the Banking Regulations Act 1949, Banks have to keep a portion of their demand and time liabilities as cash reserves with the Reserve Bank, thus necessitating a need for maintaining accounts with the Bank. Earlier, (originally in the BR act) it was as follows – 5% of demand liabilities and 2% of time liabilities. But now it is the portion of Net Demand and Time Liabilities (NDTL). So, the RBI provides banks with the facility of opening accounts with itself. This is the 'Banker to Banks' function of the Reserve Bank, which is delivered through the Deposit Accounts Department (DAD) of RBI at regional offices.

RBI continuously monitors the transactions and operations of these accounts so that defaults don't take place.

Lender of the Last Resort (LORL)

The banks can borrow from the RBI by keeping eligible securities as collateral or any other

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arrangement and at the time of need or crisis, they approach RBI for financial help. Thus RBI works as Lender of the Last Resort (LORL) for banks.

How RBI regulated and supervises the Financial System?

One of the most important functions of RBI is to work as regulator and supervisor of financial system. RBI not only regulates and supervises the Indian Banks but also Foreign Banks, Regional Rural Banks, Local Area Banks, Cooperative Banks, Financial Institutions including Development Financial Institutions (DFIs) and Non-Banking Financial Companies.

Role of RBI in the management of foreign exchange reserves

RBI manages the Foreign Exchange Management Act, 1999 to facilitate external trade and payment and promote orderly development and maintenance of foreign exchange market in India.

Post independence, India's exchange rate was fixed by the RBI against pound sterling, under the fixed or pegged exchange rate mechanism. Subsequently the exchange rate under the fixed exchange rate mechanism was changed to dollars and then to a basket of currencies.

LERMS

The first step at reforms in exchange rate management was taken in 1993, and then referred to as 'Liberalized Exchange Rate Management System' or LERMS. Under this the dollar was used as intervention currency, which implied that primary exchange rate, all official government statistics would be dominated in U.S. dollar in terms of global trends and convenience. Under LERMS there was a 'dual exchange rate', one officially decided by the RBI and the other through market forces. All foreign exchange transactions upto 40% was to be at the official rate and the remaining at the market rate. However, after 1999 the official rate was discontinued and exchange rate became market-determined exchange rate (MDER).

Under MDER the forces of demand and supply of dollars in India determine the exchange rate. The demand for dollars is downward sloping (lower demand when more rupees have to be offered and higher demand when lesser rupees have to be offered). Similarly the supply of dollars is upward sloping (less is sold when lesser rupees are offered and more is sold when more rupees are offered). Thus this interaction of demand and supply determines the exchange rate, at which the demand and supply of dollars balance out.

Any surge in the inflow of dollars leads to the rupee gaining value (appreciation). This renders imports cheaper and exports expensive. To prevent impact on exports under MDER, the RBI purchases dollars by creating an artificial demand for the excess dollars in circulation. Any act of purchase of dollars by the RBI impacts liquidity as rupees get released into the system creating inflationary pressures. In such circumstances the RBI simultaneously goes for the reverse repo

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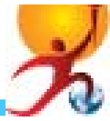

auction to soak up the excess liquidity created on account of purchase of dollars by the RBI. The reverse repo auction is done under the Market Stabilization Scheme (MSS). Any act of interference by a Central Bank like the RBI in influencing the exchange rate is called as 'dirty floats'.

But in India it is referred to as 'managed floats'. In adverse circumstances of demand for dollars going up more than the supply of dollars, it results in rupee losing value (depreciation). Though it can positively impact exports and discourage imports, it is usually seen as an erosion of faith in the home currency and can escalate into a currency crisis. In such circumstances the government has to sell foreign currency to augment the supply of dollars.

However, the experience has been that more the currency is sold, more is the depreciation. Thus RBI instead of targeting any exchange rate, intervenes in the foreign exchange market only to manage the volatility and disruptions to the macro economic situation.

[1] The financial system in India includes Commercial Banks, Regional Rural Banks, Local Area Banks, Cooperative Banks, Financial Institutions including Development Financial Institutions (DFIs) and Non-Banking Financial Companies.

[2] Prudential Norms refers to ideal / responsible norms maintained by the banks to keep their balance sheets strong. Some of them are related to income recognition, asset classification and provisioning, capital adequacy, investments portfolio and capital market exposures.

[3] OSMOS refers to Off Site Surveillance and Monitoring System. The RBI requires banks to submit detailed and structured information periodically under OSMOS.

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General Knowledge Today

Banking & Finance-3: Basics in Banking Business

Target 2016: Integrated IAS General Studies

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Banking & Finance-3: Basics in Banking Business

This document is mainly for Preliminary examination and covers the topics objectively. This content is also useful for some of you who might be appearing in Banking Examinations as well.

Prelims MCQ Topics

Time deposits and demand deposits, Current Account & Saving Account, NRO, NR(E)RA and FCNR accounts, Deposit Insurance, Concept of credit creation, Various Types of Loans, Non-performing Assets, Provision Coverage Ratio, Priority Sector Lending.

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Functions of Banks

The core functions commercial banks can be segregated into three main segments vizFinancial Intermediation, Payment System and Financial Services. Apart from these, various other functions of banks are as follows:

- Banks work as trustees for certain requirements of the businesses, governments and public.
- They issue Letter of credit for the purpose of facilitating trade.
- They help in the disbursement of the pension to pensioners.
- Enable Government to Government (G2G), Government to Corporate (G2C) transactions.
- Banks liaison with local government departments and government treasury.

Financial Intermediation

The key business of the banks is to accept different types of deposits from the public and then lend these funds to the borrowers. This is called Financial intermediation. In terms of the banks, the deposits represent the "liabilities" of the banks while loans advanced and investments made by banks represent their "assets".

Acceptance of Deposits

Banks are called custodians of public money and mobilization of the deposits from the public is the most important function of the commercial banks. There are mainly two types of deposits viz. Time deposits (Term Deposits) and Demand Deposits. As custodians of public money, the banks provide security to the money and valuables of the general public. In India, the bank deposits are covered under the deposit insurance scheme provided by DICGC. For security of valuables banks provide locker facilities.

Loans and Advances

There are various types of loans or advances, which can be divided on the basis of different sets of criteria. More information about various types of lending operations in India, click here.

Payment System

Payment refers to the transfer of an item of value from one party to another in exchange for goods or services or both; or to fulfill a legal obligation. In any economy, the banks are core to the payment systems. Banks not only enable transfer of money but also its mobilization. The basic method of financial transactions is by negotiable instruments such as cheques and drafts. In modern times, the electronic banking, wire transfers, real time settlements, internet banking etc. are various modes of financial transactions. Banks also enable the internal remittances, foreign exchange transactions, telegraphic transfers of money.

Financial Services provided by Banks

Apart from the above, Banks impart various financial services such as investment banking,

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insurance-related services, government-related business, foreign exchange businesses, wealth management services, etc. Banks also provide agency services to their customers which includes:

- Collection and payment of cheques and bills on behalf of customers.
- Collection of dividends, interest, rent etc. on behalf of customers, if so instructed by them.
- Purchase and sale of shares and securities on behalf of customers.
- Payment of rent, interest, insurance premium, subscriptions, on behalf of customers, if so instructed.
- Acting as a trustee or executor.

Deposits and Accounts

Time deposits and demand deposits

Banks are called custodians of public money and mobilization of the deposits from the public is the most important function of the commercial banks. Mainly, there are two types of deposits viz. Time Deposits and Demand Deposits. When money is deposited for a fixed period, before which it cannot be withdrawn; such deposits are called "Time deposits" or "Term deposits". The most common example of Time deposits is "**Fixed Deposit**". On the other hand, if money deposited can be withdrawn by the customer (depositor / account holder) at any time without any advanced notice to banks; it is called demand deposit. Most common example of demand deposit is our Saving Banks Account, Current Bank Accounts etc. We can withdraw the funds in these accounts on demand.

Different types of time deposits

On the basis of their nature, time deposits may be of three types as follows:

- **Fixed deposits:** A fixed rate of interest is paid at fixed, regular intervals
- **Re-investment deposits:** Interest is compounded quarterly and paid on maturity, along with the principal amount of the deposit. In the Flexi Deposits amount in savings deposit accounts beyond a fixed limit is automatically converted into term-deposits.
- **Recurring deposits:** Fixed amount is deposited at regular intervals for a fixed term and the repayment of principal and accumulated interest is made at the end of the term. These deposits are usually targeted at persons who are salaried or receive other regular income. A Recurring Deposit can usually be opened for any period from 6 months to 120 months.

Key Features of Time Deposits

- All time deposits are eligible for interest payments. Interest rate depends upon the tenure and amount of deposit. This rate varies from bank to bank.
- The interest rate is generally higher for time deposits of longer tenure.

Key features of demand deposits

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- The money as demand deposit is liquid and can be encashed at any time. The ownership of demand deposits can be transferred from one person to another via cheques or electronic transfers. There is no fixed term to maturity for Demand Deposits.
- The demand deposits may or may not pay interest to the depositor. For example, while we get an interest on savings accounts; no interest is paid on current accounts.

Different types of Demand deposits

The demand deposits are those from which one can withdraw the funds any time by issuing cheque, using ATM or withdrawal forms at the bank branches. Thus, demand deposits can be of two types viz. savings accounts and current accounts.

Main features of current account

- A current account is always a Demand Deposit and the bank is obliged to pay the money on demand.
- The Current accounts bear no interest and they account for the smallest fraction among the current, saving and term deposits.
- They provide the convenient operation facility to the individual / firm.
- The cost to maintain the accounts is high and banks ask the customers to keep a minimum balance.

Main features of savings account

- Saving account is also a demand deposit but they are subject to some restrictions on the number of withdrawals as well as on the amounts of withdrawals during any specified period.
- Further, minimum balances may be prescribed in order to offset the cost of maintaining and servicing such deposits.
- Savings deposits are deposits that accrue interest at a fixed rate set by the commercial banks.

Key differences between current accounts and savings accounts

The basic objective of a Savings Bank Account is to enable the customer save his / her liquid assets and also earn money on that saving. The Savings banks Accounts are preferred by individuals and provide liquidity for private and small businesses sometimes. On the other hand the current account is basically a transactional account which is preferred by business people. The basic objective of the current accounts is to provide flexible payment methods to the business people and entities. These payment methods include special arrangements such a overdraft facility, accommodation of standing orders, direct debits, offset mortgage facility. The Key differences are thus listed below:

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Difference	Saving Account	Current Account
Basic Objective	Enable the customer to save liquid assets and also earn interest on that	Provide flexible payment method for individuals, businesses and entities.
Preference	Preferred by individuals savers	Preferred by businesses.
Transaction scale	Usually low scale transactions	Usually high scale transactions
Interest	Earns interest	Earns no interest
Overdraft Facility	No overdraft facility	There is overdraft facility
Minimum Balance Requirement	May or May not need	Not need

CASA Deposits

CASA Deposits refers to Current Account Saving Account Deposits As an aggregate the CASA deposits are low interest deposits for the Banks compared to other types of the deposits. So banks tend to increase the CASA deposits and for this they offer various services such as salary accounts to companies, and encouraging merchants to open current accounts, and use their cash-management facilities. The Bank is High CASA ratio (CASA deposits as % of total deposits) are in a more comfortable position than the Banks with low CASA ratios , which are more dependent on term deposits for their funding, and are vulnerable to interest rate shocks in the economy, plus lower spread they earn.

Deposits which have features of both time and demand deposits

Banks also provide a combination of demand and time deposits in the form of various products. Examples of such products include Recurring Deposits, Flexible RDs, Multiplier FDs, Special Term deposit accounts etc.

Account Operations

Opening of Deposit Account & KYC

The Banks have to follow the KYC (Know Your Customer) norms to open new bank accounts. Currently, the RBI has directed the banks to accept a single document, like a driving license, which contains the applicant's photograph and address to open an account.

The officially valid documents for KYC include

- passport
- driving license

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- voter ID card
- PAN card
- Aadhaar letter issued by UIDAI and
- job card issued by MNREGA and signed by a state government official

Nomination

Nomination is a procedure wherein a depositor declares the name of the person to whom the money can be disbursed on account of former's death. The name of the nominee has to be declared while opening the account. The Banking Companies (Nomination) Rules, 1985 allows the banks to pay all dues to the nominee without any succession certificate or any claims of the legal heir. The features of nomination are:

- Nomination can be made in case of safe lockers, bank deposits, safe custody articles.
- One deposit account can only have one nominee irrespective of the account being held singly or jointly.
- In case of safe lockers, there can be 2 nominees for jointly held lockers.
- In case of a minor account, a person who is legally entitled to use his account can also file nomination on behalf of the minor.

Procedures followed to operate a deposit account

- Deposits are usually by filling a deposit or pay-in slip. The depositor or the account holder has to fill in all the particulars and undersign it. In case of transaction of above a certain denomination the depositor has to furnish the PAN (Permanent Account Number) too. Also, the deposits can be made by submitting a cheque and filling in the same deposit slip.

Withdrawals from deposit accounts

Deposits can be withdrawn from one's account in three ways:

- **Withdrawal Form:** The customer is supposed to fill various particulars in the deposit form. The latter is presented with the passbook. After a few checks like balance, signature match etc. the banker clears the form for cash to be collected at the counter.
- **Cheque:** These unlike withdrawal forms can be used to make payments to other parties. The payment can be taken from the same bank or any other bank by the other person.
- **ATM (Automated Teller Machine):** It can be used both for savings and current accounts. It can be operated by a magnetic card with a secret access PIN (Personal Identification Number) number. They work 24X7.

Passbook

A passbook is a vital document to all banking transactions.

- It carries a final and unquestionable record of all transactions between the banker and the

customer.

- It is usually a true copy of the entries in the ledger of the bank.
- It also contains all the rules and regulations to operate a savings bank account.
- It is given at the time of opening the account and carries the name of the depositor, account number, customer ID, etc.
- Some banks only issue periodic bank statements to customers and not issue a proper passbook.
- Banks issue duplicate passbooks in case of loss, mutilation or any kind of spoilage, the passbook is reissued at a nominal charge.

Closure of account of the customers

Banks have the right to close any bank account without any prior intimation if the account has not been operated for a stipulated amount of time. There can be many reasons under which bank can initiate such proceedings. They are:

- If many cheques are repeatedly issued and there are insufficient funds.
- Cheques are not honoured.
- Failing to remit funds which cover bills domiciled at the bank

Banks should however serve timely notice to the customers before initiating such proceedings.

The customers can however withdraw the balance to his credit and not give any prior notice.

In case of pre-mature closures of recurring or fixed accounts a small penalty is charged.

Procedure to Issue of a cheque book.

- Cheque-book is issued at the time of opening of the account. It is given to the depositor or any person so authorized by the former after proper acknowledgement.
- If the cheques are frequently returned or dishonored, the bank reserves the right to proceed with closure of the account.
- A person may sign for an option to not to use a cheque book at the time of opening the account.
- Person receiving the cheque book should verify the number of leaves and report any damage to the bank officer.
- It should be kept in secured possession and any loss or theft should be immediately reported to the bank.
- Banks like SBI give 40 cheque leaves free in a year. Any additional cheque leaves are issued at a service charge. This varied with banks.

Procedure for Issue of fixed deposit receipt

- A fixed deposit receipt represents the funds which a customer deposits in a bank for fixed or

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long-term deposits.

- The term of the deposit and the rate of interest are fixed in advance.
- A person having any type of dealing or account can open a fixed deposit account.
- In case of minors, the fixed deposit account can be opened under the guardianship of parents or other designated adults.
- If the fixed deposit receipt is lost or damaged, a duplicate slip can also be issued after an indemnity bond is furnished in a prescribed format accompanied by the bank guarantee.

Procedure for Closure of fixed and recurring deposits.

Banks have the right to close any bank account without any prior intimation if the account has not been operated for a stipulated amount of time. There can be many reasons under which bank can initiate such proceedings. They are:

- If many cheques are repeatedly issued and there are insufficient funds.
- Cheques are not honoured.
- Failing to remit funds which cover bills domiciled at the bank

Banks should however serve timely notice to the customers before initiating such proceedings.

The customers can however withdraw the balance to his credit and not give any prior notice.

In case of pre-mature closures of recurring or fixed accounts a small penalty is charged.

Different types of account holders

A bank account is a monetary account of a customer with a banking institution. It is a record of balance of money. A bank allows many different types of account holders. They are:

- **Individual:** It is an account held by an individual for use by his own needs. The banks usually differentiate their services like minimum balance requirements, ATM usage, fees etc. for different types of holders.
- **Joint account:** It is an account opened in name of two or more people. The account can be operated by either of the account holders. These can also be opened in names of associations, cooperative societies etc.
- **Illiterate account:** These accounts are opened on discretion of the banks if the person personally goes to the bank along with a witness already known to the bank and the depositor. No cheque books are issued for such accounts. Any withdrawal is done by a thumb impression of the depositor in presence of the bank officer who is able to verify the identity.
- **Minor account:** Savings account in name of a minor can be opened in a bank. It can be operated either by the natural guardian or a guardian appointed by the court. The minor can operate the account after an age of 21 years.

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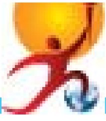

- **Married women account:** A married woman can have a bank account to which her husband has no access. Such accounts are generally provided by private banks and come with facilities like internet banking, ATM, debit cards, online bill payment.
- **Non-Resident Accounts:** NRIs can open accounts based on either repatriation facility or currency of account. These are- Non-Resident Ordinary account; Non-Resident External Rupee; Foreign Currency Non-Resident account and Resident Foreign Currency Account.

Difference between individual account and joint account.

Individual Account	Joint Account
Held by an individual for his own needs	Held by two or more individuals
It can be operated only by the individual	It can be operated by either of two or more individuals operating the account.
In case of death, the balance can be withdrawn by the nominee	In case of death of any of the account holders, the others can operate the account.
It is not required	A mandate of operation can be furnished in the account opening form.
It is not applicable in this case.	A cheque drawn by one of the account holders can be stopped by another, even if the latter is not authorised to operate the account. Such cheques can only be paid with the consent of all account holders.

Precautions the bankers should take while opening an account in the name of a married woman

A married woman can enter into a valid banking contract and can have her own bank account without giving any rights to her husband to operate it. In case of debt, only she will be responsible and her husband cannot be held liable unless under special circumstances.

- A banker should take specific precautions to open account for a pardanashin woman as her identity cannot be ascertained. The banker should get her signature attested by any responsible person.
- An overdraft facility is provided to her if she has sufficient property to her name and is prompt in her dealings.
- The banker should thus secure sufficient property which can be easily converted into liquid assets.
- As an agent of her husband banker should ensure she does not overdraw.

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- Banker should include a "Free Will" clause in loans or overdraft agreements
- In case of joint accounts banks should be sure of who should operate the account and to whom the payment will be made in case of death of any one holder.

Peculiarities of non-resident accounts

A NRI account should have the following peculiarities different from basic bank accounts:

- Funds are held in Indian currency.
- One has to pay tax on interests earned.
- A person can have a resident of India as a joint account holder.
- It can be converted to a normal resident account if the NRI shifts back to India.
- Funds can be easily deposited or withdrawn from such an account
- In case of a NRE account, one can have an option of "No Questions Asked" policy to send funds to India.
- In case of FCNR account, funds can be held in foreign currency.

Procedures to open account in the name of a Joint Hindu family

A Joint Hindu Family stands for persons who have the same ancestry. A joint Hindu family is governed by the Mitakshara or Dayabhaga laws.

- Banker should be cautious that any debt on the family head is binding on the estate of the family if the loan was sought for purposes of family benefit.
- Banker has to be careful and should have awareness about the ownership and inheritance rights as they can pose serious challenges to the banks.
- The Banker generally takes declaration signed by all members of the family giving rights of operation and decision to the senior-most male member of the house.
- The head or Karta will govern all transactions done in the account.

The banker takes residential proof, ID and also PAN Card of the Karta when starting the account.

Accounts for Non-Residents

There are several kinds of accounts available for non resident Indians , Persons of Indian Origin and Overseas Citizens of India. These mainly include NRO, NR(E)RA and FCNR account.

NRO Account

NRO refers to Non Resident Ordinary Account. Such account can be opened by any person outside India. Normally, when a resident becomes a non resident, his domestic rupee account gets converted into the NRO account. This helps the NRI to get his credits which accrue in India, for example rent or interest from investments.

NR(E)RA Account

NR(E)RA refers to Non-Resident (External) Rupee Account. This account was introduced as NRE

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scheme in 1970. It's a Rupee account and the NRI can remit money to India from the funds abroad.

FCNR Account Scheme

Foreign Currency Non-Resident Account Bank or FCNR (B) was first introduced in 1993. While NRERA Account is a rupee account and the depositor is exposed to the Currency rates risk; FCNR is opened in foreign currency only. Currently, FCNR Account can be opened in six designated currencies viz. US Dollar (USD), Great Britain Pound (GBP), Euro (EUR), Japanese Yen (JPY), Canadian Dollar (CAD) and Australian Dollar (AUD).

- However, it's worth note that the FCNR account is opened ONLY in the form of Term Deposits and NOT in the form of Demand Deposits. The term is from 1 year to 5 years.
- The person who opens FCNR account is allowed to repatriate the principal and interest after maturity. Interest on such accounts is paid only on maturity.

Deposit Insurance

In India, the bank deposits are covered under the insurance scheme provided by Deposit Insurance and Credit Guarantee Corporation (DICGC), a wholly owned subsidiary of the Reserve Bank of India. DICGC is a statutory body, created by an act of parliament in 1961. The idea behind the Deposit Insurance is to boost the faith of the public in the banking system, and provide protection against the loss of deposits to a significant extent.

Banks which are covered under Deposit Insurance Scheme

All commercial & cooperative Banks (state, district and Urban cooperative banks) are insured by DICGC; however there are a few exceptions. The following are not covered under deposit insurance scheme:

1. Primary Agricultural Credit Societies (PACS)
2. Cooperative banks from Meghalaya
3. Cooperative Banks from Union Territories of Chandigarh, Lakshadweep and Dadra and Nagar Haveli.

This implies that:

1. All commercial banks including branches of foreign banks functioning in India, local area banks and regional rural banks **are insured** by the DICGC.
2. All State, Central and Primary cooperative banks, also called urban cooperative banks, functioning in States / Union Territories **are covered under** the Deposit Insurance System.
3. At present all co-operative banks **other than** those from Meghalaya, Chandigarh, Lakshadweep and Dadra and Nagar Haveli **are covered** under the deposit insurance system of DICGC.

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Primary cooperative societies (PACS) , which are village level cooperatives and disburse short term credits in the country are **NOT insured** by the DICGC. So around 95000 PACS in the country are out of coverage of the DICGC.

Kinds of deposits that are insured under Deposit Insurance

The DICGC insures all deposit accounts including savings, fixed, current, recurring, except:

1. Deposits of the Foreign Governments
2. Deposits of the Central and State Governments.

How Deposit Insurance works?

When a bank covered by Deposit insurance scheme of DICGC fails, or undergoes liquidation or is merged with another bank; the DICGC pays the amount due to depositors via the officially appointed liquidator in a time bound manner. All claims are settled by DICGC within two months from the receipt of the claim from the liquidator.

Maximum amount insured under deposit insurance

The maximum amount per depositor insured is Rs. 1 Lakh including Principal and Interest. This means that

1. If a person has principal amount of Rs. 91000 and interest Rs. 7,000 then the amount insured by DICGC is Rs. 98,000.
2. However, if the same person has deposits Rs. 98000 and interest is Rs. 8000 then , the amount insured by the DICGC would be Rs. 1 Lakh.

The insurance cost is borne by the bank which is insured. The DGCIC charges 10 paise per Rs. 100 as insurance premium.

If a person has different accounts in different branches of the same bank, then thedeposits in different branches are totaled and the maximum cover of 1-lakh is applied. In case of the joint accounts and other accounts one had, all deposit accounts one holds in his / her name in the same bank are clubbed together to apply the maximum cover. This implies that if someone has savings, fixed, current and recurring deposit accounts in different branches of the bank, he / she will get only Rs. 1 Lakh if the bank fails. However, if one maintains deposits in different capacities in different banks; the Rs. 1 Lakh limit is applied separately for each bank.

Bancassurance

Bancassurance or Bank Insurance Model refers to the distribution of the insurance and related financial products by the Banks whose main business is NOT insurance. So, simply Bancassurance, i.e., banc + assurance, refers to banks selling the insurance products. Bancassurance term first appeared in France in 1980, to define the sale of insurance products through banks' distribution

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channels.

Benefits of Bancassurance

Bancassurance helps both the banks and Insurance Companies as follows:

- This is a referral business in which the banks tend to leverage the existing clientele.
- Insurance companies get the benefit because they can have distribution relationships with multiple insurers.

Business Model in Bancassurance

For Bancassurance, the Banks need to obtain a prior license from the IrDA or Insurance Regulatory and Development Authority, so that they can work as "Composite Corporate Agent" or may have "Referral Arrangement" with the Insurance Companies.

Major problem of Bancassurance

Banks have to follow RBI as well as IrDA regulations for Bancassurance Business. The present regulations do not allow banks to sell insurance products of more than one insurance company.

Lending policy of the commercial banks

Lending is an indispensible function of banks. Commercial banks consider have to consider many factors while deciding lending policy. These are:

- **Liquidity:** A bank has to ensure sufficient liquidity under all conditions. Any bank indulging in lending finances generally makes its investments in non-liquid assets and manages funding of loans with short-term liabilities. A bank has to thus forecast its liquidity requirements and have emergency standby credit lines at other banks.
- **Profitability:** Profits in banking are derived from the difference on the interests paid on deposits and the interests it charges on loans (lending). This is also known as "spread" between the costs of funds and interest rates of loans.
- **Safety Issues:** The failure of many banks across the world has brought the issue of safe lending to the fore.
- **Diversification of risk:** It has great effect on the performance of the bank. The most important advantage of diversification is lower cost of capital.

Major safety issues banks need to consider in lending policy

Banks across the world have faced failures due to lack of lending precautions and adopting safety valves. Banks have to tread carefully and consider the following points for successful lending:

- **Leverage:** It is a dangerous option for any bank irrespective of the quality of credit analysis behind any loan. Banks should adhere to minimum leverage and check for capital adequacy requirements, risk measurement, restrict lending against real estate, shares etc.

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- **Fully Collateralized loans:** Riskless loans are completely collateralized with actively traded assets. Collateral has to be valued at its liquidation value. It thus requires liquidity and transparency of assets accepted as collateral. The level of transparency thus warranted is supported by the Open electronic limit order book market.

Diversification of Risks

Diversification of risks have a tremendous effect on bank's performance. A well-diversified bank can effectively channelize its cash flow from less efficient operations to the ones where diversification is most beneficial. Banks can thus mainly diversify on two broad parameters:

- **Geographically:** Geographically diversified banks have high annual stock returns than geographically focused banks. Also , this leads to an access to more capital markets which can stem a lower cost of funds due to a large deposit base. Banks may also achieve economies of scale via this route.
- **Activity:** Some banks diversify in terms of activities they undertake and diversify to include newer roles and peripherals.

Policy of risk-return trade-off

Risk-return trade-off means the amount of risk a bank can take while not getting uneasy with other investments. Risk as per the dictionary is the possibility of actual returns on investment being different than the expected returns. Risks are associated with low and high levels of uncertainty. A risk-return trade-off is successful if there is proper balance between the lowest possible risk and maximum possible return. Banks often resort to diversification to manage the trade-off between portfolio risk and return. They generally have diversified portfolios. Larger banks have multiple specialized business lines and small banks have a higher ratio of marketable securities.

Credit Creation

Concept of credit creation

Credit is created by commercial banks in two ways- advancing loans and by purchasing securities.

- Banks maintain some part of deposits as liquid cash termed as cash reserve. This is in minimum requirement as specified by RBI. The excess or surplus is given out as loans and advances.
- When giving a loan, banks open deposit account in the name of the borrower. This is known as secondary or derivative deposit.
- The deposit left after giving out loans is known as credit multiplier. Thus, credit is created from secondary deposits.
- Credit multiplier indicates the number of times primary deposits are multiplies and is the

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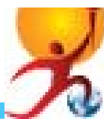

inverse of CRR.

- Thus, the entire process of credit creation rests on the following assumptions:
- Banking system is fully developed
- Transactions are through cheques
- Excess of CRR is kept as cash
- Credit policy stays the same.

Merits and demerits of credit creation

Merits:

- Banks are able to diversify risks with the help of credit creation.
- The loans and advances are generally done from excess or surplus reserves.
- This money which is lying passive joins the active process of credit creation

Demerits

Banks have to face a lot of limitations for successful credit creation.

- It is directly dependent on the volume of excess reserves available with the banks.
- CRR-the minimum cash limit of the bank which varies from 3-15%. Any increase in CRR leads to less credit.
- Risk-averse nature of customers which makes them keep some cash with them for emergencies while banks prefer giving more loans to keep credit creation going.
- Periods of economic recessions call for less loan demands from the customers.

Different types of credits

The need for credit comes from demand and supply side of the economy. The consumers of demand side require credit to acquire simple assets like consumer durables. The demand for credit from supply side corporate houses arises due to their needs for long-term investments. Types of loans:

Commercial loans: Loans which are given to supply side. These are given for 2 purposes:

1. For acquiring fixed assets
2. For maintaining the business

Individual loans: Loans which are given to demand side. These are given for 3 broad purposes:

1. Consumption
2. Acquiring durables

- Housing finance

Installment credit: Credit amount is decided in advance and the amount is disbursed either in stages or all at once. It is however, repaid in installments.

Operating credit: This is given to meet the daily credit requirements for operations. Banks decide

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the credit limit and provide a current account from which money can be withdrawn.

Receivable finance: Credit is in form of bills of finance.

Types of Loans

There are various types of loans or advances, which can be divided on the basis of different sets of criteria. They include non-fund based / fund based loans; secured / unsecured loans; term / demand loans; personal / commercial loans; working capital / project finance; priority sector loans; MSME credit; rural / agricultural loans, retail loans etc.

Non-fund based lending and fund based lending

The Fund based lending is direct form of loans on which actual cash is given to the borrower by the bank. Such loan is backed by primary and / or a collateral security.

In Non-fund based lending, bank does not make any funds outlay but only gives assurance. The "letter of credit" and "bank guarantees" fall into the category of non-funding loans. The non-funding loan can be converted to a fund-based advance if the client fails to fulfill the term of contract with the counterparty. In banking language, the non-funding advances are called Contingent Liability of the banks.

Secured loan and unsecured loan

In the secured loans, the borrower has to pledge some assets (such as property) as collateral. Most common secured loan is Mortgage loan in which people mortgage their property or asset to get loans. Other examples are Gold Loan, Car Loan, Housing loan etc. In unsecured loans, the borrowers assets are not pledged as collateral. Examples of such loans are personal loans, education loans, credit cards etc. They are given out on the basis of credit worthiness of the borrowers. We note here that the interest rates on unsecured loans is higher than the secured loans. This is mainly because the options for recourse for lender in case of unsecured loans are limited.

Term Loans and Demand Loans

The commercial banks provide loans of both short term (short term credit), Medium and long term. Short term loans are those loans whose tenure is less than one year. Medium term tenure is between 1 to 3 years and long term is above 3 years. However, In case of agriculture loans, there are three types of loans viz. Short term (tenure <15 months), medium term (tenure 15 months to 5 years) and long terms (tenure > 5 years). The demand loans are the loans which can be recalled by bank on demand at any time. The above info is presented in the below table:

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Loan Term	Farm Loans	Other loans
Short term	Less than 1 year	Less than 15 months
Medium term	1 to 3 years	15 months to 5 years
Long Term	Above 3 years	More than 5 years

Personal loans and Commercial loans

If the debtor is an individual person (consumer) or a business; it is called personal loan or consumer loan. Common examples of personal loans are mortgage loans, car loans, credit cards, educational loan etc. The credit worthiness (or credit score) of the debtor is major criteria for banks to impart such loan facility. Commercial loans include commercial mortgages and corporate bonds. The credit rating of commercial organizations is one criterion for availing such loans.

Working Capital Finance and Project finance

If the loan amount is used for operating purposes of the business, and its utilization results in the creation of the current assets; it is called Working Capital finance. To provide such loans, the lending banks carry out detailed analysis of the borrowers' working capital requirements and then fix the credit limits. Normally, this loan is a secured loan and the working capital finance is primarily secured by the inventories and receivables of the business. The common examples of Working capital finance include Cash Credit Facility and Bill Discounting. On the other hand, project finance mainly refers to extending the medium-term and long-term rupee and foreign currency loans to the manufacturing and infrastructure sectors. Various tools of project finance include Share capital, Term loan, Debenture capital etc. Difference in Cash Credit and Overdraft

MSME Credit

Banks grant a substantial amount of loans to the micro, small and medium enterprises (SMEs) as a part of Priority sector. Banks usually follow the cluster based approach while sanctioning such loans. This sector plays very important role in the economy and given its importance, RBI has taken several measures to increase flow of institutional credit to this segment. The Small Industries Development Bank of India (SIDBI) also facilitates the flow of credit to MSME sector at reasonable rates.

Retail Loans

The banks offer an array of various retail loan products such as home loans, automobile loans, personal loans (such as loans for marriage, medical expenses etc.), credit cards, consumer loans (for TV sets, personal computers etc) and loans against time deposits and loans against shares. All of them come under the umbrella of retail loans. The target market for retails loans are the consumers in the middle and high income segment, salaried or self employed. Banks participate in the credit scoring programme to judge the credit worthiness of individuals. While granting such loans, banks

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use reports from agencies such as the Credit Information Bureau (India) Limited (CIBIL).

Factors that should be considered before granting loans to corporate houses

Banks have to weigh many factors before extending credit to large corporate houses. These are involved in legal activity with the sole purpose of making profit. Various factors which banks consider are as follows:

- Banks extend loans to corporate houses based on their balance sheets, length of their cash cycle and the products available with the banks.
- Banks also study audited balance sheets to study the needs and capacity to absorb credit.
- The borrowers are required to provide their financial details in the form of CMA data to the bankers and file a formal loan application.
- The banks offer many types of loans to the corporate clients depending on their needs. They are of two types: Short-term finance (for daily, seasonal and temporary working capital needs) and Long-term finance (to meet costs of acquisition of fixed assets).

General modes for securing advances

Advances are secured by attaching a tangible security against which the loan is granted. These securities are of two types:

- Primary security: The one against which the loan is given.
- Collateral security: It is given in addition to the existing primary security.

The securities maybe movable or fixed and thus the charges on them also varies accordingly. The charge on movable properties is levied in five different ways. They are:

- Pledge: It is a contract in which the possession of the goods goes to the lender for giving credit to the borrower.
- Hypothecation: It is another way of charging a security in which the possession of goods lies with the borrower. Hypothecation has to be registered under Section 125 of the Companies Act.
- Assignment: It is charge created on assets like receivables and debtors.
- Banker's lien: It is a general lien under Section 171 of Contract Act, 1872.
- Mortgage: It is known as transfer of interest especially in a fixed asset to secure debt.

Precautions to be taken while granting advances against security of goods

Secured advances involve the security of a tangible asset against which the lender gives loans. The borrower deposits goods as security for a loan. As in a pledge, banks who are the lenders take the possession of the goods to extend the credit to the borrower.

- Banks should maintain a reasonable difference between the value of goods and the amount of credit permitted and the latter should be less than the former.

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- Banks should ensure that the goods are withdrawn with its prior approval.
- Banks have to also ensure that any additions and withdrawals from the pledged security happens with the bank's permission.
- In case of a mortgage, the banks should carefully spell out the conditions of the mortgage.

Procedure adopted by the bank for loan appraisal and disbursal

Banks have to analyze the loan profiles of the borrowers from many angles.

- Banks have to conduct an initial appraisal to approve the loan. It takes care of the technological, financial, managerial and market analysis of the borrower.
- Banks then have to take a call on the way of financing which will best suit the client.
- A bank is required to know the details of the cash requirements of the borrower and the type of advance will suit his requirement.
- Final decisions comprises the way the funds will be dispensed i.e. whether in a lump-sum amount or in instalments.

Loan administration and loan pricing

Loan administration and pricing is highly essential for effective lending.

- Loan officers should know their roles and powers. High sanctioning powers of loan officers generally leads to the increase in risk of the banks.
- Bank's loan policy should clearly define the sanctioning powers of the loan officers regarding the credit limit.
- Loan pricing in turn should effectively utilise the surplus funds with the banks which both covers the costs of the bank and also leaves a margin for the bank.
- Banks should have three main objectives in loan pricing:

1. Maintain margins
2. Balance risk and rewards

- Ensure market rates

NPAs

The assets of the banks which don't perform (that is – don't bring any return) are called Non Performing Assets or bad loans. Bank's assets are the loans and advances given to customers. If customers don't pay either interest or part of principal or both, the loan turns into bad loan.

How NPA is defined?

According to RBI, terms loans on which interest or installment of principal remain overdue for a period of more than 90 days from the end of a particular quarter is called a Non-performing Asset. However, in terms of Agriculture / Farm Loans; the NPA is defined as under:

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- For short duration crop agriculture loans such as paddy, Jowar, Bajra etc. if the loan (installment / interest) is not paid for 2 crop seasons , it would be termed as a NPA.
- For Long Duration Crops, the above would be 1 Crop season from the due date.

Standard Asset

If the borrower regularly pays his dues regularly and on time; bank will call such loan as its "Standard Asset". As per the norms, banks have to make a general provision of 0.40% for all loans and advances except that given towards agriculture and small and medium enterprise (SME) sector.

However, if things go wrong and loans turn into bad loans, the PCR (Provision Coverage Ratio[1]) would increase depending up the classification of the NPA.

Special Mention Account

Banks are required to classify nonperforming assets further into three main categories (Sub-standard, doubtful and loss) based on the period for which the asset has remained non performing. This is as per transition of a loan from standard loan to loss asset as follows:

- If the borrower does not pay dues for 90 days after end of a quarter; the loan becomes an NPA and it is termed as "**Special Mention Account**".

Sub-standard Account

- If a loan remains Special Mention Account for a period less than or equal to 12 months; it is termed as **Sub-standard Asset**. In this case, bank has to make provisioning as follows:
    - 15% of outstanding amount in case of Secured loans
    - 25% of outstanding amount in case of Unsecured loans

Doubtful Asset

- If sub-standard asset remains so for a period of 12 more months; it would be termed as "Doubtful asset". This remains so till end of 3rd year. In this case, the bank need to make provisioning as follows:
    - Up to one year: 25% of outstanding amount in case of Secured loans; 100% of outstanding amount in case of Unsecured loans
    - 1-3 years: 40% of outstanding amount in case of Secured loans; 100% of outstanding amount in case of Unsecured loans
    - more than 3 years: 100% of outstanding amount in case of Secured loans; 100% of outstanding amount in case of Unsecured loans

Loss Asset

- If the loan is not repaid even after it remains sub-standard asset for more than 3 years, it may be identified as unrecoverable by internal / external audit and it would be called loss asset. An NPA can declared loss only if it has been identified to be so by internal or external auditors.

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Impact of Implications of the NPAs on Banks

The most important implication of the NPA is that a bank can neither credit the income nor debit to loss, unless either recovered or identified as loss. If a borrower has multiple accounts, all accounts would be considered NPA if one account becomes NPA.

Difference between Gross NPA and Net NPA

The NPA may be Gross NPA or Net NPA. In simple words, Gross NPA is the amount which is outstanding in the books, regardless of any interest recorded and debited. However, Net NPA is Gross NPA less interest debited to borrowal account and not recovered or recognized as income. RBI has prescribed a formula for deciding the Gross NPA and Net NPA.

How SARFAESI Act helps to recover NPAs?

The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act has provisions for the banks to take legal recourse to recover their dues. When a borrower makes any default in repayment and his account is classified as NPA; the secured creditor has to issue notice to the borrower giving him 60 days to pay his dues. If the dues are not paid, the bank can take possession of the assets and can also give it on lease or sell it; as per provisions of the SAFAESI Act.

Asset Reconstruction Companies

If a bad loan remains NPA for at least two years, the bank can also resale the same to the**Asset Reconstruction Companies** such as Asset Reconstruction Company (India) (ARCIL). These sales are only on Cash Basis and the purchasing bank/ company would have to keep the accounts for at least 15 months before it sells to other bank. They purchase such loans on low amounts and try to recover as much as possible from the defaulters. Their revenue is difference between the purchased amount and recovered amount.

Wilful default

Willful default means that a party does not make loan repayment out of its will. There are four conditions when it is assumed that the default is a willful default:

- When a borrower defaults despite his capacity to repay
- When a borrower defaults but diverts finance away from the purpose it was availed for.
- The funds are available in the other form of assets but party does not make payment.
- Party disposed off the removable assets / immovable property which was used for thr purpose of secured loan, without knowledge of the bank.

The SS Kohli Committee had recommended some penal measures against the willful defaults. Some of them are as follows:

- The willful defaulters are not able to access the markets, so a copy of the list of the willful

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defaulters are shared by the RBI to SEBI.

- No facility is provided by a Bank / FI to a willful defaulter till 5 years from the date of publishing its name in the list of willful defaulters.
- Expeditious legal action is initiated against for the recovery of the amount.

The banks and FIs are required to compile the list of the suit filed willful defaulters and submit the same to the Credit Information Bureau of India Ltd. every quarter, provided the outstanding amount is Rs. 25 Lakh or more.

NPA and Provision Coverage Ratio

For every loan given out, the banks to keep aside some extra funds to cover up losses if something goes wrong with those loans. This is called provisioning.**Provisioning Coverage Ratio** (PCR) refers to the funds to be set aside by the banks as fraction to the loans.

- PCR is the ratio of provision to gross non-performing assets (NPAs).
- A key relationship in analyzing asset quality of the bank.
- A measure that indicates the extent to which the bank has provided against the troubled part of its loan portfolio.
- A high ratio suggests that additional provisions to be made by the bank in the coming years would be relatively low (if gross NPAs do not rise at a faster clip).
- Thus, PCR refers to the percentage of the loan amount that the bank has set aside as provisions to meet an eventuality where the loan might have to be written off it becomes irrecoverable.
- It is a measure that indicates the extent to which the bank has provided (set aside money to bear the loss) against the troubled part of its loan portfolio.
- PCR = Cumulative provisions / Gross NPAs

Thus, more the NPAs lesser will be the PCR. Kindly note that till 2011, the RBI had mandated the banks to keep a 70% PCR. This implied that more they had NPAs, more they needed to keep aside additional funds to cover up the losses. The requirement was withdrawn by RBI on the ground that such requirement would wipe out their quarterly profits.

Priority Sector Lending

Priority sector was first properly defined in 1972, after the**National Credit Council** emphasized that there should be a larger involvement of the commercial banks in the priority sector. The sector was then defined by Dr. K S Krishnaswamy Committee. The priority sectors include those sectors which may not get adequate institutional credit due to social, cultural and economic reasons.

Common priority sectors include Agriculture Finance, Small Enterprises, Retail Trade, Micro Credit,

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Education Loans and housing loans.

Sectors that come under Priority Sectors

As per Reserve Bank of India, Priority sector includes the following:

- Agriculture and Allied Activities viz. dairy, fishery, animal husbandry, poultry, bee-keeping and sericulture.
- Small scale industries (including setting up of industrial estates)
- Small road and water transport operators (owning up to 10 vehicles).
- Small business (Original cost of equipment used for business not to exceed 20 lakh)
- Retail trade (advances to private retail traders up to 10 lakh)
- Professional and self-employed persons (borrowing limit not exceeding 10 lakh of which not more than Rs.2 lakh for working capital; in the case of qualified medical practitioners setting up practice in rural areas, the limits are Rs.15 lakh and Rs.3 lakh respectively and purchase of one motor vehicle within these limits can be included under priority sector)
- State sponsored organizations for Scheduled Castes/Scheduled Tribes
- Education (educational loans granted to individuals by banks)
- Housing [both direct and indirect – loans up to 5 Lakhs (direct loans up to Rs 10 lakh in urban/ metropolitan areas), Loans up to Rs.1 lakh and Rs.2 lakh for repairing of houses in rural/ semi-urban and urban areas respectively].
- Consumption loans (under the consumption credit scheme for weaker sections)
- Micro-credit provided by banks either directly or through any intermediary; Loans to self help groups(SHGs) / Non Governmental Organizations (NGOs) for on lending to SHGs
- Loans to thesoftware industry (having credit limit not exceeding Rs 1 crore from the banking system)
- Loans to specified industries in the food and agro-processing sector having investment in plant and machinery up to Rs 5 crore.
- Investment by banks inventure capital (venture capital funds/ companies registered with SEBI)

Priority Sector Targets

In 1974, the banks were given a target of**33.33 %** as share of the priority sector in the total bank credit. On the basis of Dr. K S Krishnaswamy committee, the target was raised to 40%. The current Priority sector targets are as follows:

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Priority Sector Targets		
Categories	Domestic commercial banks / Foreign banks with 20 and above branches	Foreign banks with less than 20 branches
Total Priority Sector	40	32
Total agriculture	18	No specific target
Weaker Sections	10	No specific target

Why RBI imposes the Priority Sector Targets?

The overall objective of priority sector lending program is to ensure that adequate institutional credit flows into some of the vulnerable sectors of the economy, which may not be attractive for the banks from the point of view of profitability.

Priority Sector lending in India has been made a salient feature of the banking in India mainly due to the social and economic objectives that underlie PSL. However, banks are also required to keep certain amount to maintain Statutory Liquidity Ratio (SLR) and from the remaining disposable amount, 40 per cent is dedicated for the priority sector. Thus, large fraction of banks' resources cause the so called "Double Repression" on the banking system. The economic survey has brought this issue to the forefront and has recommended the government to re-structure SLR and Priority Sector Lending.

[1] For every loan given out, the banks to keep aside some extra funds to cover up losses if something goes wrong with those loans. This is called provisioning.

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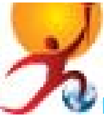

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General Knowledge Today

Banking & Finance-4: Cards, Negotiable Instruments, Basel-III

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Banking & Finance-4: Cards, Negotiable Instruments, Basel-III

This document is mainly for Preliminary examination and covers the topics objectively. This content is also useful for some of you who might be appearing in Banking Examinations as well.

Prelims MCQ Topics
Debit Cards vs. Credit Cards, Kisan Credit Card, Micro Credit, Negotiable instruments, Promissory Note, Bill of Exchange, Cheques, CTS2010, Demand Draft, Basel, Capital Adequacy, Tier-1 and Tier-II capital.

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Part-I : Debit Cards, Credit Cards

Debit Cards / Credit Cards

Debit Card

A **debit card** is a plastic card that provides a cardholder electronic access to his / her bank account. It can be used to withdraw funds or to make purchases using money in the bank account. Since a debit card is essentially linked to a checking account (saving / current), it is also known as a Checking Card. A balance in the checking account is must for the use of debit card.

Credit card allows its holder to buy goods and services based on the holder's promise to pay for these goods and services.

Credit Card

A credit card is a payment card which allows the cardholder to pay for goods and services on the basis of **line of credit** granted to him / her by the issuing bank. A credit card essentially creates a revolving account from which cardholder can borrow money for payment to merchant (and also withdraw cash). A credit card is not linked to a bank account but is linked to the bank / financial institution which has issued it.

First Credit Card of the world

The use of Credit Card first started in 1920s in United States of America for selling the fuel to the automobile owners. Later, it reached the customers when when Diners Club was launched in early 1950s. In 1958, the Bank of America issued the BankAmericard in the California state and this is known to be the first successful modern credit card.

Differences between Debit Card and Credit Card

- A debit card is like an electronic cheque book, which is linked to the account of cardholder. Balance in the account is essential to use debit card. Credit cards give a line of credit to the cardholders and they don't need a linked bank account. Credit Card payment is like a loan which needs to be paid back within a fixed period (such as 30 days).
- There is no monthly bills to be paid on debit cards. In case of Credit cards, monthly bills need to be paid by the customer. Late payments are charged a high interest.
- Obtaining the debit card is quite easy. Now a days, most banks provide Debit cards to checking account holders. After the RBI guidelines in 2005; obtaining a Credit Card has become difficult and it depends on many factors including credit score of the applicant.
- The Credit worthiness of the account holder plays no role in case of Debit Cards. The limit of usage is dependent on the balance in linked account. However, in case of credit cards, the limit of usage or credit line may increase or decrease depending on cardholder's

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creditworthiness. This limit is set by the card issuer.

- Debit Card payments invite no interest charges; Credit card loans have one of the highest interest rates.

Major players in the Credit Card transactions

There are several players in the working of credit card / debit cards.

- The **cardholder**is the authorized user of a credit or debit card.
- **Merchant**or **Point of sale** is any business entity that is authorized to accept cards for the payment of goods and services; it can be a brick and mortar shop or a website.
- **Merchant Bank or Acquirer** is a financial institution that provides card processing services to the merchant.
- **Card Issuer** is a financial institution that issues payment cards and contracts with its cardholders for billing and payment of transactions.
- Further, there is a Credit Card Network orAssociation, which is a membership organization of financial institutions that issue payment cards and/or sign merchants to accept such cards for payment of goods and services. There are two Credit Card Associations – Visa's and MasterCard.

How Credit Card transaction works?

The process can be divided into two parts viz. authorization and Clearing & Settlement.

Authorization

A credit card holder finalizes the goods to be bought and presents his card to the merchant. Merchant processes the card and while processing it seeks authorization from the Merchant Bank giving it information on transaction information. Merchant Bank submits the authorization request to Credit Card Network (MasterCard or VISA). Credit Card Network sends the request to the Card Issuer which is ICICI bank. Card Issuer either approves or declines the transaction. If it authorizes, the Credit Card Network forwards this authorization to merchant bank. Merchant bank forwards this response to the Merchant and Merchant once receiving this authorization completes the transaction.

Clearing and Settlement

The merchant deposits the transaction receipt with the merchant bank, which credits the Merchant's account and submits this transaction to Credit Card Network for settlement. Credit card Network pays the Merchant Bank and debits the account of Card Issuer. The Card Issuer posts the transaction to the account of Card holder. The cardholder received monthly statement from the Issuer. The Cardholder pays as per the conditions.

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Size of the Credit Card

ISO/IEC 7810 is the international standard which defines the shape and size of the I-Cards. In most countries, it defines ATM cards, credit cards, debit cards etc. as ID-1 which corresponds to 85.60×53.98 mm.

Swipe Card

Swipe card or magstripe or Magnetic stripe card has a band of magnetic material on the card and is capable of storing data. It was first developed by IBM for a US Government security system. IBM engineer Forrest Parry is known to have discovered Swipe Card, thanks to his wife (search Google). The data on the strips can be read by the most point-of-sale hardware.

Credit Card Number

The Credit Card numbers are governed by the **ISO/IEC 7812** which is a numbering system for the identification of issuers of cards that require an issuer identification number (IIN) to operate in international, inter-industry and/or intra-industry interchange. The Length of the number is from 14 to 19. The first 6 digits are known as the Issuer Identification Number (IIN). Out of them, the first 2 or more digits identify the Card network. For example- The card number that begins with 34, 35, 36 or 37 is an American Express Card; another which begins with 51,52,53,54 or 55 is a MasterCard and the number which becomes with 4 is a Visa card.

National Payments Corporation of India's (NPCI)

National Payments Corporation of India's (NPCI) was established in 2008 and is being promoted by State Bank of India, Punjab National Bank, Canara Bank, Bank of Baroda, Union Bank of India, Bank of India, ICICI Bank, HDFC Bank, Citibank and HSBC. NPCI is an umbrella organization for all retail payment systems in the country owned and operated by banks. Its National Financial Switch (NFS) is linked to 61702 ATMs (September 2010). The relevant data is released by NPCI.

Cumulative monthly transaction volumes recorded by the National Payments Corporation of India's (NPCI) crossed the 10-crore mark for the first time in August 2010. The Switch recorded 7.32 crore ATM transactions in July 2010.

Floor Limit and Card Limit

Floor limit is the discretion to the merchant establishment up to which it can accept the card for payment. The Card limit is the limit up to which a holder can use the card. This is restored on making the previous payments.

Hot Card v/s Hot List

A hot card is a lost or stolen card. A hot list is the list of caution against the use of a credit card by a defaulter holder.

Common Credit Card Grievances

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Some of the most common issues with the Credit Cards pertain to the late statements, harassment by the issuer, incorrect bills and cards issued without intimating the customer. The delayed payments attract an interest penalty of 2.95% of the billed amount but if the customer received the bill late, he/ she is not able to make a timely payment. In many cases, the banks executives call the customer on the pretext of increased the credit limit and try to sell other products. Sometimes, the time made payment also is charged a penalty, due to errors and omissions causing the complaints of the incorrect billing. Further, prior to the stringent action of RBI, the customers were issued credit cards without even asking for it.

RBI guidelines on Credit Card Business

To regulate credit/ATM/debit card businesses RBI constituted a 'Working Group on Regulatory Mechanism for Cards' and on the recommendation of this group, notified guidelines for card issuers laying down their duties and obligations. The salient features of the RBI guidelines, which came into effect on November 30, 2005, are as follows:

- All credit card issuers should provide Most Important Terms and Conditions (MITCs) to customers/prospective customers. MITCs should include information like joining fee, annual membership fee, cash advance fee, service charges for certain transactions, interest free grace period (illustrated with examples), finance charges for revolving credit and cash advances, overdue interest charges and charges in case of default.
- MITCs should be in Arial-12 points and not in fonts that are difficult to read with the naked eye.
- Card issuers should quote annualised percentage rate on card products (separately for retail purchase and cash advance).
- Card issuers should not provide unsolicited cards, loans and any other credit facilities or unilaterally increase credit limits. Card issuing banks/non-banking financial companies (NBFCs) should maintain Do Not Call Registries containing phone numbers of customers and non-customers who have informed them that they do not wish to receive unsolicited calls/SMSes for marketing of credit card products.
- Card issuing banks/NBFCs would be responsible as the principal for all acts of omission or commission of their agents (direct sales agents/direct marketing agents and recovery agents).
- Card issuers should follow RBI's Fair Practice Code for Lenders and Indian Banks Association's Code for Collection of Dues and Repossession of Security.

Further, the RBI guidelines provide that a customer, who fails to get a satisfactory response from a card issuer within 30 days of lodging of complaint may approach the concerned Banking

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Ombudsman for redressal of grievances before the expiry of one-year period from the date of receipt of reply from the bank or 13 months from the date of representation to the bank. Currently, there are 15 Banking Ombudsmen located in different state capitals who try to resolve complaints of customers through a process of conciliation or mediation.

Kisan Credit Card

Kisan Credit Card scheme was introduced by NDA Government in August 1998 with the aim to provide adequate and timely short-term credit needs of farmers during the cropping season. It was first proposed in the Budget 1998-99 by then Finance Minister Yashwant Sinha.
NABARD had prepared a Model Kisan Credit Card Scheme in consultation with the Major Banks on the basis of R V Gupta Committee.

Objective & Rationale Behind Kisan Credit Card Scheme

Due to lack of awareness among farmers and unnecessary delays, cumbersome procedure and improper practices adopted by institutional lending agencies; a large number of Farmers heavily depend on non-institutional sources of credit for their frequent needs to purchase farm inputs such as seeds, fertilizers, pesticides etc. The non-institutional credit is not only expensive but also counter-productive. The Kisan Credit Card scheme was launched to provide adequate, timely and cost effective institutional credit from the banking system to the farmers for their cultivation needs. Farmers can not only purchase inputs but also can withdraw cash from this credit card for their input needs.

How Kisan Credit Card Scheme works?

Kisan Credit Cards are issued to the farmers on the basis of their land holdings and other criteria such as timely payment of past credits etc. Farmers covered under the Kisan Credit Card scheme are issued with a credit card and a pass book or a credit card cum pass book incorporating the name, address, particulars of land holding, borrowing limit, validity period, a passport size photograph of holder etc., which may serve both as an identity card and facilitate recording of transactions on an ongoing basis.

Loans provided under Kisan Credit Card Scheme

The Kisan Credit Card scheme is implemented by public sector commercial banks, RRBs and cooperative banks. It was launched to provides short term loans in the form of production credit. However, later its scope was extended to term loans for agriculture and allied activities and reasonable component for consumption loan. Thus, currently this scheme provides:

- Production credit
- Working capital requirements for allied activities

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- Ancillary credit requirements related to crop production
- Contingent needs and
- Accidental insurance of KCC borrowers.

Crop loans disbursed under KCC scheme for notified crops are covered under National Crop Insurance scheme. The purpose of the scheme is to protect the interest of farmers against crop loss caused by natural calamities, pest attacks etc.

Benefits of Kisan Credit Card Scheme?

- Simplifies disbursement procedures
- Removes rigidity regarding cash and kind
- No need to apply for a loan for every crop
- Assured availability of credit at any time enabling reduced interest burden for the farmer.
- Helps buy seeds, fertilizers at farmer's convenience and choice
- Helps buy on cash-avail discount from dealers
- Credit facility for 3 years – no need for seasonal appraisal
- Maximum credit limit based on agriculture income
- Any number of withdrawals subject to credit limit
- Repayment only after harvest
- Rate of interest as applicable to agriculture advance
- Security, margin and documentation norms as applicable to agricultural advance
- Access to adequate and timely credit to farmers
- Full year's credit requirement of the borrower taken care of.
- Minimum paper work and simplification of documentation for drawal of funds from the bank.
- Flexibility to draw cash and buy inputs.
- Assured availability of credit at any time enabling reduced interest burden for the farmer.
- Flexibility of drawals from a branch other than the issuing branch at the discretion of the bank.

Key Features of Kisan Credit Card Scheme?

- Farmers eligible for production credit of Rs. 5000 or more are eligible for issue of Kisan Credit Card.
- Eligible farmers to be provided with a Kisan Credit Card and a pass book or card-cum-pass book.
- Revolving cash credit facility involving any number of drawls and repayments within the limit.

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- Limit to be fixed on the basis of operational land holding, cropping pattern and scale of finance.
- Entire production credit needs for full year plus ancillary activities related to crop production to be considered while fixing limit.
- Sub-limits may be fixed at the discretion of banks.
- Card valid for 3 years subject to annual review. As incentive for good performance, credit limits could be enhanced to take care of increase in costs, change in cropping pattern, etc.
- Each drawals to be repaid within a maximum period of 12 months.
- Conversion/re-scheduling of loans also permissible in case of damage to crops due to natural calamities.
- Security, margin, rate of interest, etc. as per RBI norms.
- Operations may be through issuing branch (and also PACS in the case of Cooperative Banks) through other designated branches at the discretion of bank.
- Withdrawals through slips/cheques accompanied by card and passbook.

Benefits to Banks under KCC scheme

- Reduction in work load for branch staff by avoidance of repeat appraisal and processing of loan papers under Kisan Credit Card Scheme.
- Minimum paper work and simplification of documentation for drawal of funds from the bank.
- Improvement in recycling of funds and better recovery of loans.
- Reduction in transaction cost to the banks.
- Better Banker – Client relationships.

Insurance facility under KCC scheme

Kisan Credit Card holders are covered by a personal accident insurance. This cover is available when the person enters the scheme. The cover is as follows:

- Death : Rs. 50,000
- Disability: Rs. 25000
- Maximum Age to enter : 70 years

Loan disbursement

Under KCC scheme, the loan amount is disbursed in cash through drawings made via withdrawal slips accompanied by KCC-cum-passbook. Cheque books are also issued to literate KCC holders enjoying KCC limit of Rs. 25000 and above.

Interest and other charges on Kisan Credit Cards

The interest rates on Kisan Credit Cards varies from bank to bank and also on borrowing limits.

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Generally, 9% per annum interest rate is charged for KCC borrowing limit up to Rs. 3 Lakh. However, central government provides interest subvention to the financing institutions. If the track record of the card holder is good; a further 2% interest subsidy is provided. After three years sound track record, a card holder can also get the credit limit enhanced.

Apart from that there are some overhead costs for borrowing under KCC. These include processing fee, charges on land mortgage deed, passport photo charges, insurance premium etc.

Micro Credit

Microcredit refers to the small credit (Below Rs. 50,000) given to poor by banks via SHGs (Self Help Groups) or JLGs (Joint Liability Groups) mechanism or by a NBFC (Non Banking Financial Company) or MFI Microfinance Institution. Reserve bank of India encourages the commercial banks to expand the coverage of micro finance in India.

The target market of the Micro Credit Institutions includes those individuals who lack collateral, steady employment and a verifiable credit history and therefore cannot meet even the most minimal qualifications to gain access to institutional credit. These include artisans, tiny and small industries, grocers, vegetable vendors, rickshaw pullers, roadside retailers and persons engaged in activities such as small farming, poultry, cattle rearing, piggery, fishery etc.

Microcredit is a part of microfinance. The term Microfinance is used for the provision of a wider range of financial services to the very poor. The United Nations declared 2005 the International Year of Microcredit.

Origin of the concept

The innovative idea of Microcredit originated in 1970s with the Grameen Bank in Bangladesh. The Grameen Bank is a microfinance organization of Bangladesh. Its founder Professor Muhammad Yunus launched a research project in 1976 to examine the possibility of designing a credit delivery system to provide banking services targeted to the rural poor. This bank successfully enabled extremely impoverished people to engage in self-employment projects that allow them to generate an income and, in many cases, begin to build wealth and exit poverty. Due to its achievements, the bank and its founder were jointly awarded Novel Prize in 2006.

Self Help Group

A Self-Help Group (SHG) is a registered or unregistered group of micro entrepreneurs belonging to homogenous social and economic background. They come together voluntarily to save small amounts regularly and contribute to a common fund to meet their emergency needs on mutual help basis. They are able to ensure proper end use of the credit and timely repayment on the basis of collective wisdom and peer pressure.

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SHG provides strength to an economically poor individual as part of a group. Financing through SHGs reduces transaction costs for both lenders and borrowers.

Lenders have to handle only a single SHG account instead of a large number of small-sized individual accounts, borrowers as part of a SHG cut down expenses on travel (to & from the branch and other places) for completing paper work and on the loss of workdays in canvassing for loans.

History of micro credit in India

Prior to the nationalization of banks in 1969, most of the small loan was given out by cooperative banks only. Commercial banks were not easily accessible to small borrowers. Those were the days of security-oriented approach and nobody could think of a loan, big or small, without a guarantor or mortgage of immovable property.

Nationalization changed the picture and the nationalized banks opened branches in the remotest corners of the country. They were to implement various government schemes such as Twenty Point Program, Antodaya, subsidized differentiated rate of interest loan etc.

SHG-Bank Linkage Programme

In 1991-92, NABARD had launched a pilot project to provide micro-credit. In this project, it was envisaged to provide micro-credit by linking SHGs with banks. This is called SHG-Bank linkage Programme. RBI had then advised commercial banks to actively participate in this linkage programme. The scheme was later extended to RRBs and co-operative banks.

Objective of this programme was to make it possible facilitating smoother and more meaningful banking for poor. This programme envisaged several models of linkages. For example:

- SHGs were directly linked to Banks without any NGO facilitation.
- SHGs were linked to banks with facilitation by NGOs and other formal agencies.
- NGO working as a facilitator and financing agency for the SHGs.

NGO's undertake social intermediation like organizing SHGs of micro entrepreneurs. They entrust them to banks for credit linkage or financial intermediation like borrowing bulk funds from banks for on-lending to SHGs.

Who provides Microcredit?

- Domestic Commercial Banks: Public Sector Banks; Private Sector Banks & Local Area Banks
- Regional Rural Banks
- Co-operative Banks
- Co-operative Societies
- Registered NBFCs
- Unregistered NBFCs
- Other providers like Societies, Trusts, etc.

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Are there any targets fixed by RBI?

No. For microcredit, there are no fixed targets and banks are free to formulate their own models. Banks are also free to design their products for promotion of microfinance. However, banks have been asked by the RBI to devise and integrate the microcredit plans in their block level, district level and state level credit plans

Banks are free to choose intermediaries, suitable branches, pockets, areas for implementation of microcredit programme. They are also free to devise appropriate lending and saving products. However banks have been instructed to include micro credit, in their branch, block and district & state credit plans. This has to be reviewed on quarterly basis.

Major problems with Micro-Credit

Despite of all these measures the performance of micro finance in India has neither been quite satisfactory quantitatively nor qualitatively. The money disbursed has not been adequate, nor has it yielded the desired results. Instead of being recycled, the major portions of loans have been lost as bad debt.

Micro Finance Development Fund

A Rs. 100 Crore Micro Finance Development Fund was created within NABARD in 2001 to impart training and exposure to SHGs, NGOs, Banks etc. for micro-finance.

Part-II: Negotiable Instruments

Introduction to NI Act

Negotiability means transfer of an instrument from a person / entity to another person / entity. The transfer should be without restriction and in good faith. As per section 13 of the Negotiable Instruments Act, 1881, a negotiable instrument means a promissory note , bill of exchange or a cheque , payable either to order or to bearer. Kindly note that a Currency Note is**not** a negotiable instrument as per section 21 of the Indian Currency Act .

Negotiable instruments covered under NI Act

Negotiable Instruments Act 1881 had been passed in 1882 and was modified in 1989 and 2002, as some more sections were added into the age old law. This act is applicable in entire India , including Jammu & Kashmir. J & K was brought in the ambit of the act in 1956. The act has provisions of Negotiable Instruments such as Promissory Notes, Checks, Drafts , Bills of exchanges etc. There are 147 different sections in this act. Initially it did not have provisions regarding the Demand Draft, which were later inserted by amendment. Key sections of this act are as follows:

- Section 4 deals with promissory notes
- Section 5 deals with Bill of Exchange

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- Section 6 deals with Cheque
- Section 9 deals with holder and holder in Due course.
- Section 15 deals with Endorsements
- Various other sections such as 123-131 deal with crossing of cheques.

Holder versus Holder in Due Course

Holder is the person who is entitled in his own name to the possession of a negotiable instrument. Normally a payee or endorsee is a holder.

- **Please note that holder may be or may not be with possession of the Instrument**.
- If the payee or endorsee dies, then the legal heir is the holder .
- If there is a forged endorsement then , last endorsee is the holder.
- If it is a bearer cheque, the person in whose name it is made is a holder.
- If it is damaged the payee or last endorsee is the holder.
- If it is stolen, then also payee or last endorsee is holder because a thief cannot become holder.
- The holder has the right to obtain a duplicate of instrument is lost.
- A holder can cross a cheque if it is not already crossed.

Holder in Due Course:

Holder in due course means a person who **must have the possession of the instrument**. This is the basic difference between the Holder and Holder in Due course.

- Holder in Due course must obtain the instrument in Good Faith.
- If the instrument bears not-negotiable crossing , then the NO person can be a holder in due course.
- If the instrument bears A/C payee crossing and restricted endorsement then NO person can be a holder in due course.
- Forgery / theft / deceit do not convey any title.

Promissory Note

PN means a paper with a writing which has a promise. But it does not mean that we write “I owe You” and it becomes a PN. When a person issues a promissory note, he/ she would have to stamp it as per the Indian Stamp Act and normally a revenue stamp is affixed on the PN signed by the promissory. Thus:

- PN is always in writing.
- PN has an unconditional undertaking called promise
- The promise is to pay money
- The money has to be paid to the certain person.

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As per section 4 of the Negotiable Instruments Act, 1881, an instrument in writing containing an unconditional undertaking signed by the maker, to pay a certain sum of money only to or to the order of a certain person or to the bearer of instrument is called Promissory note.

Different types of Promissory Notes

There are two types of the promissory notes viz. Demand Promissory Note or Usance Promissory Note. Demand Promissory Note has to be paid immediately on demand and Usance Promissory Note has to be paid after certain time period.

Parties are there to a Promissory note

There are two parties in the PN. The maker is who promises to pay and the payee is who is promised to pay.

Is Currency Note a promissory note?

Although currency Notes bear the following:

I promise to pay the bearer a sum of ________Rupee/ Rupees.

However , Currency notes are money and they don't fulfill the conditions of the Promissory note. The currency is excluded from NI act and governed by Indian Currency Act. So Currency notes are Not promissory Notes.

Bill of Exchange

BEO is a written negotiable Instrument which contains an unconditional order which is signed by the Maker; directs a certain person to pay; certain sum of Money only to, certain person or the bearer. Thus, while Promissory note has two parties, Bill of Exchange has three parties viz. **Drawer, Drawee** and **Payee.** Here drawer is the person who orders to pay; drawee is the person who is directed to pay; and payee is the person who is authorized to obtain a payment.

Under the NI Act, a minor (person of age less than 18 years) can be a Drawer but not a Drawee because he can not incur liability. Once the Drawee accepts the BOE, he becomes acceptor.

What is an Inland Bill of exchange? How it is different from Foreign Bill of Exchange?

A bill that is **drawn in India** and **paid in India or out of India**to a person, who is **in India,** whether **Indian or Foreigner, is** Inland Bill. Simply, a bill drawn in India and paid in India is a Inland Bill. A bill which is NOT drawn in India but is payable in India to a person, who is **in India and is Indian or a foreigner** is a Foreign Bill.

What is a Hundi?

Hundi is the Desi version of a bill of Exchange. They are used conventionally, not stamped and a vernacular language is written on them. They are still in use and are governed by local practices only.

- **Darshani Hundi** is akin to a Demand Promissory Note

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- **Miadi Hundi** is akin to a Usance Promissory Note
- **Khoka** is also a Hundi which refers to a bill of exchange that has been paid and canceled.

BOE , as per the NI act are charged at the rate of 18% per annum interest.

Cheque

A cheque is a bill of exchange in which one party (Drawee) is a Bank. So a Drawer (account Holder) draws the Cheque on the (Drawee bank) in the name of a Payee.

What if different amounts in words and figures are written on a cheque?

The Drawer has to write the amount in both in figures and words. If different values are written in Figures and words, the value of words can be paid as per section 18 NI act. If the amount is written in words only and NOT in figure than NO payment will be made because it would be Inchoate (incomplete).

Bearer cheque

Bearer cheque is payable to the bearer. Sometimes “Self” is written, that is also a bearer cheque payable to the account holder.

Antedated Cheque and a post dated cheque

If a check does not bear a date, it will be returned. The holder / bearer can fill a date , if there is no date written. If the date filled is a holiday, it can be paid only after that Holiday. If a person opens an account on November 10, 2010 and gives a check to somebody with date say October 25, 2010, **then it is Valid** and will be paid. This is called “Ante dated Cheque”. A post dated check can bear any date of future and the payment can be stopped.

Validity of a cheque

Normal validity is 3 months but can be restricted by the account holder. The check older than 3 months is called Stale Cheque and is NOT paid and will be returned. After the state Cheque is returned , it can be revalidated for any number of times and each time it becomes valid for next 3 months.

Crossing of Cheque

Crossing provides an additional security. Crossing means that sum of that cheque can only recovered from a specified banker and it will be credited to the holders account. The crossed cheques are not paid at the counter. Crossing is applicable in case of cheques only and not in case of Bill of Exchange or promissory notes.

- Crossing may be General crossing or Special crossing. General crossing (NI Act Section 123) is where a cheque bears two parallel lines with words such as a/c payee etc.
- In Special crossing (NI Act Section 124) the cheque bears the name of the banker also. Section 126 directs that such cheques shall be paid to the banker to whom it is crossed specially or to

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his agent for collection.

Endorsement

The section 15 of the Negotiable Instruments Act 1881 defines endorsing as "signing on the face or an instrument for the purpose of negotiating a negotiable instrument (such as Cheque)."

Endorsing is signing in the instrument either on face or on back, for the purpose of negotiation of a NI. The person who signs is called endorser. The person in whose favor the instrument has been transferred is called Endorsee.

- The holder of the instrument endorses the instrument.
- If he signs only and does not mention anything else it is called Blank Endorsement.
- If he endorses and adds a direction to pay the amount to a specified person it is called Endorsement in full.
- If he signs and adds direction for restriction on further negotiability, then it is called Restrictive Endorsement.
- Partial endorsement is NOT valid. This means that if Suresh issues you a check of Rs. 10000 and endorses on the backside of the check that "Pay Ramesh Rs. 5000" it is NOT a Valid endorsement. Again if Suresh issues you a check of Rs. 10000 and endorses with a direction that " Pay Ramesh when he passes his examination", this is again NOT a valid endorsement. Both these conditions are called partial endorsements.
- A minor is NOT a valid endorser.

Difference between a Crossed cheque and A/C Payee cheque

A person who signs the cheque and transfers the instrument is an endorser and in whose favor it is transferred is endorsee. The endorsee acquires a right to negotiate the instrument to anyone he / she likes. By making an endorsement the endorser promises that in case of dishonor, he / she provides a guarantee to compensate the holder.

Crossing a cheque by making two parallel lines with or without such words as ___& company is general crossing. Section 126 of the NI Act says that this is a direction to the bank to not to pay the cheque across the counter.

This crossed cheque is no more a bearer cheque where anyone can negotiate and get payment across the counter.

In case of a crossed cheque, the payee is free to make further endorsements.

For example , Ayesha receives a check from Rohan which has been crossed, Ayesha can get this payment in her account only and not across the counter. But in this case Ayesha is free to endorse the cheque in favor of Suresh and further Suresh is free to endorse the instrument in favor of Mukesh and so on…This means that crossing a cheque does not put restrictions on endorsements. In case the

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cheque gets dishonored, Mukesh can sue Suresh and Suresh can sue Ayesha and Ayesha can sue Rohan.

Now let's discuss A/C Payee cheques. The NI act does not talk about the A/C payee crossing. There is no definition of A/C payee crossing in the NI act and it is a child of banking practice. Making a cheque A/C Payee is a result of custom, use and practice and is now accepted legally.

But, the A/C payee cheque cannot be further endorsed. This means that if the cheque in the above example which is in favor of Ayesha bears "A/C Payee", payment can be collected in Ayesha's account only. The paying bank makes sure that amount is being credited to the account of the payee only

Cheque Truncation

The NI act was amended in 2002 and after that Cheque also means a Cheque in electronic form. The clearing of checks on the basis of electronic checks is called Cheque TruncationThe Electronic image is generated and it is used for clearing, thus at that point the Physical Movement of the Cheque is stopped.

So simply, Cheque Truncation is a system of cheque clearing and settlement between banks based on electronic data/ images or both without physical exchange of instrument.

This results in faster clearance, (T+0) in local and T+1 in intercity clearing. Faster realization is accompanied by a reduction in costs for the customers and the banks. Banks can also offer innovative products and services based on CTS and there is an additional advantage of reduced reconciliation and clearing fraud.

In cheque truncation, at some point in the flow of the cheque, the physical cheque is replaced with an electronic image of the cheque and that image moves further. The processing is done on the basis of this truncated cheque and physical cheque is stored. MICR data is very useful in check truncation. The electronic cheques are issued in electronic form with digital signatures / biometric signatures / encrypted data. The negotiable Instruments (Amendment) Act of 2002 gives constitutional validity to the electronic cheques.

CTS-2010

From January 1, 2013, cheques which do not conform to CTS-2010 standards are not entertained by banks. CTS-2010 is a set of benchmarks towards achieving standardization of cheques issued by banks all over India. These include provision of mandatory minimum security features on cheque forms such as quality of paper, watermark, bank's logo in invisible ink, void pantograph and standardization of field placements on cheques.

This standard has been adopted due to growing use of multi-city and payable-at-par cheques for handling of cheques at any branches of a bank.

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Benefits of adopting CTS-2010

- The security features in cheque forms will assist the presenting banks to identify the genuineness of the drawee banks' instruments while handling them in the image-based scenario.
- The homogeneity in security features will act as deterrent against frauds.
- The fixed field placement specifications will facilitate straight-through-processing at drawee banks' end through the use of optical/image character recognition technology.

The benefits from CTS are as follows:

- Shorter clearing cycle
- Superior verification and reconciliation process
- No geographical restrictions as to jurisdiction
- Operational efficiency for banks and customers alike
- Reduction in operational risk and risks associated with paper clearing

The images of the cheques are taken using the scanners. To ascertain the uniqueness of a physical cheque and cheque image; there is a rigorous quality check process at the level of the Capture Systems and the Clearing House Interface (of the presenting bank). The CTS-2010 prescribes certain mandatory and optional security features to be available on cheques, which will also add to the uniqueness of the images.

Security of images in Cheque Truncation

The image and data transmitted over the network is secured via a comprehensive Public Key Infrastructure (PKI).

Demand Draft

Demand draft is discussed in section 85(A) of the NI Act. A Demand draft is an order to pay money drawn at one office of a Bank upon another office of the **same bank** for a sum of money payable to order on demand.

- A Demand Draft is payable on demand
- A Demand Draft can NOT be paid t a bearer
- A DD is negotiable and its features are similar to Bill of Exchange and NOT a Check.
- If a Bank fails to honor the Draft, the Bank is liable and not the person.
- If there are wrong signatures on the Bank Draft, the Bank is liable.
- If there is a prior arrangement , the DD can be payable by different bank also.

When a Bank draft is purchased , the relations between the purchaser and bank are that of a debtor and creditor , and as soon as this bank reaches the Payee, the Payee becomes beneficiary and the Bank

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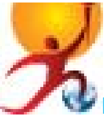

becomes trustee.

Please note that once, the payee gets a DD, the payment CANNOT be stopped unless there is an order by a competent court. So, when a draft reaches a payee, the relationship between the purchaser and Bank comes to an end.

- A demand draft can be prepared with cash payment if the value is less than 50,000.
- For a value of 50,000 or more, only paid through bank account.

Draft is valid for 3 months. On expiry of this date, the draft can be revalidated by the Bank.

Difference between a Cheque and Draft

Cheque has been defined in Negotiable Instruments Act 1881 section 6. A cheque is a bill of exchange drawn on a specified bank and not expressed to be payable otherwise than on demand.

A demand draft has been defined by Negotiable Instruments Act 1881 in section 85. A demand draft is an order to pay money drawn by one office of a bank upon another office of the same bank bank for a sum of money payable to order on demand.

Following are some more differences:

- A cheque can be made payable to bearer but a Demand Draft cannot.
- A demand draft can be cleared in a specified branch of the issuer bank
- A cheque can get dishonored but Demand draft is always honored.
- An issuer party of the cheque is liable to the cheque and not backed by a Bank Guarantee, A demand draft is backed by a bank guarantee.

Part-III: International Banking Regulation

The role of banks in global and national economies is very important. The banking industry holds reliance of the entire economy and it is important for the authorities to maintain control over the practices of banks. The most common objectives of banking regulations are

- Prudential Objectives: to reduce the level of risk to bank creditors i.e. to protect the depositors.
- Systemic risk reduction—to reduce the risk of failure of banks
- Avoid misuse of banks—to reduce the risk of banks being used for criminal purposes such as money laundering
- To protect banking confidentiality
- Credit allocation—to direct credit to favored sectors

General Principles of Banking Regulation

The general principles that deal with the banking regulation include Minimum requirements, supervisory review and market discipline. They have been discussed below:

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Minimum requirements

Certain minimum requirements are imposed on banks, which are closely tied to the level of risk exposure for a certain sector of the bank. The most important minimum requirements include the Capital Requirements and Reserve Requirements.

- **Capital Requirements:**The capital requirement sets a framework on how banks must handle their capital in relation to their assets. The first international level capital requirements were introduced by the Basel Capital Accords in 1988. The current framework of capital requirements is called Basel III.
- **Reserve Requirements:** The reserve requirement sets the minimum reserves each bank must hold to demand deposits and banknotes. Reserve requirements have also been used in the past to control the stock of banknotes and/or bank deposits. Required reserves have at times been gold coin, central bank banknotes or deposits, and foreign currency.

Supervisory review

This includes licensing by the regulator, obtaining undertakings, giving directions, imposing penalties or revoking the bank's license.

Market discipline

The central bank requires the banks to publicly disclose financial and other information, and depositors and other creditors. The bank is thus made subject to market discipline.

Basel Committee on Banking Supervision

The secretariat of Bureau of International Settlement (BIS); which fosters co-operation among central banks with a common goal of financial stability and common standards of banking regulations; are located in Basel, a city in Switzerland. The Basel Committee on Banking Supervision (BCBS) is a committee of banking supervisory authorities established in 1974 by the governors of the central banks of G-10. This committee provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It has 27 members including India and major economies of the world.

Box: The 27 countries are Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. Out of them 12 are permanent members.

Basel-I

The Basel Committee on Banking Supervision (BCBS) had introduced a capital measurement system in 1988. It was called Basel capital accord or Basel-I. The focus of Basel-I was entirely on credit risk.

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It gave a structure of risk weighted assets (RWA). RWA implies that the assets with different risk profiles are given different risk weights. For example, personal loans would carry higher loans in comparison to loans that are backed by assets. The Basel-I fixed minimum capital requirement at 8% of risk weighted assets (RWA). India adopted Basel 1 guidelines in 1999.

Basel-II

The Basel-II guidelines were published by BCBS in 2004. These guidelines refined the Basel-I norms on the base of three parameters as follows:

- Banks should maintain a minimum capital adequacy requirement of 8% of risk assets
- Banks were needed to develop and use better risk management techniques in monitoring and managing all the three types of risks
- Mandatory disclosure of risk exposure.

Basel II norms in India and overseas are yet to be fully implemented.

Basel-III

The Basel-III guidelines were issued in 2010 as a response to global financial crisis of 2008. The idea was to further strengthen the banking system. It was felt that the quality and quantity under Basel-II were insufficient to contain any further risk; so the Basel-III norms aim at making banking activities more capital-intensive. The objective of these guidelines is to achieve a resilient banking system by focusing on four key banking parameters viz. capital, leverage, funding and liquidity. The ultimate aim is to:

- Improve the banking sector'sability to absorb shocks arising from financial and economic stress.
- Improve risk management and governance
- Strengthen banks' transparency and disclosures.

Capital Adequacy

In Banking Industry, Capital refers to the stock of Financial Assets which is capable of generating income. The Capital Adequacy Ratio is a thermometer of Bank's health, because it is the ratio of its capital to its risk. So simply, Capital Adequacy Ratio = Capital ÷ Risk.

Thus, Capital Adequacy can indicate the capacity of the Bank's ability to absorb the possible losses. The Regulators check CAR to monitor the health of the Bank, because a good CAR protects the depositors and maintains the faith and confidence in the banking system.

Capital to Risk (Weighted) Assets Ratio (CRAR)

CRAR is a standard metric to measure balance sheet strength of banks. BASEL I and BASEL II are global capital adequacy rules that prescribe a minimum amount of capital a bank has to hold given the size of its risk weighted assets. The old rules mandate banks to back every Rs. 100 of commercial

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loans with Rs. 9 of capital irrespective of the nature of these loans. The new rules suggest the amount of capital needed depends on the credit rating of the customer.

Banks compute the CRAR as follows:

Total capital ratio (CRAR) = Eligible Total Capital / RWA for (Credit risk + Market risk + Operational risk)

Tier-1 and Tier-2 Capital

The Basel accords define two tiers of the Capital in the banks to provide a point of view to the regulators. The Tier-I Capital is thecore capital while the Tier-II capital can be said to be subordinate capitals.

Tier 1 mainly includes permanent shareholders' equity (which includes issued and fully paid ordinary shares / common stock and perpetual non-cumulative preference shares) and disclosed reserves (or profits created or increased by appropriations of retained earnings or other surplus, e.g.: share premiums, retained profit, general reserves and legal reserves). On the other hand, Tier-II includes undisclosed reserves and other subordinate capital. The following table differentiates between Tier-1 and Tier-2 capital.

Tier-I Capital	Tier-II Capital
Paid up Capital	Undisclosed reserves and cumulative perpetual preference shares.
Statutory Reserves	Revaluation Reserves
Other disclosed free reserves	General Provisions and loss reserves
Capital Reserves which represent surplus arising out of the sale proceeds of the assets.	Hybrid debt capital instruments such as bonds.
Investment Fluctuation Reserves	Long term unsecured loans
Innovative Perpetual Debt Instruments (IPDIs)	Debt Capital Instruments.
Perpetual Noncumulative Preference Shares.	Redeemable cumulative Preference shares
Minus:	Perpetual cumulative preference shares.
Equity Investment in subsidiaries.	
Intangible assets.	
Losses (Current period + past carried forward)	

Apart from the above, the banks may also at the discretion of their central bank employ a third tier of

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capital which consists of short-term subordinated debt for the sole purpose of meeting a proportion of the capital requirements for market risks. This is called Tier-III capital.

Three pillars of Basel-III

Basel III has three mutually reinforcing pillars as follows:

- Pillar 1 : **Minimum Regulatory Capital Requirements** based on Risk Weighted Assets (RWAs) : Maintaining capital calculated through credit, market and operational risk areas.
- Pillar 2 : **Supervisory Review Process** : Regulating tools and frameworks for dealing with peripheral risks that banks face.
- Pillar 3: **Market Discipline** : Increasing the disclosures that banks must provide to increase the transparency of banks

Common Equity

Currently, the bank's capital comprises Tier 1 and Tier 2 capital. The restriction is that Tier 2 capital cannot be more than 100% of Tier 1 capital. Under Basel III, with an objective of improving the quality of capital, the Tier 1 capital will predominantly consist of Common Equity. Common Equity is the amount that all common shareholders have invested in a company. Most importantly, this includes the value of the common shares themselves. It also includes retained earnings and additional paid-in capital. *Thus, most important part of the common equity comprises the Paid up Capital + retained earnings.*

- Although the minimum total capital requirement will remain at the current 8% level, Under Basel-III, the capital adequacy requirement was raised to 10.50%.
- Basel III norms prescribe minimum common equity of 4.5 per cent.

Elements of Common Equity

The seven elements of Common Equity include the following:

- Common shares (paid-up equity capital) issued by the bank which meet the criteria for classification as common shares for regulatory purposes;
- Stock surplus (share premium) resulting from the issue of common shares; .
- Statutory reserves;
- Capital reserves representing surplus arising out of sale proceeds of assets;
- Other disclosed free reserves, if any;
- Balance in Profit & Loss Account at the end of the previous financial year;
- Current year profits can be reckoned on quarterly basis provided incremental NPA provision at end of any of 4 quarters of previous financial year have not deviated more than 25% from average of the 4 quarters.

Deductions: Regulatory adjustments / deductions to be made from total of 1 to 7.

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The Capital Conservation Buffer

The banks will require to hold a capital conservation buffer of 2.5%. The aim of asking to build conservation buffer is to ensure that banks maintain a cushion of capital that can be used to absorb losses during periods of financial and economic stress.

Countercyclical Buffer

The countercyclical buffer has been introduced with the objective to increase capital requirements in good times and decrease the same in bad times. The buffer will slow banking activity when it overheats and will encourage lending when times are tough i.e. in bad times. The buffer will range from 0% to 2.5%, consisting of common equity or other fully loss-absorbing capital.

Leverage Ratio

Basel III rules include a leverage ratio to serve as a safety net. A leverage ratio is the relative amount of capital to total assets (not risk-weighted). This aims to put a cap on swelling of leverage in the banking sector on a global basis. A 3% leverage ratio of Tier 1 will be tested before a mandatory leverage ratio is introduced in January 2018.

Liquidity Ratios:

Under Basel III, a framework for liquidity risk management has to be created. A new Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) are to be introduced in 2015 and 2018, respectively.

Key differences between Base-II and Basel-III

The following table summarizes the key differences between Basel-II and Basel-III requirements.

A comparison of Basel II and Basel III Requirements

Requirements	Basel II	Basel III
Minimum Ratio of Total Capital To RWAs	8%	10.50%
Minimum Ratio of Common Equity to RWAs	2%	4.50% to 7.00%
Tier I capital to RWAs	4%	6.00%
Core Tier I capital to RWAs	2%	5.00%
Capital Conservation Buffers to RWAs	None	2.50%
Leverage Ratio	None	3.00%
Countercyclical Buffer	None	0% to 2.50%
Minimum Liquidity Coverage Ratio	None	TBD (2015)
Minimum Net Stable Funding Ratio	None	TBD (2018)

Risk weighted assets

The Risk Weighted Assets (RWA) refer to the fund based assets such

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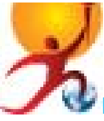

Cash, Loans, Investments and other assets but their value is assigned a risk weight (for example 100% for corporate loans and 50% for mortgage loans) and the credit equivalent amount of all off- balance sheet activities. Each credit equivalent amount is also assigned a risk weight.

Degree of risk expressed % weights assigned by the Reserve Bank of India

The degree of risk expressed % weights assigned by the Reserve Bank of India. The following table shows the Risk weights for some important assets assigned by RBI in an increasing order.

Asset	Weighted Risk
Cash	0%
Balance with Reserve Bank of India	0%
Central/ state Government Guaranteed advances	0%
SSI advances up to CGF guarantee	0%
Loans against FD (Fixed Deposits), LIC Policy	0%
Government approved Securities	2.50%
Balance with Banks other than RBI which maintain the 9% CRAR	20%
Secured Loan to the Staff Members	20%
Housing Loans	50%
Housing Loans >Rs. 30 Lakhs	75%
Loans against Gold and Jewelry	50%
Retail Lending up to Rs. 5 crore	75%
Loans Guaranteed by DGCGC / ECGC	50%
Loans to Public Sector Undertakings	100%
Foreign Exchange and Gold in Open Position	100%
Claims on unrated corporates	100%
Commercial Real estate	100%
Consumer Credit	125%
Credit Cards	125%
Exposure to Capital Markets	125%
Venture Capital Investment as a part of Capital Market exposure	150%

In the above table we can have a broad idea that the assets which are in the form of Cash, Government Guaranteed securities, against the LIC policies etc. are safest assets with 0% Risk weighted assigned to them. On the other hand, the venture Capital Investment as a part of Capital Market exposure has the maximum risk weight assigned to them.

How does this work?

Let's take this example, For a AAA client, the risk weight is 20%, which means banks have to set aside its own capital of Rs. 1.80 for every Rs 100 loan (this means 20% of 9% of Rs. 100). Similarly, in

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case of 100% risk weight (such as capital markets exposures) , banks have to keep aside its own capital of Rs 9 on the loan.

Calculation of the Ratio

Under Basel-III, banks are to compute ratio as follows:

- CommonEquity Tier-I Capital Ratio = Common Equity Tier-I Capital / RWA for (Credit risk + Market risk + Operational risk)
- Tier-I capital ratio = Tier-I Capital / RWA for (Credit risk + Market risk + Operational risk)
- Total capital ratio (CRAR) = Eligible Total Capital / RWA for (Credit risk + Market risk + Operational risk)

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General Knowledge Today

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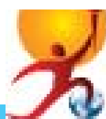

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Banking & Finance-5: Money Markets, Futures, Derivatives

This document is mainly for Preliminary examination and covers the topics objectively. This content is also useful for some of you who might be appearing in Banking Examinations as well.

Prelims MCQ Topics
Call Money, Notice Money and Term Money, Treasury Bills, Certificate Of Deposits, Commercial Paper, Functions of Money Markets, M0, M1, M2, M3, M4, Narrow Money / Broad Money, Derivatives, Mutual Funds, Real Return of Rate, Real Assets and Financial Assets, Short Term and Long Term Investment Options.

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Part-I : Money Markets

There are two kinds of markets where borrowing and lending of money takes place between fund scarce and fund surplus individuals and groups. The markets which cater to the need ofshort term funds are called Money Markets while the markets that cater to the need of long term funds are called Capital Markets.

Thus, money markets is that segment of financial markets where borrowing and lending of the short-term funds takes place. The maturity of the money market instruments is one day to one year.

In our country, Money Markets are regulated by both RBI and SEBI. Money markets are also sometimes called discount markets.

How Money markets are different from capital markets?

While money markets are markets for short term fund needs; capital markets are markets for long term funds, debts, equity, shares etc.

Segments of money markets in India

Money Market in India is divided into unorganized sector and organized sector. The Unorganized market is old Indigenous market which includes indigenous bankers, money lenders etc. Organized market includes Governments (Central and State), Discount and Finance House of India (DFHI), Mutual Funds, Corporate, Commercial / Cooperative Banks, Public Sector Undertakings (PSUs), Insurance Companies and Financial Institutions and Non-Banking Financial Companies (NBFCs). Organized Money Market is regulated by RBI as well as SEBI.

Various instruments of Money Markets

The organized money market in India is not a single market but is a conglomeration of markets of various instruments, which are called Sub-markets of Money Market. These include Call Money / Notice Money / Term Money Market, Treasury Bills, Commercial Bills, Certificates of Deposits, Commercial Bills, Commercial Papers, Money Market Mutual Funds and Repo / Reverse Repo. The most active segment of the money market is "Overnight Call market" or repo.

Call Money, Notice Money and Term Money Markets

Call Money, Notice Money and Term Money markets are sub-markets of the Indian Money Market. These refer to the markets for very short term funds. Call Money refers to the borrowing or lending of funds for 1 day. Notice Money refers to the borrowing and lending of funds for 2-14 days. Term money refers to borrowing and lending of funds for a period of more than 14 days.

Why the call / notice money market is called Inter-Bank Market?

In India, 80% demand comes from the public sector banks and rest 20% comes from foreign and private sector banks. Then, around 80% of short term funds are supplied by Financial Institutions

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such as IDBI and Insurance giants such as LIC. Rest 20% of the short term funds come from the banks. In this way, major players in call / notice money markets are banks and financial institutions, which are both lenders and borrowers. Due to this, the call / notice money market is also called Inter-Bank Market.

Interest rates in call / notice money markets

Call Money / Notice Money market is most liquid money market and is indicator of the day to day interest rates. If the call money rates fall, this means there is a rise in the liquidity and vice versa. Interest Rates in Call / Notice Money Markets are market determined i.e. by the demand and supply of short term funds. The intervention of RBI is prominent in the short term funds money market in India and it can influence the rates prominently.

MIBOR

MIBOR refers to Mumbai Interbank Offer Rate. It is the standard reference of interest rates in call / notice money markets in India. It is the average of the call money rates offered by a set of specific banks on a given day. MIBOR is calculated by the NSE (National Stock Exchange) after taking quotes from a specific set of Banks. MIBOR serves as a benchmark to which various entities in the market benchmark their short term interest rates.

Where do you find the call / notice money market in India?

The short term fund market in India is located only in big commercial centres such as Mumbai, Delhi, Chennai and Kolkata.

Bill market

Bill is a generic term which can mean a bank note, an invoice, a bill of exchange, bill of lading (in export-import business), waybill (in shipments) etc. In case of money market; bills are short term money market instruments. The bill market is a sub-market of the money market in India. There are two types of bills viz. Treasury Bills and commercial bills. While Treasury Bills or T-Bills are issued by the Central Government; Commercial Bills are issued by companies/ financial institutions.

Treasury Bills

Treasury means government treasury. The Treasury Bills or T-Bills are short term money market instruments which are released by Central Government of India to meet its need short term funds. They were introduced in 1917 for the first time.

Kindly note, State Governments don't issue Treasury Bills. The maturity of Treasury Bills in India is less than 365 days. At present, the active T-Bills are 91-days T-Bills, 182-day T-Bills and 364-days T-Bills. In 1997, the Government had also introduced the 14-day intermediate treasury bills. Auctions of T-Bills are conducted by RBI.

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How the lenders earn interest on T-Bills?

Central Government issues the T-Bills on a discount to face value, however, the lender / investor gets the face value on maturity. The return on T-Bills is the difference between the issue price and face value. This return o depends upon auctions. When the liquidity position in the economy is tight, returns are higher and vice versa. Interest on the treasury bills is determined by market forces.

Who can purchase T-Bills?

Individuals, Firms, Trusts, Institutions and banks can purchase T-Bills. The commercial and cooperative banks can use T-Bills for fulfilling their SLR requirements, because they are government securities. Treasury bills are available for a minimum amount of Rs. 25,000 and in multiples of Rs. 25,000.

What are advantages of T-Bills to Government and Investors?

Objective of issuing T-Bills is to fulfill the short term money borrowing needs of the government. For investors, T-bills have an advantage over the other instruments such as:

- Zero Risk weightage associated with them, because they are issued by government.
- High liquidity because 91 days and 364 days are short term maturity.
- Transparency
- Thesecondary market of T-Bills is very active so they have a higher degree of tradability.

Commercial Bills

Commercial bills market is basically a market of instruments similar to Bill of Exchange. The participants of commercial bill market in India are banks and financial institutions but this market is not yet developed.

Certificate Of Deposits (CDs)

Certificate of Deposit (CD) is yet another money market instrument, which is negotiable and equivalent to a promissory note. It is either issued in demat form or in the form of a usance promissory note. This instruments is issue in lieu of the funds deposited at a bank for a specified time period.

Who can Issue a Certificate of Deposit?

A Certificate of Deposit in India can be issue by:

- All scheduled commercial banks excluding Regional Rural Banks (RRBs) and Local Area Banks (LABs)
- Select All India Financial Institutions permitted by RBI

A commercial bank can issue Certificate of Deposit as per its own requirements. A financial institution can issue Certificate of Deposit within a limit prescribed by RBI. A thumb rule for FI is

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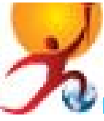

that CD together with other instruments, viz. term money, term deposits, commercial papers and inter-corporate deposits should not exceed 100 per cent of its net-owned funds, as per the latest audited balance sheet.

Certificate of Deposit can be issued to individuals, corporations, companies, trusts, funds, associations etc. The No resident Indians are also eligible for CDs provided they don't repatriate the funds.

What is Minimum amount for Certificate of Deposit?

- Minimum amount for Certificate of Deposit in India has been fixed at Rs. 1 Lakh, to be accepted from a single subscriber
- Larger amounts have to be in the multiples of Rs. 1 Lakh.

What is maturity tenure of Certificates of Deposits?

Certificates of Deposit are money market instruments and their maturity period is between seven days to one year for commercial banks. For Financial Institutions, the maturity is not less than a year and not more than three years.

What is Return on Certificates of Deposits?

The CDs are issued at a discount on face value. Return on them is difference between the issue value and face value.

How CDs can be transferred from one person to other?

If CD has been issued in physical form (as usance promissory notes), they can be freely transferred by endorsement and delivery. If they have been released in Demat form, they can be transferred as per the procedure applicable to other demat securities.

What is the lock in period for certificates of deposits

There is no lock-in period for certificates of deposit

What are conditions before banks when they issue Certificates of Deposit?

Banks/FIs cannot grant loans against CDs. They cannot buy back their own CDs before maturity. Banks need to maintain cash reserve ratio (CRR) and statutory liquidity ratio (SLR), on the issue price of the CDs.

Commercial Paper (CP)

Commercial Paper (CP) is yet another money market instrument, which was first introduced in 1990 to enable the highly rated corporates to diversify their resources for short term fund requirements. They are issued either in the form of a promissory note or in a dematerialized form through any of the depositories approved by and registered with SEBI. They are essentially unsecured debt instruments.

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Who is eligible to issue commercial papers?

Corporate, Primary Dealers and All India Financial Institutions are eligible to issue CP. To be eligible to issue Commercial Paper, the Corporate need to have a tangible net worth of minimum Rs. 4 Crore. Further,

- the company must have been sanctioned working capital limit by banks or all-India financial institutions
- The borrower account of the company should be high rated i.e. it should be classified as Standard Asset by the Financial Institutions.

Also, the Corporate, Primary Dealers as well as Financial Institutions must obtain the credit rating for issuance of Commercial Paper either from Credit Rating Information Services of India Ltd. (CRISIL) or the Investment Information and Credit Rating Agency of India Ltd. (ICRA) or the Credit Analysis and Research Ltd. (CARE) or the FITCH Ratings India Pvt. Ltd. or such other credit rating agency (CRA) as may be specified by the Reserve Bank of India from time to time, for the purpose.

What are Denominations and Maturity of Commercial Paper?

Maturity of Commercial Paper is minimum of 7 days and a maximum of up to one year from the date of issue. CP can be issued in denominations of Rs.5 lakh or multiples thereof.

Who can Invest in CP?

Individuals, banking companies, other corporate bodies (registered or incorporated in India) and unincorporated bodies, Non-Resident Indians (NRIs) and Foreign Institutional Investors (FIIs) etc. can invest in CPs. However, investment by FIIs would be within the limits set for them by Securities and Exchange Board of India (SEBI) from time-to-time.

What is return on CP?

CP is issued at a discount to face value as may be determined by the issuer. The difference between issue price and face value is return. Further, CPs are traded in the OTC markets.

What is difference between Commercial Paper and Certificates of Deposits?

- CD is issued by the Commercial banks and Finance Institutions, while commercial papers are issued by corporates, primary dealers (PDs) and the All-India Financial Institutions (FIs).
- CD is issued for Rs. 1 Lakh or its multiples while CP is issued in denominations of Rs.5 lakh or multiples thereof.

Money Market Mutual Funds (MMMFs)

Money Market Mutual Funds (MMMFs) were introduced by RBI in 1992 but since 2000, they are brought under the purview of the SEBI. They provide additional short-term avenue to individual investors.

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Repo and Reverse Repo auctions

Repo (repurchase agreement) was introduced in December 1992. Repo means selling a security under an agreement to repurchase it at a predetermined date and rate. Repo transactions are affected between banks and financial institutions and among bank themselves, RBI also undertake Repo. IN 1996, Reverse Repo was introduced. Reverse Repo means buying a security on a spot basis with a commitment to resell on a forward basis. Reverse Repo transactions are affected with scheduled commercial banks and primary dealers.

Discount And Finance House of India (DFHI)

Discount and Finance House of India was established in 1988 by RBI and is jointly owned by RBI, public sector banks and all India financial institutions, which have contributed to its paid up capital. DFHI plays important role in developing an active secondary market in Money Market Instruments. From 1996, it has been assigned status of a Primary Dealer (PD). It deals in treasury bills, commercial bills, CDs, CPs, short term deposits, call money market and government securities.

Various problems of Money Markets in India

Indian money market is relatively underdeveloped when compared with advanced markets like New York and London Money Markets. Various problems of money markets in India include Dichotomy, Lack of Coordination & Integration, Diversity in the Interest Rates, Seasonality in the markets, shortage of funds, absence of a developed Bill market, Inefficient management etc.

Overall, India's money markets are relatively less developed and have yet to acquire sufficient depth and width.

Salient features of Indian Money Market

Salient features of Indian Money Market includes:

- Presence of large unorganized market
- Less developed and less popular in comparison to developed countries.
- Seasonal interest rates. Too much difference in interest rates in busy season and slack season.
- The busiest season is November to May-June, funds are required to move the crops and this busy season causes lack of liquidity and hike in the interest rates.
- Highly volatile call / notice money market.

Main functions of Money Markets

Due to short maturity term, the instruments of money market are liquid and can be converted to cash easily and thus are able to address the need of the short term surplus fund of the lenders and short term borrowing requirements of the borrowers. Thus, the major function of the money

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markets is to cater to the short term financial needs of the economy. The other functions are as follows:

1. Money Markets help in effective implementation of the RBI's monetary policy
2. Money markets help to maintain demand and supply equilibrium with regard to short term funds
3. They cater to the short term fund requirement of the governments
4. They help in maintaining liquidity in the economy

Monetary Aggregates

Money supply & Total Stock of Money

All the money held with public, RBI as well as government is called Total Stock of Money. Money Supply is that part of this Total Stock of Moneywhich is with public. By public we refer to the households, firms, local authorities, companies etc. Thus, public money does not include the money held by the government and the money held as CRR with RBI and SLR with themselves by commercial banks. The reason of excluding the above two categories from money supply is that this money held by the Government and RBI is out of circulation. Thus, we can conclude that the money in circulation is the money supply. This money may be in the following forms:

- Currency Notes and Coins
- Demand Deposits such as Saving Banks Deposits ,
- Other Deposits such as Time Deposits / Term Deposits / Fixed Deposits
- Post Office Saving Accounts
- Cash in Hand (Except SLR) and Deposits of Banks in other Banks / RBI (except CRR)

In other way, this money has two components viz. Currency Component and Deposit Component. Currency Component consist of all the coins and notes in the circulation, while Deposit component is the money of the general public with the banks, which can be withdrawn by them using cheques, withdrawals and ATMs. Deposit can be either Demand Deposit or Time Deposit.

Monetary Aggregates

The Reserve bank of India calculates the four concepts of Money supply in India. They are called Monetary Aggregates or Money Stock Measures. These monetary aggregates are: M1 (aka Narrow Money; M2, M3 (aka Broad Money) and M4. Further, there is one more concept called M0 or Reserve Money.

Narrow Money (M1)

At any point of time, the money held with the **public** has two most liquid components

- **Currency Component:** This consists of all the coins and notes in the circulation

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- **Demand Deposit Component:** Demand Deposit component is the money of the general public with the banks, which can be withdrawn by them using cheques, withdrawals and ATMs.

The above two components i.e. currency component and demand deposit component of the public money is called **Narrow Money** and is denoted by the RBI as **M1.** Thus,

M1 = Currency with the public + Demand Deposits of public in Banks

When a third component viz. Post office Savings Deposits is also added to M1, it becomes M2.

M2 = M1 + Post Office Savings.

Broad Money

Narrow money is the most liquid part of the money supply because the demand deposits can be withdrawn anytime during the banking hours. Time deposits on the other hand have a fixed maturity period and hence cannot be withdrawn before expiry of this period. When we add the time despots into the narrow money, we get the broad money, which is denoted by M3.

M3 = Narrow money + Time Deposits of public with banks

We note here that the Broad money does not include the interbank deposits such as deposits of banks with RBI or other banks. At the same time, time deposits of public with all banks including the cooperative banks are included in the Broad Money.

Now, we understand that the major distinction between the M1 and M3 is "Treatment of deposits with the banks". If we go a little deep, the M3 is the treatment of "Time Deposits" of the public, since demand deposits are available against cheques and ATMs.

When you add the Post Office Savings money also into the M3, it becomes M4.

Why M2 and M4 are irrelevant in monetary aggregates?

Both M2 and M4 which include the Post office Savings with narrow money and broad money respectively are now a days irrelevant. Post Office savings was once a prominent figure when the banks had not expanded in India as we see them today all around. The RBI releases the data at times regarding the money supply in India and Post Office Savings Deposits have not been updated frequently. There is NOT much change in the money of people deposited with the Post office and RBI did not care to update this money. Further, there was a time when the Reserve Bank used broad money (M_3) as the policy target. However, with the weakened relationship between money, output and prices, it replaced M3 as a policy target with a multiple indicators approach. RBI started using the Multiple Indicator Approach since 1998

Currently, Narrow Money (M_1) and Broad Money (M_3) are relevant indicators of money supply in India. The RBI in all its policy documents, monthly Bulletins and other documents shows these

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aggregates.

Reserve Money (M0)

The other name of the Reserve Money is "High Powered Money" and also "Monetary Base". Reserve Money is all the Cash in the economy and denoted by M. This has the following components:

- Currency with the Public
- Other Deposits with the RBI
- Cash Reserves of the banks held with themselves
- Cash Reserves of the Banks held with RBI

Here we should know that Cash Reserves are also of two types viz. Required Reserves (RR) and Excess Reserves (ER). RR are those reserves which the banks are statutorily required to keep with the RBI. At present the Banks are required to keep 4.25% CRR (Cash Reserve Ratio) of their total time and demand liabilities. All reserves excess of RR are called Excess Reserves. ER are held with the Banks while RR is held with RBI. Banks hold the ER to meet their currency drains i.e. withdrawal of currency by depositors.

Part-II: Derivative Instruments & Derivative Markets

Derivative Instruments & Derivative Markets

Derivatives are products whose value is derived from the value of one or more basic variables, which are called **Underlying Assets**. The underlying asset can be equity, index, foreign exchange (Forex), commodity or any other asset. This means that any instrument that *derives its value* on its underlying equity, index, foreign exchange (Forex), commodity or any other asset, is a Derivative Instrument.

Please note that derivative products initially emerged as hedging devices against fluctuations in commodity prices and commodity-linked derivatives remained the sole form of such products for almost three hundred years. But after 1970s, the financial derivatives came into spotlight thanks to the growing instability in the financial markets. However, since their emergence, these products have become very popular and by 1990s, they accounted for about two thirds of total transactions in derivative products.

Different Types of Derivatives

The derivatives can be **Forwards** or **Futures** or **Options** or **Warrants**.

Forward & Future Contract: A **forward contract** is a customized contract between two parties to buy or sell an asset at a specified future time at a price agreed upon today. Futures contracts are special types of forward contracts in the sense that they are standardized exchange-traded contracts, such as futures of the Nifty index.

Options: An Option is a contract which gives the right, but not an obligation, to buy or sell the

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underlying at a stated date and at a stated price. While a buyer of an option pays the premium and buys the right to exercise his option, the writer of an option is the one who receives the option premium and therefore obliged to sell/buy the asset if the buyer exercises it on him.
Options are of two types – Calls and Puts options.

- **'Calls'** give the buyer the *right but not the obligation to buy* a given quantity of the underlying asset, at a given price on or before a given future date.
- 'Puts' give the buyer the *right, but not the obligation to sell* a given quantity of underlying asset at a given price on or before a given future date. Please note that options generally have lives of up to one year. The majority of options traded on exchanges have maximum maturity of nine months. Longer dated options are called Warrants and are generally traded over-the counter.

Long forward and short forward contracts

We suppose that Suresh wants to buy a house in next year October. At the same time, Ramesh has a house worth Rs. 15 Lakh and he plans to sell it in October next year. Since the current price is Rs. 15 Lakh, Ramesh and Suresh enter into an agreement via which Suresh will buy that house in October 2013 in Rs. 17 Lakh. This would be called a Forward Contract. The price agreed upon would be called **Delivery price**. Since Suresh is buying it, for him, it would be called **Long Forward Contract**. On the other side, Ramesh is selling it; it would be called **Short Forward Contract**.

Spot contract

Now, we suppose that in next year October, instead of Rs. 17 Lakh, the market price of that house becomes Rs. 20 Lakh. Since Ramesh is already in contract with Suresh to sell him the house in Rs. 17 Lakh, Suresh would earn a profit of Rs. 3 lakh. Ramesh would lose Rs. 3 Lakh. Here we note that forward contract is in contrast with the **Spot contract**. **Spot contract** is an agreement to buy or sell an asset today.

Non-Deliverable Forward

There is one more term related to Forward Contracts called **NDF** or **Non-Deliverable Forward**. Non-deliverable forwards are over-the-counter transactions settled not by delivery but by exchange of the difference between the contracted rate and some reference rate such as the one fixed by the Reserve Bank of India. For example, if Ramesh pays Suresh Rs. 3 Lakh without delivering the actual house, it would be called NDF. The same is basic *funda* for commodity forward contracts and currency forward contracts.

Role of Future Markets in Economy

There are two important roles of the Futures markets.

- **Price Discovery:** Price discovery is the process of determining the price of an asset in the

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marketplace through the interactions of buyers and sellers. The forward markets provide the collective assessment of a large number of individual market participants about the direction and price trends of a commodity in future. The price discovery is affected by the internal knowledge about the likely production, crop size, weather projections etc of the buyers and sellers.

- The benefit of forwards is that the producers of commodities such as farmers can plan production and to shift acreage or production facilities from one commodity to another. The fight for acreage between wheat, soya bean and corn is an example of the demand forecast given by futures against the backdrop of complex interplay of forces like by forces bio-fuel demand, meat consumption (giving rise to larger utilization of feed to animals- in turn larger demand) etc.
- **Hedging of price Risk:** if a producer or buyer has a general sense of the likely future price, the he can lock the produce so that his risk of price or for that matter availability is mitigated.

However, **Speculators** are one of the biggest segment of future markets participants. The speculative investors pour their money into the futures markets andthus are held responsible for increased volatility in commodities.

In any case, the social utility of futures markets is considered to be mainly in the transfer of risk, and increased liquidity between traders with different risk and time preferences. However, it does not take much time to convert the hedger into a speculator.

Option Premium

At the time of buying an option contract, the buyer has to pay premium. The premium is the price for acquiring the right to buy or sell. It is price paid by the option buyer to the option seller for acquiring the right to buy or sell. Option premiums are always paid up front.

Commodity Futures

FCRA Forward Contracts (Regulation) Act, 1952 defines "goods" as "every kind of movable property other than actionable claims, money and securities". Futures' trading is organized in such goods or commodities as are permitted by the Central Government. At present, all goods and products of agricultural (including plantation), mineral and fossil origin are allowed for futures trading under the auspices of the commodity exchanges recognized under the FCRA.

Commodity derivatives market trade contracts for which the underlying asset is commodity. It can be an agricultural commodity like wheat, soybeans, rapeseed, cotton, etc or precious me tals like gold, silver, etc.

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First Commodity Future Market in India

In our country, the Commodity Futures market dates back to more than a century. The first organized futures market was established in 1875, under the name of 'Bombay Cotton Trade Association' to trade in cotton derivative contracts. This was followed by institutions for futures trading in oilseeds, foodgrains, etc.

The futures market in India underwent rapid growth between the period of First and Second World War. As a result, before the outbreak of the Second World War, a large number of commodity exchanges trading futures contracts in several commodities like cotton, groundnut, groundnut oil, raw jute, jute goods, castorseed, wheat, rice, sugar, precious metals like gold and silver were flourishing throughout the country. In view of the *delicate supply situation of major commodities in the backdrop of war efforts mobilization, futures trading came to be prohibited* during the Second World War under the Defence of India Act.

After Independence, especially in the second half of the 1950s and first half of 1960s, the commodity futures trading again picked up and there were thriving commodity markets. However, in **mid-1960s, commodity futures trading in most of the commodities was banned**and futures trading continued in two minor commodities, viz, pepper and turmeric.

Commodity Exchange

Commodity Exchange is an association, or a company of any other body corporate organizing futures trading in commodities. In a wider sense, it is taken to include any organized market place where trade is routed through one mechanism, allowing effective competition among buyers and among sellers – this would include auction-type exchanges, but not wholesale markets, where trade is localized, but effectively takes place through many non-related individual transactions between different permutations of buyers and sellers.

Difference between Commodity and Financial derivatives

The basic concept of a derivative contract remains the same whether the underlying happens to be a commodity or a financial asset. However there are some features which are very peculiar to commodity derivative markets. In the case of financial derivatives, most of these contracts are cash settled. Even in the case of physical settlement, financial assets are not bulky and do not need special facility for storage. Due to the bulky nature of the underlying assets, physical settlement in commodity derivatives creates the need for warehousing. Similarly, the concept of varying quality of asset does not really exist as far as financial underlyings are concerned. However in the case of commodities, the quality of the asset underlying a contract can vary at times.

Badla System

Badla System is an outdated Indian term for a trading system with a mechanism for deferring either

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payment for shares purchased or delivery of shares sold. The system, discontinued by the Securities and Exchange Board of India (SEBI), from March 1994, was applicable to a group or 'Specified' shares.

Mutual Funds

A mutual fund is a fund that is created when a large number of investors put in their money, and is managed by professionally qualified persons with experience in investing in different asset classes-shares, bonds, money market instruments like call money, and other assets like gold and property.
The name of the mutual fund gives a good idea about what type of asset class a fund, also called a scheme, will invest in. For example, a diversified equity fund will invest in a large number of stocks, while a gilt fund will invest in government securities while a pharma fund will mainly invest in stocks of companies from the pharmaceutical and related industries.

Is SEBI approval necessary for Mutual Funds?

Yes. Mutual funds are compulsorily registered with the Securities and Exchange Board of India (Sebi), which also acts as the first wall of defence for all investors in these funds.

Who runs Mutual Fund?

A mutual fund is run by a group of qualified people who form a company, called an asset management company (AMC) and the operations of the AMC are under the guidance of another group of people, called trustees.
Both, the people in the AMC as well as the trustees, have a fiduciary responsibility because these are the people who are entrusted with the task of managing the hard-earned money of people who do not understand much about managing money.

How to Invest in Mutual Funds?

An investor willing to invest in a mutual fund can approach a fund house or a distributor working for the fund house (which could be an individual, a company or even a bank), and ask a person qualified to sell mutual funds to explain how to go about it.
After some regulatory requirement is fulfilled, the investor can fill up a form and write a cheque-the fund house or the distributor will take care of the process after that. Once the cheque is cleared by the investor's bank, the fund house will allot what are called 'units' to the investor, at a price that is fixed through a process approved by Sebi.
This price is based on the net asset value (NAV), in simple terms which is the total value of investments in a scheme divided by the total number of units issued to investors in the same scheme.
In most mutual fund schemes, NAVs are computed and published on a daily basis. However, when a fund house is launching a scheme for the first time, the units are sold at Rs 10 each.

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What are kinds of Mutual Funds?

There are three types of schemes in which an investor can invest in. These are open-ended schemes, closed-ended schemes, and exchange-traded funds (ETFs).

Open Ended Fund:

An open-ended fund is the one which is usually available from a mutual fund on an ongoing basis that is an investor can buy or sell as and when they intend to at a NAV-based price.

As investors buy and sell units of a particular open-ended scheme, the number of units issued also changes every day.

The value of the scheme's portfolio also changes on a daily basis. So, the NAV also changes on a daily basis. In India, fund houses can sell any number of units of a particular scheme, but at times fund houses restrict selling additional units of a scheme for some time.

Close-ended Fund:

A close-ended fund usually issue units to investors only once, when they launch an offer, called new fund offer (NFO) in India.

Thereafter, these units are listed on the stock exchanges where they are traded on a daily basis. As these units are listed, any investor can buy and sell these units through the exchange.

As the name suggests, close-ended schemes are managed by fund houses for a limited number of years, and at the end of the term either money is returned to the investors or the scheme is made open-ended.

However, usually, units of close ended funds which are listed on the stock exchanges, trade at a high discount to their NAVs. But as the date for closure of the fund nears, the discount between the NAV and the trading price narrows, and vanishes on the day of closure of the scheme.

Exchange Traded Funds

ETFs are a mix of open-ended and close-ended schemes.

ETFs, like close-ended schemes, are listed and traded on a stock exchange on a daily basis, but the price is usually very close to its NAV, or the underlying assets, like gold ETFs.

What are Advantages and Disadvantages of Mutual Funds?

If one invests in a well-managed mutual fund scheme, the advantages outweigh disadvantages and in the long term, which is 10 years or more. There is a very high probability of investors making more money than by investing in other risk-free investments such as FDs, public provident fund, etc.

Advantages of investing in MFs include diversification, good investment management services, liquidity, strong government-backed regulatory help, professional service, and all these at a low cost.

The disadvantages of mutual fund investing include lack of flexibility to sell or buy a stock or a portfolio of stocks of choice. The investor does not have any freedom relating to customize the

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fund's portfolio. Another disadvantage is that although in the long term MFs give good returns, the returns are not as predictable as say in bank FDs and PPF.

Legislations that control the securities market

Major legislations that control the securities market are the SEBI Act, 1992, the Companies Act, 1956, Securities Contracts (Regulation) Act, 1956, Depositories Act, 1996 & Prevention of Money Laundering Act, 2002. Please note that previously we had a British Era legislation Capital Issues (Control) Act, 1947, which has been repealed now.

When was SEBI established?

SEBI was established and empowered statutory powers for (a) protecting the interests of investors in securities, (b) promoting the development of the securities market, and (c) regulating the securities market.

Jurisdiction of SEBI extends over corporates in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with securities market. It can conduct enquiries, audits and inspection of all concerned and adjudicate offences under the Act. It has powers to register and regulate all market intermediaries and also to penalise them in case of violations of the provisions of the Act, Rules and Regulations made there under. SEBI has full autonomy and authority to regulate and develop an orderly securities market.

What are key provisions of Securities Contracts (Regulation) Act, 1956?

This act provides for direct and indirect control of virtually all aspects of securities trading and the running of stock exchanges and aims to prevent undesirable transactions in securities. It gives Central Government regulatory jurisdiction over (a) stock exchanges through a process of recognition and continued supervision, (b) contracts in securities, and (c) listing of securities on stock exchanges. As a condition of recognition, a stock exchange complies with conditions prescribed by Central Government. Organised trading activity in securities takes place on a specified recognised stock exchange. The stock exchanges determine their own listing regulations which have to conform to the minimum listing criteria set out in the Rules.

What are key provisions of Depositories Act, 1996

Depositories Act, 1996 provides for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security by (a) making securities of public limited companies freely transferable subject to certain exceptions; (b) dematerialising the securities in the depository mode; and (c) providing for maintenance of ownership records in a book entry form. In order to streamline the settlement process, the Act envisages transfer of wnership of securities electronically by book entry without making the securities move from person to person.

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The Act has made the securities of all public limited companies freely transferable, restricting the company's right to use discretion in effecting the transfer of securities, and the transfer deed and other procedural requirements under the Companies Act have been dispensed with.

What are key provisions of Companies Act, 1956?

It deals with issue, allotment and transfer of securities and various aspects relating to company management. It provides for standard of disclosure in public issues of capital, particularly in the fields of company management and projects, information about other listed companies under the same management, and management perception of risk factors. It also regulates underwriting, the use of premium and discounts on issues, rights and bonus issues, payment of interest and dividends, supply of annual report and other information.

What are key provisions of Prevention of Money Laundering Act, 2002?

The primary objective of the Act is to prevent money-laundering and to provide for confiscation of property derived from or involved in money-laundering. The term money-laundering is defined as whoever acquires, owns, possess or transfers any proceeds of crime; or knowingly enters into any transaction which is related to proceeds of crime either directly or indirectly or conceals or aids in the concealment of the proceeds or gains of crime within India or outside India commits the offence of money laundering. Besides providing punishment for the offence of money-laundering, the Act also provides other measures for prevention of Money Laundering. The Act also casts an obligation on the intermediaries, banking companies etc to furnish information, of such prescribed transactions to the Financial Intelligence Unit- India, to appoint a principal officer, to maintain certain records etc.

Apart from the above legislations, government has framed rules under the SCRA, SEBI Act and the Depositories Act. SEBI has framed regulations under the SEBI Act and the Depositories Act for registration and regulation of all market intermediaries, and for prevention of unfair trade practices, insider trading, etc. Under these Acts, Government and SEBI issue notifications, guidelines, and circulars which need to be complied with by market participants.

Basics of Investments

What is the real return on investments?

The money which we earn is partly spent and the rest saved for meeting future expenses. Instead of keeping the savings idle we would like to use savings in order to get return on it in the future. This is called Investment. We invest because of many reasons. One important reason is that<u>we want to meet the cost of Inflation</u>. The Inflation which is the rate, at which the cost of living increases, indicates the rate at which the prices of the goods and services we need are increasing.

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If there is inflation, the money loses value, because it will not buy the same amount of a good or a service in the future as it does now or did in the past.
For example, we suppose that if there was a 6% inflation rate for the last 20 years, a Rs. 100 purchase in 1992 would cost Rs. 321 in 2012. So, whenever we make a long term investment strategy, we need to consider inflation. An investment's real return is that return which is after deducting the inflation. This means that if the annual inflation rate is 6%, what we invest should earn more than 6% annually so that we get a positive real return.

What are Real Assets and Financial Assets?

A person can invest in **Physical assets** like real estate, gold/jewellery, and commodities etc or **Financial assets** such as fixed deposits with banks, small saving instruments with post offices, insurance/provident/pension fund etc. Apart from that an investor can invest in **securities market related instruments** like shares, bonds, debentures etc.

What are major Short Term Investment Options?

There are short term investment options such as savings bank account, money market/liquid funds and fixed deposits with banks.

- Out of them the Savings Bank Account is often the first banking product people use, which offers low interest, making them only marginally better than fixed deposits.
- In India, the interest rate on savings bank accounts is now deregulated as the banks themselves decide the interest rates.
- The *Money Market or Liquid Funds* are a specialized form of mutual funds that invest in extremely short-term fixed income instruments and thereby provide easy liquidity.

There is a big difference between the Mutual Funds and Liquid Funds. Unlike most mutual funds, money market funds are primarily oriented towards protecting the investor's capital and then, aim to maximise returns. Money market funds usually yield better returns than savings accounts, but lower than bank fixed deposits. Lastly, the Fixed Deposits with Banks can be long term as well as short term investment options as minimum investment period for bank FDs is 30 days. Fixed Deposits with banks are for investors with low risk appetite, and may be considered for 6-12 months investment period as normally interest on less than 6 months bank FDs is likely to be lower than money market fund returns.

What are Long Term Investment Options?

The Long term investments typically comprise the Post Office Savings Schemes, Public Provident Fund, Company Fixed Deposits, Bonds and Debentures, Mutual Funds etc.

Post Office Investments:

- Post Office Monthly Income Scheme is a low risk saving instrument, which can be availed

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through any post office. It provides an interest rate of around 8% per annum, which is paid monthly.

- Minimum amount, which can be invested, is Rs. 1,500/- and additional investment in multiples of 1,000/-.
- Maximum amount is Rs. 3,00,000/- (if Single) or Rs. 6,00,000/- (if held Jointly) during a year. It has a maturity period of 6 years. Premature withdrawal is permitted if deposit is more than one year old. Post office also provides time deposits for 1, 2, 3, 5 years. The monthly scheme and term deposits of Post offices don't provide any Tax benefits.

Public Provident Fund:

PPF is a long term savings instrument with a maturity of 15 years and interest payable at 8.25 % per annum (2011-12, it was 9.5 per cent paid in 2010-11) compounded annually. A PPF account can be opened through a nationalized bank at anytime during the year and is open all through the year for depositing money.

Tax benefits can be availed for the amount invested and interest accrued is tax-free. A withdrawal is permissible every year from the seventh financial year of the date of opening of the account and the amount of withdrawal will be limited to 50% of the balance at credit at the end of the 4th year immediately preceding the year in which the amount is withdrawn or at the end of the preceding year whichever is lower the amount of loan if any.

Corporate FDs

Corporate FDs or Company Fixed deposits are short-term (six months) to medium-term (three to five years) borrowings by companies at a fixed rate of interest which is payable monthly, quarterly, semi-annually or annually. They can also be cumulative fixed deposits where the entire principal along with the interest is paid at the end of the loan period. The rate of interest varies between 6-9% per annum . The interest received is after deduction of taxes.

Bonds

Bonds are fixed income instruments issued for a period of more than one year with the purpose of raising capital. The central or state government, corporations and similar institutions sell bonds. A bond is generally a promise to repay the principal along with a fixed rate of interest on a specified date, called the Maturity Date.

Mutual Funds

- The Mutual funds are operated by an investment company which raises money from the public and invests in a group of assets (shares, debentures etc.), in accordance with a stated set of objectives. Mutual Funds are for those who are unable to invest directly in equities or debt because of resource, time or knowledge constraints.

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- Mutual Funds come with benefits such as professional money management, buying in small amounts and diversification. Mutual fund units are issued and redeemed by the Fund Management Company based on the fund's net asset value (NAV), which is determined at the end of each trading session.
- NAV is calculated as the value of all the shares held by the fund, minus expenses, divided by the number of units issued. Mutual Funds are usually long term investment vehicle though there some categories of mutual funds, such as money market mutual funds which are short term instruments.

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General Knowledge Today

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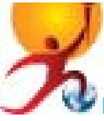

This document is mainly for Preliminary examination and covers the topics objectively. This content is also useful for some of you who might be appearing in Banking Examinations as well.

Prelims MCQ Topics

Unlimited Company versus Limited Company, Private Limited Company versus Public Limited Company, Share and Share Capital, Types of Share Capital, Capital Reserves versus Reserve Capital, Preference Shares and Equity shares, IPO, Book Building, Red Herring Prospectus, FPO, Voting Rights & Differential Voting Rights (DVR), Debt instruemtns, Debentures, Debentures and Shares.

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Types of Companies

Main types of companies in India

The companies registered under the Companies Act 1956 are of three types as follows:

- Unlimited Company
- Company Limited by Guarantee
- Company Limited by Shares: These are of two types-
    - Private company
    - Public Company

Further, the Companies Act 2013 has also provisions to start a **One Person Company (OPC)** in India.

Unlimited Company

The unlimited company is a company where there is no limit on the liability of its members. This means that if the company suffers a loss and the company's property is not enough to pay off its debts, the private property of its members is used to meet the claims of the creditors. This means that there is a huge risk in such companies. Unlimited companies are not found in India; instead, their space is occupied by the proprietary kind of businesses.

Limited Company

In a limited company is limited either by Guarantee or Shares. On this basis, there are two types of limited companies in India.

- Company Limited by Guarantee: In such a company, the liability of the members is limited to the extent of guarantee given by them in the event of winding up of the company.
- Company Limited by Shares: In this kind of the company, the liability of the members is strictly limited to the extent of nominal value of shares held by each of them. If a member has already paid the full amount of the shares, he shall not be liable to pay any amount. If a member has partly paid the shares, he can be forced to pay the remaining amount during the existence of the company as well as during the winding up. Such companies are of two kinds, private and public.

Private Limited Company

In India, a private company is the one which has a minimum paid up share capital of ` 100000 or such higher capital as prescribed by the Companies Act. Its Article of association mentions that the company

- Restricts the right to transfer its shares
- Limits the number of its members from 2 to 50
- Cannot go for invitation from public to subscription to any of its shares

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- Cannot accept deposits from persons other than its members, directors and relatives.

What is a Public Limited Company?

A public company means a company which is not a private company and has minimum of 7 shareholders/subscribers. It has to have a minimum paid-up share capital of ` 5 Lakh.

What are the differences between a Public Limited Company and Private Limited Company?

Distinction	Private Company	Public Company
Minimum Paid-up Capital	1 Lakh	5 Lakh
Minimum Number of Members	2	7
Maximum Number of Members	50	No restriction
Transerferability of shares	Complete Restriction	No Restriction
Issue of Prospectus	Prohibited	Free
Number of Director	At least 2	At least 3
Commencement of Business	Immediately after incorporation	Only after commencement of business certificate is obtained
Statutory meeting	No Obligation	Obligatory
Quorum	2 members	5 members
Managerial remuneration	No restriction	Can not exceed more than 11% of Net Profits

Share Markets

Understanding Shareholding

Every business needs some capital to start up. When a new business is started, the personal savings of an entrepreneur along with contributions from friends and relatives are the source of fund. The entrepreneur in this case can also be called a promoter. This may not be feasible in case of large projects as the required contribution from the entrepreneur (promoter) would be very large even after availing term loan; the promoter may not be able to bring his / her share (equity capital).Thus availability of capital can be a major constraint in setting up or expanding business on a large scale, because of this limited pool of savings of small circle of friends and relatives.

However, instead of depending upon this small pool, the promoter has the*option of raising money*

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from the public across the country by selling (issuing) shares of the company. For this purpose, the promoter can invite investment to his or her venture by issuing offer document which gives full details about track record, the company, the nature of the project, the business model, the expected profitability etc. If an investor is comfortable with this proposed venture, he / she may invest and thus become a shareholder of the company. *This means that a shareholder is an owner of the company to the extent of his / her shareholding.* The values of these shares are very small, but when the large number of shares aggregate, it makes substantial amount which is usable for large corporates.

Share

The total capital of the company is divided into units of small denominations as mentioned above. Each unit is called a share. For example if the total capital f the company is ` 10 Lakh divided into 1 Lakh units of Rs. 10 each, each Rs. 10 unit will be called a share. Shares are numbered so that they can be identified.

Please note that following are the properties of all kinds of shares of a public company:

- They are movable property
- They are transferable in the manner prescribed in the Articles of Association
- They are treated as Goods under the Sale of Goods Act , 1930.
- *A member who holds the shares of a company **does not imply** that the member owns any of the company's assets. This is because assets would be still possessed by the company which is a legal person in itself. However, if the company is wound up, after selling its assets, the shareholder has the right to participate in the assets after the debts have been paid. This means that **it is the right to what assets remain after liquidation.** At the same time, the shareholder is also liable for the amount, if any unpaid on the shares held by him.*

Share versus Share Capital

Please note that in context of a company, Capital means the share capital only. The reason is that many investors and promoters contribute varying sums to the Company's capital yet, there is no separate Capital account for each investor or promoter. Hence, there is a single consolidated Capital Account which is called the Share Capital Account.

Here are some important observations:

- Equity is an instrument for its owner for share in profits (and losses). Equity shares are instruments issued by companies to raise capital and it *represents the title to the ownership of a company*. An investor becomes an owner of a company by subscribing to its equity capital (whereby investor will be allotted shares) or by buying its shares from its existing owners. As a shareholder, investors bear the entrepreneurial risk of the business venture and are entitled to benefits of ownership like share in the distributed profit (dividend) etc. The returns earned

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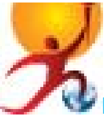

in equity depend upon the profits made by the company, company's future growth etc.

- Equity share is initially issued to those who have contributed capital in setting up an enterprise. This would be called the Public Issue. Apart from a Public Issue, equity shares may originate through an issue of *Bonus Shares, Convertible securities etc. All of them are collectively called Common Stock or Simply Stock.*
- *Please note that if the company fails or gets liquidated otherwise, the claim of equity shareholders on earnings and on assets in the event of liquidation, follows all others Similarly, the dividend on equity shares is paid after meeting interest obligations and dividends to Preference shareholders. That is why the holders of the Equity shares are also known as* ***'residual owners'.*** Since the equity shareholders bear such risks, they expect handsome returns by way of DIVIDENDS and price appreciation of the share, when their enterprise performs well.
- The total equity capital of a company is divided into equal units of small denominations, each called a share. For example, in a company the total equity capital of Rs 2,00,00,000 is divided into 20,00,000 units of Rs 10 each. Each such unit of Rs 10 is called a Share. Thus, the company then is said to have 20,00,000 equity shares of Rs 10 each. The holders of such shares are members of the company and have voting rights.

Different Types of Share Capital

There are various terms used in connection with the share capital of the company. They are as follows:

Authorized / Registered / Nominal Capital

This is the Maximum Capital which the company can raise in its life time. This is mentioned in the Memorandum of the Association of the Company. This is also called as Registered Capital or Nominal Capital.

Issued Capital

This is the part of the Authorized Capital which is issued to the public for Subscription. The act of creating new issued shares is called issuance, allocation or allotment. After allotment, a subscriber becomes a shareholder. The number of issued shares is a subset of the total authorized shares and

Shares authorized = Shares issued + Shares unissued

Subscribed Capital

The issued Capital may not be fully subscribed by the public. Subscribed Capital is that part of issued Capital which has been taken off by the public i.e. the capital for which applications are received from the public. So, it is a part of the Issued Capital as follows:

Issued Capital = Subscribed Capital + Unsubscribed Capital

This can be understood by an example. If we say that 15000 shares of Rs. 100 each are offered to the

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public and public applies only for 12000 shares, then the Issued Capital would be Rs. 15 Lakh and Subscribed Capital would be Rs. 12 Lakh.
Please note that once the shares have been issued and purchased by investors and are held by them, they are called Shares Outstanding. These outstanding shares have rights and represent ownership in the corporation by the person that holds the shares. The unsubscribed capital is also known as **Treasury shares**, which are shares held by the corporation itself and have no exercisable rights. Shares outstanding plus treasury shares together amount to the number of issued shares.

Called – up Capital

The Company may not need to receive the entire amount of capital of capital at once. It may call up only part of the subscribed capital as and when needed in installments. Thus, the called – up Capital is the part of subscribed capital which the company has actually called upon the shareholders to pay. Called – up Capital includes the amount paid by the shareholder from time to time on application, on allotment, on various calls such as First Call, Second Call, Final Call etc. The remaining part of subscribe capital not yet called up is known as Uncalled Capital. The Uncalled Capital may be converted, by passing a special resolution, into Reserve Capital; Reserve Capital can be called up only in case of winding up of the company, to meet the liabilities arising then.

Paid-up Capital

The Called-up Capital may not be fully paid. Some Shareholders may pay only part of the amount required to be paid or may not pay at all. Paid-up Capital is the part of called-up capital which is actually paid by the shareholders. The remaining part indicates the default in payment of calls by some shareholders, known as Calls in Arrears. Thus,
Paid-up Capital = Called-up Capital – Calls in Arrears.
Reserve Capital: As mentioned above, the company by special resolution may determine that a portion of the uncalled capital shall not be called up, except in the event of the winding up of the company. This part is called Reserved Capital. It is kept reserved for the Creditors in case of the winding up of the company.

Capital Reserves versus Reserve Capital

Here please note that **Capital Reserve** and **Reserve Capital** are two different animals. **Capital Reserves** are those reserves which are created out of the **Capital Profits. Capital Profits** are those profits which are not *earned in the normal course of the business*. Some examples are as follows:

- Profit on sale of fixed assets
- Profit on revaluation of fixed assets
- Premium on issue of shares and debentures

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- Profit on redemption of debentures
- Profit earned by the company prior to its incorporation

Please note that Capital Reserves cannot be utilized for the distribution of dividends as dividends are something which can be given from a profit that is earned by normal business of a company.

Understanding Shares

"A share is the share in the Capital of the Company" so defines the Companies Act 1956. A Company can issue two types of shares viz. Equity Shares and Preference Shares.

- Equity Shares:**Equity shares** or the **Ordinary Shares** means that part of the share capital which is not a Preference share capital. It means all such shares which are not Preference shares.
- Preference Shares: Preference shares are those shares which fulfil both the following two conditions:
    - They carry preferential share right in respect of dividend at a fixed rate,
    - They also carry preferential right in regard to payment of capital on winding up of the company.

Preference Shares

Apart from the other differences, the major difference between Ordinary shares and preference shares is of "dividend". Preference shares are those shares which carry the following two rights:

- They have the right to receive dividend at a fixed rate before any dividend is paid on the equity shares
- When the company is wound up, they have a right to return of the capital before that of equity shares.
- Apart from the above, the preference shares may carry some more rights such as the right to participate in excess profits which a specified dividend has been paid on the equity shares or the right to receive a premium at the time of redemption.

Different Types of Preference Shares

When we buy shares, we do not invest in the stock market itself but in the equity shares of a company. That makes us a shareholder or part-owner in the company. This means that we own part of the assets of the company, and we are entitled to a share in the profits these assets generate. A company may keep a fraction of profit generated within it. This will be utilised to buy new machinery or more raw material or to reduce its loan with the bank. It distributes the other fraction as dividend.

Cumulative Preference Shares:

Please note that when we buy equity shares or ordinary shares, we are not automatically entitled to a

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dividend every year. *The dividend will be paid only if the company makes a profit and declares a dividend.* But that is not the case with the**preference shares**. A preference shareholder is entitled to a dividend every year. Please note that it may be possible that a company doesn't have the money to pay dividends on preference shares in a particular year. The dividend is then added to the next year's dividend. If the company can't pay it the next year as well, the dividend keeps getting added until the company can pay. These are known as cumulative preference shares. Thus, cumulative preference shares are those preference shares, the holders of which are entitled to recover the arrears of preference dividend, before any dividend is paid on equity shares.

Non-cumulative Preference Shares:

Some preference shares are non-cumulative — if the company can't pay the dividend for one particular year, the dividend for that year lapses. If the company does not declare a dividend in any year due to any reason, such shareholders get nothing nor they can claim unpaid dividend of any year in any subsequent year.

Participating Preference Shares

They have fixed preference dividend and also a right to participate in surplus profits after a dividend is paid.

Non-Participating Preference Shares:

Such shares get only a fixed rate of dividend every year and there is no right to participate in the surplus profits.

Convertible Preference Shares:

Holders of these shares have right to get their preference shares to be converted into equity shares (but not debentures or other debt securities)

Non-Convertible Preference Shares

Holders of these shares have no right of getting their preference shares converted into equity shares

Differences between Preference Shares and Equity shares

The differences between them are listed in the following table:

Difference between Preference Shares and Equity shares		
Basis of Distinction	Preference Shares	Equity Shares
Rate of Dividend	Paid at fixed rate	May vary , depending upon the profits
Arrears of Dividend	Get accumulated for cumulative preference shares	No accumulation

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Difference between Preference Shares and Equity shares		
Preferential Rights	Before Equity shares	After
Winding up	Have a right to return of capital before equity shares . This means they are safer.	Only paid when preference share capital is paid fully
Voting Rights	No voting rights	Voting rights
Right to participate in Management	Have NO right	Have right

Investment in which type of share is safer?

The preference shares are safer investments than the equity shares In case the company is wound up and its assets (land, buildings, offices, machinery, furniture, etc) are being sold, the money that comes from this sale is given to the shareholders. After all, shareholders invest in a business and own a portion of it.

Can a retail investor purchase Preference shares?

Please note that usually, the preference shares are most commonly issued by companies to institutions. That means, it is out of the reach of the retail investor. For example, banks and financial institutions may want to invest in a company but do not want to bother with the hassles of fluctuating share prices. In that case, they would prefer to invest in a company's preference shares. Companies, on the other hand, may need money but are unwilling to take a loan. So they will issue preference shares. The banks and financial institutions will buy the shares and the company gets the money it needs. This will appear in the company's balance sheet as 'capital' and not as debt (which is what would have happened if they had taken a loan).

Are preference shares traded in Stock Exchanges?

Preference Shares are NOT traded in stock exchange. This also means they are not 'liquid' assets; there's little scope for the price of these shares to move up or down. On the other hand, ordinary or equity shares are traded in the markets and their prices go up and down depending on supply and demand for the stock. But, that does not mean the investor is stuck with his shares. After a fixed period, a preference shareholder can sell his/ her preference shares back to the company. This cannot be done with the ordinary shares. Ordinary shares can be only sold to another buyer in stock market. One can sell the ordinary shares back to the company only if the company announces a buyback offer.

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Procedure of issuing the shares

There are several stages in the process of issuing shares such as issuing a prospectus, application of Shares, allotment of Shares, book building etc.

Prospectus

Whenever shares are to be issued to the public the company must issue a prospectus. Prospectus means an open invitation to the public to take up the shares of the company thus a private company need not issue prospectus. Even a Public Company issuing its shares privately need not issue a prospectus. However, it is required to file a "Statement in lieu of Prospectus" with the register of companies.

The Prospectus contains relevant information like names of Directors, terms of issue, etc. It also states the opening date of subscription list, amount payable on application, on allotment & the earliest closing date of the subscription list.

Over-subscription and Under Subscription

A person intending to subscribe to the share capital of a company has to submit an application for shares in the prescribed form, to the company along with the application money before the last date of the subscription mentioned in the prospectus.

Over Subscription: If the no. of shares applied for is more than the no. of shares offered to the public then that is called as over Subscription.

Under Subscription: If the no. of shares applied for is less then the no. of shares offered to the public then it is called as Under Subscription.

Allotment of Shares

After the last date of the receipt of applications is over, the Directors, Provide with the allotment work. However, a company cannot allot the shares unless the minimum subscription amount mentioned in the prospectus is collected within a stipulated period. The Directors pass resolution in the board meeting for allotment of shares indicating clearly the class & no. of shares allotted with the distinctive numbers. Then Letters of Allotment are sent to the concerned applicants. Letters of Regret are sent to those who are not allotted any shares & application money is refunded to them.

Partial Allotment: In partial allotment the company rejects some application totally, refunds their application money & allots the shares to the remaining applicants.

Pro-rata Allotment

When a company makes a pro-rata allotment, it allots shares to all applicants but allots lesser shares then applied for E.g. If a person has applied for three hundred shares he may get two hundred shares.

Calls on Shares

The remaining amount of shares may be collected in instalments as laid down in the prospectus.

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Such instalments are called calls on Shares. They may be termed as "Allotment amount, First Call, Second Call, etc."

- **Calls–in–Arrears:** some shareholders may not pay the money due from them. The outstanding amounts are transferred to an account called up as "Calls-in-Arrears" account. The Balance of calls-in-arrears account is deducted from the Called-up capital in the Balance Sheet.
- **Calls–in–Advance:** According to sec.92 of the Companies Act, a Company may if so authorized by it s articles, accept from a shareholder either the whole or part of the amount remaining unpaid on any shares held by them, as Calls in advance. No dividend is paid on such calls in advance. However, interest has to be paid on such calls in advance.

Issue of Shares on discount and Premium

A limited company may issue the shares on following different terms.

1. Issue of Shares for Consideration other than cash or for cash or on capitalization of reserves.
2. Issue of Shares at par i.e. at face value or at nominal value.
3. Issue of Shares at a Premium i.e. at more than face value.
4. Issue of Shares at a Discount i.e. at less than the face value.

Issue of shares at a premium

When the shares are issued at a price higher than the nominal value of the shares then it is called as shares issued at a premium. The amount of premium is decided by the board of Directors as per the guide lines issued by SEBI. Please note that the Securities Premium is a profit to the company, but it is not a revenue profit, it is treated as **Capital Profit**, which can be utilized only for the following purposes:

- Issue of fully paid bonus shares to the existing shareholders.
- Writing off the preliminary expenses of the company.
- Writing off the expenses of issue or the commission paid or discount allowed on any issue of shares / debentures.
- Providing the premium payable on redemption of preference shares or debentures. The company can utilize the security Premium for any other purpose only on obtaining the sanction of the court.

Issue of shares at a discount

The companies can issue the shares at a discount subject to the following conditions:

1. The issue must be of a class of shares already issued.
2. Not less than 1 year has at the date of issue elapsed since the date on which the company

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became entitled to commence business.

3. The issue at a discount is authorized by a resolution passed by the company in the general meeting & sanctioned by the company law board.
4. The maximum rate of discount must not exceed 10% or such rate as the company law board may permit.
5. The shares to be issued at a discount must be issued within two months of the sanction by the company law board or within such extended time as the company law board may allow

IPO

When an unlisted company makes either a fresh issue of securities or an offer for sale of its existing securities or both for the first time to the public, it is called **Initial Public Offering** or IPO. An IPO paves way for listing and trading of the issuer's securities.

How Pricing of IPO is done?

When a company makes an IPO, the prior requirement would be to decide a price of the Issue / share. The question is -who will decide what should be the price? In India, there is a system of **free pricing** since 1992. However, there are guidelines that the company (Issuer) will decide the price in consultation with Merchant Banker. Still there is no formula for deciding the price of an IPO. *Please note that SEBI does not play any role on pricing of shares, but the company and merchant banker are required to give full disclosures of the parameters which they had considered while deciding the issue price*. While deciding the prices, there are two possibilities,

- Where company and Lead Merchant Banker fix a price. This is called Fixed Price.
- Where the company and the Lead Manager (LM) stipulate a floor price or a price band and leave it to market forces to determine the final price. This is called the **Price discovery through book building process.**

Book Building

Book Building is basically a process used in IPOs for efficient price discovery. It is a mechanism where, during the period for which the IPO is open, bids are collected from investors at various prices, which are above or equal to the floor price. The offer price is determined after the bid closing date.

Please note that in our country, the Price discovery through book building process is more popular than a normal issue. In the case of Price discovery through book building process, the price at which securities will be allotted is not known, while in case of offer of shares through normal public issue, price is known in advance to investor. Under Book Building, investors bid for shares at the floor price or above and after the closure of the book building process the price is determined for

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allotment of shares.

Role of SEBI in issuing shares

Many companies float public issues in market everyday. They also advertise the IPO and often when we read such advertisements we come across such lines printed in small font.

Please read the prospectus carefully prior to investing.

While most of the companies are genuine, there are also few who may want to exploit the investors. Therefore, it is very important that an investor before applying for any issue to judge and identify the future potential of a company. SEBI guidelines stipulate that the company must provide "***disclosure of information to the public***". This disclosure would include the information such as what is the reason for raising money, how this money will be spent, what are possible returns on expected money. All this contained in a document which is called "Prospectus".

Apart from the above, the Prospectus would also cover information regarding the size of the issue, the current status of the company, its equity capital, its current and past performance, the promoters, the project, cost of the project, means of financing, product and capacity etc. It also contains lot of mandatory information regarding underwriting and statutory compliances. The sole objective of the Prospectus is to provide investors an opportunity to evaluate short term and long term prospects of the company.

Draft Offer Document

Now, we understand that Prospectus gives information to the public about the potential of an IPO and its issuer company. But what if the company shows the people a rosy picture in its prospectus? It is not possible, because before a prospectus is available to the general public, the company has to make a "Offer document' , which is a "Prospectus" in case of a public issue or offer for sale and "Letter of Offer" in case of a rights issue which is filed with the Registrar of Companies (ROC) and Stock Exchanges (SEs). An offer document is thus a "Draft Prospectus", which covers all the relevant information to help an investor to make his/her investment decision. The draft offer documents are filed with SEBI, at least 30 days prior to the registration of**Red Herring Prospectus**. Since it's a draft, SEBI may specify changes, if any, in the draft Offer Document and the issuer or the lead merchant banker shall carry out such changes in the draft offer document before filing the Offer Document with ROC. The Draft Offer Document is made available on the SEBI website for public comments for a period of 21 days from the filing of the Draft Offer Document with SEBI.

Red Herring Prospectus

The literary meaning of idiom "Red Herring" is the rhetorical tactic of diverting attention away from an item of significance. In terms of capital markets, Red Herring Prospectus is a prospectus which contains all information about the IPO barring a few key details such as issue price.

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Draft Red Herring Prospectus

The Indian regulatory framework is based on a disclosure regime. A company which wants to raise funds from public via public issues is needed to file a draft prospectus with SEBI(Securities and Exchange Board of India).

This prospectus has most information related to company's operations, its directors, its past record etc. except some key details such as issue price. There is a bold disclaimer which mentions that the information is preliminary and subject to change. This is called **Draft Red Herring Prospectus**.

What SEBI does with DRHP?

SEBI reviews and ensures that adequate disclosures are made by the issuer to enable investors to make an informed investment decision in the issue. It must be clearly understood that SEBI does not 'vet' and 'approve' the offer document. Also, SEBI does not recommend the shares or guarantee the accuracy or adequacy of DRHP. SEBI'S observations on the draft offer document are forwarded to the merchant banker, who incorporates the necessary changes and files the final offer document with SEBI, Registrar of Companies (RoC) and stock exchanges. After reviewing the DRHP, the market regulator gives its observations which need to be implemented by the company. Once the observations are implemented, it gets final approval & the document then becomes RHP (Red Herring Prospectus).

When RHP's registration with RoC becomes effective, a final prospectus which contains IPO price and issue size is released.

Follow on Public Offer

FPO refers to follow on public offering. It is also known as **Further Issue**. A Further Issue is s when an already listed company makes either a fresh issue of securities to the public or an offer for sale to the public, through an offer document.

What are Issue Price & Market Price?

The price at which a company's shares are offered initially in the primary market is called as the Issue price. When they begin to be traded, the market price may be above or below the issue price.

Market Capitalization

The market value of a quoted company, which is calculated by multiplying its current share price (market price) by the number of shares in issue, is called as market capitalization. For example, if a company A has 150 million shares in issue and current market price is Rs. 100. The market capitalisation of company A is Rs. 15000 million.

What is 'Listing & Delisting of Securities"?

Listing means admission of securities of an issuer to trading privileges (dealings) on a stock exchange through a formal agreement. The prime objective of admission to dealings on the exchange is to

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provide liquidity and marketability to securities, as also to provide a mechanism for effective control and supervision of trading. The term 'Delisting of securities' means permanent removal of securities of a listed company from a stock exchange. As a consequence of delisting, the securities of that company would no longer be traded at that stock exchange.

Voting Rights & Differential Voting Rights (DVR)

Please note that the owners of equity shares have the voting rights in the annual general meetings of the company. Traditionally, voting right was like universal suffrage such as ownership of one share conferred one vote. Voting rights of a person in a company were equal to shares owned. However, concept of shares with differential rights was introduced by the Companies (Amendment) Act 2000. Section 86 of the Act was amended to make a provision to issue differential shares by Indian companies. These shares are expected to benefit the investors as well as corporates. As per section 86, equity shares with differential rights as to dividend, voting or otherwise can be issued.

A DVR share is like an ordinary equity share, but it provides fewer voting rights to the shareholder. *The objective of issuing DVR shares is for prevention of a hostile takeover and dilution of voting rights.* It also helps strategic investors who do not want control, but are looking at a reasonably big investment in a company. At times, companies issue DVR shares to fund new large projects, due to fewer voting rights, even a big issue does not trigger an open offer.

The Companies Act permits a company to issue DVR shares when, among other conditions, the company has distributable profits and has not defaulted in filing annual accounts and returns for at least three financial years. However, the issue of such shares cannot exceed 25 per cent of the total issued share capital.

Denomination

A public limited company is free to make right or public issue of equity shares in any denomination determined by it. It has however to comply with SEBI regulations that shares should not be of decimal of rupee and at any point of time there shall be only one denomination.

Face Value of Shares

Face Value is the nominal or stated amount (in Rs.) assigned to a security by the issuer. For shares, it is the original cost of the stock shown on the certificate; for bonds, it is the amount paid to the holder at maturity. Face Value is also known as the par value or simply par. For an equity share, the face value is usually a very small amount (Rs. 5, Rs. 10) and does not have much bearing on the price of the share, which may quote higher in the market, at Rs. 100 or Rs. 1000 or any other price. For a debt security, face value is the amount repaid to the investor when the bond matures (usually, Government securities and corporate bonds have a face value of Rs. 100). The price at which the security trades depends on the fluctuations in the interest rates in the economy.

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Premium and Discount values

Securities are generally issued in denominations of 5, 10 or 100. This is known as the Face Value or Par Value of the security as discussed earlier. When a security is sold above its face value, it is said to be issued at a Premium and if it is sold at less than its face value, then it is said to be issued at a Discount.

Forfeiture of shares

When shares are allotted to an applicant, it becomes a contract between the shareholder & the company. The shareholder is bound to contribute to the capital and the premium if any of the company to the extent of the shares he has agreed to take as & when the Directors make the calls. If the fails to pay the calls then his shares may be forfeiture by the directors if authorised by the Articles of Association of the company. The Forfeiture can be only for non-payment of calls on shares and not for any other reasons.

Bonus Shares

Profit making companies may desire to convert their profit into share capital. This can be done by issue of bonus shares. Issue of Bonus shares is also called as conversion of profit into share capital or capitalisation of profits. Bonus can be of two types:

- Making partly paid shares into fully paid by declaring bonus without requiring shareholders to pay for the same.
- Issue of fully paid equity shares as bonus shares to the existing equity shareholders

Rights Shares

A company can issue additional shares at any time by passing an ordinary resolution at its General Meeting. However such additional shares must be first offered to the existing equity shareholders in the proportion of the shares already held by them. Such additional shares are called "Rights Shares". Rights shares should be within the limits of the authorized capital. If not so, then the authorized capital must be increased first suitably. The issue of Rights Shares is to be made after two years from the formation of the company or after one year from the first allotment of shares.

Primary Market & Secondary Market

The mechanism by which the companies raise capital from the issuing if the shares is called Primary Market. Thus, Primary market is for raising the*Equity capital or share capital, which is the owners' interest on the assets of the enterprise after deducting all its liabilities.* It appears on the balance sheet / statement of financial position of the company.

When the shareholder needs the money back, he / she would not sell it back to the company except in some cases, (such as buyback offer) but would sell them to other new investors. *The trade of shares*

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does not reduce or alter the company's capital. This trading of shares is facilitated by the Stock Exchanges, which bring such sellers and buyers together and facilitate trading. Therefore, companies raising money from public are required to list their shares on the stock exchange. *This mechanism of buying and selling shares through stock exchange is known as the secondary markets.*

Stock Exchanges & Stock Markets

Stock exchanges are defined by the Securities Contract (Regulation) Act, 1956 [SCRA]. As per this act, anybody of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities, is called Stock Exchange. Stock exchange may be a regional stock exchange whose area of operation/jurisdiction is specified at the time of its recognition or national exchanges, which are permitted to have nationwide trading since inception. Examples are Delhi Stock Exchange and National Stock Exchange respectively.

Who owns the Stock Markets?

Please note that broker members of the exchange are both the owners and the traders on the exchange and they further manage the exchange as well. However, there can be two cases viz, Mutualized and demutualized exchanges. In a mutual exchange, the three functions of ownership, management and trading are concentrated into a single Group. This at times can lead to conflicts of interest in decision making. A demutualised exchange, on the other hand, has all these three functions clearly segregated, i.e. the ownership, management and trading are in separate hands.

What are the Factors that influence the price of a stock?

Factors that influence the price of a stock can be stock specific or market specific. The stock-specific factor is related to people's expectations about the company, its future earnings capacity, financial health and management, level of technology and marketing skills. The market specific factor is influenced by the investor's sentiment towards the stock market as a whole. This factor depends on the environment rather than the performance of any particular company. Events favourable to an economy, political or regulatory environment like high economic growth, friendly budget, stable government etc. can fuel euphoria in the investors, resulting in a boom in the market. On the other hand, unfavourable events like war, economic crisis, communal riots, minority government etc. depress the market irrespective of certain companies performing well. However, the effect of market-specific factor is generally short-term. Despite ups and downs, price of a stock in the long run gets stabilized based on the stock specific factors. Therefore, a prudent advice to all investors is to analyse and invest and not speculate in shares.

What are Bid and Ask prices?

The 'Bid' is the buyer's price. It is this price that you need to know when you have to sell a stock. Bid

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is the rate/price at which there is a ready buyer for the stock, which you intend to sell. The 'Ask' (or offer) is what you need to know when you're buying i.e. this is the rate/ price at which there is seller ready to sell his stock. The seller will sell his stock if he gets the quoted "Ask' price.

What is a share market Index?

A share market Index shows how a specified portfolio of share prices is moving in order to give an indication of market trends. It is a basket of securities and the average price movement of the basket of securities indicates the index movement, whether upwards or downwards. BSE Sensex is one index. The BSE SENSEX is a free-float market capitalization-weighted stock market index of 30 well-established and financially sound companies listed on Bombay Stock Exchange. The 30 component companies which are some of the largest and most actively traded stocks, are representative of various industrial sectors of the Indian economy. Published since January 1, 1986, the SENSEX is regarded as the pulse of the domestic stock markets in India. The base value of the SENSEX is taken as 100 on April 1, 1979, and its base year as 1978-79. On 25 July, 2001 BSE launched DOLLEX-30, a dollar-linked version of SENSEX.

What is a Depository?

A depository is like a bank wherein the deposits are securities (viz. shares, debentures, bonds, government securities, units etc.) in electronic form. A Depository can be compared with a bank, which holds the funds for depositors. There are many similarities in Banks and Depositories.

- While the Bank holds funds in an account, depositories hold securities in an account.
- While Bank transfers funds between accounts on the instruction of the account holder, Depository transfers securities between accounts on the instruction of the account holder.
- While the bank facilitates transfers without having to handle money, Depository facilitates transfers of ownership without having to handle securities. Banks keep safe money, depositories keep safe securities.

In India, we have two depositories viz. National Securities Depository Limited (NSDL) and Central Depository Services (India) Limited (CDSL).

What is a Depository Participant?

After depository, we have another entity called**Depository Participant**. Depository provides its services to investors through its agents called depository participants (DPs). These agents are appointed by the depository with the approval of SEBI. According to SEBI regulations, amongst others, three categories of entities, i.e. Banks, Financial Institutions and SEBI registered trading members can become DPs. Please note that accounts are always no frills at Depositories. This means an investor can have an account with depository without any balance.

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What is a Custodian?

There is one more entity about which you must know. It is called Custodian. A Custodian is basically an organisation, which helps register and safeguard the securities of its clients. Besides safeguarding securities, a custodian also keeps track of corporate actions on behalf of its clients. The functions of custodians are to maintain client's securities account, Collecting the benefits or rights accruing to the client in respect of securities, keeping the client informed of the actions taken or to be taken by the issue of securities, having a bearing on the benefits or rights accruing to the client.

Securities Basics

What are Securities?

Security is a broader term in comparison to share market. The definition of 'Securities' as per the Securities Contracts Regulation Act (SCRA), 1956, includes instruments such as shares, bonds, scrips, stocks or other marketable securities of similar nature in or of any incorporate company or body corporate, government securities, derivatives of securities, units of collective investment scheme, interest and rights in securities, security receipt or any other instruments so declared by the Central Government. Securities Markets is a place where buyers and sellers of securities can enter into transactions to purchase and sell shares, bonds, debentures etc. Further, it performs an important role of enabling corporates, entrepreneurs to raise resources for their companies and business ventures through public issues. Transfer of resources from those having idle resources (investors) to others who have a need for them (corporates) is most efficiently achieved through the securities market. Stated formally, securities markets provide channels for reallocation of savings to investments and entrepreneurship. Savings are linked to investments by a variety of intermediaries, through a range of financial products, called 'Securities'.

How security market is regulated in India?

The securities markets need regulation because there is absense of perfect competition and markets are prone to manipulation. It is the duty of the regulator to ensure

that the market participants behave in a desired manner so that securities market continues to be a major source of finance for corporate and government and the interest of investors are protected. In India, the responsibility for regulating the securities market is shared by Department of Economic Affairs (DEA), Department of Company Affairs (DCA), Reserve Bank of India (RBI) and Securities and Exchange Board of India (SEBI). The Securities and Exchange Board of India (SEBI) is the regulatory statutory authority in India established under Section 3 of SEBI Act, 1992. SEBI Act, 1992 .The statutory powers of SEBI are:

1. Protecting the interests of investors in securities

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2. Promoting the development of the securities market
3. Regulating the securities market.
4. Regulating the business in stock exchanges and any other securities markets
5. Registering and regulating the working of stock brokers, sub–brokers etc.
6. Promoting and regulating self-regulatory organizations
7. Prohibiting fraudulent and unfair trade practices
8. Calling for information from, undertaking inspection, conducting inquiries and audits of the stock exchanges, intermediaries, self – regulatory organizations, mutual funds and other persons associated with the securities market.

Debt Capital and Debt Instruments

Debentures or bonds are debt instruments which*pay interest over their life time*and are used by companies to raise medium or long term debt capital. If an investor prefers fixed income, he / she may invest in these instruments which may give him / her higher rate of interest than bank fixed deposit.

- In the Indian securities markets, the term '**bond**' is used for debt instruments issued by the Central and State governments and public sector organizations and the term '**debenture**' is used for instruments issued by private corporate sector.

The Debt Instruments may be Corporate Debt or Government Debt. Corporate debt instruments are generally called Debentures while Government debt instruments are generally called Bonds, but Bonds can be issued by companies and local governance bodies too.

Debenture

A debenture is one of the capital market instruments which is used to raise medium or long term funds from public. A debenture is essentially a debt instrument that acknowledges a loan to the company and is executed under the common seal of the company. The debenture document, called Debenture deed contains provisions as to payment, of interest and the repayment of principal amount and giving a charge on the assets of a such a company, which may give security for the payment over the some or all the assets of the company. Issue of Debentures is one of the most common methods of raising the funds available to the company. It is an important source of finance.

Salient Features of Debentures

The most salient features of Debentures are as follows:

- A debenture acknowledges a debt
- It is in the form of certificate issued under the seal of the company (called Debenture Deed). It usually shows the amount & date of repayment of the loan.

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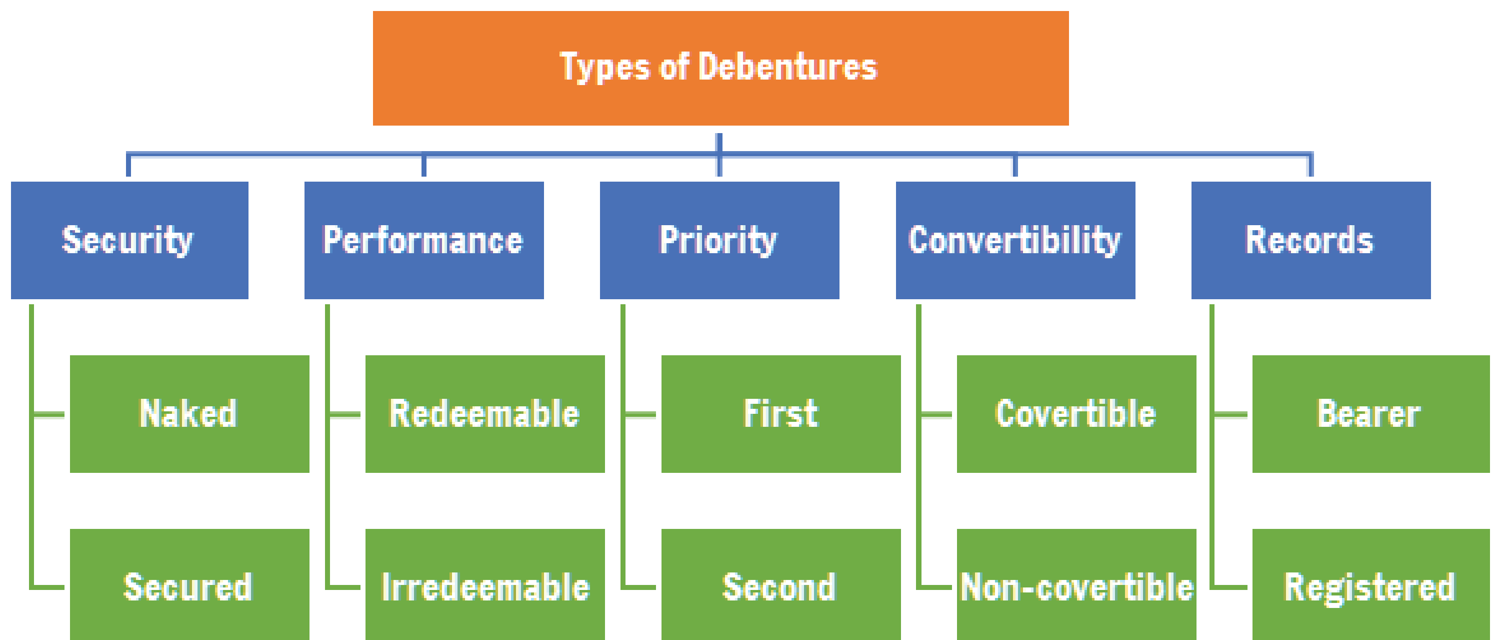
- It has a rate of interest & date of interest payment.
- Debentures can be secured against the assets of the company or may be unsecured.
- Debentures are generally freely transferable by the debenture holder. Debenture holders have no rights to vote in the company's general meetings of shareholders, but they may have separate meetings or votes e.g. on changes to the rights attached to the debentures.
- The interest paid to them is a charge against profit in the company's financial statements.

Types of Debentures

The debentures can be divided into various types on the basis of security, performance, priority, convertibility and Records as shown in the below graphics:



What are naked debentures and secured debentures?

- **Naked Debentures:** These *Debentures are not secured against any assets of the Company*. In case of winding of the company, debentures holders holding unsecured debentures treated as unsecured creditors.
- **Secured Debentures:** These Debentures are secured by a charge on the assets of the company. These debentures are secured either on particular assets called fixed charge or on the general assets of the company called floating charge. The debentures holder has a right to recover outstanding loan & interest out of such charge assets. These debentures are issued by the company under an agreement which is called "Mortgage Deed". Such mortgage is registered with Register of Companies.

What are Redeemable and Irredeemable debentures?

- **Redeemable Debentures:** The debentures are redeemed by repayment of the amount of debentures after a specified date, as per terms & conditions issued.

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- **Irredeemable Debentures:** In this case the issuing company does not fix any date by which debentures should be redeemed & the debentures holder cannot demand repayment of the sum of debenture from the company so long as it is going concern.

What are first debentures and second debentures ?

- **First debentures:** This type of debentures are repaid before the repayment of other debentures.
- **Second debentures:** These debentures are paid after payment of first debentures.

What are convertible debentures and non-convertible Debentures?

- **Convertible debentures:** Holders of such debentures are given option to convert the debentures fully or partly into ***equity shares or preference shares or new debentures*** after a specified time.
- **Nonconvertible debentures:** The holders of this type of debentures do not have any right to convert them into equity shares etc.

What are bearer debentures and registered debentures?

- **Bearer debentures:** Just like bearer cheques these debentures can be transferred freely. Payment of interest is made on productions of coupons attached with debentures.
- **Registered debentures:** These are transferred only by transfer deed. The complete particulars in regard to such debentures are entered into register & the interest is paid only to those whose name appears in the register.

What are at par, at premium and at discount issue of Debentures?

Debentures can, be issued in three ways.

- **At par:** Debenture is said to have been issued at par when the amount collected for it is equal to the nominal value of debentures. e.g. the issue of debentures of Rs. 100/- for Rs. 100/-
- **At Discount:** Debenture is said to have been issued at discount when the amount collected is less than the nominal value, for e.g., issue of debentures of Rs. 100/- for Rs. 95/-. The difference of Rs. 5/- is the discount and is called discount on issue of Debentures. *This discount on issue of debentures is a capital loss.*
- **At Premium:** When the price charged is more than its nominal value, a debentures is said to be issued at a premium. e.g., issue of debentures of Rs. 100 each for Rs. 120, the excess amount over the nominal value i.e., Rs. 20 is the premium on issue of debentures. Premium received on issue of debentures is a capital gain. *Please note that this Premium on issue of debentures cannot be utilised for distribution of dividend.* Premium on debentures is shown under the head Reserves & Surplus on the liability side of the Balance Sheet.

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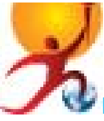

What is Issue of Debentures for Cash?

Debentures may be issued for cash at a par, at a discount or at a premium. When amount is payable in instalments entries will be similar to the issue of shares. Any premium or discount on issue of debentures is usually adjusted at the time of making allotment. Premium payable on redemption of debentures is also adjusted at the time of issue of debentures.

What is Issue of debentures for non-cash consideration?

Debentures may be issued for consideration other than cash such as acquisition of business, or assets. It should be noted that ouch debentures may be issue at par or at a premium or at a discount.

What is Issue of debentures as a collateral security?

Debentures can be issued as collateral security against a loan or overdraft from bank or other financial institution. Collateral Security means an additional or parallel security.

What is Redemption of Debentures?

Debentures may be redeemed (repaid) a) at a par b) at a premium or c) at a discount.

- **Redeemable at par:**When debentures are to be redeemed at their face value they are said to be redeemable at par.
- **Redeemable at a premium:**When debentures are to be redeemed at an amount higher than their face value they said to be redeemable at a premium. Premium payable on redemption of debentures is a capital loss for the company. Such premium even though payable on redemption must be provided as a liability at a time of issue of debentures.
- **Redeemable at a discount:**When debentures are to be redeemed at an amount lower than their face value, they are said to be redeemable at a discount such discount is a capital profit for the company.

How debentures are different from bonds?

Bonds and Debentures, both are similar and holders of both of them are creditors to the company. Both bonds and debentures can be secured or unsecured. Generally, the bonds issued by the companies are secured by their assets. But there are unsecured bonds as well. The bonds issued by municipalities or government companies etc. are normally not secured by any assets.

Both bonds and debentures get priority over shares when company is liquidated. However, if the bonds are secured, they get priority over unsecured debentures.

What is Convertibility in Debentures?

Convertibility in debentures denotes conversion of a debenture to equity shares. On this basis they are of four types as follows:

- **Partly Convertible Debentures (PCD):**A part of these instruments are converted into Equity shares in the future at notice of the issuer. The issuer decides the ratio for conversion.

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This is normally decided at the time of subscription.

- **Fully convertible Debentures (FCD):**These are fully convertible into Equity shares at the issuer's notice. The ratio of conversion is decided by the issuer. Upon conversion the investors enjoy the same status as ordinary shareholders of the company.
- **Optionally Convertible Debentures (OCD):**The investor has the option to either convert these debentures into shares at price decided by the issuer/agreed upon at the time of issue.
- **Non Convertible Debentures (NCD):**Non-convertible debentures , which are simply regular debentures, cannot be converted into equity shares of the liable company. They are debentures without the convertibility feature attached to them. As a result, they usually carry higher interest rates than their convertible counterparts. Thus, these instruments retain the debt character and can not be converted in to equity shares

What is difference between Debentures and Shares

The key difference between a share and a debenture is that while share represents part of ownership of a company, debenture acknowledges loan or debt to the company.

Shares	Debentures
Share capital is an ownership capital.	Debentures capital is credit to the company.
A shareholder is the owner of the company.	A debenture holder is the creditor of the company
Share capital is not returnable in the life time of the company. However, the redeemable preference shares are refunded during the life-time of the company.	Debenture capital returnable during the lifetime of the company. The exception is the irredeemable debentures which are not redeemable during the life-time of the company.
Equity Shareholders enjoy the voting rights.	Debentures holders do not have the voting rights.
Dividend is payable on shares & it is an appropriation of profits	Interest on debentures is payable at a fixed rate on specified date irrespective of profits of the company.
Dividend depends on the profit of the company	Interest is paid on debentures & it is a charge on the revenue of the company.
Shares are unsecured.	Debentures are generally secured.
In the event of winding up of the company shareholders are the last person in re-fund of their capital.	Debenture holder being the creditors are paid prior to the shareholders. If secured they have priority even over the unsecured creditors.

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G-Secs

Government securities (G-Secs) are instruments issued by Government of India to raise money. G Secs pays interest at fixed rate on specific dates on half-yearly basis. It is available in wide range of maturity, from short dated (one year) to long dated (up to thirty years). Since it is sovereign borrowing, it is free from risk of default (credit risk). The investors can subscribe to these bonds through RBI or buy it in stock exchange.

Hybrid Instruments

The Hybrid Instruments are a combination of ownership and loan instruments. Examples are Preference Shares, Cumulative Preference Shares and Cumulative Convertible Preference Shares. Preference shares are also known as Preferred Stock. The Preference share entitle the investors to receive dividend at a fixed rate. This is the major difference between the equity share holder and preference share holder that the later gets dividend at a fixzed rate. This dividend had to be paid to the investor before dividend can be paid to equity shareholders. In the event of liquidation of the company, the claim to the company's surplus will be higher pf the holders of Prefernce shares than that of the equity holders, but however, below the claims of the company's creditors, bondholders / debenture holders. This means that if a company is liquidated, the payment will be done in the following order:

Creditor's →Debenture / Bond Holders →Preference share holder's → Equity Share Holders

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General Knowledge Today

Banking & Finance-7: Insurance Industry, NBFCs

Target 2016: Integrated IAS General Studies

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Banking & Finance-7: Insurance Industry, NBFCs

This document is mainly for Preliminary examination and covers the topics objectively. This content is also useful for some of you who might be appearing in Banking Examinations as well.

Prelims MCQ Topics

IRDA Functions, Insurance Ombudsman, Employee's State Insurance Corporation, Underwriting, Types of NBFCs and their regulators, Difference between NBFC and Banks, Infrastruture Debt Fund, Deposit Taking by NBFCs

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Part-I : Insurance Industry

Insurance is the equitable transfer of the risk of a loss, from one entity to another in exchange for payment. It is a form of risk management primarily used to hedge against the risk of a contingent, uncertain loss.

There are different kinds of insurance. Like Auto insurance, Health Insurance, Fire insurance to protect against varied risks. Mainly however, insurance is divided into two broad Categories:

- Life Insurance
- General Insurance

History of Life Insurance

The technique of pooling of resources to be re-distributed in times of calamities and emergencies like fire, floods, famine and epidemics is not new in India. This concept of insurance finds mention in the writings of Manu's Manusmiriti, Yagnavalkya's Dharmasastra and Kautilya's Arthasastra. Insurance records in the form of Marine trade loans and carrier's contracts exist dating ancient times. Over time, the concept of Insurance evolved in India drawing heavily from other countries, particularly England.

Timeline of Life Insurance Companies

- 1818: establishment of the Oriental Life Insurance Company in Calcutta. This company failed in 1834.
- 1829: the Madras Equitable started transacting life insurance business in the Madras Presidency.
- 1870: British Insurance Act enacted, Industry back then was dominated by foreign insurance offices which did good business in India.
- 1914: the Government of India started publishing returns of Insurance Companies in India.
- 1912: The Indian Life Assurance Companies Act, the first statutory measure to regulate life business was enacted.
- 1928: Indian Insurance Companies Act was enacted. This act enabled the Government to collect statistical information about both life and non-life business transacted in India by Indian and foreign insurers including provident insurance societies.
- 1938: Insurance Act, 1938 amended previous act and consolidated it with comprehensive provisions for effective control over the activities of insurers.
- 1950: The Insurance Amendment Act abolished Principal Agencies. However, due to fierce competition and allegations of unfair trade practices, The Government of India, decided to nationalize insurance business.

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- 1956 Insurance sector nationalized and Life Insurance Corporation came into existence.

Life Insurance Corporation

The LIC absorbed 154 Indian, 16 non-Indian insurers as also 75 provident societies—245 Indian and foreign insurers in all. The LIC had monopoly in the insurance sector in India till the late 90s when the Insurance sector was reopened to the private sector.

History of General Insurance in India

Industrial Revolution in the west and the consequent growth of sea-faring trade and commerce in the 17th century gave rise to the concept of General Insurance.

Timeline of General Insurance Cos.

- 1850: General Insurance has its roots in the establishment of Triton Insurance Company Ltd., in Calcutta by the British.
- 1907: Indian Mercantile Insurance Ltd, was set up and was the first company to transact all classes of general insurance business.
- 1957: the General Insurance Council, a wing of the Insurance Associaton of India was formed. It framed a code of conduct for ensuring fair conduct and sound business practices.
- 1968, the Insurance Act was amended to regulate investments and set minimum solvency margins.
- 1972 *General Insurance Business (Nationalization) Act* was passed and with it, general insurance business was nationalized with effect from 1st January, 1973. 107 insurers were grouped into four companies, namely:
    - National Insurance Company Ltd.,
    - The New India Assurance Company Ltd.,
    - The Oriental Insurance Company Ltd and
    - The United India Insurance Company Ltd.
- 1971: The General Insurance Corporation of India was incorporated as a company, it commence business on January 1st 1973.
- 1990s: The process of re-opening of the sector had began and the last decade and more has seen it been opened up substantially.
- 1993: the Government set up a committee under the chairmanship of RN Malhotra, former Governor of RBI, to propose recommendations for reforms in the insurance sector. The objective of Malhotra committee was to complement the reforms initiated in the financial sector. The committee submitted its report in 1994 and recommended that the private sector be permitted to enter the insurance industry, preferably in a joint venture with Indian

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partners.

- 1999: Following the recommendations of the Malhotra Committee report, in 1999, the Insurance Regulatory and Development Authority (IRDA) was constituted.
- 2000: IRDA opened up the market with the invitation for application for registrations. Foreign companies were allowed ownership of up to 26%.
- 2000: Subsidiaries of the General Insurance Corporation of India were restructured as independent companies and GIC was converted into a national re-insurer.
- 2002: Parliament passed a bill de-linking the four subsidiaries from GIC.

Structure of Insurance Industry in India

Today there are 27 general insurance companies including the ECGC and Agriculture Insurance Corporation of India and 24 life insurance companies operating in the country.

The insurance sector is a 72 Billion USD industry and is growing at a speedy rate of 15-20%. Together with banking services, insurance services add about 7% to the country's GDP.

A well-developed and evolved insurance sector is a boon for economic development of the country as it provides long-term funds for infrastructure development at the same time strengthening the risk taking ability of the country. The insurance sector went from being unregulated to completely regulated and then being partly deregulated.

IRDA: The Insurance Industry Regulator

The autonomous, apex and statutory body which regulates and develops the insurance industry in India is the Insurance Regulatory and Development Authority (IrDA). It is a statutory body constituted by IrDA act 1999, which was passed on the recommendation of the Malhotra Committee report of 1994. IrDA began functioning in April 2000. This agency operates from its headquarters at Hyderabad, where it was shifted from Delhi in 2001.

Functions of IRDA:

- Protect the rights of policy holders
- Provide registration certification to life insurance companies
- Renew, Modify, Cancel or Suspend this registration certificate as and when appropriate.
- Promoting efficiency in the conduct of insurance business;
- Promoting and regulating professional organisations connected with the insurance and re-insurance business
- Regulating investment of funds by insurance companies;
- Adjudication of disputes between insurers and intermediaries or insurance intermediaries;

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Organizational structure or Composition of IrDA

IRDA is a ten member body consisting of:

- A Chairman (Currently T.S. Vijayan)
    - Five whole-time members,
        - Four part-time members,

All members are appointed by the Government of India.

Insurance Ombudsman

The Insurance Ombudsman is created by Government of India for individual policyholders to have their complaints settled out of the courts in an impartial, efficient and cost-effective way.

There are 12 Insurance Ombudsman in different locations in India that an insured person can approach. Usually complaints are lodged with the ombudsman having jurisdiction over the location of the insurance company office that the insured person has a complaint against.

- Insured persons can approach the Ombudsman with complaint if:
- They have first approached their insurance company with the complaint and the company has not resolved it.
- Not resolved it to the insured person's satisfaction or
- Not responded to it at all for 30 days
- An insured person's complaint pertains to any policy you have taken in his/her capacity as an individual and
- The value of the claim including expenses claimed is not above Rs 20 lakh

A complaint to the Ombudsman can be about:

- Any partial or total repudiation of claims by an insurer
- Any dispute about premium paid or payable in terms of the policy
- Any dispute on the legal construction of the policies as far as it relates to claims
- Delay in settlement of claims
- Non-issue of any insurance document to you after you pay your premium
- The settlement process

The Ombudsman acts as counsellor and mediator and arrives at a fair recommendation based on the facts of the dispute.

Integrated Grievance Management System

IRDA has launched the Integrated Grievance Management System (IGMS). Apart from creating a central repository of industry-wide insurance grievance data, IGMS is a grievance redress monitoring tool for IRDA. Policyholders who have grievances should register their complaints with

the Grievance Redress Channel of the Insurance Company first. If policyholders are not able to access the insurance company directly for any reason, IGMS provides a gateway to register complaints with insurance companies.

- Complaints are registered with insurance companies first and only if need be, be escalated them to IRDA (Consumer Affairs Department). IGMS is a comprehensive solution which not only has the ability to provide a centralised and online access to the policyholder but complete access and control to IRDA for monitoring market conduct issues of which policyholder grievances are the main indicators.
- IGMS has the ability to classify different complaint types based on pre-defined rules. The system has the ability to assign, store and track unique complaint IDs. It also sends intimations to various stakeholders as required, within the workflow. The system has defined target Turnaround Times (TATs) and measures the actual TATs on all complaints. IGMS sets up alerts for pending tasks nearing the laid down Turnaround Time. The system automatically triggers activities at the appropriate time through rule based workflows.

A complaint registered through IGMS will flow to the insurer's system as well as the IRDA repository. Updating of status will be mirrored in the IRDA system. IGMS enables generation of reports on all criteria like ageing, status, nature of complaint and any other parameter that is defined. Thus IGMS provides a standard platform to all insurers to resolve policyholder grievances and provides IRDA with a tool to monitor the effectiveness of the grievance redress system of insurers.

Insurance Repository

An Insurance Repository is a facility to help policy holders buy and keep insurance policies in digital/electronic form, rather than as a paper documents.

The Finance Minister of India recently announced the setting of insurance repository system.Like Share Depositories or Mutual Fund Transfer Agencies, Insurance Repositories, will hold electronic records of insurance policies issued to individuals and such policies are called "electronic policies" or "e-Policies".

In 2013, IRDA has issued licences to five entities to act as Insurance depositories, these companies will maintain data of insurance policies in electronic form for insurers and will open e-Insurance accounts for policyholders.

- Central Insurance Repository Limited (CIRL)
- NSDL Database Management Limited
- SHCIL Projects Limited
- Karvy Insurance repository Limited

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- CAMS Repository Services Limited

Benefits of Insurance Repositories

- Policies stored in the electronic form, don't run the risk of losing the physical documents.
- It becomes easier to track one's policies as the details will be available at one place. Insured person won't have to go to different offices anymore.
- Less paperwork. With the repository as the single point of service, updating details will become easier, faster and more reliable.

Privatization of Life Insurance in India

In 1993 RN Malhotra Committee was appointed by the Government of India to lay down a road map for privatisation of the life insurance sector. The committee submitted its report in 1994, but it took another six years before the enabling legislation was passed in 2000.

In the same year, insurance regulator – Insurance Regulatory and Development Authority IRDA—started issuing licenses to private life insurers. All insurance companies in India have to comply with the regulations laid out by IRDA. Today, life Insurance is the fastest growing sector in India since 2000 as Government allowed Private players and FDI up to 26% and then Cabinet approved a proposal to increase it to 49%. Apart from Life Insurance Corporation of the Public sector, there are 23 other private sector life insurers, most of them joint ventures between Indian and global insurance groups.

Some famous brand names in the Life Insurance Business in India are:

Aviva India, AEGON Religare, Bajaj Allianz, HDFC Life, ICICI Prudential, IDBI Federal Life Insurance, IndiaFirst Life Insurance Company, ING Life India, LIC, Max Life, Peerless Group, Reliance, SBI Life, Sun Life Financial etc.

Foreign Direct Investment (FDI) Policy in Insurance Sector

- As of now, the maximum participation in an Indian insurance company is restricted to 26.0% of its equity / ordinary share capital with the balance being funded by Indian promoter entities.
- 26% cap on foreign investments in the insurance sector also applies to intermediaries such as brokers, third party administrators and surveyors.
- Insurance brokers are entities which arrange insurance contracts with insurers or reinsurers on behalf of their clients.
- The Indian government has supported an increase in the FDI limit, which requires a change in the Insurance Act.
- In 2005 the Union budget had recommended that the ceiling on foreign holding be increased

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to 49.0%.

- A change in the Insurance Act requires a passage of the bill in both houses of Parliament.
- The Indian government tabled the bill in the Upper House of Parliament in August 2010 and again in 2014 but did not pass.
- IRDA has set up a committee to study the option of allowing 100 percent FDI in insurance intermediaries, third-party administrators, surveyors and loss assessors. But action on this, too, would have to wait.

Types of Life Insurance

Term Insurance Policies

This kind of policy secures the immediate needs of nominees or beneficiaries in the event of sudden or unfortunate demise of the policy holder. The policy holder does not get any monetary benefit at the end of the policy term except for the tax benefits. In the event of death of the policy holder, the sum assured is paid to his or her beneficiaries.

Money-back Policies

Under such a policy the policy holder receives a fixed amount at specific intervals throughout the duration of the policy. In the event of the unfortunate death of the policy holder, the full sum assured is paid to the beneficiaries.

Unit-linked Investment Policies (ULIP)

A ULIP is a product offered by insurance companies gives investors the benefits of both insurance and investment under a single integrated plan, unlike a pure insurance policy which only provides financial cover without the added advantage of an investment.

The money collected by the insurance provider is utilized to form a pool of fund which is used to invest in various markets instruments (debt and equity) in varying proportions just like it is done for mutual funds.

Pension Policies

These are retirement planning investment schemes where the sum assured or the monthly pay-out after retirement entirely depends on the capital invested, the investment timeframe, and the age at which one wishes to retire.

Health Insurance In India

Health insurance is the issuance that essentially coves all types of medical expenses. A health insurance policy is a contract between insurance and individual or group in which insurer agrees to provide specified health insurance cover in exchange of a regular “premium”.

Since 1986 the health insurance industry has grown significantly due to liberalisation and general

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awareness. By 2010, more than 25% of India's population had access to some form of health insurance.

The General Insuance Corporation and IRDA have even launched an awareness campaign for all segments of population to improve awareness and reduce procrastination for buying health insurance.

Policies available under the health insurance cover both individuals and families.

Aspects of Health Insurance

Tax Deductions

- Under section 80D of the income tax act, the insured person who takes out the policy can claim for tax deduction for the amount invested.

Payment Options

- Direct payment / Cashless facility: here, the person does not need to pay the hospital as the insurer takes care of the all the treatment bills.
- Reimbursement at the end of the hospital stay : after staying for the duration of the treatment, the patient can take a reimbursement

Cost and Duration

Policy price range: Insurance companies offer health insurance from a sum insured of Rs. 5000/- for micro-insurance policies to a higher sum insured of Rs. 50 lacs and above. The common insurance policies for health insurance are usually available from Rs. 1 lac to Rs. 5 lacs.

Duration: Health insurance policies offered by non-life insurance companies usually last for a period of one year. Life insurance companies offer policies for a period of several years.

Types of Policies

Hospitalization Policy : Under such policies the insurer pays the total or partial amount of the insured person's hospital bills.

Hospital Daily Cash Benefit Policy : Under this type of schemes daily ash benefits are offered to the policyholder in terms of a fixed amount for each day of hospitalisation

Critical Illness Benefit : In the event of having critical illness, this policy is designed to mitigate expenses.

Employee's State Insurance Corporation

Functioning under the aegis of Ministry of Labour and Employment and Incorporated under the ESI Act of 1948, the ESIC is a self-financing health insurance and social security scheme for all indian workers earning less than 15000 per month as wages.

It is a contributory insurance scheme in which employer contributes 4.75% and employee contributes 1.75% of a total 6.5% of the wages earned. In return, the insured per on and their family are entitled

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to different types of befenits, both medical and cash. In addition to insured workers, poor families eligible under the Rashtriya Swasthya Bima Yojana can also avail facilities in ESI hospitals and dispensaries.

Recently there has been an increase in the role of information technology in ESI, with the introduction of Pehchan smart cards under the corporation's '**Project Panchdeep**', India's largest e-governance project.

Future of Insurance Sector

The future looks good for in Insurance sector. The sector has a strong potential to grow from US$ 72 billion in 2012 to US$ 280 billion by 2020. India's favorable regulatory environment which guarantees stability and fair play will be the primary driver for this growth. Foreign investors want to tap into the sector's massive potential.

Since the government liberalized the insurance sector in 2000 by opening the doors for private participation, the Indian insurance sector has gotten stronger.

Competition has provided the consumer with an unforeseen range of products, providers and enhanced service levels. The health of the insurance sector reflects a country's economy. Insurance sector generates long-term funds for infrastructure development and also increases a country's risk-taking capacity.

India's economic growth since the turn of the century is viewed as a significant development in the global economy. This view is helped in no small part by a booming insurance industry.

Select Terms related to Insurance Sector

Actuary

Actuary is a business professional who analyzes probabilities of risk and risk management including calculation of premiums, dividends and other applicable insurance industry standards.

Annuity

Annuity refers to a contract providing income for a specified period of time, or duration of life for a person or persons.

Collateralized Mortgage Obligations (CMOs)

CMOs are a type of mortgage-backed security (MBS) with separate pools of pass-through security mortgages that contain varying classes of holders and maturities (tranches) with the advantage of predictable cash flow patterns.

Policy Lapse

Policy lapse refers to termination of a policy due to failure to pay the required renewal premium.

Micro Insurance

A micro-insurance policy is a general or life insurance ploy with a sum assured of 50000 or less.

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IRDA has created this special category under the micro-insurance regulations, 2005, to promote insurance coverage among the economically vulnerable sections of society.

Morbidity Risk

Morbidity Risk is the potential for a person to experience illness, injury, or other physical or psychological impairment, whether temporary or permanent. Morbidity risk excludes the potential for an individual's death, but includes the potential for an illness or injury that results in death.

Mortgage Insurance

Mortgage Insurance is a form of life insurance coverage payable to a third party lender/mortgagee upon the death of the insured/mortgagor for loss of loan payments.

Package Policy

When two or more distinct policies combined into a single contract, it is known as Package Policy.

Premium

Premium is the money charged for the insurance coverage reflecting expectation of loss.

Underwriter

Underwriter is a person who identifies, examines and classifies the degree of risk represented by a proposed insured in order to determine whether or not coverage should be provided and, if so, at what rate.

Underwriting

Underwriting is the process by which an insurance company examines risk and determines whether the insurer will accept the risk or not, classifies those accepted and determines the appropriate rate for coverage provided.

Part-II: Non-Banking Financial Companies

NBFCs or Non Banking Financial Companies are those companies which provide banking services without meeting the legal definition of a bank. A NBFC is incorporated under the Companies Act, 1956 and desirous of commencing business of non-banking financial institution as defined under Section 45 I(a) of the RBI Act, 1934.

The NBFCs do the business of loans and advances, acquisition of shares, stock, bonds, debentures, securities issued by Government. They also deal in other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business.

However, the companies cannot be NBFCs if their primary business is related to agriculture activity, industrial activity, sale/purchase/construction of immovable property.

Usually, the 50-50 test is used as an anchor to register an NBFC with RBI. 50-50 Test means that the companies at least 50% assets are financial assets and its income from financial assets is more than 50% of the gross income.

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Regulation of NBFCs

Non-Banking Financial Companies are regulated by different regulators in India such as RBI, Irda, SEBI, National Housing Bank and Department of Company Affairs. RBI regulates the companies which deal in lending, accepting deposits, financial leasing, hire purchase and acquisition of shares / stocks etc. The companies that take up activities like stock broking, merchant banking etc. are regulated by SEBI while the Nidhi and Chitfund companies are regulated by Department of Company Affairs. Housing finance companies are regulated by National Housing Bank.

Category of Companies	Regulator
Chit Funds	Respective State Governments
Insurance companies	IRDA
Housing Finance Companies	NHB
Venture Capital Fund /	SEBI
Merchant Banking companies	SEBI
Stock broking companies	SEBI
Nidhi Companies	Ministry of corporate affairs, Government of India

NBFCs which are regulated by other regulators are exempted from the requirement of registration with RBI but they need to register with respective regulators. For example:

- Venture Capital Fund/Merchant Banking companies/Stock broking companies are registered with SEBI
- Insurance Company needs to hold a certificate of registration with 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.

Difference between NBFC and Banks

The major differences between NBFCs and Banks are as follows:

- NBFC cannot accept demand deposits (they can accept term deposits)
- NBFCs do not form part of the payment and settlement system
- NBFCs cannot issue cheques drawn on themselves
- Deposits with NBFCs are not covered by Deposit Insurance.

Different Categories of NBFCs

All NBFCs are either deposit taking or Non-deposit taking. If they are non-deposit taking, ND is suffixed to their name (NBFC-ND). The NBFCs which have asset size of Rs.100 Crore or more are

known as Systematically Important NBFC. They have been classified so because they can have bearing on financial stability of the country. The Non-deposit taking NBFCs are denoted as NBFC-NDSI. Under these two broad categories, the different NBFCs are as follows:

Asset Finance Company(AFC)

The main business of these companies is to finance the assets such as machines, automobiles, generators, material equipments, industrial machines etc.

Investment Company (IC)

The main business of these companies is to deal in securities.

Loan Companies (LC)

The main business of such companies is to make loans and advances (not for assets but for other purposes such as working capital finance etc.)

Infrastructure Finance Company (IFC)

A company which has net owned funds of at least Rs. 300 Crore and has deployed 75% of its total assets in Infrastructure loans is called IFC provided it has credit rating of A or above and has a CRAR of 15%.

Systemically Important Core Investment Company (CIC-ND-SI)

A systematically important NBFC (assets Rs. 100 crore and above) which has deployed at least 90% of its assets in the form of investment in shares or debt instruments or loans in group companies is called CIC-ND-SI. Out of the 90%, 60% should be invested in equity shares or those instruments which can be compulsorily converted into equity shares. Such companies do accept public funds.

Infrastructure Debt Fund (IDF-NBFC)

A debt fund means an investment pool in which core holdings are fixed income investments. The Infrastructure Debt Funds are meant to infuse funds into the infrastructure sector. The importance of these funds lies in the fact that the infrastructure funding is not only different but also difficult in comparison to other types of funding because of its huge requirement, long gestation period and long term requirements.

In India, an IDF can be **set up either as a trust or as a company**. **If the IDF is set up as a trust,** it would be a mutual fund, regulated by SEBI. Such funds would be called**IDF-MF.** The mutual fund would issue rupee-denominated units of five years' maturity to raise funds for the infrastructure projects.

If the IDF is set up as a company, it would be an NBFC; it will be regulated by the RBI. The IDF guidelines of the RBI came in September 2011. According to these guidelines, such companies would be called **IDF-NBFC.**

An IDF-NBFC is a non-deposit taking NBFC that has Net Owned Fund of Rs 300 crores or more

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and which invests only in Public Private Partnerships (PPP) and post commencement operations date (COD) infrastructure projects which have completed at least one year of satisfactory commercial operation and becomes a party to a Tripartite Agreement.

Non-Banking Financial Company – Micro Finance Institution (NBFC-MFI)

NBFC-MFI is a non-deposit taking NBFC which has at least 85% of its assets in the form of m microfinance. Such microfinance should be in the form of loan given to those who have annual income of Rs. 60,000 in rural areas and Rs. 120,000 in urban areas. Such loans should not exceed Rs. 50000 and its tenure should not be less than 24 months. Further, the loan has to be given without collateral. Loan repayment is done on weekly, fortnightly or monthly installments at the choice of the borrower.

Non-Banking Financial Company – Factors (NBFC-Factors)

Factoring business refers to the acquisition of receivables by way of assignment of such receivables or financing, there against either by way of loans or advances or by creation of security interest over such receivables but does not include normal lending by a bank against the security of receivables etc. An NBFC-Factoring company should have a minimum Net Owned Fund (NOF) of Rs. 5 Crore and its financial assets in the factoring business should constitute at least 75 percent of its total assets and its income derived from factoring business should not be less than 75 percent of its gross income.
Systemically important NBFCs.

Deposit Taking by NBFCs

- All NBFCs are not allowed to take deposits. Only those NBFCs which have specific authorization from RBI are allowed to accept/hold public deposits. NBFCs cannot take demand deposits. They can accept only term deposits with a tenure of minimum 12 months.
- The NBFCs cannot offer interest rates higher than the ceiling rate prescribed by RBI from time to time. The present ceiling is 12.5 per cent per annum. The interest may be paid or compounded at rests not shorter than monthly rests.
- NBFCs cannot offer gifts/incentives or any other additional benefit to the depositors. NBFCs (except certain AFCs) should have minimum investment grade credit rating.
- The deposits with NBFCs are not insured under Deposit Insurance Scheme.
- NBFCs cannot accept deposits from NRIs except deposits by debit to NRO account of NRI provided such amount does not represent inward remittance or transfer from NRE/FCNR (B) account. However, the existing NRI deposits can be renewed.
- An unrated NBFC, except certain Asset Finance companies (AFC), cannot accept public deposits.

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- There is no Ombudsman for hearing complaints against NBFCs. However, all NBFCs have in place a Grievance Redressal Officer, whose name and contact details have to be mandatorily displayed in the premises of the NBFCs.

Other Important Information

Residuary Non-Banking Company

Residuary Non-Banking Company is a class of NBFC which is a company and has as its principal business the receiving of deposits.

Do Multi-Level Marketing companies, Chit funds come under the purview of RBI?

No, Multi-Level Marketing companies, Direct Selling Companies, Online Selling Companies don't fall under the purview of RBI. Activities of these companies fall under the regulatory/administrative domain of respective state government.

What are Unincorporated Bodies (UIBs)?

Unincorporated bodies (UIBs) include an individual, a firm or an unincorporated association of individuals, which accept deposits. In terms of provision of section 45S of RBI act, accepting such deposit is illegal. The state government has to play a proactive role in arresting the illegal activities of such entities to protect interests of depositors/investors.

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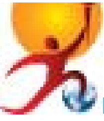

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General Knowledge Today

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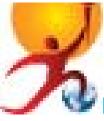

Banking & Finance-8: Terms and Concepts

This document is mainly for Preliminary examination and covers the topics objectively. This content is also useful for some of you who might be appearing in Banking Examinations as well.

Prelims MCQ Topics

Asset Liability Mismatch, Letter of Credit, ADR, IDR, GDR, Arbitrage, Mezzanine Financing, Baby Bond, Bear & Bull, Bonus Shares & Rights Share, Circular trading, Employee Stock Option, External Commercial Borrowings, Gilt fund, Green shoe option, Hedging, Insider trading, Market capitalization, Net Asset Value (NAV), Offer For Sale (OFS), Stagfiation, Underwriting, Anchor Tenant.

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Various Risks associated with Banking Business

There are various kinds of risks associated with the banking such as credit risk, interest rate risk, foreign exchange rate risk, liquidity risk, equity price risk, commodity price risk, legal risk, regulatory risk, reputation risk, operational risk etc. They can be broadly converged into three categories viz. Credit Risk, Market Risk and Operational Risk. They have been briefly discussed below:

Credit Risk

Credit risk is risk of loss arising from a borrower who does not make payments as promised. This event would be called "Default" and the person/ company/ entity would be called "Defaulter". Due to this, credit risk is also known as "Default Risk".

Market Risk

Market risk is the possible losses due to movement in the market prices. There are four standard market risk factors viz. stock prices, interest rates, foreign exchange rates, and commodity prices. Apart from there are associated market risks as follows:

- Equity risk, the risk that stock prices and/or the implied volatility will change.
- Interest rate risk, the risk that interest rates and/or the implied volatility will change.
- Currency risk, the risk that foreign exchange rates and/or the implied volatility will change.
- Commodity risk, the risk that commodity prices (e.g. corn, copper, crude oil) and/or implied volatility will change.

Operation Risk

Operational Risk refers to the risk of loss from inadequate or failed internal processes, people, systems or external events including

- Incompetent management
- Improper planning
- Staff fraud
- Noncompliance
- Programming errors
- System Failure
- Increased competition
- Deficiency in loan documentations.

What are different approaches for risk assets calculation?

Banks have several approaches for risks assets calculations. They have been summarized in the below table:

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Credit Risk	Standard Approach, Foundation Internal rating Based approach, Advance approach. Internal rating Based
Market Risk	Standard Approach (comprising maturity method & duration method), Internal risk based approach
Operational, Risk	Basic Indicator Approach, Standard Approach, Advance measurement Approach

Internal rating and external rating approaches

Standardized Approach / External Rating Approach

Under this approach the banks are required to use ratings from External Credit Rating Agencies to quantify required capital for credit risk. The Banks have to follow it without any discretion to modify. The Reserve Bank of India has identified 4 external domestic agencies for this approach. They are CRISIL, ICRA, Care and Fitch.

Apart from this, there are international agencies such as Moody's, Fitch, Standard and Poor's etc.

Internal rating based Approach

This is basically an alternative to standardized approach. The Banks do the internal assessment of the Counterparties and exposures. Banks need RBI's nod to do this.

Different credit rating agencies in India

The Credit rating market taken a definite shape in India after the SEBI made it mandatory for any debenture that has maturity of more than 18 months maturity. There are four domestic credit ratings in India for standardized approach for credit risk calculation. They have been discussed below:

CRISIL

CRISIL is India's first credit rating agency, incorporated in 1987 and was promoted by the erstwhile ICICI Ltd, along with UTI and other financial institutions.

It commenced operations from 1988 onwards. In 1995, in partnership will National Stock Exchange, CRISIL developed **CRISIL500 Equity Index**. In 1996, it made a strategic alliance with the Standard & Poor's (S&P) Ratings Group and in the following year Standard & Poor's (S&P) Ratings Group acquired 9.68% shares in it.

In services Industry, the CRISIL in 1998 set up the Indian Index Services Ltd as a joint venture with the NSE and in 1999, it developed a Risk Assessment Model (RAM) which became a banking industry standard. S&P acquired the majority stake in the company in 2005 and so today CRISIL is a S&P company.

ICRA

India's second credit rating agency is ICRA (Investment Information and Credit Rating Agency) which was set up in 1991. It was promoted by Industrial Finance Corporation of India (IFCI), other

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leading financial/investment institutions, commercial banks and financial services companies as an independent and professional Investment Information and Credit Rating Agency. Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA Limited is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange.

CARE

The third Credit rating Agency in India was CARE, that started working in 1993. It was mainly promoted by the IDBI.

ONICRA

Later another Credit rating agency ONICRA was established which now Onicra Credit Rating Agency Of India Ltd. This is a private sector agency set up by Onida Finance. Today it has a niche market and provides assessment, grading and rating models for individuals & MSMES (micro, small and medium enterprises.

Prompt Corrective Action

Prompt Corrective Action is a system of RBI under which it can initiate a corrective action in case of a bank which is found to be having low capital adequacy or high Non-performing Assets. These are called Trigger Points. RBI takes such action when Capital Adequacy Ratio goes down to less than 9% and Non-Performing Assets go up to more than 10%. Further, if return on assets us below 0.25%; this also serves as a trigger point to Prompt Corrective Action.

Asset Liability Mismatch

Asset Liability Mismatch or ALM is considered to be a comprehensive and dynamical framework for measurement, monitoring and managing the market risk of the Banks. Asset Liability Mismatch arises in the following situation:

- The Primary source of funds for the banks is deposits, and most deposts have a short- to medium-term maturities, thus need to be paid back to the investor in 3-5 years. In comparison, the banks usually provide loans for a longer period to borrowers. Out of them, the home loans and Infrastructure projects loans are of longest maturity. So when a bank provides the long term loans from much shorter maturity funds, the situation is called asset-liability mismatch.
- ALM creates Risk and Risk has to be managed. This is calledAsset Liability Management.

What are Consequences of the Asset Liability Mismatch?

The Interest rate risks (due to fluctuation) and Liquidity Risk (due to long maturity of loans) are two typical consequences of Asset Liability Mismatch.

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- **Interest Rate Risk:**The banks would require to reprice the deposits faster than the loans and during this process if the bank has to pay a higher rate, the adjustment is difficult.
- **Liquidity Risk:**The banks would have to repay the depositors when their funds mature. But when they repay, the cannot recall their loans. In this situation, bank would require the new deposits. This may create a acute situation if there are no deposits available. In some cases, the bank may also need to be paying higher interests on new deposits.

Asset Liability Management

Asset Liability Management is basically management of the structure of the balance sheet (which comprises the assets and liabilities) in such a way that interest gain is maximized and risk is minimized. Most of the banks have an elaborate institutional arrangement to manage the Asset liability Mismatch. They manage the above as follows:

- Pricing large percentage of loans at variable (Floating Rate Regime) interest rates which actually move in tandem with the markets.
- Pricing the fixed interest rate loans at ahuge markup, this is usually done so that borrower is enticed to go for floating rate regime.

The above two generally take care of the Asset liability mismatch situation.

Letter of Credit

A letter of credit (L/C) is a type of "documentary credit" or a "non-fund based credit". It is a document issued by a bank or financial institution at the request of a buyer whereby the bank or financial institution gives assurance of payment to a seller if the terms and conditions specified in the document are fulfilled. This means that Letter of Credit is a promise made by Bank to pay to exporter / seller on behalf of importer / buyer. The seller receives the payment only when all the requirements specified in the L/C are met including the documents, delivery dates, product specification, etc.

Thus, a Letter of Credit has three parties:

- Buyer / Importer: Also known as Opener, as he opens the credit
- Bank / Financial Institution: Also known as Issuer, as it opens the letter of credit
- Seller / Exporter : Also known as beneficiary as credit is opened in favour of him.

Types of Letter of Credit

There are several types of Letter of Credit on the basis of various levels of security they grant to the beneficiary (seller/exporter).

Irrevocable Letter of Credit

An irrevocable Letter of Credit cannot be modified or cancelled without the agreement of all the

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three parties.

Revocable Letter of Credit

A revocable letter of credit may be modified or even cancelled by the issuing bank at any time and without notice to the beneficiary. Such L/Cs are rare now a days as they give maximum flexibility to the buyers but involve risk to the seller.

Confirmed Irrevocable Letter of Credit

In a confirmed Irrevocable L/C, another bank (called Confirming Bank) is yet more party which obliges itself to honour the L/C in same manner as issuing bank. Such L/C is used to back up the credit standing of the issuing bank and to mitigate the risk in foreign trade by replacing foreign bank risk by domestic bank risk.

Unconfirmed Irrevocable Letter of Credit

In Unconfirmed Irrevocable Letter of Credit, a seller's domestic bank (called advisory bank) acts as agent of the issuing bank but without assuming any responsibility towards the beneficiary. The role of advisory bank here is limited to taking care of the authenticity of the issuing bank and documentary credit.

Revolving Letter of Credit

A revolving Letter of Credit is used in the case of regular business transactions between the buyer and the seller. The L/C is issued only once but remains valid for a stated period of time for a number of transactions without issuing another L/C. The Revolving L/C can be either revocable or irrevocable.

A Letter of Credit ensures the seller that his payment will be made as long as the services are performed (dispatch of goods in case of foreign trade). Thus, Letter of Credit serves as a guarantee to the seller that he or she will be paid as agreed. Letter of Credit is an instrument of trade financing.

Glossary of Terms

American Depository Receipts (ADR)

American Depository Receipt is a certificate issued in the United States declaring ownership of shares of a foreign company. The original securities are lodged in Bank/ Custodian abroad, and the American Depository Receipts (ADRs) are traded in the US for all intents and purposes as if they were a domestic stock. An ADR dividend is paid in US dollars, so it provides a way for American investors to buy foreign securities without having to go abroad, and without having to switch in and out of foreign currencies.

Appreciation and depreciation of currency

Appreciation refers to rise in the value of one currency in terms of another, while depreciation is reverse. For example, when value of 1 Dollar changes from Rs. 60 to Rs. 64; it will be appreciation of

dollar while depreciation of Rupee.

Arbitrage

Arbitrage consists of purchasing a commodity or security in one market for immediate sale in another market to make profit.

Arbitration

An alternative dispute resolution mechanism for resolving disputes.

Asset based securitization

This refers to the process in which the securities are collaterised by assets mortgaged against loans, assets leased out, trade receivables, or assets sold on hire purchase basis or installment contracts on personal property.

Authorized Capital

The amount of capital that a company has been authorized to raise by way of equity and preference shares, as mentioned in the Articles of Association / Memorandum of Association of the company.

Baby Bond

This term is used in United States. It refers to a bond with a face value of less than $1000 usually in $100 denominations.

Badla

Badla is a term is used in stock markets. It refers to carrying forward of transactions from one settlement period to another without effective delivery. This is permitted only in specified securities and is done at the making up price which is usually the closing price of the last day of settlement.

Bancassurance

It’s a phenomenon whereby a bank sells insurance product via cross selling.

Bankers acceptance

A short-term credit investment created by a non-financial firm and guaranteed by a bank to make payment. Acceptances are traded at discounts from face value in the secondary market.

Basis Point

Basis point in banking / finance refers to one hundredth of a percentage point. This term is frequently used in terms of interest rates and monetary policy rates of RBI. For example, when RBI reduces a rate such as Bank Rate from a rate such as 5.25% to 5.33% the change would be eight basis points.

Bear & Bull

In terms of share markets, a Bear is an investor / broker or any other market player who expects the market price of shares to decline. The term also refers to the one who has sold shares which he

does not possess, in the hope of buying them back at a lower price, when the market price of the shares come down in the near future.

- A Bear Market is a weak or falling market characterized by the abundance of sellers.
- If there is a false signal in the markets that the rising prices of a stock would reverse and sink, but actually it does not happen; then it is called a Bear Trap.

On the other hand, a market player who believes prices will rise and would, therefore, purchase a financial instrument with a view to selling it at a higher price is called Bull. A Bull Market refers to a rising market with abundance of buyers and relatively few sellers.

Bid Price and Ask Price

In auctions markets, a bid price is an offer to buy; while ask price is an offer to sale. The difference between the bid price and the ask price is called Bid-Ask spread.

Blue Chip

Blue chip companies refer to the companies which have best rated shares with the highest status as investment based on return, yield, safety, marketability and liquidity.

Bonus Shares

Profit making companies may desire to convert their profit into share capital. This can be done by issue of bonus shares. Issue of Bonus shares is also called as conversion of profit into share capital or capitalization of profits. Bonus can be of two types:

- Making partly paid shares into fully paid by declaring bonus without requiring shareholders to pay for the same.
- Issue of fully paid equity shares as bonus shares to the existing equity shareholders

Rights Share

A company can issue additional shares at any time by passing an ordinary resolution at its General Meeting. However such additional shares must be first offered to the existing equity shareholders in the proportion of the shares already held by them. Such additional shares are called “Rights Shares”. Rights shares should be within the limits of the authorized capital. If not so, then the authorized capital must be increased first suitably. The issue of Rights Shares is to be made after two years from the formation of the company or after one year from the first allotment of shares.

Book building process

In share Markets, the Book Building is basically a process used in IPOs for efficient price discovery. It is a mechanism where, during the period for which the IPO is open, bids are collected from investors at various prices, which are above or equal to the floor price. The offer price is determined after the bid closing date.

In India, the Price discovery through book building process is more popular than a normal issue. In

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the case of Price discovery through book building process, the price at which securities will be allotted is not known, while in case of offer of shares through normal public issue, price is known in advance to investor. Under Book Building, investors bid for shares at the floor price or above and after the closure of the book building process the price is determined for allotment of shares.

Market Boom

A condition of the market denoting increased activity with rising prices and higher volume of business resulting from greater demand of securities. It is a state where enlarged business, both investment and speculative, has been taking place for a sufficiently reasonable period of time.

Bubble

A speculative sharp rise in share prices which like the bubble is expected to suddenly burst.

Bulldog Bond

This term is used in UK. It refers to a bonddenominated in sterling but issued by a non British borrower.

Buoyancy

Buoyancy refers to the rising trend in prices.

Butterfly spread

An option strategy involving the simultaneous sale of an at the money straddle and purchase of an out of the money strangle. Potential gains will be seen if the underlying remains stable while the risk is limited should the underlying move dramatically. It's also the simultaneous buying and selling of call options at different exercise prices or at different expiry dates.

Call option and Put option

An option agreement that gives an investor the right, but not the obligation, to buy an instrument at a known price by a specified date. For this privilege, the investor pays a premium, usually a fraction of the price of the underlying security.

In put option, the investor the right, but not the obligation, to sell an instrument at a known price by a specified date.

Circular trading

Circular trading is a fraudulent trading scheme where sell or buy orders are entered by a person who knows that the same number of shares at the same time and for the same price either have been or will be entered. These trades do not represent a real change in the beneficial ownership of the security. These trades are entered with the intention of raising or depressing the prices of securities.

Circuit Breaker

A system to curb excessive speculation in the stock market, applied by the Stoc Exchange authorities, when the index spurts or plunges by more than a specified per cent. Trading is then suspended for some time to let the market cool down.

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Common stock

Common stock refers to the units of ownership of a public company or bank. Holders of common stock typically have voting rights and receive dividends, but there is no guarante of dividend payment.

Correction

Correction refers to temporary reversal of trend in share or commodity prices This could be a reaction (a decrease following a consistent rise in prices) or a rally (an increase following a consistent fall in prices).

Coupon Rate

Coupon rate refers to the interest rate stated on the face of a money market instrument or bond. The interest paid on a bond expressed as a percentage of the face value. If the instrument carries a fixed coupon, the interest is paid on an annual or semi-annual basis.

Cumulative Convertible Preference Shares

A type of preference shares where the dividend payable on the same accumulates, if not paid. After a specified date, these shares will be converted into equity capital of the company.

Cumulative Preference Shares

A type of preference shares on which dividend accumulates if not paid. All arrears of preference dividend have to be paid out before paying dividend on equity shares.

Current Ratio

Current ratio measures a company's current assets relative to its current liabilities. This gives an indication of its abilities to meet short-term liabilities; the higher the ratio, the more liquid the company.

Debentures

Debt instruments bearing a fixed rate of interest usually payable half yearly on specific dates and principal amount repayable on a particular date on redemption of the debentures.

Depository

A depository is like a bank wherein the deposits are securities (viz. shares, debentures, bonds, government securities, units etc.) in electronic form. A Depository can be compared with a bank, which holds the funds for depositors. There are many similarities in Banks and Depositories.

- While the Bank holds funds in an account, depositories hold securities in an account.
- While Bank transfers funds between accounts on the instruction of the account holder, Depository transfers securities between accounts on the instruction of the account holder.
- While the bank facilitates transfers without having to handle money, Depository facilitates transfers of ownership without having to handle securities. Banks keep safe money,

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depositories keep safe securities.

In India, we have two depositories viz. National Securities Depository Limited (NSDL) and Central Depository Services (India) Limited (CDSL).

Depository Participant

After depository, we have another entity called Depository Participant. Depository provides its services to investors through its agents called depository participants (DPs). These agents are appointed by the depository with the approval of SEBI. According to SEBI regulations, amongst others, three categories of entities, i.e. Banks, Financial Institutions and SEBI registered trading members can become DPs. Please note that accounts are always no frills at Depositories. This means an investor can have an account with depository without any balance.

Demutualization

Process of transition from "mutually-owned" association to a company "owned by shareholders". In other words, transformation of the legal structure from a mutual form to a business corporation form and privatisation of the corporations so constituted, is referred to as demutualization.

Depository participant (DP)

An agent of the depository through which it interfaces with the investor. A DP can offer depository services only after it gets proper registration from SEBI.

Derivative Market

Markets such as futures and option markets that are developed to satisfy specific needs arising in traditional markets. These markets provide the same basic functions as forward markets, but trading usually takes place on standardized contracts.

Dividend

Dividend is the share in the company's profit after tax, paid to the shareholders, usually once or twice a year. Dividend payments do not distribute the entire net profit of a company, a part or substantial part of which is held back as reserves for the company's expansion. Dividend is declared on the face value or par value of a share, and not on its market price.

Dutch Auction

Dutch auction refers to an auction in which the auctioneer's prices fall rather than rise. In such an auction, the first person to bid wins whatever it is that the auctioneer is selling. The system is used in the Dutch flower markets and also, occasionally, as a method of selling securities.

Employee Stock Option

"Employee stock option" means the option given to the whole-time directors, officers or employees of a company which gives such directors, officers or employees, the benefit or right to purchase or subscribe at a future date, the securities offered by the company at a predetermined price.

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Electronic fund transfer (EFT)

EFT refers to a system which utilizes computer and electronic components in order to transfer money or financial assets. EFT is information based and intangible.

Employee Stock Purchase Scheme (ESPS)

"Employee stock purchase scheme (ESPS)" means a scheme under which the company offers shares to employees as part of a public issue or otherwise.

Equity

Equity refers to the ownership interest in a company of holders of its common and preferred stock.

Exchange Rate Risk

The risk that adverse movements in exchange rates lead to capital losses in assets or revaluation of liabilities.

Exchange-traded derivative

A derivative which is listed and traded at an organized market-place. Derivatives exchanges generally provide standardised contracts and central clearing facilities for participants.

External Commercial Borrowings

In India External Commercial Borrowings are defined to include commercial bank loans, buyers' credit, suppliers' credit, securitized instruments such as Floating Rate Notes and Fixed Rate Bonds, etc., credit from official export credit agencies and commercial borrowings from the private sector window of Multilateral Financial Institutions such as International Finance Corporation (Washington), ADB, AFIC, CDC etc. ECBs are being permitted by the Government as a source of Finance for Indian corporates for expansion of existing capacity as well as for fresh investment.

Face Value

Face Value is the nominal or stated amount (in Rs.) assigned to a security by the issuer. For shares, it is the original cost of the stock shown on the certificate; for bonds, it is the amount paid to the holder at maturity. Face Value is also known as the par value or simply par. For an equity share, the face value is usually a very small amount (Rs. 5, Rs. 10) and does not have much bearing on the price of the share, which may quote higher in the market, at Rs. 100 or Rs. 1000 or any other price. For a debt security, face value is the amount repaid to the investor when the bond matures (usually, Government securities and corporate bonds have a face value of Rs. 100). The price at which the security trades depends on the fluctuations in the interest rates in the economy.

Premium and Discount

Securities are generally issued in denominations of 5, 10 or 100. This is known as the Face Value or Par Value of the security as discussed earlier. When a security is sold above its face value, it is said to be issued at a Premium and if it is sold at less than its face value, then it is said to be issued at

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a Discount.

Forward Contract

An agreement for the future delivery of the underlying commodity or security at a specified price at the end of a designated period of time. Unlike a future contract, a forward contract is traded over the counter and its terms are negotiated individually. There is no clearing house for forward contracts, and the secondary market may be non-existent or thin.

Fortune 500

Since 1958, Fortune Magazine has published a list of five hundred largest American Industrial Corporations, ranked according to size of sales. These are called Fortune 500 companies.

Gilt fund

Fund that invests exclusively in government securities.

Gilt Edged

A term used to describe a bond, generally issued by the Government or issued with a Government Guarantee so much so that there are no doubts about the ability of the issuer to pay regular interest and the principal amount to the bond holders.

Global Depository Receipts

Any instrument in the form of a depository receipt or certificate created by the Overseas Depository Bank outside India and issued to non-resident investors against the issue of ordinary shares or Foreign Currency Convertible Bonds of issuing company.

Green shoe option

Green Shoe option means an option of allocating shares in excess of the shares included in the public issue and operating a post- listing price stabilizing mechanism in accordance with the specific provisions in DIP Guidelines, which is granted to a company to be exercised through a stabilising Agent.

Hedging

Hedging refers to a simultaneous sale and purchase to avoid loss.

Hypothecation

Hypothecation refers to pledging assets against a loan. The ownership of the asset or the income from the asset is not transferred, except that in default of repayment of loan the asset may be sold to realize its value. Brokers will accept shares as collateral for loans to finance purchase of shares or to cover short sales.

Indian Depository Receipt

A receipt, evidencing an underlying foreign security, issued in India by a foreign company which has entered into an agreement with the issuer and depository, custodian and depository or underwriters and depository, in accordance with the terms of prospectus or letter of offer, as may be prescribed.

Insider trading

Practice of corporate agents buying or selling their corporation's securities without disclosing to the public significant information which is known to them but which has not yet affected the price.

Institutionalization

The gradual domination of financial markets by institutional investors, as opposed to individual investors. This process has occurred throughout the industrialized world.

Interest Rate Risk

The risk that movements in the interest rates may lead to a change in expected return.

Liquid Assets

Liquid assets refer to cash or easily encashable assets to meet any request for redemption.

Market capitalization

The market value of a quoted company, which is calculated by multiplying its current share price (market price) by the number of shares in issue, is called as market capitalization. For example, if a company A has 150 million shares in issue and current market price is Rs. 100. The market capitalization of company A is Rs. 15000 million.

Maturity Date

The date on which a loan, bond, or debenture becomes due for payment. The amount an investor receives when a security is redeemed at maturity is called Maturity value.

Merchant Banks

A bank who is engaged in the business ofssue management either by making arrangement regarding selling, buying or subscribing to securities or acting as manager, consultant, adviser or rendering corporate advisory service in relation to such issue management. In other words, merchant bank provides capital to companies in the form of share ownership instead of loans.

Further, the banks which deal in converting and trading foreign exchange to facilitate international trade and development are also known as Merchant banks. These banks finance trade between companies which are based in different countries. They ease the way of doing business in other countries.

MIBOR

Mumbai Interbank Bid and Offer rates. Calculated by the average of the interbank offer rates based on quotations at nearly 30 major banks.

Money Market Mutual Funds

MMMF are instruments of money markets.

Mortgage Trust

Mortgage is a unit trust which invests in mortgage loans. Effectively the unit trust invests money in real estate and receives an interest return with security over the property which has been purchased.

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The interest which is charged on mortgage trust loans is normally higher than that other sources of finance like banks so that the investor usually receives a very competitive rate or return.

Mortgage backed securities

Securities backed by mortgage loans, including pass-through securities, modified pass-through securities, mortgage-backed bonds, and mortgage pay-through securities.

Moral Hazard

In terms of banking and finance, moral hazard is the risk arising from morally incorrect actions of a party. For example, risk arising when party does not enter into a contract in good faith and possibly provided misleading information about its assets, liabilities or credit capacity.

NASDAQ

NASDAQ refers to National Association of Security Dealers Automated Quotations. This is a United States organization that provides a computerized information network through which brokers, banks and other investment professionals can obtain up to the minute price quotations on securities traded over the counter.

Negotiated Dealing System (NDS)

Electronic platform for facilitating dealing in Government Securities and Mon Market Instruments, introduced by RBI.

Net Liquid Assets

Net Liquid Assets is Cash and readily marketable securities minus current liabilities of a company. This figure gives information about a company's ability to meet its current debt obligations.

Net Asset Value (NAV)

Net Asset Value refers to the current market worth of a mutual fund's share. A fund's net asset value is calculated by taking the fund's total assets, securities, cash and any accrued earnings deducting liabilities, and dividing the remainder by the number of units outstanding.

In context with investment, the NAV of an investment scheme is a number which represents the value in rupees per fund unit as on a particular date of the assets of the fund less liability and outstanding expenses.

Thus, if the NAV in more than the face value, it means our money has appreciated and vice-versa.

NAV is only the value that a fund's assets would realise, less liabilities, in case the fund was liquidated as on the particular date to which NAV relates. But there is no uniformity in accounting policies of the various funds and hence one cannot compare one fund with another.

Non deliverable swap

Similar to a non deliverable forward, the only difference being that settlement for both parties is done through a major currency.

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Offer For Sale (OFS)

OFS refers to an offer of securities by existing shareholder(s) of a company to the public for subscription, through an offer document.

OTC (Over the Counter)

A financial transaction that is not made on an organized exchange. Generally the parties must negotiate all the details of each transaction or agree to use simplifying market conventions.

Penny Stocks

This term is used in United States. It refers tovery low priced stocks– sometimes selling at a few pennies per share sometimes for a dollar or two- in speculative companies.

Price Earnings Ratio

The ratio of the market price of the share to earnings per share. This measure is used by investment experts to compare the relative merits of a number of securities.

Price rigging

When persons acting in concert with each other collude to artificially increase or decrease the prices of a security, the process is called price rigging.

Samurai Bonds

Foreign bonds offered in the Japanese Bond Market.

Stagflation

The combination of sluggish economic growth, high unemployment and high inflation.

Underwriting

An agreement with or without conditions to subscribe to the securities of a body corporate when the existing shareholders of such body corporate or the public do not subscribe to the securities offered to them.

Underwriter

One who does underwriting. A financial organization that handles sales of new securities which a company or municipality wishes to sell in order to raise money. Typically the underwriters will guarantee subscription to securities say, an issue of equity from the company at a stated price, and are under an obligation to purchase securities upto the amount they have underwritten, should the public not subscribe for the issue.

Venture Capital

Professional moneys co-invested with the entrepreneur usually to fund an early stage, more risky venture. Offsetting the high risk is the promise of higher return that the investor takes. A venture capitalist not only brings in moneys as " equity capital" (i.e. without security/charge on assets) but also brings on to the table extremely valuable domain knowledge ,business contacts, brand equity, strategic advice, etc. He is a fixed interval investor, whom the entrepreneurs approach without the

risk of "takeover".

Window Dressing

A manoeuvre often engaged in by companies, banks, mutual funds etc., at the end of the accounting period in order to impress stock holders who will be receiving the report showing that funds are better managed and invested than what might have been drawn up.

Yankee Bond

A bond offering in the U.S. domestic market by a non-U.S. entity registered with the SEC.

Joint Venture

Association of two or more entities (whether corporate, government, individual or otherwise) combining property and expertise to carry out a single business enterprise and having a joint proprietary interest, a joint right to control and a sharing of profits and losses.

Regardless of the scope of the undertaking, the nature of the JV must:

- be a separately identifiable entity
- have an ownership interest in such entity by each joint venture partner ("JVP"); and
- have an active management involvement or deliberate rejection of the right to such involvement by each JVP.

JVs are common and successful in several industries. For example, in the land development and construction industries, JVs are often used to obtain sufficient financing to acquire large land tracts or to undertake major building projects. JVs are also common in the manufacturing, mining, and service industries.

Credit Authorization Scheme

The Credit Authorization Scheme (CAS) was launched in 1965 and was withdrawn in 1989. Under this scheme, all commercial banks had to obtain prior approval / authorization of the RBI before granting a loan of Rs. 1 crore or more to a single borrower.

Anchor Tenant

Planned shopping mall concept was developed by Victor Gruen in 1950s. It was then only realised that the success of the mall will depend on the number and kind of large stores which will set-up their business in there. Such stores will ultimately define the financial stability of the mall as it acts as the major crowd pullers.

An Anchor Tenant, anchor store, draw tenant or key tenant is the major departmental store in the mall which becomes the reason for people to visit the mall. As the anchor store pulls the maximum traffic it is also called as the magnet store. The concept of malls caught up in Indian markets in the last decade. India now has over 300 malls, but it is only a few of them which are running successfully. As per a report by CBRE South Asia Private Limited, the rate of success is more dependent on the

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anchor tenant mix than the location or size. The anchor tenants usually have their rents discounted and may also be offered cash benefits by the mall to remain in the mall or may also be offered a share in profits. Also, within a mall such stores are widely spaced to make other stores visible by getting suitable exposure as the shoppers move from one anchor to another. Mostly it is the presence of an anchor store in the vicinity that drives the traffic for satellite stores. Thus, anchor tenants are given the right to dictate the choice of satellite stores around it. This is done to not let any satellite store to open shop whose core philosophy is juxtaposed with that of the anchor.
The International Council for Shopping Centers has outlined the presence of anchors as the main characters for two kinds of malls classified on the basis of their area-regional center mall and superregional center mall. The former has only 2 or more anchors while the latter have 3 or more.
Another popular term is Shadow Anchor which means a small shopping complex gains from the presence of a magnet store in close vicinity or just next door.

Primary Credit Societies

Primary Cooperative Credit Societies are formed at village or town level. A primary credit society refers to any cooperative society other than a primary agricultural credit society. It is basically an association of members residing in a particular locality. The members can be borrowers or non-borrowers. The funds of this society are derived from the share capital of the deposits and also the loans from central cooperative banks.
According to the norms, the paid-up share capital and reserves of a Primary Credit Society should be less than Rs 1 lakh. Such as society can do banking business without being required to take a licence from the RBI. However, the Banking Laws (Amendment) Act, 2012 has permitted RBI to assume additional regulatory powers over co-operative banks. It also gives the regulator the power to withdraw freedom given to primary co-operative credit societies to operate as banks without a licence from RBI.
In the Primary Cooperative Credit Society, the borrowing powers of the members as well as of the society are fixed. It generally gives small credit for farm inputs, fodder, fertilizers, pesticides etc.

Initial Public Offering (IPO)

When an unlisted company makes either a fresh issue of securities or an offer for sale of its existing securities or both for the first time to the public, it is called Initial Public Offering or IPO. An IPO paves way for listing and trading of the issuer's securities.

Pricing of IPO

When a company makes an IPO, the prior requirement would be to decide a price of the Issue / share. The question is -who will decide what should be the price? In India, there is a system of free pricing since 1992. However, there are guidelines that the company (Issuer) will decide the price in

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consultation with Merchant Banker. Still there is no formula for deciding the price of an IPO. Please note that SEBI does not play any role on pricing of shares, but the company and merchant banker are required to give full disclosures of the parameters which they had considered while deciding the issue price. While deciding the prices, there are two possibilities,

- Where company and Lead Merchant Banker fix a price. This is called Fixed Price.
- Where the company and the Lead Manager (LM) stipulate a floor price or a price band and leave it to market forces to determine the final price. This is called the Price discovery through book building process.

Listing & Delisting of Securities

Listing means admission of securities of an issuer to trading privileges (dealings) on a stock exchange through a formal agreement. The prime objective of admission to dealings on the exchange is to provide liquidity and marketability to securities, as also to provide a mechanism for effective control and supervision of trading. The term ' Delisting of securities' means permanent removal of securities of a listed company from a stock exchange. As a consequence of delisting, the securities of that company would no longer be traded at that stock exchange.

Bid Price

The ' Bid' is the buyer's price. It is this price that you need to know when you have to sell a stock. Bid is the rate/price at which there is a ready buyer for the stock, which you intend to sell. The 'Ask' (or offer) is what you need to know when you're buying i.e. this is the rate/ price at which there is seller ready to sell his stock. The seller will sell his stock if he gets the quoted "Ask' price.

Debt Instruments

A shareholder, whatever might be the quantity of the shares, is a part owner of the company and entitled to all the benefits of ownership, including dividend (company's profit distributed to owners). Over the years if the company performs well, other investors would like to become owners of this performing company by buying its shares. This increase in demand for shares leads to increase in its share prices. When the prices of the share increase, the investors have option of selling their shares at a higher price than at which they purchased it. Thus investor can increase their wealth, provided they make the right choice, as the reverse is also true.

Apart from the shares, there are many other financial instruments (securities) used for raising capital. Debentures or bonds are debt instruments which pay interest over their life time and are used by companies to raise medium or long term debt capital. If an investor prefers fixed income, he / she may invest in these instruments which may give him / her higher rate of interest than bank fixed deposit.

In the Indian securities markets, the term ' bond' is used for debt instruments issued by the Central

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and State governments and public sector organizations and the term 'debenture' is used for instruments issued by private corporate sector.

The Debt Instruments may be Corporate Debt or Government Debt. Corporate debt instruments are generally called Debentures while Government debt instruments are generally called Bonds, but Bonds can be issued by companies and local governance bodies too.

Joint stock company

Business partnership done by separate contributions individually from a group of stakeholders. The stockholders get certificate of ownership which they can freely transfer or sell to others. Company is managed and run by an appointed Board of Directors. Shareholders can attend AGMs, get copy of annual report and also vote on account audits.

Trusts

It is an obligation where property is held by one person or persons for the benefit of the owner. The owner thus transfers his property to the trustees. It is run under a contract which defines the terms on which the trust is run. It generally has the following participants: Appointer, beneficiary, protector and settler.

Executors and administrators

They are the ones to whom the property of a dead person gets attached. Their role becomes prominent if the deceased person has left a will If person dies without making a will, an administrator will be appointed by the court. The power of an administrator is drawn from the Probate Act while the powers of the executor are statutory. He can also be given some additional powers as per the terms of the will.

Local authorities

They are government administrative offices which are smaller in scale than a state or a province. They are like municipal corporations, zila parishads, taluka panchayats etc. They execute plans for local and economic development of local area. They have right to impose various kind so taxes and duties at a local level.

SWIFT

It stands for the Society for Worldwide Interbank Financial Telecommunication. It is a mode of exchange of messages between banks in a secure and reliable way. Under the SWIFTNet network, it also markets softwares and services to other institutions dealing in finance. SWIFTNet is an international platform which connects 8,000 financial institutions in 205 countries.

SWIFT does not accommodate funds transfer and needs a corresponding banking relationship for financial exchanges. SWIFT is a cooperative society, which works under Belgian Law and has its HQs at La Hulpe. It provides revolutionary solutions for members to allow connectivity to

SWIFTNet and CBTs (computer-based terminals) which members use to manage their messages. SWIFT services fall under three key areas: securities, treasury and derivatives, trade services and payments and finally cash management. It also comes equipped with a person to person messaging service called SWIFTNet Mail.

Automated Trading System

Automated trading stands for trading financial instruments completely on computers with zero human intervention. These are the new face of investment banks as human hands are not able to cope up with volume and speed required for these systems. Banks and other financial vendors are now switching to newer programmatic trading opportunities as their e-commerce options galore. It is enabled on all kinds or primary financial instruments and derivatives.

Electronic funds transfer (EFT)

It is a way to transfer money from one place to another via electronic means. It is one of the fastest and easiest method to transfer money and is widely in use today. The money thus transferred is instantly available on the other end. Many security and safety procedures are applied like encryption, verification and passwords etc. PayPal is the biggest EFT tool available. A variety of different transactions can be performed: sale, refund, withdrawal, deposit, cashback, inter-account transfer, payment, inquiry etc.

Digital Payment System.

Digital payments deal in electronic cash, electronic currency, digital money, digital cash etc. which are exchanged only by electronic means. This involves use of digital stored value systems. It deals with a system of debts and credits which exchanges value with other system or itself. It can at times be backed by gold to increase security and authenticity. Banks too have started to offer many services wherein a person can transfer funds, purchase stocks, etc. However, there are many incidences of fraud, technical snags etc. reported

E-banking

E-banking is the electronic management of information retrieval, storage and management. In addition, customer service is highly facilitated by e-banking as bankers can give instant information about account statements, balance or other enquiries. It also reduces the cost of doing business. Banks use IT effectively to create products and sell them. It also comprises many banking services like: email, research and development, provision of services, minimises physical interaction.

Loan to Value Ratio

LTV Ratio is a lending risk assessment ratio that financial institutions and others lenders examine before approving a mortgage. Assessments with high LTV ratios are generally seen as higher risk and, therefore, if the mortgage is accepted, the loan will generally cost the borrower more to borrow

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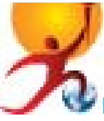

or he or she will need to purchase mortgage insurance.

Mezzanine Financing

This refers to a hybrid of debt and equity financing that is typically used to finance the expansion of existing companies. Mezzanine financing is basically debt capital that gives the lender the rights to convert to an ownership or equity interest in the company if the loan is not paid back in time and in full. It is generally subordinated to debt provided by senior lenders such as banks and venture capital companies.

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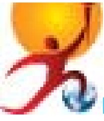

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Model Questions

Prelims MCQ Topics
Difference between Economic Growth and Economic Development, Composition of Human Development Index, Gender Inequality Index, Multidimensional Poverty Index, Capital Formation, Supply of Capital, Gini coefficient, Special Category States.

1. "Economic growth means more output … Development goes beyond this …". In the light of your answer, comment on the performance of the Indian economy since Independence.
2. Distinguish between 'economic development' and 'economic growth'. What are the factors which determine economic development?
3. Define economic development. Do you agree with the view that India has experienced growth but no economic development? Give reasons for your answer.
4. Do you agree with the view that growth is a necessary but not sufficient condition for development? Substantiate your answer
5. What is Sustainable Development? Explain the features and strategies of sustainable development.
6. "Growth and Development are inseparable elements of each other. One can't exist without the other." Explain.
7. What are the main characteristics of a developing economy? To what extent are they found in Indian Economy?
8. Critically examine the bottlenecks in achieving rapid economic growth in India.
9. What are the main causes of underdevelopment of India? Do you think that India is still an underdeveloped country?
10. Higher growth rate of real national income of a country does not necessarily imply its development'. Explain.
11. Critically discuss the factors that determine and influence the economic development of a country.
12. Discuss the importance of Capital Formation in development, while throwing light on key obstacles to capital formation in underdeveloped economies from demand and supply side.
13. Discuss the role of capital formation in India's economic development. Would you agree with this view that domestic saving constitute enough potential for development.
14. Differentiate between human capital and physical capital. What are the sources of human capital formation?

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15. How is human capital different from human development? How can the process of human capital formation be accelerated?
16. What factors contribute to the process of human capital formation? Explain the significance and success of educational programmes in India in the context of human capital formation.
17. Investment in health and education are the principal sources of human capital formation. Critically evaluate.
18. Discuss the reasons and extent of regional disparity in India. What role has been played by Finance commission to fill the gulf of regional disparity?

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Economic Growth versus Development

Economic Growth and Economic Development are central to developed as well as developing economies. Classical thinkers such as Adam Smith, Karl Marx examined the problem of economic development as early as 18th century. However, the study of economic growth and development as a specialized study started during the period of Great depression of 1929-33 and World War-II. Classical economists used the terms economic growth and economic development as synonyms of each other. However, modern economists such as J.A. Schumpeter, Ursula Hicks and Kindleberger have focused on growth and development as two different concepts. They argued that growth need not necessarily imply the occurrence of development.

Economic Growth

Economic growth refers the long term increase in real national output or real national income. Any increase in national income can offset with rapid growth of population if we don't take per capita income as a measure of economic growth. Further, despite of increase in per capita income, the number of poor people may rise if the distribution of income remains unequal. Thus, Economic growth is a *single dimensional quantitative concept* which is concerned only with the rate of increase in national income. It ignores distribution of income and it ignores qualitative aspects of human life.

Economic Development

Economic development is broader in nature. It not only includes the quantitative change but also includes certain qualitative changes in the economy. Economic development means not just increase in the real per capita income but also reduction in economic-divide, poverty, illiteracy and unemployment. Thus, economic development includes both economic growth as well as social welfare. Economic development should focus on inclusive growth – growth that includes all sectors of the economy and all sections of the society.

The following table outlines the basic differences between Economic Growth and Development:

Economic Growth	Economic Development
Single dimension Concept: Economic growth is merely a quantitative concept. It is concerned with rate of increase in national income.	Double / Multi dimension Concept: Concept of economic development is both quantitative and qualitative in nature. It is concerned with welfare of people (a qualitative aspect) along with increase in per capita income (a quantitative concept).

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Economic Growth	Economic Development
Ignores Distribution of Income: Distribution of income is ignored in case of economic growth. In spite of increase in income, number of poor people may rise if the distribution of income becomes further unequal.	Considers Distribution of Income: In case of economic development, distribution of income is given due consideration. Reduction in inequality (of income distribution) is one of the principal targets of economic development. In equality of income and wealth must be reduced.
Independent of Structural, Institutional and Technical Changes: Economic growth may occur independent of any structural, institutional and technical changes in the economy.	Associated with socio-technological Change: Economic development is invariably associated with significant structural, institutional and technical changes in the economy.

Measurement of Economic Growth

Economic growth is the rate of change at which an economy is growing year after year or the percentage change in the Gross Domestic Product (GDP) of a country year after year. The economic growth can be actual growth or potential growth. Actual growth is the growth actually achieved, while potential growth is the expected achievable growth when all resources in the economy are fully utilized at their normal level of utilization. Potential growth is also sometimes called as targeted growth.

Measurement of Economic Development

Economic development is a normative concept which takes into account both qualitative and quantitative aspects. Economic development is an increase in overall living standards and quality of life of the people, On this basis, there are several parameters for measurement of the economic development as discussed below:

Rise in Real National Income

Real national income at constant prices is conventionally a comprehensive measure of economic growth as well as development of an economy. It is estimated by dividing national income at current prices (also called monetary income) by the index of price level (showing the percentage change in price level over time). Generally, the increased real national income means higher economic development. However growing population, environmental degradation may affect the economic development.

Increase in Real Per Capita Income

Real per capita income is often considered as a better indicator of economic development than the real national income. *This is because per capita income accounts for a change in population size.* Per capita income is estimated as the ratio between national income and population of a country.

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Economic Welfare

Economic development of a country can be viewed better in terms of economic welfare of the people. Economic welfare means lower levels of poverty and inequalities, better health conditions, high literacy levels and better standard of life.

Structural, Institutional and Technical Changes

Development process must bring about structural, institutional and technical changes which stimulate the process of growth and social justice. Structural change means change in the structure of production and employment in the economy. For example, *a shift from primary sector to the secondary and tertiary sector is an important structural change.* Further, a change from labour intensive technology to capital intensive technology is a technological change. A shift in the ownership of natural resources is an important institutional change associated with the process of development.

Sustained Change

Development is a long term phenomenon of economic prosperity and social equality.

Differences between Economic Growth and Economic Development

Differences between Economic Growth and Development can be summarized in the below points:

- Economic growth is a narrow concept (It studies only increase in real per capita income) while economic development is a broad concept (it studies increase in real per capita income as well as economic welfare).
- Economic growth is only a quantitative concept whereas economic development is both a quantitative as well as a qualitative concept.
- Economic growth ignores distribution of income. Economic development studies distribution of income.
- Economic growth is the essential element of progress of developed countries. Economic development is the essential element of the progress of under developed countries.
- Economic development accounts for structural, institutional and technical change in the economy while economic growth does not.

India Economy and the Growth Development Paradox

Economic growth is possible without development and like many others, Indian economy also presents a growth development paradox. Since 1992, the average growth rate of India has been above 6% and it has attracted global attention as a resilient economy that was able to keep itself tamperproof against the effects of the subprime crisis and the global financial slowdowns. Due to this, India is seen as emerging economic powerhouse in the South Asia region. However, India is also home to a large concentration of people living in debilitating poverty and social deprivation. This is because the pace of poverty reduction and human development has not kept pace with the economic

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growth. The key reasons for this paradox are inequitable distribution of land and income, lack of adequate funding on social development, adverse impacts of liberalization on poor, lack of political will, lack of economic agenda towards etc. and to a great extent the trade regime led by WTO. These all have resulted in increasing gap between macroeconomic development and social development and lack of inclusive growth overall in the Indian economy. Thus, despite of more than two decades of economic growth, India has yet to achieve economic development.

Human Development Index

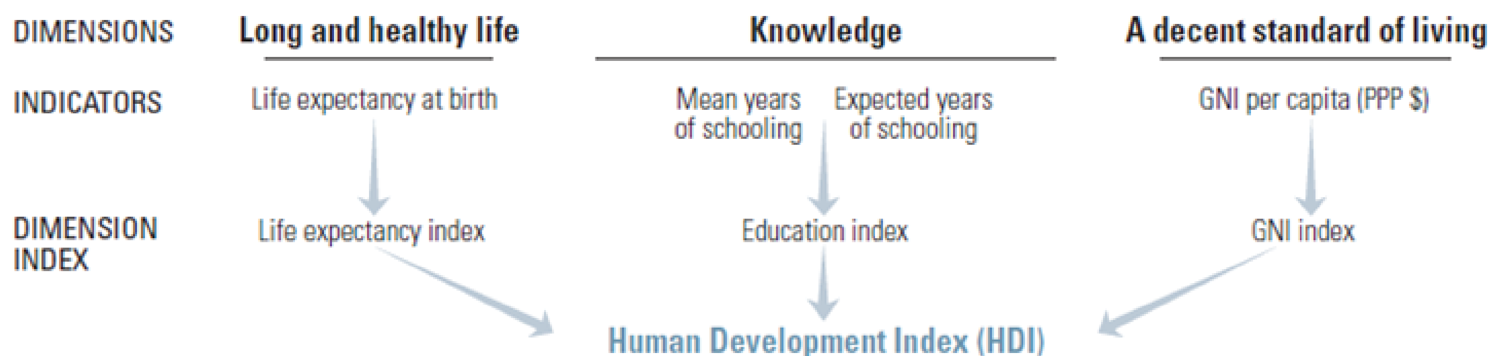
The logic behind development of Human Development Index (HDI) was to do away with the inherent weakness of use of GDP as measure of development. HDI is a part of the Human Development Report, which is an editorially independent annual publication of UNDP. The report was first launched in 1990 by the Pakistani Economist Mahbub ul Haq and Indian Nobel laureate Amartya Sen. Its goal was *to place people at the centre of the development process in terms of economic debate, policy and advocacy*. "*People are the real wealth of a nation*" was the opening line of the first report in 1990. This report ranks the countries on the basis of the Human Development Index.

About Human Development Index

Human Development Index (HDI) is a summary measure of human development. It measures the average achievements in a country in three basic dimensions of human development:

- A long and healthy life
- Access to knowledge
- A decent standard of living.

The HDI is the geometric mean of normalized indices measuring achievements in each dimension, viz. Life Expectancy Index, Education Index, GNI Index. They are shown in the following graphics:



There are two steps to calculating the HDI.

- Step 1. Creating the dimension indices
- Step 2. Aggregating the sub-indices to produce the Human Development Index

In the first step, the Minimum and maximum values (goalposts) are set in order to transform the

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indicators into indices between 0 and 1. The minimum value for life expectancy is 20 years while maximum value is 85 years. It is based on the premise that in 20th century, no country had a minimum life expectancy below 20 years. Similarly, in education, minimum value is 0, while maximum value is 18 years of schooling with 15 mean years of schooling. GNI is 100 dollars at minimum while 75000 at maximum. Maximum value of GNI at 75000 dollars per year is based upon a study by Kahneman and Deaton (2010) that there is a virtually no gain in human development and well-being from annual income beyond $75,000.

Dimension	Indicator	Minimum	Maximum
Health	Life expectancy (years)	20	85
Education	Expected years of schooling	0	18
	Mean years of schooling	0	15
Standard of living	Gross national income per capita (PPP 2011 $)	100	75,000

Having defined the above values, the sub-indices are calculated as follows:

$$\text{Dimension Index} = \frac{\text{actual value} - \text{minimum value}}{\text{maximum value} - \text{minimum value}}$$

After that, the HDI is calculated as geometric mean of the three dimension indices. The following example, sourced from the HDR-2014 shows calculation of the same for Costa Rica:

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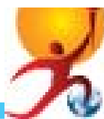

Indicator	Value
Life expectancy at birth (years)	79.93
Mean years of schooling	8.37
Expected years of schooling	13.50
Gross national income per capita (PPP 2011 $)	13,011.7

Note: Values are rounded.

$$\text{Health index} = \frac{79.93 - 20}{85 - 20} = 0.922$$

$$\text{Mean years of schooling index} = \frac{8.37 - 0}{15 - 0} = 0.558$$

$$\text{Expected years of schooling index} = \frac{13.50}{18} = 0.750$$

$$\text{Education index} = \frac{0.558 + 0.750}{2} = 0.654$$

$$\text{Income index} = \frac{\ln(13{,}011.7) - \ln(100)}{\ln(75{,}000) - \ln(100)} = 0.735$$

$$\text{Human Development Index} = (0.922 \cdot 0.654 \cdot 0.735)^{1/3} = 0.763$$

Inequality-adjusted HDI (IHDI)

The Inequality-adjusted Human Development Index (IHDI) adjusts the Human Development Index (HDI) for inequality in distribution of each dimension across the population. The IHDI accounts for inequalities in HDI dimensions by "discounting" each dimension's average value according to its level of inequality.

If there is no inequality across people, HDI is equal to IHDI. *However, in case of inequalities, the value of IHDI is always less than HDI.* This implies that the IHDI is the actual level of human development (accounting for this inequality), while the HDI can be viewed as an index of "potential" human development (or the maximum level of HDI) that could be achieved if there was no inequality.

The "loss" in potential human development due to inequality is given by the difference between the HDI and the IHDI and can be expressed as a percentage.

Gender related Development Index (GDI)

The Gender related Development Index (GDI) measures gender inequalities in achievement in three basic dimensions of human development as follows:

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- Health, which is measured by female and male life expectancy at birth
- Education, which is measured by female and male expected years of schooling for children and female and male mean years of schooling for adults ages 25 and older
- Command over economic resources, measured by female and male estimated earned income

The index shows the loss in human development due to inequality between female and male achievements in these dimensions. It ranges from 0, which indicates that women and men fare equally, to 1, which indicates that women fare as poorly in comparison to their male counterparts as possible in all measured dimensions.

In order to address shortcomings of the GDI, a new index Gender Inequality Index (GII) was proposed. This index measures three dimensions viz. Reproductive Health, Empowerment, and Labor Market Participation.

Multidimensional Poverty Index (MPI)

The Multidimensional Poverty Index (MPI) identifies multiple deprivations at the individual level in health, education and standard of living. It uses micro data from household surveys, as basis of deprivation of Cooking fuel, Toilet, Water, Electricity, Floor, Assets. Each person in a given household is classified as poor or non-poor depending on the number of deprivations his or her household experiences. These data are then aggregated into the national measure of poverty. The indicator thresholds for households to be considered deprived are as follows:

Education

- School attainment: no household member has completed at least six years of schooling.
- School attendance: a school-age child (up to grade 8) is not attending school.

Health

- Nutrition: a household member (for whom there is nutrition information) is malnourished, as measured by the body mass index for adults (women ages 15–49 in most of the surveys) and by the height-for-age z score calculated using World Health Organization standards for children under age 5.
- Child mortality: a child has died in the household within the five years prior to the survey.

Standard of living

- Electricity: not having access to electricity.
- Drinking water: not having access to clean drinking water or if the source of clean drinking water is located more than 30 minutes away by walking.
- Sanitation: not having access to improved sanitation or if improved, it is shared.
- Cooking fuel: using 'dirty' cooking fuel (dung, wood or charcoal).
- Having a home with a dirt, sand or dung floor.

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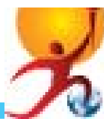

- Assets: not having at least one asset related to access to information (radio, TV, telephone) and not having at least one asset related to mobility (bike, motorbike, car, truck, animal cart, motorboat) or at least one asset related to livelihood (refrigerator, arable land, livestock).

Computation of the Multi-Dimensional Poverty Index (MDPI) reveals that, despite recent progress in poverty reduction, more than 2.2 billion people are either near or living in multidimensional poverty.

Sustainable Development

Sustainable development is development that *meets the needs of the present without compromising the ability of future generations to meet their own needs* Thus, it *takes into account both the present and future generations* without over exploitation of natural resources and environmental degradation.

Features of Sustainable Development:

Sustained Rise in Real Per Capita Income

There should be a sustained rise in real per capita income and economic welfare on long term basis.

Rational Use of Natural Resources

Sustainable development simply means that natural resources should be rationally used in a manner such that they are not over exploited.

Preserving the natural resources for future generations

Sustainable development aims at making use of natural resources and environment for raising the existing standard of living in such a way as not to reduce ability of the future generations to meet their own needs.

Strategies for Sustainable Development

Sustainable development depends on optimum utilisation of resources and in a manner such that the pace of economic growth is sustained with inter-generational equity.

- Efficient Technology: Use of production technologies which are input efficient. It means more is produced per unit of input.
- Use of Environment-friendly Sources of Energy: promotion of wind energy, solar energy and other environment friendly sources of energy in place of fossil fuels.
- Promotion of Organic Farming: Adaption of chemical free agriculture.
- Recycling of the Wastes
- Stringent Laws on the Disposal of Chemical Effluents
- Creation of awareness to conserve natural assets for inter-generational equity
- Public Means of Transport: Public means of transport are to be rapid, comfortable and economical.

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Measurement of Sustainable Development

The measurement of sustainable development is done in terms of two different aggregates

Green Net National Income

It is the difference between Net National Income and Depreciation of Natural Capital. Net National Income is the market value of the final goods and services produced by the residents of the country during the period of one year. Depreciation of Natural Capital meansloss of value of the capital because of its continuous use. Natural capital refers to the sum total of natural resources including environment.

Green Net National Income = Net National Income – Depletion of Natural Resources – Environmental Degradation.

Sustainable development is to be measured in terms of the rise in Green National Income.

Genuine Savings

The genuine savings are the rate of savings adjusted not only for depreciation of man-made capital but also for loss of value of the natural capital.

Genuine Savings = Gross Savings – Depreciation of Manmade Capital – Depreciation of Natural Capital (Depletion of Natural Resources and Degradation of Environment).

Increase in Genuine Savings implies higher rate of sustainable development and vice versa.

Concept of Underdevelopment

World Development Report categorizes economies on the basis of income in three categories viz. *high income, middle income* and *low income economies.* Usually, high income countries are known as developed / advanced economies while low income countries are known as underdeveloped economies. Developed or advanced economies are also characterised by high standard of living, universal and quality education, better health care facilities and high life expectancy.

However, all high income economies may not be developed economies. Some of the middle and low income economies are developing faster than high income economies.

Further, the *underdeveloped economies showing high potential of growth in terms of their natural, physical and human resources are often referred to as developing economies* Economists also use the terms, first world, second world and third world for the developed, socialist industrialist countries and underdeveloped economies respectively.

Criterion for Classifying Economies as Developed and Underdeveloped

Economies cannot be classified as developed and underdeveloped economies based on their natural resources, population and sectoral dependency. However, there is a set of common characteristics of underdeveloped economies such as low per capita income, low levels of living, high rate of population growth, illiteracy, technical backwardness, capital deficiency, dependence on backward

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agriculture, high level of unemployment, unfavourable institutions and so on. It is on the basis of these characteristics that we draw a line of distinction between developed and underdeveloped economies.

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:

Low Per Capita Income

Almost all underdeveloped countries of the world show low per capita income in comparison to developed countries of the world.

Slow Growth Rate of Per Capita Income

Low per capita income and slow growth rate of per capita income are characteristics of these countries.

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.

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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.

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.

Backward Techniques of Production

Underdeveloped economies use outdated technology for production. Lack of capital leads to less spending on research and development.

High Growth Rate of Population and Dependency Burden

These countries are characterised by high growth rate of population and high dependency burden.

Low Productivity of Labour

Underdeveloped economies are characterised by low labour productivity due to low level of skill set.

Underutilisation of Natural Resources

Natural resources are underutilised in underdeveloped economies. Their capability to exploit them is very low.

Large Scale Unemployment

Large scale unemployment is another characteristic feature of underdeveloped countries.

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.

High Incidence of Poverty

Low per capita income results in high incidence of poverty in underdeveloped economies.

Infrastructural Backwardness

Economic infrastructure and social infrastructure are almost at their bottom level in underdeveloped countries.

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.

India as a Developing Economy

Though the Indian economy is growing, it is still lagging behind in terms of reducing poverty, unemployment, backwardness and hunger and in terms of low technological development. Some other culprits for low development include low per capita income, excessive dependency on primary

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sector and high pressure on natural resources.

The key reasons for low development in India include exploitation during colonial era, pressure of population, infrastructure bottlenecks, brain-drain, corruption in public offices, low farm productivity, unfriendly business environment, inefficiency of public sector, high ratio of non-development expenditure etc.

Determinants of Development

The process of development depends on a host of factors like natural resources, physical and human capital, technology, socio-politico-economic structure of the country. Determinants of development are broadly classified into economic factors and non-economic factors.

Economic Factors as determinants of Development

Economic factors as determinants of development include natural and human resources. Natural resources (those which are available as a free gift of nature) include land, water, minerals, fossil-fuel, forest products, wind and solar energy, etc. Natural resources can be broadly divided into three categories viz. Bioclimatic resources (land, water, forests and climatic environment), Fossil Fuel and non-fuel mineral resources. The countries, which are rich in natural resources have more scope for high economic growth. Many of the western countries development is due to their abundant availability of natural resources. But there are a lots of exception to this. For example, many countries in Africa are rich in natural resources, but poor in development.

Human resources are also equally important. Few countries such as Japan are poor in natural resources but their human resources have turned those countries into epitome of success.

Human resources are a prerequisite for development of a country. A country devoid of human resources cannot progress even if it is abundant with natural resources. Human resource can be divided into two categories viz. Physical labour and Human skill. Physical labour is the labour supply and skill is the knowledge embodied in humans. Human skill is formed when investment is made into education, health, training etc.

Non-economic Factors

Non-economic factors refer to socio-political factors or even religious factors. Political environment directly influences the economic development. Stable political administration generates faith of the people in the programmes and policies of the government. Accordingly, people venture to make investment in diverse areas of economic activity. Social institutions like caste system, joint family system and laws of inheritance play an important role in economic development. A corruption-free system is certainly more conducive to the process of growth and development, than the one where corruption is present.

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Physical Capital Formation and Economic Development

Development of a nation without the availability of adequate capital either in the form of physical capital or in the form of human capital is not possible. The higher the rate of capital formation (physical as well as human), the faster is the pace of economic growth. On the other hand, deficiency of capital has been the primary cause of underdevelopment in the third world economies.

Capital, Saving, Investment and Capital Formation

Capital refers to the stock of all the produced means of production that an economy possesses at a point of time. Capital includes only those means of production which are produced by man. For example – Plant and machinery, tools and instruments. The capital formation means addition to the existing stock of capital. Capital formation may be defined as the process of adding to the stock of capital per year.

The part of income which is not spent on consumption is called saving. If our savings are spent on capital goods, such as, machines, instruments, factories, or on increasing the stock of raw material or finished goods, this expenditure is called *investment.* Investment results in the production of capital goods or in the increase in capital stock. The increase in capital stock is called capital formation. Physical capital formation means stock of physical capital. There are two aspects of capital formation viz. Gross Capital Formation (GCF) and Net Capital Formation (NCF).

- **Gross Capital Formation:** It means gross investment. It includes both replacement investment and net investment.
- **Net Capital Formation:** It means increase in net investment only. Net investment is estimated by deducting depreciation from gross investment.

Process and Sources of Capital Formation

Process of capital formation refers to the way addition of capital stock is done. It involves saving and mobilisation of savings, and conversion of savings into capital goods through investment.

Saving and Mobilisation of Saving (Supply of Capital)

Saving is the surplus of income after consumption. The savings are used for further generation of income through investment. Investment is an instrument of capital formation. Thus, higher the rate of saving, higher the rate of capital formation. *Idle savings do not form part of capital formation.*

Financial institutions play an important role in converting saving into investment. Supply of capital not only depends on the rate of saving but also depends on how savings are mobilised through various channels. There are broadly two sources of savings viz. Internal Sources and External Sources.

Internal sources include household savings, public savings and corporate savings. External sources

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include foreign investment, trade surplus, foreign borrowing, etc. Domestic savings can be either voluntary saving by people or forced saving by government through taxes and inflation. An external source of saving comes in the form of foreign loan and grants, private foreign investment (FDI and FII) and international terms of trade.

Investment or Demand for Capital

Mobilised savings by the banking and other financial institutions need to be invested for capital formation. Higher investment implies higher capital formation. However, there should be demand for capital from entrepreneurs or from government. Government can use the investment to develop public infrastructure.

Role and Significance of Capital Formation in Economic Development:

Capital Formation ensures a Sustained Rise in Output

Higher capital formation ensures a continuous rise in economic growth. Higher economic growth means rise in the output of the country.

Capital Formation generates Employment

Generation of employment opportunities is a prerequisite for growth and development. Increase in capital formation generates more employment opportunities to produce more output.

Capital Formation facilitates Technical Progress

Capital formation creates an environment for technical progress with more spending on research and development.

Physical Capital Formation prompts Human Capital Formation

Human capital formation is possible only through physical capital formation. The expenditure incurred on health, education and social welfare, is the expenditure for the formation of human capital.

Capital Formation and Infrastructural Development

Capital formation provides the required capital for development of infrastructure.

Capital Formation and Self-reliance

Higher capital formation through domestic savings can create a self-reliance condition.

Capital Formation Facilitates Exploitation of Natural Resources

Capital formation facilitates exploitation of natural resources in the development process.

Factors responsible for lower capital formation

Low Per Capita Income

Low per capita income in less developed countries results in lower savingwhich is the primary source of capital formation.

Large Size of Population

Large size population is an impediment for capital formation. Because of large size population there is increase in consumption expenditure. Higher consumption expenditure means lower saving.

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Inflation

Higher inflation means less surplus of income for further investment, implying a low rate of capital formation.

Demonstration Effect

Consumption expenditure tends to be high and the rate of capital formation tends to be low due to Demonstration Effect in the less developed countries. The low-income group people imitate high-income group's way of life and start spending much of their income on expensive consumer durables. It causes lower rate of capital formation.

Lack of Investment-friendly Environment

Lack of investment-friendly environment suppress the investment.

Complex Tax-structure

Complex tax-structure in less developed economies lowers the capital formation.

Limited Extent of Market

Demand in small size market is low. Lower the demand, lower investment for capital formation.

Measures to Promote Capital Formation in Underdeveloped Countries

Increase in Voluntary savings

Increase in rate of voluntary savings is a prime requirement in less developed countries. Increase in interest rate can encourage more voluntary savings.

Expansion of Banking Institutions

Banking facilities expansion in rural areas can increase the savings in rural areas.

Forced Saving through Taxation

Government can increase the capital formation by imposing direct and indirect tax on economic activities.

Encouraging private Enterprises

Generally, private enterprises are efficiently run when compared to public enterprises. Encouraging private enterprises can increase the capital formation.

Reduction in Non-developmental expenditure

The government should reduce non-developmental expenditure related to administration and defence. Their reduction will result in more savings to be invested in the Public sector.

Price Stability

Price stability is conducive to both the supply of capital as well as demand for capital.

Liberal government Policies

Liberal fiscal and credit of the government encourages saving and investment for capital formation.

Surplus through International Trade

International trade can encourage the flow of capital to the less developed countries.

Concept of Human Capital

Human capital refers to stock of 'skill and expertise' embodied in humans. Human capital is as

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important as physical capital for economic development. Human capital formation is the process of adding to stock of human capital over time. Human capital can be developed through creation of skilled, trained and efficient labour force by providing better education, health care facilities, etc. Highly skilled people can create new ideas and methods of production. Thus, expenditure on education, on health and on on-job-training are key instruments of human capital formation. Expenditure on education is one of the most important way of enhancing and enlarging a productive workforce in the country. Expenditure on health can create more efficient and more productive human capital. Further, on-the-job-training helps workers to update skills. Training enhances the productivity and is expected to accelerate the process of human capital formation.

Role of human capital formation in economic Development

The human capital formation plays crucial role in the economic development.Firstly, formation of human capital would tend to change the traditional society to modern society, which has higher scope for economic development. Secondly, human capital increases the productivity of the physical capital (for example, they can handle the tools and machines in better way). Enhanced productivity would accelerate the growth. Thirdly, higher standard of life is possible only via development of human capital. Fourthly, human capital formation facilitates the use and growth of innovation. Innovation is the principal determinant of growth.Fifthly, human capital formation increases the rate of participation. Higher the rate of participation, greater is the degree of economic equality in the society. *Finally*, investment in human capital yields larger returns and the returns on this type of investment far outweigh its input costs. For example, training of the workers increases their productivity which ultimately leads to overall increase in production.

Various Problems in formation of human capital in India

There are several problems of formation of human capital in India. Firstly, rapid growth of population adversely affects the quality of human capital. It reduces per head availability of the natural resources. Secondly, migration of skilled persons to developed countries is a serious brain drain threat to the process of human capital formation in the country. Thirdly, there is insufficient manpower planning by raising the standard of education at different stages. There is a need to maintain a balance between the demand and supply of technical labour force. Last but not the least, the insufficient supply of qualified and trained technologists is a pointer to a serious neglect of human capital formation in India. On-the-job training should be provided to working population to create a productive human capital formation.

How to Raise the Rate of human capital Formation in India?

- Check the high rate of population growth.
- Proper Manpower Planning: A proper manpower planning is a critical requirement to

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combat the problem of human resource wastage. The planning needs to focus on both the quantitative and qualitative aspects of human capital.

- Proper educational planning: An effective educational planning that promotes human capital formation must be developed.
- It should provide for adequate health services and nutritive food to the existing population of the country.

Basics of Inclusive Growth

Definition and Meaning

Inclusive growth has been defined differently by different organizations and scholars. The dictionary meaning of the term "inclusive" is "comprehensive", "including all extremes" and "not excluding any section of the society".

UNDP has defined inclusive growth as "*the process and the outcome where all groups of people have participated in growth and have benefited equitably from it*". This implies that inclusive growth should include all sections as beneficiaries as well as partners in growth and that inclusion of the excluded should be embodied in the growth process.

Basely *et el* (2007) defined inclusive growth as the "*growth that has a high elasticity of poverty reduction*", i.e. it should have a higher reduction in poverty per unit of growth.

In summary, Inclusive growth is the growth that reduces disparities among per capita incomes in agriculture and non-agriculture, in rural and urban areas, and in different socio-economic groups, particularly between men and women and among different ethnic groups. The result of inclusive growth is reduction in vertical inequalities (individual inequalities) and horizontal inequalities (group inequalities).

Salient Features of Inclusive Growth

The growth is inclusive growth when it is socially inclusive, regionally balanced, which enables every state to do better than in the past, which narrows the gap between different communities, which also brings in our concern for gender equality, upliftment of women, improving their educational condition and social status. The key features of Inclusive growth are as follows:

- *Economic growth is a precondition for inclusive growth* though the nature and composition of growth has to be conducive to inclusion.
- Inclusive growth is to include the poor and lagging socio-economic groups such as ethnic groups, weaker sections as well as lagging regions as partners and beneficiaries of economic growth.
- The Inclusive growth *addresses the constraints of the excluded and the marginalised*. It has to open

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up opportunities for them to be partners in growth.

- Inclusive growth should be non-discriminatory and favourable for the excluded. This implies that inclusive growth has to be broad-based in terms of coverage of regions, and labour-intensive in terms of creating large-scale productive employment opportunities in the economy.
- Inclusive growth is expected to ***reduce poverty faster*** in the sense that it has to have a *higher elasticity of poverty reduction*.
- Inclusive growth has to ensure access of people to basic infrastructure and basic services/capabilities such as basic health and education. This access should include not only the quantity, but also quality of these basic services.
- Inclusive growth *should reduce vertical as well as horizontal inequalities* in incomes and assets.

Theoretical Aspects in Inclusiveness Growth

Inclusive growth is a Multi-dimensional Concept

Inclusive growth is understood as a multi-dimensional concept that facilitates inclusion from a variety of fronts that include:

- Increase of employment;
- Elimination of poverty;
- Elimination of discrimination
- Elimination of horizontal and vertical inequalities
- Promotion of access to a variety of public resources and institutions.

Basic idea is that the fruits of rapid economic growth should be widely shared, particularly by the poor and marginalised segments of society. Even if the rates of economic growth are high, that is, even if the cake is growing rapidly in size, nothing will trickle down to those who are not involved in the growth process either as entrepreneurs or employees, because of lack of appropriate capabilities. This is why the state has to intervene and orchestrate an inclusive growth path.

Inclusive Growth is an Utopia

The concept of inclusive growth is basically a utopian concept. This is because inclusive growth is based on the assumption of equitable allocation of resources and benefits accruing to every section of society, but perfect equality cannot be found anywhere.

However, the practical idea is to keep inequality into tolerable limits. Even bringing inequality within tolerable limits cannot be achieved overnight. Thus, the goal of inclusive growth needs to be a medium-long-term goal, as it takes time to include the excluded. However, the processes of such growth should start in the short run, as the medium-term goals have implications for short-term

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processes and activities.

Inclusive growth should be reflected in better opportunities for both wage employment and livelihood and in improved provision of basic amenities such as water, electricity, roads, sanitation and housing.

Inclusive Growth is beyond reducing poverty

There are several aspects of inclusive growth, the key aspects being adequate flow of benefits to the poor and the most marginalised. However, inclusive growth also involves group equality, regional balance, gender balance and social / economic empowerment. The poor are certainly one group, but inclusiveness must also embrace the concern of other groups such as the Scheduled Castes (SCs), Scheduled Tribes (STs), Other Backward Classes (OBCs), Minorities, differently-abled and other marginalised groups. Women can also be viewed as a disadvantaged group for this purpose. Further, regional balance aspect of inclusiveness relates to whether all regions, are seen to benefit from the growth process. An important constraint on the growth of backward regions in India is the poor state of infrastructure, especially road connectivity, schools and health facilities and the variability of electricity, all of which combine to hold back development. Improvement in infrastructure must therefore be an important component of any regionally inclusive development strategy.

Economic Inequality

Economic inequality is a hindrance to the process of growth and development in India. Even though there is an economic growth in India, it is not able to reduce the growing inequalities of the Indian society. Our development strategies failed to reduce the extent of regional and sectoral inequalities. Domestic and foreign investments are not directed to backward regions of the country. Already developed states are found to be preferred destination of investment.

Meaning of Economic Inequality

In India four forms of inequalities are found.

1. Inequality of income,
2. Inequality of consumption expenditure,
3. Inequality of asset holding, and
4. Regional inequality.

Inequality of the distribution of wealth and income refers to a situation in which small section of society share large part of nation income whereas large sections of society are devoid of income. There is an unequal distribution of income.

Inequality in consumption expenditure refers to a situation in which a large percentage of total consumption expenditure is incurred by a small percentage of population. Inequality of consumption

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expenditure shows that a large percentage of bottom population has to struggle to survive, whereas a small percentage of top population enjoys a lavish lifestyle.

Regional inequality refers to inequality of growth process across various states in the country and different regions with in a single state. Some states or regions are far more prosperous than the others.

Nature and Extent of Economic Inequality in India

In India inequality of income is calculated based on the data on consumption distribution (provided by NSSO) and income tax data. To examine the distribution of income in India, a Committee was appointed by the Government under the chairmanship of Prof. P.C. Mahalanobis. The committee submitted the report in 1964. Besides this Committee, National Council of Applied Economic Research (NCAER), Reserve Bank of India, World Bank and many economists have undertaken important research studies relating to distribution of income. However, these studies relate to different periods of time, and are based on different methodologies. The results of these studies are not strictly comparable. Higher Lorenz ratio or Gini-coefficient points to a greater degree of inequality. Gini index in India was 33.4 in 2011-12 which points to an alarming magnitude of inequality in India.

Rural and Urban Breakup

In India there are inequalities of income are found in rural and urban areas as well. Per capita income in rural areas is less than the per capita income in urban areas. However the inequality levels in rural areas are less than the inequality at urban areas.

Causes of Inequality of Income and Wealth in India

Causes of Inequality of Income in India:

- Inequality in the ownership of assets,
- Laws of inheritance,
- Cost of professional training,
- Inflation,
- Unemployment,
- Tax evasion,
- Corruption and smuggling,
- Greater Burden of indirect taxation or regressive tax structure.

Government Policy to Reduce Inequalities of Income and Wealth

Ever since independence, Government has been focussed on reduction of inequalities of income and wealth in the country.

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Land Reforms

Land reforms have been introduced to remove inequality in the ownership of land. Land in excess of the ceiling limit has been distributed among the tenant farmers, and among the small and marginal holders.

Expansion of Public Sector

Government pursued a policy of assigning a 'flagship-role' to the Public Sector. Many commercial banks were nationalised in 1966-68. However, since 1991, there has been reversal of the government policy. Privatisation has become the centrestage of growth-strategy. This is because public sector has only yielded inefficiency and bankruptcy.

Encouraging Small Scale Industry

The Government is providing support to develop small scale industry.

Monopolies and Restrictive Trade Practices Act

Monopolies and Restrictive Trade Practices Act, 1969 was passed to put a check on concentration of economic power.

Poverty Alleviation Programmes

Government should frame poverty alleviation programmes particularly those which provide gainful employment to the economically weaker section of the society.

Pricing Policies

Government should design the pricing and distribution policies to reduce the inequalities present in the society. Government should provide the basic amenities at lower price to the weaker sections of the society.

Measures to Correct Regional Imbalances

Following measures have been taken to remove regional imbalances: (i) Greater share of central pool of funds should be allocated to backward states. (ii) Provision of Grant-in-aid by the Central Government to the backward states. (iii) Launching of Special Area Programmes like Desert Development Programme, Drought Prone Area Programme, etc. (iv) Propagation and use of improved dry farming technology. (v) Provision of infrastructural facilities in backward districts. (vi) Development of forward and backward linkages in those backward regions.

Economic Inequalities and Five Year Plans

Economic growth with social justice has been one of the most important objectives of five year plans in India. Growth must be inclusive of all segments of the society rather than exclusive of larger sections of the society. Keeping in mind the goal of social equality, Planning Commission of India adopted different strategies during different five year plans to achieve this goal. During the initial period of planning (up to third plan), the objective of equitable distribution was not given any centrestage priority. However, in subsequent plans, equality received its due focus. Abolition of

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zamindari System, ceiling on landholding, subsidy for use of HYV technology are important measures taken in the five year plans. But the plans are not able to succeed fully as the inequalities are not removed fully.

Gini coefficient

Gini coefficient represents the income distribution of a country's residents. It was developed by the Italian statistician and sociologist Corrado Gini. It measures the inequality. The coefficient ranges from zero to one, with *zero representing perfect equality* and *one showing perfect inequality*. The higher is the Gini Coefficient, more is gap between rich and poor in a country. If the value of Gini Coefficient is 1, it implies that all wealth of that country belongs to one person and everybody else is poor. The 0 value of Gini Coefficient implies that all people have exactly equal wealth. Practically, the Gini Coefficient value falls between 0 and 1 for all the countries.

India's Gini Coefficient

In India, National Sample Survey does not collect data on income, because people deliberately don't tell their income when asked during data collection. The Gini coefficients cited are from NSSO is based on consumption expenditure rather. (This simply implies that inequality in distribution of income will be more than inequality in distribution of consumption expenditure). The only organization that provides income distribution data is National Council of Applied Economic Research (NCAER), through the National Survey of Household Income and Expenditure (NSHIE). Last time, the NSHIE was done in 2004-05. NSHIE showed a Gini coefficient of 0.466 in 2004-05. In recent times, the People Research on India's Consumer Economy (PRICE) survey called ICE (India's Consumer Economy) had come up a Gini coefficient with income distribution data at 0.386. If we take both data correct, we can say that income inequality has declined in last 10 years.

Regional Disparity

'Unity in diversity' is a fundamental characteristic of India. The growth pattern of Indian Economy has reflected in various dimensions of social, economic, political, geographical, religious, cultural and linguistic diversities.

Reasons for Disparity

Natural Resources

- Most important reason for regional disparity is that India's different regions are endowed with different natural and human-based resources. Some states such as West Bengal, Jharkhand, Odisha, Chhattisgarh etc. are endowed with better mineral resources while others such as Punjab and Haryana have better irrigation facilities.

Manmade / Historical Reasons

- The manmade reasons for regional disparity lie in the neglect of some regions and preference

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of other regions in terms of investments and infrastructure facilities. Apart from uneven distribution of geographical advantages, *historical factors that go back to mughal era and became prominent in British Era*, have also contributed to regional inequities.

Government Polices / Planning/ Economic Liberalization etc.

- To a great extent, the faulty planning process has been responsible for that. The striking regional disparities, inherited from colonial rule of over two centuries, have increased in the post-independence era because of faulty unified and centralized planning, political structure and social traditions.
- However, while income growth performance has diverged, there is a pleasant evidence of some convergence in Human Development indicators across the states.
- The government's development policies adopted during successive plan periods have stressed the need to develop backward regions of the country. In promoting regional balanced development, public sector enterprises were located in backward areas of the country during the early phase of economic planning. However, despite of the pro-backward areas policies and programmes, considerable economic and social inequalities exist among different States of India, as reflected in differences in per capita State Domestic Product.
- However, the income differentials between more developed and relatively poorer states show a widening trend which is a matter of serious concern.
- Inter-state disparities in growth of GSDP have increased post economic reforms period. In general the richer states have grown faster than the poorer states, leaving the backward states struggling even for basic amenities such as universal primary education, primary health care, housing, rural roads, drinking water and electricity. Moreover, the regional disparities in per capita GSDP growth are even greater because the poorer states in general have experienced a faster growth in population.

Disparity in other parameters

Apart from the disparities in GSDP and Incomes, there are wide variations between the states even on other parameters such as health (IMR, MMR, expectancy of life at birth, access to safe drinking water, etc.), education (Adult literacy, Gross enrolment ratio at elementary, intermediate and higher education level) and infrastructure indicators.

Intra-state disparity

Various economic and social indicators confirm the higher level of inter-state disparities in India. Almost the same picture emerges among the different districts and regions within the states. Even in highly developed states such as Maharashtra, Gujarat, Tamil Nadu, Punjab and Haryana, there are districts and regions whose indicators are comparable to those of the poorest districts in most

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backward states. Maharastra is one of the most developed states in India but maximum numbers of farmers have committed suicides over there. This proves to the hypothesis that the benefits of the economic growth have not percolated downward.

Important Notes

- Rate of divergence has increased since the initiation of economic reforms as the value of gini coefficient has increased, intermittently.
- There are wide variations on account of social and demographic indicators such as poverty ratio, IMR, literacy rate, which plays an important role in the development of standard of living.
- While the GSDPs have been on the rise for all the states since 1991-92, there has been inequality in terms of development expenditure on education, infrastructure, health, urbanization, irrigation etc. The overall effectiveness of public investment and growth prospects of poor states could be improved by higher investment in social and economic infrastructure.
- Many of the states such as West Bengal have seriously deteriorated fiscal health. Some other states have been able to sustain fiscal health in quite satisfactory condition.
- Economic reforms led growth process increased concentration of economic activities in and around the centers already developed. High inequalities in infra-structural facilities, easy availability of skilled labour and raw material along with the investment friendly policies of state governments gave impetus to entrepreneurs to select developed regions for the expansion of their activities.
- The successive Finance Commissions with their recommendations on devolution of tax revenue between Union of India and States have tried to benefit the backward states, sometimes even on biased parameters, yet we have not been able to fill the gap between the states.

Role of Finance Commission in addressing Regional Disparity

The framers of the constitution were aware that our country has an in-built imbalance between the expenditure responsibilities and the revenue sources of the State governments. So, it was ensured that a comprehensive scheme of devolution of Central Tax revenues through the mechanism of Finance Commissions is put in place.

The sharing of Personal Income Tax and Excise duties collected by the Centre with the States is periodically reviewed by the Finance Commission appointed every five years as per mandate of Constitution via Article 280.

The Commission also decides the principles and the formula by which the allocable funds are to be

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distributed among the States.

An important aspect of the devolution of Central tax revenues under Finance Commission dispensation is that *it has an in-built bias in favour of fiscally weak States* Population and per capita income of the State get high weight-age in the distribution formula. A State with larger population and lower per capita income gets a higher share in the Central tax revenues.

The gap between revenue receipts (other than the Central tax revenues) and revenue expenditure is another parameter, which decides the level of a State's share. As a result the Central tax share constitutes a major revenue source for the backward States. While it constitutes about one-third of the total tax revenues of all the States taken together; it accounts for more than 50 per cent of the total tax revenues of less developed States like Bihar and Odisha; but its share is less than 15 per cent of the total tax revenues of more developed States like Gujarat, Haryana, Maharashtra and Punjab.

Special Category States

The Special Category states was introduced in 1969. So far extended to 11 states including seven North East states viz. Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland and Tripura and the border states of Himachal Pradesh, Jammu and Kashmir and Sikkim as well as Himalayan state of Uttarakhand.

Special category status enhances the resource capability of the state by altering the mix of Centre-state contribution for centrally-sponsored schemes. It frees state resources, enabling access to external funds, and the associated tax breaks with a sunset clause incentivizes private investments.

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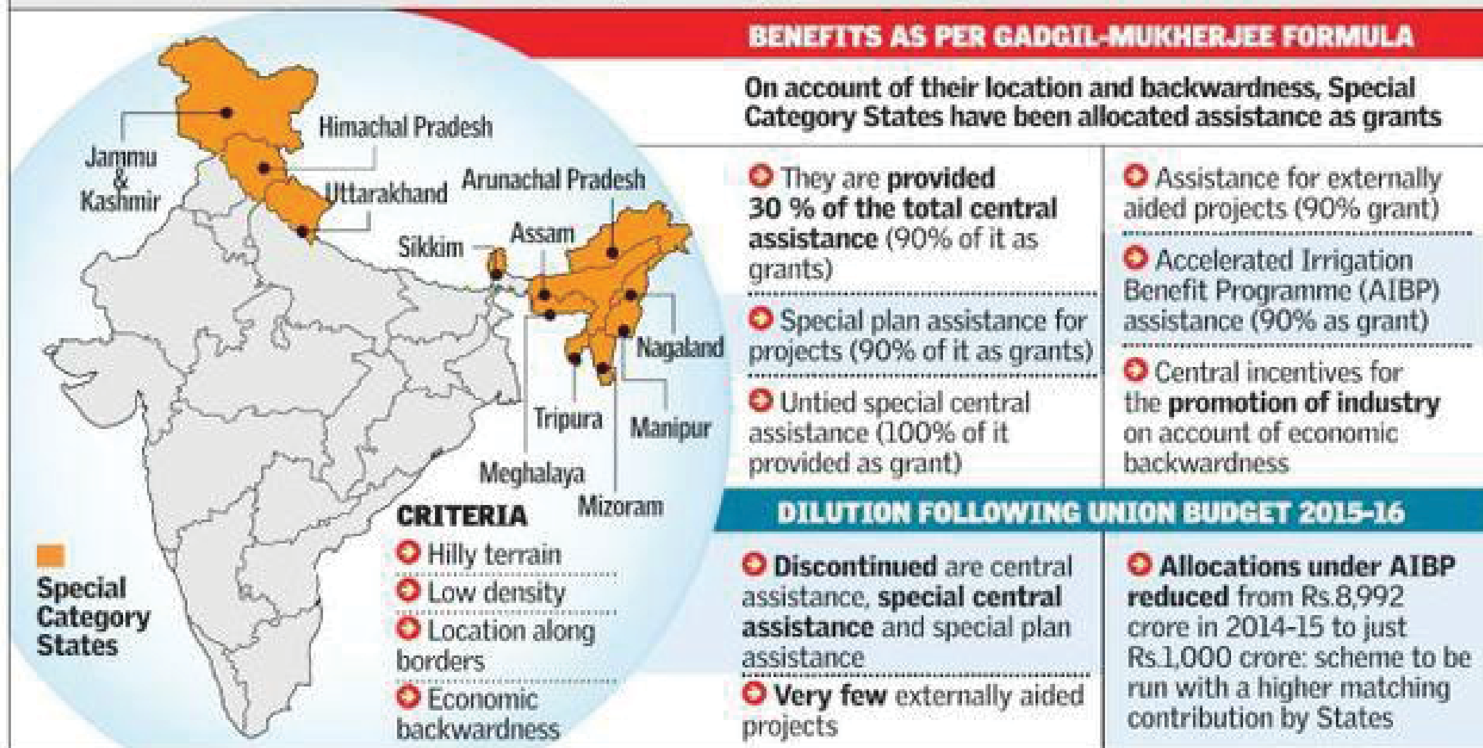

Special Category states are **not a constitutional prerogative**. The category has been devised by the Government to pay attention to the many problems apart from the financial viability of these states. Almost all of them have a hilly and difficult terrain and very low level of infrastructural development. Most of them have significant tribal population. Almost all of them are border States with considerable international borders. Most of them are poor and have very own low revenue resources.

- These states are given favored treatment in respect of plan financing and financial devolutions.
- According to the Gadgil formula for devolution of Central assistance for States plan as approved by the National Development Council, 30 per cent of the total funds is earmarked for Special Category States.
- Further, as against the composition of Central assistance of 30 per cent grant and 70 per cent loan for major States (characterized as non-special category States), special category States receive 90 per cent plan assistance as grant and just 10 per cent as loan.
- Similar favored treatment is received by the special category States in the hands of the Finance Commission in respect of devolution of Central tax revenues. High levels of

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devolution by the Planning Commission and the Finance Commission compensate for the very fragile own revenue basis of these States.

Backward Region Grants Fund is NOT applicable to only special category states. Backward Regions Grant Fund (BRGF), which began in 2006-07, addresses backwardness on multiple criteria covering 272 districts. This programme is now delinked from central support and states themselves implement it.

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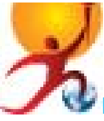

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General Knowledge Today

Economic Planning Fundamentals

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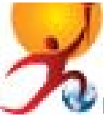

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Model Questions

Prelims Topics

Indicative Planning versus Imperative Planning, Perspective Planning, National Planning Committee, Gandhian Plan and Sarvodaya Plan, Domer-Mahalanobis Model, Rolling Plans, NITI Aayog – Composition & Objectives, Difference between NITI Aayog & Planning Commission

Mains Model Questions

1. Independent India chose the path of socialism because that was the dominating thought when British left India. Assess Critically.
2. Discuss the efforts towards economic planning in India during the Pre-independence Period.
3. Critically discuss the achievements and failures of economic planning in the pre-liberalization period.
4. What do you understand by evidence based policy making? In your view, how NITI Aayog would provide a good platform for a shift towards evidence-informed policy making?
5. Planning Commission outlived its original objectives and its credibility has rapidly lost. Discuss the various reasons that led to demise of this body.
6. Discuss the aims & objectives of NITI Aayog. To what extent, it is different from the erstwhile Planning Commission?

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Types of Economic Planning

Economic Planning refers to any plans of economic activity which point to achieve specific social and economic outcomes. The planning mechanism involves the specific economic or social outcomes. The philosophy of planning is that only markets and price system cannot ensure the welfare of citizens. Apart from this there are economic requirements such as investment in infrastructure, investments in public goods such as transport & other public utility which are enjoyed by the society.

Types of Economic Planning

In today's world, most economies are mixed economies. The planning can be of several types as discussed below:

Indicative Planning

- It puts forward / indicates to some broad principles and guidelines to achieve some goals. Not much specific particulars.

Comprehensive / Imperative Planning

- Refers to centralized planning and implementation with allocation of resources
- Used by socialist countries and each and every aspect of planning is controlled by state.

Structural Planning

- Aims to change the existing structures

Functional Planning

- Aims to achieve the objectives without making much changes to existing structural framework

Centralized Planning

- One central authority formulates plan, targets and priorities for all sectors. Also called Top bottom

Decentralized planning

- Multi-level planning in which more than one institutions work for implementation

Perspective Planning

- Refers to Long term planning 15-20-25 years. Implemented by breaking the plan period into smaller plans such as 5 years

Planning Before Independence

First of all the idea of planned economy was crystallized in 1930s when our national leaders came under the influence of socialist philosophy. India's Five year plans were very much impressed by the rapid strides achieved by the USSR through five years plans.

In 1934, Sir M. Visvesvaraya had published a book titled *"Planned Economy in India"*, in which he presented a constructive draft of the development of India in next ten years. His core idea was to lay out a plan to shift labor from agriculture to industries and double up National income in ten years.

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This was the first concrete scholarly work towards planning. The economic perspective of India's freedom movement was formulated during the thirties between the 1931 Karachi session of Indian National Congress, 1936 Faizpur session of India National Congress.

National Planning Committee

The first attempt to develop a national plan for India came up in 1938. In that year, Congress President Subhash Chandra Bose had set up a National Planning Committee with Jawaharlal Nehru as its president. However the reports of the committee could not be prepared and only for the first time in 1948 -49 some papers came out.

Bombay Plan

In 1944 Eight Industrialists of Bombay viz. Mr. JRD Tata, GD Birla, Purshottamdas Thakurdas, Lala Shriram, Kasturbhai Lalbhai, AD Shroff , Ardeshir Dalal, & John Mathai working together prepared "*A Brief Memorandum Outlining a Plan of Economic Development for India*". This is known as "Bombay Plan". This plan envisaged doubling the per capita income in 15 years and tripling the national income during this period. Nehru did not officially accept the plan, yet many of the ideas of the plan were inculcated in other plans which came later.

People's Plan

People's plan was drafted by MN Roy. This plan was for ten years period and gave greatest priority to Agriculture. Nationalization of all agriculture and production was the main feature of this plan. This plan was based on Marxist socialism and drafted by M N Roy on behalf of the Indian federation of Lahore.

Gandhian Plan

This plan was drafted by Sriman Nayaran, principal of Wardha Commercial College. It emphasized the economic decentralization with primacy to rural development by developing the cottage industries.

Sarvodaya Plan

Sarvodaya Plan (1950) was drafted by Jaiprakash Narayan. This plan itself was inspired by Gandhian Plan and Sarvodaya Idea of Vinoba Bhave. This plan emphasized on agriculture and small & cottage industries. It also suggested the freedom from foreign technology and stressed upon land reforms and decentralized participatory planning.

Planning and Development Department

In August 1944, The British India government set up "Planning and Development Department" under the charge of Ardeshir Dalal. But this department was abolished in 1946.

Planning Advisory Board

In October 1946, a planning advisory board was set up by Interim Government to review the plans

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and future projects and make recommendations upon them.

Planning Commission

Immediately after independence in 1947, the Economic Programme Committee (EPC) was formed by All India Congress Committee with Nehru as its chairman. This committee was to make a plan to balance private and public partnership and urban and rural economies. In 1948, this committee recommended forming of a planning commission. In March 1950, in pursuance of declared objectives of the Government to promote a rapid rise in the standard of living of the people by efficient exploitation of the resources of the country, increasing production and offering opportunities to all for employment in the service of the community, the Planning Commission was set up by a Resolution of the Government of India as an advisory and specialized institution. Planning Commission was an extra-constitutional body, charged with the responsibility of making assessment of all resources of the country, augmenting deficient resources, formulating plans for the most effective and balanced utilization of resources and determining priorities. Jawaharlal Nehru was the first Chairman of the Planning Commission.

National Development Council

Government of India could take the initiative to set up the planning commission only by virtue of provision in the constitution which made Economic & Social planning an item in Concurrent list. The Resolution to set up a planning commission was actually based upon the assumption that the roots of Centre- State cooperation should be deeper. Later, in 1952, the setting up of the National Development Council was in fact a consequence of this provision.

Features of Indian Planning

The planning era has ended with planning commission but here are some of the key features of Indian planning for academic purposes.

Five Year Planning

- India's plans are of 5-year period. The five year plans integrated the short term objectives with long term objectives.

Comprehensive Planning

- The focus of the planning was not only on economic parameters but also on social parameters of growth and development. On one side, it focused on acceleration of the pace of growth, on other side, it focussed to minimize vertical and horizontal disparities. The focus of comprehensive planning was to achieve 'inclusive growth'.

A Tilt towards the Public Sector and Regulation of the Market Forces

- Even though India adopted mixed economy, it encouraged more participation of public sector in development process. Private sector was controlled through legislative restrictions like

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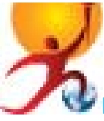

MRTP Act (to check on growth of monopolies). Public sector involved in provision of food grains and essential goods to people through a comprehensive public distribution system (PDS).

- Since 1990's the strategy was changed. Now the private sector is encouraged more to participate in development process.

Democratic Planning

- At the formulation level as well as at the implementation level of plans, India followed the democratic approach. Planning commission prepares the draft plan and it was approved by the National Development Council(NDC) body, which included stakeholders from state governments. Opinions of various organisations and experts are taken into consideration while formulating the plans. While implementing the plans, bottom-up approach was followed with involvement of democratic bodies at village and district level.

Prospective and Perspective Planning

- Indian planning incorporated both short-term and long-term programmes of growth and development. The integration of both the strategies is required to exploit the potential of growth process.

Central Planning Authority

- Planning Commission was established in 1950 as a central authority to develop the plans and to oversee the implementation.

Economic and Social Spheres of Planning

- In planning objectives along with economic development goals, social development goals are included.

Financial Planning

- Indian planning involves allocation of funds to various sectors and activities, rather than achieving the physical targets of the plan.

Objectives of Planning

In India objectives of planning are mainly classified as long-term objectives and short-term objectives.

Long-term objectives try to solve the socio-economic issues that the country is facing over the years. It includes increase in national income or per-capita income, achieving full employment, social justice and equitable distribution, poverty alleviation, self-sufficiency and modernisation, etc. Achieving all these objectives would be termed as 'Growth with Social Justice'. Short term objectives are plan specific to be achieved within the plan itself. They are often concerned with the allocation of resources to various sectors of the economy according to immediate demand as envisaged by the

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policy makers.

Long-term Objectives

Economic Growth

- Achievement of economic growth is the main motive of planning. Economic growth can be measured in terms of rate of growth of GDP or GNP. Higher rate of economic growth creates multiplier effect which will further improve the economic growth indicators. Each five year plan sets a target to achieve growth in terms of increase in GDP.

Full Employment

- Rampant unemployment is a serious issue in India. Provision of full employment is a long-term objective of planning in India. For the first time Sixth five year plan accorded the priority status for employment.

Equity and Social Justice

- The fruits of economic growth should benefit large sections of the society. Development of few sections of the society will lead to the inequality in society. Indian planning should aim at reducing such inequalities, so that the benefits of economic development percolate down to the lower strata of the society.

Eradication of Poverty

- Eradication of poverty is one of the long-term objectives of the planning in India. Fifth and Sixth five year plans primarily focussed on eradication of the poverty problem in India.

Modernisation

- Modernisation means updation of technical know-how and adoption of new technologies for betterment of the society. Productivity of the economy can be raised many-fold with the use of innovative and modern technology. Green Revolution and IT revolution are best examples of how technology can transform a country. Modernisation also includes issues like empowerment of women.

Self-sufficiency

- Self-sufficiency means dependence on domestically produced goods, particularly foodgrains. The basic idea was not to expose India's fragile economy to political diktats of rest of the world as it happened in 1965 when U.S.A., threatened to stop exports of foodgrains to India unless the latter stopped the then war with Pakistan.

Short Period Objectives

Short period objective have been varying from plan to plan depending on current needs of the economy.

Planning Strategies

In order to achieve the long-term and short-term objectives set in the each five year, specific

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strategies are required. It involves allocation resources across different sectors of the economy in tandem with the specified objectives. It involves selection choices like development of agricultural sector or industrial sector, public sector or private sector involvement, closed economy or open economy model. Indian planning strategies can be split into two phases: pre-1991 phase and post – 1991 phase.

Pre 1991 Phase or Pre-reform Phase

During pre – 1991 phase (1951 to 1990), India followed the strategy of planning with greater reliance on the public sector along with a regulated private sector. Following strategies are followed during 1951-91 phase:

Heavy Reliance on Public Sector

- Greater reliance was placed on public sector compared to private sector. As private sector was not able to invest in large amount for development of heavy industries, government turned towards public sector for provision of essential and basic needs for the people. At the same time private sector was not willing to provide the services in backward regions of the country.

Regulated Expansion of Private Sector

- Private sector was restricted to few areas of activities. New legislations were created for the restriction for the restriction of private sector.

Development of Heavy Industries

- Government invested heavily in development of Heavy industry like iron industry.

Protection of Small Scale Industry

- Small scale industry was protected by means of establishment of boards for different small scale industries and reserving few areas of production exclusively for the small scale industry.

Inward Looking Trade Strategy

- Domestic industry was protected from competition in the international market. Heavy import duty was imposed to curb competitive imports, while domestic industries were encouraged to produce domestic substitutes of essential imports.

Thrust on Savings and Investment

- Promotion of savings and investment was the undisputed objective of monetary and fiscal policies of the government. Savings are induced through high rate of interest. Tax concessions were to mobilise savings.

Restriction on Foreign Capital

- Several types of restrictions were imposed on foreign direct investment. To control and regulate it, Foreign Exchange Regulation Act (FERA) was enforced.

Adherence to Centralised Planning

- State level plans were aligned in sync with the over all objectives and strategy of growth as

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specified in Five Year Plans.

Post 1991 Phase (Post-reform Phase)

Strategy of planning in India witnessed a marked shift in the year 1991. Following are main changes observed under NEP (new economic policy):

- Fiscal policy and monetary policy have been reoriented to facilitate the free play of market forces.
- Foreign capital in the form of FDI (Foreign direct investment) and FII (Foreign Institutional Investment) are encouraged.
- Import restrictions are restricted to the minimum, while export promotion has been accorded a high priority.
- Competition rather than controls have become the fulcrum of growth process.
- Direct participation of the government is significantly tempered and confined only to strategic industries such as atomic energy, minerals and railways.
- Partial convertibility of Indian Rupee.

Recently, the concept of Sustainable development is included as main feature of the strategy of planning in India. Sustainable development refers to the development of present generation by taking into consideration of the future generations.

Following are some notable reasons for change in economic policy:

1. Mounting Fiscal Deficit and revenue deficit: Fiscal deficit and revenue deficit of the country are increased due to the policies followed before the 1990's governments.
2. Balance of Payments (BoP) Crisis: Heavy dependence on imports resulted in a BoP crisis.
3. Gulf Crisis: On account of Iraq war in 1990-91, prices of petrol started increasing. Remittances from gulf countries are also stopped.
4. Fall in Foreign Exchange Reserves: In 1990-91, India's foreign exchange reserves lowered to such a level that these were not enough even to pay for an import bill of 10 days.
5. Rise in Prices: In India prices happened to rise rapidly. Expansion in money supply was the principal cause of inflationary pressures. In turn, this was related to deficit financing. Country has experienced the situation of stagflation.
6. Dismal Performance of Public Sector Undertakings (PSUs):Public sector undertakings were showed dismal performance.

On account of all these factors, the government shifted to New Economic Policy.

Three Principal Components of New Economic Policy

Liberalisation, Privatisation and Globalisation are the three principal components of New Economic

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Policy. Liberalisation of the economy means freedom of the economy from restrictions of the Government. Liberalisation was expected to break the deadlock of low investment by exposing the economy to the forces of supply and demand. Privatisation refers to allowing private sector to enter in those areas of production which were previously reserved for the public sector. Also, existing public enterprises are either wholly or partially sold to private sector. It was considered to be the fittest option to stave off problems of public sector enterprises. Globalisation means integrating domestic economy with rest of the world under conditions of free flow of trade and factors of production across borders. Globalisation results in flow of capital and technology from developed countries into the Indian economy.

Summary of the Five Year Plans

Since 1951 India has completed 11 five year plans and 12th five year plan is about to finish in 2017. Each five year plan started from April 1 of a particular and ended on March 31 of a particular year, so by convention the five year plans take on 5 financial years. India's First Five year plan was launched on April 1, 1951. *Three Annual Plans were launched between third five year plan & fourth five year plan .* The fifth five year plan was launched by the Indira Government but was abandoned one year before its scheduled end by the Janta Alliance government. Instead of a regular plan, the Janta Government introduced Rolling plan in 1978. This rolling plan was launched actually as 6th plan from 1978 to 1983, but soon Janta Government was ousted from power and incumbent Indira Government abandoned it and launched her own sixth plan in 1980. The Eighth five year plan started two years than the scheduled time because India's economy was in shambles during 1990-92.

First Five Year Plan 1951-56

The first five year plan was presented in the parliament by Prime Minister Jawaharlal Nehru in December 1951.This plan promoted the idea of *self reliant closed economy* and was developed by Prof. P. C. Mahalanobis. The plan had heavily borrowed ideas from USSR's five year plans developed by Domer. Due to this, the first five year plan is also called *Domer-Mahalanobis Model.*

In this plan, highest priority was given to the Agriculture, Irrigation & Power Projects. Total plan budget of Rs. 2069 Crore was allocated to seven broad areas: irrigation and energy (27.2 percent), agriculture and community development (17.4 percent), transport and communications (24 percent), industry (8.4 percent), social services (16.64 percent), land rehabilitation (4.1 percent), and other (2.5 percent). The plan was success due to favourable monsoons and relatively higher crop yields.

Notable Points

Other key notable points are as follows:

- Many irrigation projects including Bhakra Dam and Hirakund Dam were started in first five

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year plan.

- At the end of the plan period in 1956, five Indian Institutes of Technology (IITs) were started as major technical institutions.
- University Grant Commission was set up to take care of funding and take measures to strengthen the higher education in the country.

Critical Assessment of First Five Year Plan

At the time of Independence, India faced several problems such as partition and influx of refugees, severe food shortage, mounting inflation and disequilibrium in economy due to second world war. First five year plan ushered India into planned economy with a socialist aim. Its key objective was to achieve self sufficiency in food production, so highest preference was given to agriculture. The total outlay of this plan was Rs. 2069 Crore which was later increased to Rs. 2378 Crore.

But this plan was more or less a haphazard venture because at that time there were no concrete data and reliable statistics. The plan was basically a patchwork of so many projects which were isolated with each other. However, the plan was a great success thanks to the two continuous good harvests and emphasis on agriculture & irrigation. The country was able to achieve the targeted growth and was able to increase national income. However, the per capita income did not increase substantially because increase in national income was offset by increase in population. Indian Government had collaborated with the WHO to address infant mortality and this also contributed in growth of population.

Second Five Year Plan: 1956-61

The success of the First Five year plan boosted the confidence of the leaders. The agriculture growth target in the first plan was achieved, so government quickly started looking beyond agriculture. The second five-year plan focused on industry, especially heavy industry. The target of 25% Increase in the national income was set through rapid industrialization.

The second five year plan is based on so called Mahalanobis model. This was the USSR model indianized by PC Mahalanobis, the founder of Indian Statistical Institute and a close aide of Nehru. This model is known to have set the statistical foundations for state-directed investments and created the intellectual underpinnings of the license-raj through an elaborate input-output model. This Model suggested that there should be an emphasis on the heavy industries, which can lead the Indian Economy to a long term higher growth path. India's second five year plan and Industrial policy Resolution 1956, which paved the way for development of Public Sector and license raj; were based upon this model.

Notable Points

- Steel mills at Bhilai, Durgapur, and Rourkela were established in second five year plan.

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- Enhanced coal production and more railway lines were introduced in this plan.
- Atomic Energy Commission was formed in 1957 with Homi J. Bhabha as the first chairman.
- Tata Institute of Fundamental Research was established as a research institute.
- In 1957 a talent search and scholarship program was begun to find talented young students to train for work in nuclear power.

Achievements

The second five year plan, based on socialistic pattern, had targeted increase of 25% in National Income by Rapid industrialization, however, achieved target was of only 20%. Further, per capita income grew by 8% only. Domestic production of industrial products was encouraged, particularly in the development of the public sector.

Critical Assessment of Second Five Year Plan

The second five year plan was a big leap forward and it laid a heavy emphasis on the heavy industries. During this plan period the Industry policy resolution was amended and the primary responsibility for development was left to the Public Sector. The private sector was more or less confined to the consumer industries only. The small and cottage industries remained sluggish during this plan. The imports increased and lot and this uncovered India's Sterling Balances. The results were seen in the third plan when India was forced to devalue its currency twice.

Third Five Year Plan : 1961-1966

The first two plans developed a institutional structure to take the country on path of developed economy. Third plan for the first time rode on the wave of high expectation following overall growth of the economy of India. In this plan, India made efforts to achieve self reliance in food production and industry. However, the plan period saw a lots of political and economic problems. The Indo-China war 1962 and Indo-Pak War 1965 etc. exposed weakness of the country. These conflicts substantially shifted the focus towards defense production. Country's morale was down due to death of Jawaharlal Nehru in 1964 and Lalbahadur Shastri soon afterwards. Further, the 1965-66 was a near famine year, and the problem became more severe due to lack of buffer stocks.

Critical Assessment of Third Five Year Plan

During the third five year plan, the country was reeling under high budget deficit. In 1966 the third plan struck because of the more and more borrowing from the International Monetary Fund. Foreign aid was cut off and there was an international pressure to devaluate the Rupee. When rupee was devalued in 1966, it had its own impacts on economy. Growth rate was targeted 5%, however achieved only 2.2%. Much of the achievement was null and void because of 36% inflation and devaluation of rupee in 1966.

Due to bitter experience, the demand for a plan holiday were raised from various sectors and the

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planning commission admitted that this plan was a failure. Accordingly, government declared a plan holiday for next three years and due to this, the fourth plan started in 1969. Government mobilized all available resources for stepping up food production and establishing buffer stocks to meet the contingency. In this way, the economy had so much degenerated that planning was now made annual with three annual plans to take on the short term objectives.

However, there were positive achievements also. The years 1965-66 ushered India into Green Revolution and advanced agriculture. The construction of dams continued. Many cement and fertilizer plants were also built. Punjab began producing an abundance of wheat. Many primary schools were started in rural areas. In an effort to bring democracy to the grassroots level, Panchayat elections were started and the states were given more development responsibilities. State electricity boards and state secondary education boards were formed. States were made responsible for secondary and higher education. State road transportation corporations were formed and local road building became a state responsibility.

Fourth Five Year Plan 1969-74

Fourth Five Year plan was the first plan launched by Indira Gandhi government amid pressure of drought, devaluation and inflationary recession. The country was fighting with population explosion, increased unemployment, poverty and a shackling economy. In addition, the situation in East Pakistan (now independent Bangladesh) was becoming dire as the Indo-Pakistani War of 1971 and Bangladesh Liberation War took place. Funds earmarked for the industrial development had to be used for the war effort. The result was that this plan period was also no better than the third five year plan.

Notable Points

- India fought yet another war with Pakistan and helped in creation of Bangladesh. Needed to tackle the problem of Bangladeshi refugees after the 1971 war.
- Nationalization of 14 major Indian Banks was a key even during this war. This boosted the confidence of the people in banking system and started greater mobilization of private savings into banking system.
- At the end of this plan, India also performed the*Smiling Buddha underground nuclear test in 1974*. This test was partially in response to the US deployment of the Seventh Fleet in the Bay of Bengal to warn India against attacking West Pakistan and widening the war. The international community took several harsh measures against India, which affected the domestic economy.
- The Oil Crisis of 1973 skyrocketed the oil and fertilizer prices leading to a very high inflation.

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Critical Assessment of Fourth Five Year Plan

The Fourth plan when it was introduced after a gap of three years, was an ambitious plan with an aim of 5.5% growth as the previous plans had a growth target / achievement of maximum 3.5%. But the Indo-Pakistan war, liberation of Bangladesh and problem of Bangladesh refugees , successive failures of monsoon, Asian Oil Crisis of 1973 marred the objectives of this plan. The international economic turmoil due to Oil crisis upset the calculations for Fourth Plan. So only 3.4% growth could be achieved.

Fifth Five Year Plan: 1974-79

Critical Assessment

The fifth five year plan was launched with twin objectives of poverty eradication and attainment of self reliance.

The planning commission devised a *national program for minimum needs,* which included elementary education, safe drinking water, health care, shelter for the landless etc. The Electricity Supply Act 1975 was enacted to enable the central government to enter into power generation and transmission. Meanwhile, India had seen substantial rise in the food grain production and from fifth plan onwards India achieved self-sufficiency in food grains production.

To alleviate the problem of unequal spread of green revolution, government unsuccessfully tried to take over the wholesale trade in wheat. Indira Gandhi government also launched twenty point programme and irrigation schemes such as Command Area Development Programme in this plan. However, in 1975, Indira Gandhi imposed emergency and planning became subject to much politicization. In 1977, the government changed and first non-Congress Government took over power with Morar Ji Desai at its helm. The new central government was a coalition called *Janata Alliance*. This government reconstituted the planning commission and announced a new strategy in the planning. This new strategy involved a change in the objective and approach pattern. The new objective laid down was "Growth for Social Justice". The new approach was "Rolling Plan". It terminated the fifth five year plan in 1977-78 and launched its own sixth five year plan for period 1978-83 and called it rolling plan. Later, Janta government self-destructed itself and Indira Gandhi again became prime minister. She immediately threw the Janta's rolling plan in dustbin and launched her own plan for year 1980-85. *The year 1978-79 was restored back to fifth plan of 1974-79.*

Rolling Plans

The Janta Government terminated the fifth five year plan in 1977-78 and launched its own sixth five year plan for period 1978-83 and called it a Rolling Plan.

Meaning of Rolling Plan

The meaning of the Rolling Plan was that now, *every year the performance of the plan will be assessed*

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and a new plan will be made next year based upon this assessment.

In the rolling plans there are three kind of plans. First is the plan for the current year which comprises the annual budget. Second is a plan for a fixed number of years, which may be 3, 4 or 5 years. This second plan is kept changing as per the requirements of the economy (and politics). Third is a perspective plan which is for 10, 15 or 20 years. Thus, there is no fixation of dates in respect of commencement and end of the plan in the rolling plans.

Advantages and Issues with Rolling Plans

The main advantage of the rolling plans is that they are flexible. They are able to overcome the rigidity of fixed five year plans by revising targets, projections and allocations as per the changing conditions in the country's economy. Thus, the rolling plans allow for revisions and adjustments. In rolling plans the review of a plan becomes a continuous exercise. The effect of changed circumstances and the changed demand and supply conditions can be incorporated in the plan.

No doubt in fixed plans, the annual reviews are made, but they are getting information regarding the progress of the economy. While in case of rolling plans, the yearly reviews are such a nature that they serve the basis for the revised new five year plan every year. Such yearly review is the essence of rolling plans.

However if targets are revised each year, it becomes very difficult to achieve the targets which are laid down in the five year period. Frequent revisions make it difficult to maintain right balances in the economy which are essential for its balanced development.

So far, rolling plans have been unsuccessful in underdeveloped economies like Mexico and Myanmar and were later discarded, however in developed nations like Japan & Poland they have been successfully used.

Fate of India's Rolling Plans

Due to political problems, Morar Ji Desai was forced to resign and his successor Chaudhary Charan Singh (was in office for 170 days) failed to sustain a parliamentary majority as alliance partners withdrew support. The new elections were held and now Indira Gandhi came back to power with thumping success in January 1980. She resumed her own strategy and new 6th plan was started on April 1, 1980 which continued till March 31, 1985.

Sixth Five Year Plan (1980-85)

From the sixth five year plan onwards, there was massive investment in the Social Services.*These social services included Education, Health and Family Planning, Housing & Urban Development and other services.* From the 6th Plan onwards, the role & scope of the Planning Commission also increased.

The plan objectives were poverty alleviation and higher economic growth. Special attention was paid to removal of poverty through the rural development schemes such as Integrated Rural

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Development Programme (IRDP), National Rural Employment Programme (NREP), and Rural Landless Employment Guarantee Programme (RLEGP) etc. The poverty was 47% in the beginning of the plan and a target of 30% was fixed to achieve. The actual target achieved at that time was 37%.

- Training of Rural Youth for Self-Employment (TRYSEM) was started in 1979.
- Integrated Rural Development Programme (IRDP) was launched on October 2nd. 1980 all over the Country
- The National Rural Employment Programme (NREP) was launched in October, 1980 and became a regular Plan programme from April, 1981
- Till recently, 37% population of India was below poverty line, which has now come down to 20.9% as per government.
- Training of Rural Youth for Self-Employment (TRYSEM) was started in 1979.
- Integrated Rural Development Programme (IRDP) was launched on October 2nd. 1980 all over the Country
- The National Rural Employment Programme (NREP) was launched in October, 1980 and became a regular Plan programme from April, 1981

Seventh Five Year Plan: 1985-1990

A long term plan was outlined for 1985-2000 and the 7th five year plan was announced in this backdrop on November 9, 1985. This plan was started by Rajiv Gandhi government when Dr. Manmohan Singh was Deputy chairman of planning commission. The basic objectives were: Speedy development, modernization, self reliance and social justice. Seventh Plan also envisaged the continuance and expansion of the National Rural Employment Programme (NREP) and Rural Landless Employment Guarantee Programme (RLEGP) which were started in the Sixth Plan.

The 7th Five Year plan was considerably big. The outlay of Rs. 1, 80,000 Crore was not only double of the previous plan but also had a broader scope and the actual spending of Rs. 218700 Crore was 21.5% more than then plan outlay. The outlay on Rural Development was doubled in this plan.

Annual Plans: 1990-92

The unsustainable fiscal deficit of the 1980s along with the excessive external borrowing accumulated and culminated in the crisis of 1991. The Foreign exchange reserves were left a just one billion Dollars in January 1991, which was sufficient to finance three weeks' worth of imports.

So, the country was on the brink of default on its external obligations. The immediate response of the caretaker government under Chandrasekhar was to secure an emergency loan of $2.2 billion from the International Monetary Fund by pledging 67 tons of India's gold reserves as collateral. This triggered the wave of the national sentiments against the rulers of the country.

After assassination of Rajiv Gandhi in 1991, a nationwide sympathy wave secured the victory of the

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Congress. New Prime Minister was Narsimharao and his finance minister was Manmohan Singh. This new government started several reforms which are collectively called "Liberalization". This process brought the country back on the track and after that India's Foreign Currency reserves have never touched such a brutal low.

During the period of 1990-92, two annual plans for 1990-91 and 1991-92 were launched. They were worth Rs. 58,369.30 Crore and Rs. 64,751.20 Crore. The Eighth plan could not start because of politico-economical turmoil in the country during 1990-92.

Eighth Five Year Plan: April 1, 1992 to March 31, 1997

Critical Overview

The eighth five year plan can be called a "Rao and Manmohan Plan". This was reform period and the following took place during the reform period. In 1991, Rupee was once again devaluated. Due to the currency devaluation the Indian Rupee fell from 17.50 per dollar in 1991 to 45 per dollar in 1992. The Value of Rupee was devaluated 23%. The Government announced the new Industrial Policy whereby it delicensed most industries, reduced import tariffs, opened door for foreign direct investment, introduced a market determined exchange rate system.

The Eighth plan started in April 1992. One of the major highlight was modernization of the industries. The plan was launched with twin objectives of alleviation of poverty and unemployment. This plan period saw launching of many flagship programmes. In the 8th five year plan, growth rate achieved was 6.8% against the target of 5.6% . In the first two years the achieved growth rate was in the tune of 7.7%. Later it decreased due to a mounting pressure on Asian Economies which later culminated in the *Asian Financial Crisis of 1997.*

Ninth Five Year Plan: April 1, 1997 to March 31, 2002

This period saw the change in the government. The Ninth plan was started with an objective of "*Growth with Social Justice and Equality*". It also assigned importance to agriculture growth. Regulation of the debt programmes was emphasized to improve government's financial position. It was developed in context of 4 important dimensions of the government policy:

- Improving the quality of the life
- Generation of Productive employment
- Creation of regional balances
- Self reliance

The average target growth rate was 6.5% but the achieved growth rate was 5.5%. The growth in agriculture fell to 2.1% and manufacturing fell to 4.51% from 4.69% and 7.57 % from the previous plans.

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Tenth Five Year Plan: April 1, 2002 to March 31, 2007

The tenth plan was launched by Atal Bihari Vajpayee Government on December 21, 2002. This plan was prepared in the background of high expectations arising from the better growth rate achieved after the liberalization. Economy accelerated in the Tenth Plan period (2002–03 to 2006–07) to record an average growth of 7.7%, the highest in any Plan period so far. National Income increased by 7.6% and Per capita income by 6% per annum. Industrial production increased at the rate of 8.6% per year. In the last year of the plan double digit growth was achieved. This led the Vajpayee government to call for new election bit earlier than its scheduled time in 2004. The NDA asked vote in the name of "feel good factor" but somehow, this did not work. Vajpayee was ousted from power and UPA-I government came at the centre. The 61st report of the NSSO for 2004-05 recorded poverty to be 22% from the earlier level of 26.1%. UPA government continued many of the NDA schemes. It launched Bharat Nirman to upgrade rural infrastructure.

11th Five Year Plan

India entered the Eleventh Plan period with an impressive record of economic growth. Together with 10th plan progress, India emerged as one of the fastest growing economies in the world in the initial years of 11th plan. India's economic fundamentals have been improving in many dimensions, and this is reflected in the fact that despite the slowdown in 2011–12,the growth rate of the economy averaged 8 per cent in the Eleventh Plan period. This was lower than the Plan target of 9 per cent, but it was better than the achievement of 7.8 per cent in the Tenth Plan.

Achievements of Planning

India has completed eleven plans and twelfth is underway. The 65 years of planning in India has a mixed result. Sometimes targets have been realised while some other times we only shared disappointment and despair.

Achievements of Five Year Plans

Increase in National Income

- Five year plans are able to increase the nation income level form a stagnant position at the time of independence.

Increase in Per Capita Income

- Increase in national income resulted in increase of per capita income.

Increase in Rate of Capital Formation

- Capital formation is a key factor of economic growth. It depends on saving and investment. During Five Year Plans, there has been a considerable increase in the rate of saving and investment. It was around 35% by 2010-11.

Growth of Agricultural Sector

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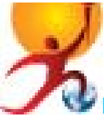

- Both crop productivity and crop production have shown a substantial rise in India. From the net importer of foodgrains, India became net exporter.

Development of Industries

- There has been a substantial improvement of the capital goods industry including iron and steel, machinery, chemical fertilisers, etc.

Development of Economic Infrastructure

- Five-year plans laid the foundation for development of economic infrastructure which include transportation, power generation, communication etc.

Development of Social Infrastructure

- Social infrastructure includes such services as education, health facilities, etc. In this area also, five year plans able to achieve desired success.

Other areas of achievements are in increased employment, modernisation of the society and achieving self-sufficiency.

Failures of Economic Planning

Following observations highlight failures of planning in India:

- No Substantial Increase in the Standard of Living
- Rise in Prices
- Increase in Unemployment
- Inadequate Increase in Production
- Inadequate Development of Infrastructure
- Inefficient Administration
- High Capital Output Ratio

Nehru's Democratic Socialism & Democratic Collectivism

Jawaharlal Nehru was greatly influenced by the achievements of Soviet Planning. Since he also viewed democratic qualities of capitalism as indispensable for complete economic and social growth and since he wished to take advantage of both, he came out with his vision of so called "Democratic Socialism" for new India. Ideally, the democratic socialism was to not only check the growth of monopolistic tendencies of the private sector but also provide freedom to the private sector to play for main objective of social gain rather than economic gain.

Another feature of Nehru's planning philosophy was "Democratic Collectivism", which emphasized on planning by consensus. Nehru had a genuine concern about the need for a peaceful transition through consensus in the development process in India. The emphasis was on "Social" implications of the economic ideas along with wider national and international lines. The "Democratic Socialism" and the "mixed economy' demanded equality of opportunities for all and it was the basic theme.

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Nehru's vision of a technologically progressive India was also inspired by a socially inspired process of integrating the technology with the modern methods of agriculture and production.

Why India chose the so called Nehruvian Socialism?

Generally, it is said that socialism was the dominating economic thought after the World War II and this was the reason that India also chose this path. However, this is a myth. In fact, in those days, those who were in favour of the free enterprise system vastly outnumbered their opponents favouring states control. Indians had consistently opposed the state controls imposed by the British. They protested the regulations of the textile industry, taxes on goods such as salt, opposed setting up of the Reserve Bank of India and opposed pegging of Indian Rupee with Pound Sterling.

The reason to why India chose the path of socialism are more political than economic and go back to the British Era. On the basis of the views on economy, the congress leaders of those times can be divided into **three** groups.

- First group, who eventually were in majority, were called**capitalists**. The leaders of this group included leaders such as Rajendra Prasad, Sardar Patel and C Rajagopalachari.
- The second group can be called This group included Ram Manohar Lohiya, Jai Prakash Narayan and Acharya Kripalani.
- The Third group consisted of Jawahar Lal Nehru and some other leaders. Although Nehru later called himself a socialist, he was labelled as a 'radical' and a 'Marxist' by the press of the day. Marxist-derived ideas were at the heart of the economic thinking of leaders such as Jawaharlal Nehru.
- The economic thought of the above mentioned second group of socialists was not something related to the 'communist' or 'state-control' but an economy *containing cottage industries run by cooperative societies*. That is why; this group opposed the communists and also raised its voice against Nehru when they got a clue about the economic policy of the Congress.
- After the demise of Sardar Patel and elevation of Dr. Rajendra Prasad to the office of the President, Nehru got a free reign and the first thing he did was to create a Planning Commission on the lines of the *Gosplan* of the Soviet Union. He imitated the Soviet Union by drawing up Five Year Plans. At the time of drafting the first Five Year Plan, Nehru was ambivalent and talked of a mixed economy that would accommodate the private sector.
- However, later he progressively implemented his plan to usher the country in an era of socialism. In Mid 1950s, Nehru got Parliament to accept the "socialist pattern of society" as the aim of economic development, and at the Avadi session of the Indian National Congress (1955), the resolution now known as the Avadi Resolution was passed. This resolution called

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for establishment of a socialistic pattern of society where the principal means of production are under social ownership or control and there is "equitable distribution of the national wealth." This was followed by the Industrial Policy of 1956 in which only the government was permitted to undertake new ventures in several sectors such as textiles, automobiles, and defence. For the private sector the policy said that the state would "progressively participate" and would not "hesitate to intervene" if it found progress to be "unsatisfactory." The second five year plan was based on the Industrial Policy Resolution of 1956. This plan asserted the economic goal as the socialist pattern of society. The economy was now modelled after that of the Soviet Union. The private individuals were deprived of the right to indulge in many forms of commercial activities. The government policies of the 1950s and 1960s transformed India into such a socialist country in which all the flaws of socialism took root.

Did Nehru's philosophy truly embody the Democratic Socialism and Collectivism?

Nehru's Planning philosophy was branded "democratic socialism" but in practice, it lacked the proper objectives, priorities, strategy and budgeting which are fundamental themes of the socialistic planning. The basic approach in the socialistic economy is that *there is a control of the means of production and distribution.* But it was not done right from the beginning and with passage of time new capitalist hold strengthened in the form of foreign aid and collaboration. The adverse impact of the philosophy was seen in the Public sector companies which became sick soon due to mismanagement and corruption. India's power generation got erratic during the first few five year plans and power generation was not considered to be the lifeline of India's progress in initial decades. The result was that India stagnated until bold neoliberal economic reforms triggered by the currency crisis of 1991, and implemented by the then government.

Comparison of Planning Philosophy of Nehru and Bose

When Subhash Chandra Bose was congress president, he had appointed Nehru as chief of National Planning Committee in 1938-39. The basic difference between the philosophy of Nehru and Bose were that while *Nehru was inspired by the planned economy of Soviet, Bose wanted a controlled economy.* The thought of Bose were with dictatorial tendencies and reflected in his political and economic thoughts but Nehru was inspired by the "democratic collectivism" and he thought that it was always good to take all the sectors together. He was only partially successful during his era.

Rise and Fall of Planning Commission

On 15 August 2014, India's Prime Minister Narendra Modi declared to replace the Planning Commission by a new body. On January 1, 2015, the government by a resolution established the NITI Aayog or National Institution for Transforming India. This body would work as a policy think-

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tank of Union Government and aims to involve the states in economic policymaking. This article looks into the rise and fall of planning commission

The rise of Planning Commission

Planning Commission was set up by a Government of India Resolution in 1950 as an advisory and specialized institution. It was charged with the responsibility to formulate a strategy of development for independent India in a long-term perspective and for making assessment of all resources of the country, augmenting deficient resources, formulating plans for the most effective and balanced utilization of resources and determining priorities. Its first chairman, as we all know was Jawaharlal Nehru.

The constitutional provision that was kept in mind while creating the planning commission was that the Economic & Social planning is an item of Concurrent list and creation of such body will strengthen the roots of Centre-State Cooperation and Indian federalism. Later in 1952, the National Development Council was established as an advisory body to the Planning Commission.

The planning commission emerged as an intellectual hub with distinguished scholars and economists as its members. It was such as a respectable body, that it became a role model for planning commissions and boards of many developing countries in those times.

Fall of Planning Commission

Gradually, both planning as well as planning commission lost rationale. It actually began from 1960s, when successive droughts and poor harvests led the government to abandon planning for an interregnum of three years (plan holiday). These plan holidays were early signals of decline of planning commission. Slowly and steadily, the administrative fiat eroded its role and the spirit with which its original writer Nehru had launched it, was never revived later.

Due to administrative fiat, it was transformed into a government department without any proper function or mandate. Its functions collided with Finance Commission as well as Finance Ministry. A few examples are:

- Its role of serving as an intermediate between the centre and state continued, but collided with Finance Commission, which recommended on statutory transfers.
- Its role on non-discretionary transfers was almost nothing as there was a Gadgil Formula in place.
- Its role on residual discretionary allocation of resources to states was in effect nothing, because this is being done by the finance ministry.

However, despite no legal or constitutional backing, planning commission \continued to preside over the allocation of central funds meant for the "Plan" both for the centre and the states. There was a one way flow of policy and for the state governments, the practice of requiring them to come to

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Delhi for their "plan approval" every year also continued. But, the focus was shifted to crisis management and academic exercises rather. If there is any other notable work of planning commission in recent times, it has been various committees and the ritual of preparing five-year plan documents, mid-term reviews etc. A few nice ideas that have been incubated in the planning commission include Direct Benefit Transfer, Financial Inclusion and Banking Correspondent models etc. The other specific factors that led to lost of its relevance are as follows:

Globalization, Liberalization and Privatization

When the planning commission was launched, India was on the path of Nehru's socialistic economy. Today, India is largely a market driven economy where three fourths of investments flow from the private sector. The planning in a largely market-driven economy cannot be similar to an economy that is heavily controlled by the state. Thus, there was a need of shift in the focus of planning in current times in comparison to the past.

Shortcoming in the planning process: Why Planning Commission was abolished?

The planning process in India, particularly after liberalization, has become erratic due to an array of reasons some of which are as follows:

- Firstly, it is focused on theoretical tools such as sophisticated mathematical models. These models did not work on ground because they were based on input/output coefficients that are highly aggregative. This was mainly due to data problems.
- Secondly, the planning documents generally resulted in duplication of the jobs of central ministries and the states by setting up parallel divisions in planning commission itself.
- Thirdly, during the successive plan periods, the targeted goals were compromised in most arbitrary way. This was mainly because of the faulty budgeting resulting in absence of annualized break-up of targets set in the plan.
- Fourthly, the multiyear budgeting in our country has its own problems. The rationale behind multiyear budgeting is that different programmes have different time spans. For example, Bharat Nirman was launched for four-year period 2005-09, while JNNURM was launched for seven years beginning 2006. However, five years is a too long a period and almost every plan immediately started dwindling after its launch. It could be more logical if a plan could be prepared for 3 years timeframe and fourth and fifth years would be set as tentative plans. Further, the five year plans were not in sync with the annual budgeting exercise. In the absence of a budget system that helps a five year plan get implemented annually, the five year planning remained at best as an academic exercise.
- Fifthly, the plan/non-plan distinction in government expenditures has lost its relevance and needs to go.

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- Sixthly, the dwindling flow of central assistance for state plans and the cessation of on-lending to the states by the centre the system of Annual Plan approval with the states has lost its significance and needs to be done away with.
- Finally, the system of transfers from the centre needs to be reformed.

Lost credibility of the planning commission

Successive governments have used the planning commission as a parking lot for decent placement for the favorable officers and academics, who could not be accommodated anywhere else as its members. Its credibility was lost due to its theoretical reports and data-mining which generally did not stand correct on ground.

In words of finance minister Arun Jaitley, the Planning Commission was useful in a command economy structure, which is not relevant today. India is a diversified country and its states are in various phases of economic development along with their own strengths and weaknesses. Planning commission used "one size fits all" approach and imposed policies on states and tied allocation of funds with projects it approved. In contrast, the government has established Niti Ayog as a "Think Tank" which has no power to impose policies.

NITI Aayog

The Government of India has established Niti Ayog as a "Think Tank" which has no power to impose policies. By establishing Niti Ayog the government wants to be an "enabler" and leaves the impetus to provide a platform for cooperative and competitive federalism to the newly established body. India was probably the first non-Communist country which went for central planning. Starting with the Harrod-Domar Model and later statistics of Mahalanobis model, the planning commission set out sector- specific output and investment targets. It was strong enough to have a final say on resource allocation. For the last few decades, funds were simply tied to not only successful but also failed schemes because vested interests demanded their continuation. There was an increasingly frustration in the states but they had to yield to the arrogant fund controlling body. Most underdeveloped states including the North East had to suffer due to the dogged prescription of one-size-fits-all schemes by the planning commission. The Niti Ayog seeks to give up the one size fits all prescriptions for a huge country like India with lots of vertical and horizontal imbalances. Whether it would be able to carve out its unique place in today's time, is yet to be seen.

Aims and Objectives of Niti Ayog

- NITI Aayog is essentially an advisory body that seeks to provide critical directional and strategic inputs across spectrum of key elements of policy to the centre as well as states.
- It also seeks to put an end to the slow and tardy implementation of the policy by fostering

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inter-ministry, inter-state and centre-state coordination.

- Strong states make a strong nation, is the core idea; and the Ayog will foster cooperative federalism by evolving a shared vision of national development priorities.
- It has been envisaged to follow the bottom-top development approach whereby, it would develop mechanisms to formulate credible plans to the village level and aggregate these progressively at higher levels of government.
- It would also pay attention to the weaker sections of the society that may not have benefitted from economic progress.
- It would create a knowledge, innovation and entrepreneurial support system via a community of national and international experts, practitioners and partners.
- It would serve as a platform for resolution of inter-sectoral and inter-departmental issues in order to accelerate the implementation of the development agenda.
- It will also monitor and evaluate the implementation of programmes and focus on technology upgradation and capacity building.

Composition of NITI Ayog

- **Chairperson** -Prime Minister
- **Governing Council** – Its members are Chief Ministers and Administrators of the Union Territories
- **Regional Councils** -These would be created as per need and its members would be chief ministers and administrators of UTs of respective regions.
- **Vice-Chairperson** – The Vice-chairperson of the Niti Ayog will be appointed by Prime Minister. The first Vice-Chairperson of Niti Ayog is Arvind Panagariya.

Further, the Niti Ayog has full time members (number unspecified), part time members (maximum 2 , these would be scholars from universities and research institutions), Ex-officio members (maximum 4, these are ministers from Union Council of Ministers), Special Invitees (appointed by PM for fixed tenure. Finally, there is a Chief Executive Officer (CEO) of the Niti Ayog, who is appointed by Prime Minister and has a rank similar to Secretary to the Government of India. Current CEO was named on January 10 (Sindhushree Khullar). The secretariat will be established if deemed necessary.

NITI Aayog & Planning Commission: Comparison

Planning Commission was an advisory body, and so is Niti Ayog. But the key difference between them is that while the former had powers to allocate funds to ministries and states; this function will be now of finance ministry. Niti Ayog is essentially a think tank and a truly advisory body. Other differences are as follows:

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- The role of states in the planning commission era was limited. The states annually needed to interact with the planning commission to get their annual plan approved. They had some limited function in the National Development Council. Since Niti Ayog has all chief ministers of states and administrators of UT in its Governing Council, it is obvious that states are expected to have greater role and say in planning/ implementation of policies.
- The top down approach is reversed in Niti Ayog. It will develop mechanisms to formulate credible plans to the village level and aggregate these progressively at higher levels of government.
- The provision of regional council is there in Niti Ayog to address local / regional development issues.
- One of the new functions of Niti Ayog is to address the need of the National Security in the economic strategy. How this is to be done – is yet to be watched.
- While the planning commission formed Central Plans, Niti Ayog will not formulate them anymore. It has been vested with the responsibility of evaluating the implementation of programmes. In this way, while Niti Ayog retains the advisory and monitoring functions of the Planning commission, the function of framing Plans and allocating funds for Plan assisted schemes has been taken away.

The governing council, which has all chief ministers of states and administrators of the Union Territories sounds much like the National Development Council.

NITI Aayog and Evidence Based Policy Making

Evidence-informed policymaking is an approach that aims to integrate the best available scientific evidence into the design of public policies. Central and state governments make hundreds of policy decisions, small and big, every day that have an impact on millions of lives. Many of the policy questions have been rigorously researched, and controlled trials are conducted in order to assess the impact, leading to valuable insights into which policies work, which don't and why. But not all of this research finds its way into government policies. This is often because we lack a unifying mechanism within government that can synthesise a diverse array of scientific evidence, from India and other developing countries, and provide coherent recommendations for policymakers. This is also why a centrally located government think tank like the NITI Aayog, which can command the necessary resources and attention, is well placed to play this role.

NITI Ayog and Evidence based policy making

NITI Aayog is mandated to work towards furthering cooperative federalism. It can also promote evidence based policy making by ensuring that a policy innovation from any state, regardless of the

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party in power, gets due attention and becomes a template for other states as long as it is backed by rigorous scientific evidence. In policy areas where evidence is scarce, the NITI Aayog can actively promote collaborations between policymakers and researchers by funding and rigorously testing policy innovations at the pilot stage, before recommending them for scale. This comes from a realisation that despite decades of effort in designing and implementing anti-poverty programmes, there is little consensus on the most effective strategies for improving the lives of the poor. Reflecting this thought, the World Development Report 2015, the flagship report of the World Bank, focuses on mind, society and behaviour and makes a strong case for the application of behavioural science in development.

Challenges

To achieve this in practice will require the NITI Aayog to overcome two key challenges:

- accessing high-quality researchers in multiple disciplines who can partner with policymakers, and
- creating a willingness among policymakers to learn from evidence instead of relying solely on intuitions or ideologies.

Learning from Tamil Nadu

In fact, the state of Tamil Nadu has already taken a step in this direction. In 2014, the government of Tamil Nadu entered into a partnership with the Abdul Latif Jameel Poverty Action Lab (J-PAL) to institutionalize the use of evidence in policymaking by rigorously evaluating innovative programmes before they are scaled up, strengthening monitoring systems and enhancing the officials' capacity to generate and use data. In perhaps a first for any state government in India, the Tamil Nadu government also set up an Innovation Fund, with an annual allocation of Rs. 150 crore, through which any government agency can access resources for pilot innovation programmes through a competitive process.

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General Knowledge Today

Government Budgeting-1: Basic Concepts For Prelims

Target 2016: Integrated IAS General Studies

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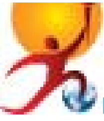

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Prelims MCQ Topics

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Fiscal Policy

Fiscal policy refers to all the means which influence the income and expenditure of the Government. Since most of the government income comes from taxation and most of the government expenditure goes to public expenditure, these two viz. taxation and public expenditure are main fiscal policy instruments. Any government policy stance that influences the government taxation and government spending – would be termed as a fiscal policy.

Any changes in the level and composition of taxation and government spending can affect the economy because –

- This can bring a change in the aggregate demand and the level of economic activity
- This can bring a change in the pattern of resource allocation
- It can bring a change in the distribution of income.

A welfare government tries to reallocate income by designing tax systems that treat high-income and low-income households differently.

Types of Fiscal Policies

There are three types of the Fiscal Policies viz. neutral, expansionary and contractionary.

Neutral Fiscal Policy

A neutral fiscal policy means that total government spending is fully funded by the tax revenue. The government takes a neutral fiscal policy stance when the economy is in a state of equilibrium.

Expansionary Fiscal Policy

An expansionary fiscal policy means that the government spending is more than tax revenue. Government needs to spend more than its revenue during the time of recessions. This is because recession occurs when there is a general slowdown in economic activity. Recessions generally occur when there is a widespread drop in **overall spending**. Recessions may be triggered by various events, such as

- financial crisis
- External trade shock,
- Adverse supply shock
- Bursting of an economic bubble.

Governments usually respond to recessions by adopting expansionary fiscal policies such as increasing money supply, increasing government spending and decreasing taxation. When the tax is decreased, there is more money left with people, who can spend more.

Contractionary fiscal policy

Contractionary fiscal policy occurs when government spending is lower than tax revenue. When the tax revenue of the government is more, the excess money can be used to pay the government debt.

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Difference between Fiscal Policy and Monetary Policy

Fiscal policy deals with the taxation and expenditure decisions of the government. On the other side, the **monetary policy** deals with the supply of money in the economy and the rate of interest. The Fiscal Policy and the monetary policy are the main policy approaches used by economic managers to steer the broad aspects of the economy. In India as well as almost all countries, the *government deals with fiscal policy while the central bank (RBI in India) is responsible for monetary policy.*

Implications of Fiscal Policy on the Economy

Fiscal policy is composed of several parts such as taxation policy, expenditure policy, investment / disinvestment policies, debt and surplus management etc. Fiscal policy is an important constituent of the overall economic framework of a country and is therefore intimately linked with its general economic policy strategy. Moreover, fiscal policy has direct relation with the economic trends. The fiscal policy directly influences monetary policy. When the government receives more than it spends, it has a surplus. If the government spends more than it receives it runs a deficit.

Government Receipts and Expenditures

The most basic thing in public finance is to know the difference between revenue and capital flows, be they receipts or expenditures. On this basis, there are four elementary concepts viz. Revenue Receipts, Revenue Expenditures, Capital Receipts and Capital Expenditures. On the basis of these four elementary concepts, the government budget can be divided into two parts viz. Revenue Budget and Capital Budget. While revenue budget deals with revenue receipts and expenditures; capital budget deals with capital receipts and expenditures. *Revenue budget is also known as Current Budget.*

Revenue Budget

Revenue budget deals with revenue receipts and expenditures of the government.

Revenue Receipts

The term "Revenue Receipt" is made up of two words revenue and receipts. Any income that *does not generate a liability is revenue*. For example, if the Government borrows money from World Bank, it will increase its liabilities (because this money has to be paid back)- so cannot be called revenue. However, if the government gets the same money has grant (donation), its revenue receipt because grants are not to be paid back.

Taxes are the most important revenues receipts of the governments. However, some revenue receipts are non-tax revenues such as grants. On this basis, revenue receipts are of two types viz. Tax Revenue and Non-tax revenue.

Tax Revenues

Tax revenues are either from direct taxes or indirect taxes. Direct tax generally means a tax paid

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directly to the government by the persons on whom it is imposed. Income Tax, Gift Tax, Wealth Tax and Property tax etc. are direct taxes. Indirect tax is a tax collected by an intermediary (such as a retail store) from the person who bears the ultimate economic burden of the tax (such as the consumer). Sales tax, Value Added Tax (VAT), Goods and Services tax (GST) or any other such tax is an indirect tax. Largest chunk of tax revenues of government of India currently comes from Corporation Tax, followed by Income Tax, followed by Union Excise duties, customs and thereafter service tax. The collection of service taxes is increasing over the last years. The amount collected under Direct Taxes (Corporate/ Income/ wealth) is larger than that under Indirect taxes.

Non-Tax Revenue

Non Tax Revenue Receipts are those revenue receipts which are not generated by Taxing the public.

- Money which the Government earns as "Dividends and profits" from its profit making public enterprises (PSUs).
- Interest which the Government earns on the money lent by it to external or internal borrowers. Thus this revenue receipts may be in foreign currency as well as Indian Rupees.
- The money which the government receives out of its fiscal services such as stamp printing, currency printing, medal printing etc.
- Money which the Government earns from its "General Services" such as power distribution, irrigation, banking services, insurance, and community services etc. which make the part of the Government business.
- Money which the government accrues as fees, fines, penalties etc.
- Grants the Government of India receives from the external sourcesIn case of the state Governments, it may be the internal grant from the central Government.

In recent times, spectrum auctions have been one of the major sources of non-tax revenues for the government. We note here, that despite it looks that spectrum amount should be a capital receipt, it is shown as a non-tax revenue receipt in budget documents as one time spectrum charges levied on telecom players.

Revenue Expenditure

While the Revenue Receipts are those incomes of the Government which don't create additional liability, the Revenue Expenditures are those expenditures which don't create any productive assets. The money in these expenditures goes either in running administration / operation of government or in welfare schemes which don't result in creation of assets. Specific examples are discussed below:

- The **interest paid by the Government of India** on all the internal and external loans does not produce any assets, so it is revenue expenditure.
- The **salaries and Pension paid by the Government to Government employees** is

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needed to run the Government's business. It is revenue expenditure.

- The **subsidies forwarded by the government** to all sectors do not produce any productive asset, so it is revenue expenditure.
- The **defense expenditures** which are **needed for smooth operation** of the standing armed forces is a revenue expenditure. However, purchase of equipments produces assets, so that would be a Capital expenditure.
- The **postal expenditures** and deficits are Revenue expenditures.
- The money spent of **maintaining the law and order situation** of the country is also revenue expenditures.
- The money spent on **various social services** such as public health, education, poverty alleviation, scholarships, etc. all revenue expenditures.
- The **grants** given by the Government of India to states and other countries is Revenue expenditures.

Revenue Deficit and Surplus

If total Revenue receipts are more than total revenue expenditure, it is called *revenue surplus*. If the total revenue receipts are less than total revenue expenditures, it is called *Revenue Deficit*.

Implications of Revenue Deficit and Revenue Surplus on Economy

Revenue expenditures are a consumptive kind of expenditures and that is why the Governments try to minimize the Revenue deficit. The Revenue deficit does not add into the production of productive assets so, it is considered dangerous to have a large revenue deficit.

Revenue surplus is good because it would give the government some opportunity to use some of the surplus in those activities which might create some productive assets. But the revenue surplus is not appreciated for many other reasons. We can easily understand that if the Tax revenue of the Government is increased, it may give the Revenue surplus to the Government. But ultimately it would not be judicious to burden the public with large taxes. Further, large taxes would result in Tax evasion, corruption and problem of black money. So, the aim of the governments is to have a judicious tax structure, so that the balance is near Zero.

Primary Deficit

The Revenue expenditures include the interest liabilities of the Government. If the interest liabilities are NOT included from the revenue deficit, it is called primary Deficit.

How can government increase revenue receipts?

Since the grants are generally fixed, the most common way to increase revenue receipt is to raise taxation. Raising taxation also implies increasing Tax-GDP Ratio and this would include:

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- Raising tax rates i.e. direct and / or indirect
- Lowering tax exception slabs
- Impose new taxes, cess or surcharges
- Improving profitability of PSU companies.
- Increasing government business.

How can government curb the revenue deficit?

The government can curb the revenue deficit either by increasing revenue receipts or by decreasing revenue expenditure. Revenue expenditure can but reduced by a cut in social expenditures and subsidies. Since both ways have their own economic and political ramifications, government could never achieve what it was supposed to achieve as per the FRBM act. The FRBM act had mandated the government to eliminate revenue deficit by March 2008 (it was later shifted to March 2009). It has never been achieved. The act also mandates the government to place the three separate documents along with Budget documents viz. Macro-Economic Framework Statement, Medium-Term Fiscal Policy Statement and Fiscal Policy Strategy Statement. These statements every time reiterate the government vow to achieve FRBM targets.

Revenue Deficit in India's budget

The term Revenue deficit and fiscal deficit are being used in the Government of India Budget since the fiscal year 1997-98. Please note that *since 1997-98, the Government budget has shown revenue deficit every year.*

Effective Revenue Deficit

The definition of the revenue expenditure is that it must not create any productive asset. However, this creates a problem in accounts. There are several grants which the Union Government gives to the state / UTs and some of which do create some assets, which are not owned by union government but by state government. For example, under the MGNREGA programme, some capital assets such as roads, ponds etc. are created, thus the grants for such expenditure will not strictly fall in the revenue expenditure.

So, to do away with such anomaly, the government introduced the Effective Revenue Deficit concept from Union Budget 2010-11. From 2012-13 onwards the Effective Revenue Deficit is being brought in as a fiscal parameter.

Definition and logic behind Effective Revenue Deficit

Effective Revenue Deficit is the difference between revenue deficit and grants for creation of capital assets. In other words, the Effective Revenue Deficit excludes those revenue expenditures which were done in the form of grants for creation of capital assets aka GoCA. Such grants include the grants given under:

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- Pradhan Mantri Gram Sadak Yojana
- Accelerated Irrigation Benefit Programme
- Jawaharlal Nehru National Urban Renewal Mission
- MGNREGA etc.

The logic is clear; these expenses despite being shown in the accounts as Revenue Expenditures, are involved with asset creation and cannot be considered completely 'unproductive'.

India's Effective Revenue Deficit?

According to the Interim Budget 2014-15 documents, the Effective revenue deficit is 2.2 % of the GDP and the government projects it to be 1.8% of GDP in fiscal year 2014-15.

Effective Revenue Deficit				
Year →	2012-2013	2013-2014	2013-2014	2014-2015
Effective Revenue Deficit	250383	205182	249005	236342
As % of GDP	-2.5	-1.8	-2.2	-1.8
Data in middle row: In Crores of Rupees				

Capital Budget

Capital budget deals with the capital receipts and expenditures of the government.

Capital Receipts

A receipt that results in either reduction in government assets (sale of share, disinvestment) or increase in some liability (government borrowings) is a capital receipt. These receipts are NOT a part of normal operations of government business. Capital Receipts include market loans, external loans, small savings, Government Provident Funds, Accretions to various Deposit Accounts, Depreciation and Reserve Funds of various departments like Railways.

The Capital receipts are of two types viz. Debt receipt and non-debt receipts. The debt receipts are those which government needs to repay along with interest. Non-debt receipts are those which come to the government by sale of some assets. Most of the capital receipts of the government are debt receipts and are shown as liabilities of the Government's balance sheet.

Borrowings by the Government

The Government borrows from domestic as well as foreign sources. All borrowings are called capital debt receipts. However, interest paid on such borrowings is placed under Revenue expenditures.

It's worth note that Government of India is the largest borrower in India and the market borrowings

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are the largest source of capital receipts of the Government.
Government raises its market loans by selling dated government securities by Auction since 1992-93. These auctions are conducted by the Reserve Bank of India, as debt manager to the Central Government. These bonds are of either fixed interest rate (called Fixed Coupon Securities) or of floating interest rate (called Floating Rate Bonds (FRB)).
Apart from these, Government also issues short term money market instruments viz. 364/182/91 days Treasury Bills. These treasury bills offer short-term investment opportunity to financial institutions, banks, etc. Finally, government also issues Cash Management Bills, which are issued to meet the temporary cash flow mismatches of the Government. The Cash Management Bills are issues only when Government needs a short term cash. Thus, the maturities of the Cash Management Bills are always less than 91 days. The above borrowings are from the market.
Government also borrows from common people like all of us in the form of small saving schemes. At present, the active small saving schemes are as follows:

- Post Office Saving Account
- Post office fixed deposits of 1, 2, 3 & 5 years
- Post Office RDs (Recurring Deposits)
- Post Office Monthly Income Account
- Senior Citizens Saving Scheme
- National Saving Certificates
- Public Provident Fund (PPF)
- Sukanya Samriddhi Account
- Kisan Vikas Patra
- Monthly Income Scheme

The money of all of these goes to National Small Savings Fund. This fund is a part of Public Account of India and is active since 1.4.1999.All withdrawals are also taken out of this fund. What remains as balance in the fund is invested in the Central and State Government Securities. How should be these invested and in which securities, this is decided by the Government from time to time. At present, the term of Central and State Government Securities is 10 years, 9.5 per cent interest rate.
Then finally, government issues savings bonds for people to invest in them. There are two kinds of Bonds viz. Tax Saving and not Tax Saving. Obviously the interest rate in taxable bonds is higher.

Miscellaneous Capital Receipts

Miscellaneous Capital Receipts refers to the money receipt by disinvestment of the public sector companies. This money comes from sale of government share / equity in public sector companies. In

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2013-14, Government received around Rs. 40,000 crore in lieu of sale of its shares in Hindustan Copper, ITDC, MMTC, National Fertilizer, Neyveli Lignite, State Trading Corporation Ltd, Power Grid Corporation of India Ltd, NHPC Ltd, Indian Oil Corporation, Engineers India Ltd, BHEL, Hindustan Aeronautics Ltd. The money from this disinvestment earlier used to go to**National Investment Fund**' (NIF). Currently, this fund is merged with the Public Account of India and these proceeds are maintained in the public Account as a separate head – NIF.
The Money from NIF is used for several purposes as decided by the Government. These include recapitalisation of Public Sector Banks', investment in Indian Railways, investment in other public sector units towards capital expenditure.

Loan Recovery

The money which the Government of India had lent in the past to the states, to the PSUs and to the Union Territories, and to the parties and Governments abroad, when recovered back, are called Capital Receipts. Here, please note that Loan recovery is Capital Receipt but the interest received on these loans is revenue receipts.

Capital Expenditures

Capital Expenditure is that expenditure which results in increasing of government asset (giving out loans) or reduce in some liability (paying back old loans). Following are the key examples of capital expenditures.

Loan disbursals

The loans given by the Government to the states, PSUs and other governments come under Capital Expenditures because such loans are assets of the government.

Loan Repayments

The loans that were borrowed in past but are now returned back are included in the capital expenditures; because they result in reduction of liability.

Expenditures resulting in asset creation

The government's budget expenditures on infrastructure, machinery, land, roads, bridges etc. and purchase of arms and equipments, modernization of the army etc. are also Capital Expenditures.

Capital Deficit

In Public Finance or Economy, The term Capital Deficit is not used. Generally, we read about the *Capital crunch which refers to the expenditures needed by the Government for Capital Expenditures.*

Fiscal Deficit

The term Revenue deficit and fiscal deficit are being used in the Government of India Budget since the fiscal year 1997-98. Fiscal deficit is the difference between total expenditure and total revenue receipts including recoveries of loans and other receipts.

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Fiscal Deficit = Total Expenditure – (Revenue Receipts + Recoveries of Loans + Other Receipts)

or

Fiscal Deficit = (Revenue Expenditure + Capital Expenditure) – {(Tax Revenue + Non Tax Revenue) – + Recoveries of Loans + Other Receipts}

Funding of Fiscal Deficit

The rising fiscal deficit has dominated all discussions on the budget in recent years. The biggest question is that if there is an excess of government's expenditure over its tax and non-tax revenues, where it will be funded from? The answer is that the excess of the government expenditure has to be met with borrowings from the public. To be exact, this borrowing is called fiscal deficit, which is usually expressed as a percentage of GDP.

This also means that a high fiscal deficit runs the risk of government cornering the bulk of the savings, leaving little for corporate and other borrowers (crowding out). Prolonged periods of high fiscal deficit run the risk of raising interest rates and inflation and depressing growth. A deficit of 3% of GDP is seen as sustainable.

- A deficit budget shows that the government proposes to spend more in the coming year than its receipts. A surplus Budget shows that Government will get more receipts and spend less.
- In a developing country like India, the Government always seeks to present a "deficit budget" because it intends to spend more (on development) than what its receives. This is because; the deficit budget symbolizes the concerns of the Government towards the development activities. In India a surplus budget was NEVER presented.

Current Year Targeted Fiscal Deficit

For 2015-16, Indian Government has aimed to contain the fiscal deficit at **3.9 per cent** of the GDP and the revenue deficit at 2.8 per cent of the GDP in the current fiscal.

Deficit Financing

The Government, when proposes a deficit budget is well aware of the fact that its total expenditures are going to be more than its receipts. So, it adopts the policies and process which can sustain the burden of the deficit. The process of supporting the budget deficit of the country is called **Deficit Financing**. There are several methods of Deficit Financing such as:

- Borrow from domestic or foreign sources
- Draw upon its foreign exchange reserves
- Print an equivalent amount of money.

Any of the above three activities would tend to influence other economic variables. The following observations must be noted in this context:

- In a general sense, **excessive printing of money** leads to inflation. This is because when

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government prints too much money, its purchasing power goes down and a situation of*too much money choosing too few goods*

- If the government **borrows too much from abroad**, it leads to a debt crisis. The money that has been borrowed from abroad comes on **sovereign guarantee and is called Sovereign Debt**. Governments usually borrow by issuing securities, government bonds and bills. However not all governments can borrow by these methods. The less creditworthy countries need to borrow directly from World Bank or other financial institutions. The debt may be short term or long term. Inability to service the debt may result in **Sovereign Default** which is another name of **Debt Crisis.**
- If the government **draws down on its foreign exchange reserves**, a **Balance of Payments** crisis may arise. Balance of payments (BoP) accounts are an accounting record of all monetary transactions between a country and the rest of the world. These transactions include *payments for the country's exports and imports of goods, services, financial capital, and financial transfers*. A BOP crisis, also called a currency crisis, occurs when a nation is unable to pay for essential imports and/or service its debt repayments. Typically, this is accompanied by a rapid decline in the value of the affected nation's currency.
- **Excessive domestic borrowing** by the government may lead to higher real interest rates and the domestic private sector being unable to access funds resulting in the "crowding out" of private investment.

The above discussion makes it clear that it is not prudent for a government to run an unduly large deficit. But at the same time, for a developing country like India, it is also not prudent to have surpluses at the cost of long-term growth. This is because the need for infrastructure and social investments is substantial. So, the most developing country governments have the biggest challenge to meet infrastructure and social needs while managing the government's finances in a way that the deficit or the accumulating debt burden is not too great.

Domestic Borrowing Versus External Borrowing

Government in India prefers external funding of the Deficit Budget because **External Borrowing** is cheaper in long term and comes in foreign exchange, which the Government can use to meet its fiscal deficit. The Government also prefers borrowing from the external sources because if it only resorts to the internal borrowing, there may be a problem of liquidity in the country. External grant comes as free, *but in recent years, external grant has been very low.*

Why printing of currency is used as a last resort?

Printing Currency is used by the Government as last resort in deficit financing The printing of currency

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has its own side effects such as increasing inflation and pressure on the Government for upward revision of the wages. *Further, printing currency does not meet the expenditures which are needed to be met with foreign currency only.*

Internal Debt and External Debt

Internal Debt

Internal debt is that part of the total debt that is owed to lenders within the country. It is the money the government borrows from its own citizens. *The government borrows by issuing the Government Bonds and T-Bills (Treasury Bills). It also includes the Market borrowings by the government.* The government bonds and T-Bills are traded in the market which is also known as **Gilt Market.** When government borrows from the domestic sources, the increase in inflation is less in comparison to simply printing the money.

External Debt

External debt is owed to creditors outside the country. The outsider creditors can be foreign governments, International Financial Institutions such as World Bank, Asian Development Bank etc., corporate and foreign private households. External debt may be of several kinds such as multilateral, bilateral, IMF loans, Trade credits, External commercial borrowings etc. When the non-resident Indians park their funds in India, it is also a type of external debt and is called NRI deposits. If the external debt is denominated in Indian Rupee, it is called Rupee Debt.

External Debt Sustainability

Every country needs to meet its current and future external debt service obligations. If these obligations are met in full, without recourse to debt rescheduling or the accumulation of arrears and without compromising growth – then it would be called external debt sustainability. If not, then the condition would be called a debt burden. The external debt sustainability can be measured by several indicators such as Debt to GDP ratio; Foreign debt to exports ratio; Government debt to current fiscal revenue ratio etc.

Sovereign Default

A failure or refusal of the government of a sovereign state to pay back its debt in full is called *Sovereign Default*. Sovereign Default may be accompanied by a formal declaration of a government not to pay (repudiation) or only partially pay its debts (due receivables), or the de facto cessation of due payments.

Framework of India's Fiscal Administration

Indian constitution has divided the taxing powers as well as the spending powers (and responsibilities) between the Union and the state governments. The subjects on which Union or

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State or both can levy taxes are defined in the 7th schedule of the constitution. Further, limited financial powers have been given to the local governments also as per 73rd and 74th amendments of the constitution and enshrined in Part IX and IX-A of the constitution.

Since the taxing abilities of the states are not necessarily commensurate with their spending responsibilities, some of the centre's revenues need to be assigned to the state governments. On what basis this assignment should be made and on what guidelines the government should act – the Constitution provides for the formation of a Finance Commission (FC) by President of India, every five years, or any such earlier period which the President deems necessary via Article 280 Based on the report of the Finance Commission, the central taxes are devolved to the state governments.

Separation of Powers

The Union government is responsible for issues that usually concern the country as a whole, for example national defence, foreign policy, railways, national highways, shipping, airways, post and telegraphs, foreign trade and banking. The state governments are responsible for other items including, law and order, agriculture, fisheries, water supply and irrigation, and public health.

Some items for which responsibility vests in both the Centre and the states include forests, economic and social planning, education, trade unions and industrial disputes, price control and electricity. Then, there is devolution of some powers to local governments at the city, town and village levels.

The taxing powers of the central government encompass taxes on income (except agricultural income), excise on goods produced (other than alcohol), customs duties, and inter-state sale of goods. The state governments are vested with the power to tax agricultural income, land and buildings, sale of goods (other than inter-state), and excise on alcohol. Local authorities such as Panchayat and Municipality also have power to levy some **minor** taxes.

The authority to levy a tax is comes from the Constitution which allocates the power to levy various taxes between the Centre and the State. An important restriction on this power is Article 265 of the Constitution which states that *"No tax shall be levied or collected except by the authority of law"* This means that no tax can be levied if it is not backed by a legislation passed by either Parliament or the State Legislature.

Sources of Revenue for Union Government

The sources of Revenue of the Union Government are as follows:

- Income (except tax on agricultural income), Corporation Tax & Service Tax
- Currency, Coinage, legal tender, Foreign Exchange
- Custom duties (except export duties)
- Excise on tobacco and other goods.

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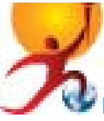

- Estate Duty (except on agricultural goods) (Kindly note that its mentioned in the constitution but Estate duty was abolished in India in 1985 by Rajiv Gandhi Government)
- Fees related to any matter in Union list except Court Fee
- Foreign Loans
- Lotteries by Union as well as State Governments.
- Post Office Savings bank, Posts, Telegraphs, Telephones, Wireless Broadcasting, other forms of communication
- Property of the Union
- Public Debt of the Union
- Railways
- Stamp duty on negotiable instruments such as Bills of Exchange, Cheques, Promissory notes etc.
- Reserve Bank of India
- Capital gains taxes, Taxes on capital value of assets except farm land
- Taxes other than stamp duties on transactions in stock exchanges and future markets
- Taxes on the sale and purchase of newspapers and advertisements published therein.
- Terminal Taxes on Goods and passengers, carried by Railways and sea or air.

Sources of revenue for State Governments

The following are sources of revenue for State Governments.

- Taxes and duties related to agricultural lands
- Capitation Taxes
- Excise on liquors, opium etc.
- Fees on matters related to state list except court fee
- Land Revenue, Land and buildings related taxes
- Rates of Stamp duties in respect of documents other than those specified in the Union List
- Taxes on mineral rights subject to limitations imposed by the parliament related to mineral development
- Taxes on the consumption or sale of electricity
- Sales tax on goods (other than newspapers) for consumption and use within state.
- Taxes on advertisements except newspaper ads.
- Taxes on goods and passengers carried by road or on inland waterways
- Taxes on vehicles, animals and boats, professions, trades, callings, employments, luxuries, including the taxes on entertainments, amusements, betting and gambling.

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- Toll Taxes.

Certain Taxes levied as Concurrent Powers

Please note that the Union and the State Governments have the concurrent powers to fix the principles on which taxes on motor vehicles shall be levied and to impose stamp duties on non-judicial stamps. The property of the Union is exempted from State Taxation; and the property of the states is exempted from the Union Taxation. But the parliament of India can pass legislation for taxation by Union Government of any business activities / trade of the state which are not the ordinary functions of the state.

Residuary Power of Taxation

Union Government has exclusive powers to impose taxes which are not specifically mentioned in the state or concurrent lists. Some taxes imposed using these powers include Gift tax, wealth tax and expenditure tax.

State's power Regarding Sales Tax

The sales tax on consumer goods such as toothpastes, soaps, daily use items, electronic items etc. are *imposed, collected and appropriated by state governments.* However, newspapers and newspaper ads are exception to this. Further, there are four restrictions to this power of the state. These include:

- A state cannot impose sales tax if a good is produced there but is sold outside the state.
- A state cannot impose sales tax if the sale and purchase is taking place for items due for export.
- A state cannot impose tax on interstate trade and commerce of goods
- State cannot impose a tax on a good that has been declared of special importance by parliament.

Other facts about levying and appropriation of Taxes

- Sales tax is imposed, levied, collected, appropriated by states as mentioned above
- Income tax, Corporation Tax, Service tax are levied and collected by Centre but are appropriated by both states and centres as per distribution formula recommended by Finance Commission. This formula is NOT binding upon the parliament.
- However states have no share in surcharges, cesses on these taxes.
- Stamp duties on negotiable instruments and excise duties on medicinal and toilet preparations that have use of alcohol and narcotics are levied by Centre. But these taxes don't make a part of consolidated fund of India. They are assigned to respective states only, which appropriate these taxes.
- Sales tax in case of Inter-state trade of goods (except newspapers) is levied and collected by the centre but such proceeds are assigned to states. (This is known as Central Sales Tax)

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Direct Taxes

Direct tax generally means a tax paid directly to the government by the persons on whom it is imposed. Income Tax, Gift Tax, Wealth Tax and Property tax etc. are direct taxes.

Income Tax

There are two kinds of Income Taxes viz. Personal Income Tax and Corporation Tax.

Personal Income Tax

Personal Income tax is levied on individuals and HUF (Hindu Undivided Families) by the Central Government. The levy of the Income tax follows the principle of "ability to pay" and is a progressive tax. This implies that *those who can pay more should pay more*; as the rate of tax increases as the taxable amount increases. On this basis, low income people have been exempted from the Income Tax with minimum exempt limit varying from year to year. Currently, the minimum taxable income with reference to Income Tax is Rs. 250,000. It was Rs. 40,000 in 1995-96 budget. The current income tax slabs are as follows:

Type	Age	Income	Tax Rate
Male / Female Individual	<60 years	2.5 Lakh or below	Nil
Male / Female Individual	<60 years	2.5 Lakh to 5.0 Lakh	10% on income above 2.5 lakh
Male / Female Individual	<60 years	5 Lakh to 10 Lakh	10% on income between 2.5 Lakh to 5 Lakh and 20% on income above 5 Lakh
Male / Female Individual	<60 years	Above 10 Lakh	10% on income between 2.5 Lakh to 5 Lakh; 20% on income between 5-10 Lakh and 30% on income above 10 Lakh
Male / Female Individual	>60 years	3 Lakh	NIL
Male / Female Individual	>60 years	3 Lakh to 5.0 Lakh	10% on income above 3 lakh
Male / Female Individual	>60 years	5 Lakh to 10 Lakh	10% on income between 3 Lakh to 5 Lakh and 20% on income above 5 Lakh
Male / Female Individual	>60 years	Above 10 Lakh	10% on income between 3 Lakh to 5 Lakh; 20% on income between 5-10 Lakh and 30% on income above 10 Lakh
Male / Female Individual	>80 years	5 Lakh or below	NIL
Male / Female Individual	>80 years	5 Lakh to 10 Lakh	20% on income above 5 Lakh

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Type	Age	Income	Tax Rate
Male / Female Individual	>80 years	Above 10 Lakh	20% on income between 5-10 Lakh and 30% on income above 10 Lakh

Further, currently, there is a surcharge of 12% on the persons having taxable annual income exceeding Rs 1 crore. Taking this into account, the maximum marginal tax rate at present stands at around 34%.

Corporate Income Tax

Corporation Tax is levied on the net income of the companies. The rates of corporate taxes were very high once upon a time. They were reduced gradually since liberalization and it was pegged at around 35% in 2005-06. Still, India is ahead of many economies in terms of corporation tax.

Currently, basic tax rate for domestic companies is 30% and for foreign companies is 40%. A minimum alternate tax (MAT) is levied at 18.5 percent of the adjusted profits of companies where the tax payable is less than 18.5 percent of their book profits. After including surcharges, the current *effective corporate taxes* are 33.9% for domestic companies and 43.26% for foreign companies.

The effective rate of dividend distribution tax remains at almost 17%. Large dividend tax-paying companies include ONGC, Coal India, TCS, ITC, NTPC etc.

Income Tax Department

Income Tax Department functions under the Department of Revenue in Ministry of Finance. It is responsible for administering following direct taxation acts passed by Parliament of India.

- Income Tax Act
- Wealth Tax Act (Abolished now)
- Gift Tax Act
- Expenditure Tax Act
- Interest Tax Act
- Various Finance Acts (Passed Every Year in Budget Session)

Income Tax Department is also responsible for enforcing Double Taxation Avoidance Agreements and deals with various aspects of international taxation such as Transfer Pricing.

Central Board of Direct Taxes

The Central Board of Direct Taxes (CBDT) is a part of the Department of Revenue in the Ministry of Finance. CBDT provides essential inputs for policy and planning of direct taxes in India and is also responsible for administration of the direct tax laws through Income Tax Department. The CBDT is a statutory authority functioning under the Central Board of Revenue Act, 1963.It is India’s official FATF (Financial Action Task Force) unit.

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Indirect Taxes

Indirect taxes include service tax, sales tax, custom, excise duties, VAT, MODVAT, CENVAT, proposed Goods & Services Act etc. Initially the indirect tax regime was too complicated and there was an ubiquitous problem of **tax on tax.** Post liberalization, there is a lot of change in the Indirect tax administration of the country and there was a dramatic change when the country shifted to VAT regime in 2000s.

Custom Duties

Custom duties are imposed on both during import and export of goods. The custom duties imposed during export are generally called "export duties". Since, export duties reduce the competitiveness of the Indian products in the international markets, the Government has abolished the export duties. The import duty is quite productive, particularly when it is levied on high value imports such as iron and steel etc.

The custom duties were very important in the decades of 50s and 60s and later their place was taken by the excise duties as more and more goods were produced domestically. From 1990-91 to till date the custom duties have fallen drastically due to trade liberalization also.

Sales Tax

Sales tax is the tax which a purchaser pays when he / she purchases goods. The sales tax in most goods (except newspapers) for intra-state sales and consumption are within the powers of the states governments, which levy, collect and appropriate these taxes. This is the reason that some goods may be cheaper in a particular state as compared to another state. The sales tax on inter-state sale of goods is levied by Central Government and is payable to the state where the particular goods are sold. Today, sales tax regime has drastically changes and its place is now taken by VAT in most states.

Value Added Tax (VAT)

Today, in many states, the Sales Tax has been abolished and replaced with the Value Added Tax (VAT). While Sales Tax is a single point tax levied on the price of the goods; VAT is a multipoint tax in which tax is levied at each stage of transaction in the production/ distribution chain. By value addition, we mean the increase in the value of goods / services at each stage in the value chain. The tax paid at earlier stage is called 'Input tax credit (ITC)' and this credit can be used against a tax at later stage.

Similarity between Sales Tax and VAT

Both Sales Tax and VAT are indirect taxes which are ultimately borne by the consumer. Both taxes come within the jurisdiction of the states and are levied, collected and appropriated by states. The state legislature needs to pass state level acts to provide legal backing to Sales Tax and VAT. The

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states where VAT acts have been enacted, the sales taxes have been abolished. The idea of replacing Sales Tax with VAT was to rationalize the taxes and bring the retail price of products to minimum possible level.

Difference between Sales Tax and VAT

Sales tax is levied on the sale of goods/ service and thus is simple to calculate and accounting purpose. VAT is multistage tax, so involves complex accounting. This difference makes VAT evasion difficult because VAT evaded at one stage would be caught at next stage.

MODVAT / CENVAT

MODVAT was introduced in 1986-87 to overcome the problem of cascading effect of Central Excise Duty. Currently, MODVAT has been replaced by CENVAT. In MODVAT, the manufacturer was able to obtain reimbursement of the excise duty and countervailing duties paid on the components against the duty payable on the final product. *For example, if the* excise duty of Rs. 1,000 was already paid on inputs or raw materials; and the final good attracted an excise duty of Rs. 10,000, then the manufacturer would pay only Rs. 9000 as MODVAT.

Thus, the key objective of MODVAT was to avoid repetitive payment of duties from raw material to the final product stage. The idea was that it would reduce the cost of the final product. However, it was later found that in many consumer goods, the final price got increased due to MODVAT. Further, the tax evasion was possible by creation of false invoices.

In 2000-2001, MODVAT was replaced with the CENVAT. This system has only one basic excise duty of 16% that is applicable to almost all goods except some goods which attract special excise duties of 8%, 16% or 20%. The system is much simpler but still leaves scope for tax evasion.

Service tax

Service tax was not in the constitution until 88th Amendment was passed. Via this amendment, article 268-A was added and also added a new entry in Union List viz. 92-C (taxes on services). Like Income tax and Corporate tax, Service tax is levied by the centre but collected and appropriated by both the centre and the states.

The Service tax was imposed in India initially from 1994-95 on electricity services, telephone services, brokerage etc. With every passing year, more and more services were brought into the ambit of the service tax. The first year collection of the Service Tax in 1994-95 was Rs. 407 Crore, which rose to Rs. 2610 Crore in 2001-02.

Currently, service tax is levied at the rate of 14% subject to minimum service value exceeds Rs. 10 Lakh in a year.

Goods and Services Tax

The Goods and Services Tax (GST) is a value added tax to be implemented in near future. It will

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replace all indirect taxes levied on goods and services by the Union and State governments. It is aimed at being comprehensive for most goods and services with little tax exemption.
(GST is discussed in Government Budgeting-2)

Government Budgeting

Article 112 of the Indian Constitution, says that every year "the President of India shall cause to be laid before both the houses of the parliament" the "Annual Financial Statement". This is popularly known as Budget. "*cause to be laid*' here means that the person through whom President acts, is *Finance Minister of the country, who is known as the custodian of the nation's Finances.* The Budget gives the complete picture of the estimated receipts and expenditures of the Government of India for that year. This picture is actually based upon the budget figures of the previous years. There are three kinds of figures in this set. If we are studying the budget of 2015-16, then this set would be made up of actual of 2013-14, budget & revised estimates of 2014-15 and budget estimates of 2015-16.

Budget Estimates

The Budgetary estimates are based upon the previous data. Similarly provisional estimates are also based upon the previous data. When these data are revised as per the current position, they are called "**Revised Estimates**". However, if the **Revised estimates** show the latest short term situation, then they are called "**Quick Estimates**". **Advance estimates** are a kind of "Quick Estimates" which are done ahead of the time.

The main Budget documents are presented to the parliament accordingly various articles of our constitution as follows:

- Annual Financial Statement (AFS) : As per Article 112
- Demand for Grants (DG) : As per Article 113
- Appropriation Bill: as per Article 114 (3)
- Finance Bill: As per article 110 (a)
- While presenting the Budget, the following are presented as mandated in Fiscal Responsibility and Budget Management Act 2003.
- Memorandum Explaining the Provisions in the Finance Bill,
- Macro-economic framework for the relevant financial year
- Fiscal Policy Strategy Statement for the financial year
- Medium Term Fiscal Policy Statement

Discussion on Budget

On a day subsequent to the presentation of the Budget, the House takes up the General Discussion of the Budget which is called the *first stage followed by second stage i.e. discussion and voting on Demands for*

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Grants.

During the General Discussion on the Budget, the house is at liberty to discuss the Budget as a whole or any question of principle. The scope of discussion at this stage is confined to the general examination of the Budget i.e. the proper distribution of the items of expenditure according to the importance of a particular subject or service, the policy of taxation as is expressed in the Budget and the speech of the Finance Minister.

Standing Committee Reports

After the General Discussion on Budget in both the Houses is over and **Vote on Account** is passed, the House is adjourned for a specified period. The Demands for Grants of each Ministry/Department will be examined by the concerned Standing Committee having jurisdiction over it during the said recess period. The Committee gives separate report for each Ministry. The Demands for Grants are discussed / considered in the House in the light of the reports of the Standing Committee. The reports of the Standing Committees which are of persuasive value are nevertheless treated as considered advice given by the Committee.

The detailed discussions are followed by Guillotine. Guillotine refers to closure imposed on the debate. On the last of the allotted days at the appointed time, the Speaker puts every question necessary to dispose of all the outstanding matters in connection with the Demands for Grants. The Guillotine concludes the discussion on Demands for Grants.

Appropriation Act and Finance Act

An Appropriation Act in India is an act of Parliament which allows the withdrawal of funds from Consolidated Fund of India or Consolidated Funds of States (in case of state budgets). Similarly, the Finance Act of Central Government gives effect to the taxation proposals in the beginning of every financial year. For taxation proposals at state levels, State Finance Acts are enacted every year.

Appropriation Act

Constitution says that *no money shall be withdrawn from the consolidated fund of India except under the appropriation made by law.* Thus, the Appropriation Bill authorizes the amount which can be drawn out of the Consolidated Fund of India for meeting the expenditures. This bill is required to be passed for votable as well as non-votable expenditures and also any vote on account.

Further, kindly note that once the Lok Sabha has passed the Appropriation Bill, no amendments in its amounts can be proposed in either house of Parliament. Once the bill gets President's assent, it becomes Appropriation Act. The Appropriation Act authorises the government to withdraw funds from Consolidated Fund of India.

Finance Act

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The Constitution (Article 265) says that *no tax shall be levied or collected except by authority of law* Consequently, a Finance Bill dealing with such law is introduced to authorize the government to raise funds through taxation. This bill must become an act within 75 days of introduction.

Difference between Appropriation and Finance Bills / Acts

- While Appropriation act legalizes the expenditure side of the budget, Finance act legalizes the income side (Taxes) of budget.
- While no amendments can be moved or passed in case of appropriation bill, amendments seeking to reject or reduce a tax can be moved in the case of finance bill.

Vote on Account and Interim Budget

Vote on Account

The Appropriation Bill and Finance Bill are presented in the month of February, and they take their own time to become act. In order to keep the Government functioning, the House is asked to vote usually **two months**' funds i.e. approximately 1/6th of the total estimated expenditure under various grants. This is called **Vote on Account**. Vote on Account is passed after general discussion on the Budget. Usually it is treated as a formal matter and is passed without discussion. Vote on account is as per provisions of Article 116 of the Constitution. This makes clear that Vote on Account __:

- Can be passed on occasions when government needs some money on its disposal to keep running the administration till appropriation act is passed.
- Related to only taking money out of Consolidated Fund of India and thus *limited to expenditure side*
- Normally related to expenditures of 2 months only that is equivalent to 1/6th of the total budget; but that is NOT a rule. In 2004-05, the NDA Government sought for a Vote on Account for Four Months. In fact, during election year or when it is anticipated that the main demands and appropriation bill will take longer time than two months; the vote-an-account may be for a period extending two months. Typically this period does not exceed six months, as that is the maximum gap possible between two sittings of the Parliament.
- *Not related to Taxation* matters or revenue side of budget
- Can be passed by all governments whether incumbent or regular or caretaker, however, Vote On Account becomes of special importance when the elections are underway and a caretaker government is in place.

Interim Budget

While a vote-on-account deals only with the expenditure side of the government's budget, interim budget is a complete set of accounts, including both expenditure and receipts. When a government

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presents Vote on Account as a part of its Budget exercise; two appropriation bills viz. Appropriation (Vote on Account) Bill and Appropriation Bill of that year are passed. For example, the current (outgoing) Lok Sabha has passed Appropriation (Vote On Account) Bill, 2014 authorising the government for withdrawal of Rs 20,30,334 crore from the Consolidated Fund of India for expenses during the first four months of the new financial year 2014-15.

Interim Budgets also can be presented by all governments whether incumbent or regular or caretaker, however, Interim Budget becomes of special importance when the elections are underway and a caretaker government is in place. It can also be presented when a new Government has recently sworn in.

The Votable and Non-Votable Expenditures

The budget shows the estimated receipts and expenditure of the upcoming Financial Year. After the budget is presented to the house (parliament), the government needs its approval to draw even one rupee from the Consolidated Fund of India. This approval comes by voting, which means that the Budget proposals must be passed by the Parliament. However, there are some charges which essentially have to be paid by the Government and for those charges no voting takes place. Thus, the expenditure embodied in the Budget Documents is of two types:

- The sums required for charged expenditures. These are non-votable.
- The sums required for other expenditures as mentioned in the Budget Documents. These are votable.

Charged Expenditures or Non-Votable Charges

Non-votable charges are called Charged Expenditures; and no voting takes place for the amount involved in these expenditures for their withdrawal from Consolidated Fund of India. This means that they have to be paid in any case, whether the budget is passed or not passed. Following are the charged expenditures:

- Salary and Allowances of the President, Speaker / Deputy speaker of Lok Sabha, Chairman/ Deputy chairman of Rajya Sabha, Salaries and Allowances of Supreme Court judges, Pensions of Supreme Court as well as High Court Judges, Salaries and Allowances of CAG, Lok Pal
- Debt charges of Government of India.

The above expenditures cannot be voted because; these payments are deemed to be guaranteed by the state. Although voting does not take place on such charges, discussion can take place in any house of the parliament. The demand for grant for these charges is also made on recommendation of the president. (Article 113)

Here we should not that retainer of Attorney General or Solicitor General is NOT a

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charged expenditure upon Consolidated Fund of India. They are paid a fee which comes from the budgetary allocations of Department of Legal Affairs, which itself though comes from consolidated fund but is a votable charge. Further, while salary of High Court Judges is charged from Consolidated Fund of States, their pension comes from Consolidated Fund of India.

Votable / Voted Expenditures

The Votable part is actual Budget. The expenditures in the Budget are in the forms of**Demand for Grants**. There Budget also presents ways and means – how the government would be recovering the expenditures. Generally, the demands for Grants of each and every ministry are made separately in the Budget documents and each demand for grant has the provisions under its different heads.

Cut Motions

After the budget is presented in Parliament and discussions over it are completed, the members get an opportunity to move cut motions to reduce the amount of demand. The members from particular parties or coalitions may bring their own cut motions. The members generally give notice of the Cut Motions for the reduction of the votable heads of expenditure of the Demands for Grants immediately after the Finance Minister or the Railway Minister as the case may be, has presented the Budget in the House.

Every Cut Motion to a demand for Grant represents*disapproval* of some aspect or other of the Budget or the economic policy of the Government. Accordingly Cut Motion is of three kinds:

Policy Cut

This type of cut motion aims that the amount of the demand be reduced to Re. 1. It represents the complete disapproval of policy underlying the Demand. This is because the motion aims to reduce the demand for grant to Re. 1 only, which almost finishes the demand for grant of a ministry.

Economy Cut

This type of cut motion aims that the amount of demand be reduced to certain other amount and it represents that the demand for grants should be altered.

Token Cut

This Cut Motion aims that the amount of the Demand be reduced by Rs. 100" in order to*ventilate a specific grievance,* which is within the sphere of responsibility of the Government of India. Actually, Token cut is symbolic and is humiliating for the Government. To be precise*all cut motions are humiliating for the ruling party or coalition. The Cut motions provide the members maximum opportunity to examine every part of the budget and criticize the Government.*

Implications of Cut Motions

The Cut Motions are mostly defeated due to Number strength of the ruling party or coalition. As the

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cut motion is a veto power given to the member of the Lok Sabha to oppose a demand in the financial bill discussed by the government, it is seen as an effective tool to test the strength of the government. If a cut motion is adopted by the House and the government does not have the numbers, it is obliged to resign. The cut motion can be admitted to the house only if it is related to only one demand and not many. No cut motion can be moved on charged expenditures. The cut motions are important because they facilitate the constructive discussion on each demand and uphold the principle of democratic government, by giving the members power to veto the demands.

Plan and Non Plan Expenditures

All the expenditures that are incurred on the public exchequer of the country are kept in two categories viz. Plan and Non Plan. The expenditures which are done by the Government of India in the name of Planning are Plan expenditures. All other expenses are Non-plan expenditures. Generally (not always), the plan expenditure produces some tangible assets related to economic development. This is not a rule, but this is one reason that plan expenditures are also called *Developmental expenditures*. In fact till 1997-98, the budget used to show development and non-development expenditures. Now they are called planned and non-planned expenditures as per recommendations of *Sukhmay Chakraborty Committee*. The important heads among the expenditure parts are enumerated below:

Non-Plan Revenue Expenditure

Important Non-Plan Revenue Expenditures are as follows:

- Interest payments on the loans taken by Government of India
- Expenditure incurred on Defence Services (except Defence Equipment which is a capital expenditure)
- Subsidies
- Grants to the states and UTs, including those from calamity fund
- Pensions, Social services such as healthcare, education, social security etc.
- Police
- Economic services by the government such as Agriculture, Industry, Power, Science & Technology
- Grants to foreign Governments

Non-Plan Capital Expenditure

Important Non-Plan Capital expenditures are as follows:

- Defence Equipments and modernization
- Loans to Public sector companies

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- Loans to states and union territories

One of the most important headings under the non plan revenue expenditures is "Interest payments on the loans taken by Government of India". The Budget 2014-15 makes a provision of payment of Rs. 4.27 Lakh Crore as interest payment on public debt. This amount includes the internal debt / external debt and other liabilities.

Plan Expenditures

The plan components relate to items dealing with long-term socio-economic goals as determined by the ongoing plan process. They often relate to specific schemes and projects. Furthermore, they are usually routed through central ministries to state governments for achieving certain desired objectives. These funds are generally in addition to the assignment of central taxes as determined by the Finance Commissions. In some cases, the state governments also contribute their own funds to the schemes.

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Model Questions

Prelims MCQ Topics

James Wilson, Rule of Lapse, Participatory Budgeting, Gender Budgeting, Zero Based Budgeting, Incremental budgeting, Taxes mentioned in Arthashashtra, Progressive and Regressive Taxes, Elasticity in Taxes, Sin Tax, Difference between Direct and Indirect Taxes, tax avoidance, tax evasion and tax planning, locations of major Tax Havens, Thin Capitalization, Base Erosion and Profit Sharing (BEPS), Letterbox Entity, GAAR, Tax Information Network, eSahyog, Constitution (122nd Amendment) Bill, 2014 provisions and GST Council.

1. Trace the evolution of Budget In India since East India Company rule.
2. "Budget serves as a public policy document expressed in money and is an embodiment of implied policy objective in monetary terms." With this reference assess the role played by budget in economy.
3. "Budget transparency and accountability are two of the eight basic indicators of good governance as propounded by United Nations." With this reference, critically discuss the principles followed in budgterary process in India.
4. Elaborate the various stages of preparation of budget in India before it is presented in the parliament.
5. "Open and participatory budget making is imperative for good governance; yet by international standards India fares badly on this count." Discuss critically.
6. Assess the efforts by state and union towards Gender Budgeting while throwing light on its benefits.
7. Differentiate between Zero Based Budgeting and Incremental Budgeting. Why they are not adopted now? Examine.
8. What do you understand by "Kosha Moolo Danda"? Discuss in the light of Kautiliya's tax administration.
9. "There are many similarities between the current day tax system and the Kautilya's system of Tax administration". Explain.
10. What do you understand by progressiveness and regressiveness in the taxes? Make a comparison of direct and indirect taxes on this basis.
11. Critically compare the Direct and Indirect Taxes.
12. What do you understand by tax avoidance, tax evasion and tax planning? Objectively discuss various methods involved in the same.

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13. Base Erosion and Profit Sharing (BEPS) has emerged as one of the most important challenges for the governments across the world today. Critically examine in the light of G20- OECD's BEPS Action Plan and the recently released BEPS Package.
14. "The basic issue with GAAR provisions is the trust deficit between the corporate entities and government." Discuss in the light of recent developments.
15. Outline the Direct & Indirect Tax Reforms in India in recent times.
16. Discuss the composition and functions of the GST Council as proposed in the Constitution (122nd Amendment) Bill, 2014.

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Government Budget: Select Topics

Evolution of Budget

Etymologically, the term budget is related to Latin *bulga* , which refers to a 'leather bag. The term comes from a Gaulish source connected to the Irish bolg, which means a bag. It got associated with finance in mid 18th century following up a pamphlet titled "The Budget Opened" sarcastically attacking the tax plans of Great Britain's first prime Minister Sir Robert Walpole. However, the term budget was first used in 1760 for statement of the actual results of receipts and expenditure in the preceding fiscal year presented in House of Commons by UK's Chancellor of Exchequer. The term budget was used in current context only after mid 19th century. 20th century was a stimulating era for budgeting. It was only after 1950s that budget was more rationally used for public planning and policy. The development of the theoretical framework of budgeting during 20th century has been shaped by the political, social and administrative players and circumstances.

During the 20th century, while the Budget and Accounting Act 1921 systematized the budgeting in USA, the Parliament Act 1911 excluded the Lords in UK to refuse money bills, thus depriving House of Lords of its power of veto over financial legislation. Since then, the elected House of Commons has supreme powers regarding budget decisions in UK and same was followed in India where Lok Sabha has such powers.

Key Points: Evolution of Indian Budget

A rough budget of East India Company was prepared in 1790. After the end of East India's Company's rule, India's first budget was presented on February 18, 1860 by James Wilson, a Finance Member of the India Council. The Finance Member's work was to advise the Viceroy on financial matters.

After the Morley-Minto Reforms of 1909, the Finance Member had to present his estimates to the Central Legislature in first quarter of every year. The Finance Member's presentation was followed by discussions on Budget proposals. During discussions, the members of the legislature could propose alterations in tax provisions, loans and grants to local government. The Finance Member was able to accept or reject these proposals but he needed to justify why he accepted some proposals and why rejected others.

Initially, the Railway budget was part of the general budget. On the basis of recommendations Acworth Committee, the Rail Budget was separated in 1924. That system follows till date. Recently, the Bibek Debroy committee has recommended to abolish the separate Railway Budget in a period of five years. The first budget of Independent and united India was presented by John Mathai in 1949-50. This budget also included the financial statements for former Princely States. The decision

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of forming a planning commission was declared in this budget.

Functions Of a Government Budget

The key functions of a government budget are discussed below:

Public Policy Document

The budget serves as a public policy document expressed in money and is an embodiment of implied policy objective in monetary terms.

Redistribution of Wealth

The most important function of budget is redistribution of wealth. However, that needs proper integration of revenue and expenditure side.

Instrument of Economic Development

Budget serves as an instrument of economic development, which embodies a work programme for administration and government. It's a source of information for all stakeholders.

Instrument of budgetary control

Budget also serves as an instrument of financial control by legislative over executive. It also serves as instrument of accountability and financial control. Further, it is a management tool for achieving efficiency, productivity, improvements and for determining the degree to which policy goals have been accomplished.

Instrument of accountability

Budget is an instrument to make elected legislators accountable to people. It also upholds the economic, social and cultural rights of the people.

Principles of Budgeting

There are a few principles followed in budget preparation exercise. These are as follows:

Principle of Annuality

This implies that a budget is prepared every year on annual basis. One year is considered ideal period for budget because it's an optimum period for which the legislature can afford to give financial authority to the executive. Further, executive also needs this much time to implement the budget proposals effectively. Further, a year corresponds with the customary measures of human estimates. Annuality in budget formation is a widespread phenomena. In some countries of OECD, yearly budgets are now framed within a multi-year framework.

Rule of Lapse

Principle of Annuality also implies that the money left unspent in a year must also lapse to the public treasury and government should not be able to spend it unless it is re-sanctioned in next year's budget. This is called Rule of Lapse and is useful as an effective tool of financial control.

Fiscal Discipline

Budget should be balanced and should be able to display congruence between the income and

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expenditure. This is known as Fiscal Discipline and it adheres to the Keynesian School of Thought. Fiscal discipline helps to eliminate fiscal deficits and offset fiscal surplus.

Inclusiveness

Budget should be comprehensive and inclusive of diverse budget estimates. An inclusive budget includes all government revenue and expenditures and helps evaluating the much required trade-offs between different policy options.

Accuracy

Budget figures are essentially predictions of the amount of money to be generated in the forthcoming year and its expenditure. The Finance Ministry is accountable for its formulation with the help of the data and material from the various departments. These estimates need to be accurate and precise. The preciseness is dependent real and credible input data, information and unbiased information.

Transparency and Accountability

Budget transparency and accountability are two of the eight basic indicators of good governance as propounded by United Nations. Budget transparency implies that government gives out all data regarding budget. These two traits of budget also involve ethics on the part of the Government. For the sake of clarity and transparency, the revenue and capital portion of the budget are kept separate.

Budget Preparation Process

The preparation of budget in India involves the several stages before its presentation to the house. The fiscal year of the Union and State Governments is from April to March. The preparatory work on budget documents starts around 6-8 months before the commencement to of the fiscal year. The first initiative is taken by the finance ministry which sends *circulars* along with some *skeleton forms* to different ministries and departments asking them to start preparing in advance for the coming fiscal year. It also sends various instructions and guidelines in the Budget Circular, releases via Department of Economic Affairs, Budget Division.

The ministries and departments pass on these printed forms to the disbursing officers. Disbursing Officers are the heads of the local offices such as Deputy Commissioners of the districts, for preparing their own estimates. The forms are filled with items of income and estimated expenditures with actual figures of last year, sanctioned budget of current year, revised estimates of current year and proposed estimates of next year.

This makes it clear that in our country, *process of budget preparation is bottom up process,* that starts at the lowest level in departments and moves upwards to the level of the Head of the Department. The head of the department works as Controlling Officer for budgetary transactions. This is as per the below flowchart:

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In the second stage, the estimates sent by the disbursing officers are scrutinized by Head of Departments (Controlling Officers). They have the option to either accept the estimates as they are or revise it. These revised estimates are then sent to the Budget Department of the Ministry of Finance by mid November. The Estimates Committee considers these estimates and after its approval sends them to the Finance Ministry. They are further scrutinized by the finance ministry. This scrutiny by Finance Ministry is of different nature. For example, it would correlate the estimates with the state of economy and see if the revenues are available. It also would correlate them with new schemes to be announced soon. Simple questions are kept in mind while scrutinizing the estimates for example:

- If the proposed expenditures are really necessary?
- How without this expenditure was done till now? How this expenditure would make difference?
- Is such expenditure done elsewhere?
- From where the funds would come?

The Finance ministry justifies and passes the demands of several Administrative Ministries and fixed a net figure for each Ministry. We note here that the decision of the finance ministry is final in determining the provision. Many a times, there might be differences between ministries over inclusion or exclusion of some schemes. Such disputes are sorted out by finance ministry at ministerial level and such disputes might also be sent to Union Cabinet or Prime Minister, whose decision in this context is final.

Once the budget estimates on the expenditure side are done; the Finance Ministry prepared the estimates of revenue side with the help of Central Board of Direct Taxes and Central Board of Excise and Customs (a.k.a. Central Board of Indirect Taxes).

Finally, a consolidated statement is prepared which is now considered by the cabinet. Cabinet approval of the budget is done by January. The Finance minister in consultation with the Prime Minister now prepares a Financial Policy, which is essentially kept secret.

Participatory Budgeting

According to the International Budget Project (IBP), participatory budgeting is the process by which

citizens *deliberate and negotiate over the distribution of public resources* Participatory budgeting creates opportunities for engaging, educating and empowering citizens, which can equip and advance a more vibrant civil society.

Union Budget affects almost every sector of the economy and the policies driving the budget and implementation of the budget proposals are of direct relevance to the entire population. However, neither the budget process nor the budget policies come under substantial public scrutiny. The entire exercise of budget-making remains shrouded in complete secrecy till the budget is presented in the parliament. Only then, the general public gets relief from the vague guesswork of media. While budget presentation in the Parliament and subsequently its legalisation are quite transparent, the process of budget preparation by the Government is rather closed.

The interest and participation of the civil society in Budget making process has increased in recent times. In countries such as US, South Africa, New Zealand, the UK, the governments provide extensive information to their citizens on budget, while in India, only limited information is available to the public as well as parliament.

Status of public participation in Budget making in India

The process of the budget preparation starts in the month of September every year. The Budget Division of the Ministry of Finance collects estimates of expenditure of the next fiscal year and after a scrutiny of these estimates, the Ministry of Finance finalized these estimates. Prior to finalization, the finance ministry holds discussions with concerned ministries and departments. The finance minister has authority to make changes in consultation with the Prime Minister. The Budget is briefed to President and also Cabinet shortly before it is presented in the parliament. During the process of budget making, various lobby groups, representing the interests of industrialists, traders and exporters are able to express their interests. However, *there is no visible lobbying with the Finance Ministers for the poor and marginalized sections of the population.* Thus, general public and civil society organizations have been traditionally excluded from the budget making process in India. Thus, open and participatory budget making is imperative for good governance; yet by international standards India fares badly on this count.

Reasons for low participation

One of the major obstructions in public involvement in the budget process is the inability of majority of people to understand budget terminology and budget-related debates. Given the technicalities associated with budgets, even the highly educated people could be budget-illiterates, and unable to grasp the arguments put forward in the debates over budget policies. Majority of the population in India gets to know about the Union Budget when it is covered in the media, i.e., during the

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immediate interval of budget presentation in the Parliament.

Arguments for Participatory Budgeting

There are several arguments making a case of active public participation in budget process in India. These are discussed as below:

- The budget embodies the socio-political and economic policy priorities and fiscal targets of the government. Since the government cannot spend or raise public money without the authorisation of Parliament which in principle amounts to people's sanction; *the people have a right to know how the public resources are being raised and spent.*
- Openness or transparency is an indispensable principle of public finance management and it is a prerequisite for answerability. However, one can argue that the people have exercised their vote in the elections and elected representatives do the work of creating budget. However, participation of the informed citizens in crucial budget process is warranted ***in between the elections***
- It has been further argued that informed citizens make a very small fraction of the large population of India. However, looking at the nil participation of the public in the budget making process, civil society must be given an opportunity to raise issues relating to the vulnerable sections of the population.

Initiatives towards public awareness

A few civil society organisations in India at the national and state levels have been focusing on budget work with a pro-people perspective. Some of them have come up with very significant and innovative work in their areas. Developing Initiatives for Social and Human Action (DISHA) is perhaps the pioneer organisation in India working on budget analysis with perspectives for marginalised sections of people. There are other organisations like the Public Affairs Centre, Centre for Budget and Policy Studies, Samarthan Centre for Budget Studies, Centre for Budget and Governance Accountability (NCAS programme), Social Watch Tamil Nadu, and Budget Analysis Rajasthan Centre, which work on budget analysis mainly with the viewpoint of the social sector and other sectoral issues. Most of their work is centred on post-budget analysis of allocation for the social sector and its implications. Budget groups' low involvement in shaping or influencing budget decision-making is said to be because of the closed budget formulation process of the government.

Gender Budgeting

A gender budget is **not** a separate budget for women. Instead, the gender budgets are an attempt to assess government priorities as they are reflected through the budget and examine how they impact women and men.

Gender budgets look at what the impact of the spending is on men and women and whether or not

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budgets respond to the needs of both women and men adequately.

"Women's budgets", "gender budgets", "gender-sensitive budgets", and "gender responsive budgets" are all terms that are used to describe initiatives that have used gender as lens from which to analyse budgets at national, regional, and civic levels.

Gender Responsive Budget

A Gender-Responsive Budget is a budget that acknowledges the gender patterns in society and allocates the money to implement policies and programs that will change these patterns in a way that moves towards a more gender equal society. Gender budget initiatives are exercises that aim to move the country in the direction of a gender-responsive budget.

Need of a Gender Budget

Gender Budget Initiatives are attempts to disaggregate the government's mainstream budget according to its impacts on women and men. It refers to the process of conceiving, planning, approving, executing, monitoring, analysing and auditing budgets in a gender-sensitive way. The gender budgeting exercise would potentially assist and lead to the following empowering measures:

- Addressing gap between policy commitment and allocation for women by emphasizing on adequate resource allocation.
- Putting pressure and focus on gender sensitive programme formulation and implementation.
- Mainstreaming gender concerns in public expenditure and policy.
- By being a tool for effective policy implementation where one can check if the allocations are in line with slated gender sensitive policy commitments and are having the desired impact.

Gender budget is helpful in

- Improving women's economic equality.
- Improving effectiveness, efficiency, accountability, and transparency of government budgets.
- Revealing discrepancies between what a governments says it is doing and the actual impact of government policies.
- Offering a practical way for the governments to implement their obligations under international human rights agreements such as the Convention on the Elimination of All Forms of Discrimination against Women (CEDAW).

Gender Budgeting Around the World

- The concept of gender budgeting is a nineties' trend that has been introduced *mostly in Commonwealth countries.*
- Australia was the first country to implement a women's budget in 1984. Federal, state and territorial governments in Australia examined the impact of budgets on women and girls for 12 years until a change of government in 1996.

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- South Africa's Women's Budget Initiative was initiated in 1995 and involves NGOs, parliamentarians, and a wide range of researchers and advisors. Gender budget initiatives in Tanzania(1997) and Uganda(1999) examine the impacts of structural adjustment programs in these countries and specifically focus on education and health.
- Many of the earlier gender budget initiatives focused primarily on the expenditure side rather than the revenue side of government budgets. Since 1995 there have been gender budget initiatives in more than 60 countries around the world.

How Gender Budgeting helped the Governments around the world?

- In Australia, Gender Budgeting significant increase in spending in areas of importance to women. There was also a five-fold increase in child care places for working women.
- In Philippines, there was made a specific requirement that every government agency allocate at least five per cent of its budget to gender and development initiatives.
- UK "***From the wallet to the purse***". In United Kingdom, the government announced that from 2003 onwards the new Child Tax Credit would be paid to the main carer — usually a woman — rather than to the main earner — usually a man. The group supporting this used the slogan "From the wallet to the purse"(men carry wallets while women carry purses) to argue that giving money to women was more efficient and in-line with government policy on reducing child poverty.
- In South Korea, a gender budget initiative demonstrated that most of the beneficiaries of training and education programs were leaders or women from women's organizations.
- Gender Budgeting Statement (GBS)
- The Gender Budgeting Statement (GBS) which *comprises the gender specific demands for grants*, has emerged as an important advocacy tool which reflects on the flow of funds for women and encourages debate and discussions on Gender Budgeting.

Gender Budgeting in India

The first Gender Budget Statement appeared in the Union Budget 2005-06 and included 10 demands for grants. However, in recent budgets the number of demands of grants have been as high as 36. Ten states in India have also introduced gender budgeting but the lack of a standardised nomenclature for the various schemes has made it difficult to replicate or assess them.

Zero Based Budgeting

Zero-based budgeting is a method of budgeting in which all expenses for each new period must be justified. Under zero-based budgeting, no reference was made or considered of previous years. The budget request has to be evaluated thoroughly with its commencement from the zero-base. The

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concept was advocated in 1924 by British budget authority Edward Hilton Young. He advocated complete justification of every item requested in a budget. The ZBB concept became more popular only in 1970s.

In India, the principle of ZBB was initiated in the Department of Science and Technology in 1983. In 1986, the Indian government adopted ZBB as a technique for determining expenditure budget. The government made it mandatory for all ministries to review their programmes and activities and prepare their expenditure estimations based on ZBB concept. In seventh five-year plan, the ZBB system was promoted. However, later not much progress happened in this area.

Though ZBB is a good technique of budgeting, it was not implemented successfully because ZBB does not fit into organisations with long range objectives. Proper attention, Commitment form management and trained personnel can better implement the ZBB process. (You may read about ZBB here)

Incremental budgeting

Incremental budgeting is a way of budgeting where the future allocations are based on current allocations. The new budget is prepared by increasing or decreasing the current budget by certain amounts or percentages. The increased amounts are arrived through a fairly simple calculation and the scope for political conflicts is minimised because everyone is treated as same.

The Theory of Budgetary Incrementalism was formulated by Aaron Wildavsky in the 1960's. It has dominated the mainstream of American budgeting for decades. The theory of budgetary incrementalism assumed that budget process is driven by the 'department heads' and they are annually revised by having an increment. The revised budget heads were examined by the legislature. The theory of Budgetary Incrementalism survived till 1984 because of several problems. Though incremental budgeting is the basis for some baseline decisions, there are some drawbacks also. Incremental budgeting focuses on aggregate trends and fails to analyse revenue and expenditure changes. Although there are many criticisms of incremental budgeting, it is being followed in many countries.

Issues: Taxation and Fiscal Policy

Kautilya's Taxation: "Kosha Moolo Danda"

Kosha Moolo Danda, which means " revenue is the backbone (of administration)" is sourced from Kautilya's Arthshastra Part 8, Chapter 1. This implies that a nation's status relies upon its fiscal power. He expressed that the Government's power had source of treasury. This verse is used in the logo of Income Tax Department of India in Devanagari script.

Taxation as discussed by Kautilya

Arthashashtra was the first authoritative text on Public Finance, Public Administration and the Fiscal Laws in this country. In Arthashashtra, Kautilya has mentioned various types of taxes and duties such as those imposed on agricultural produce, trade, octroi, tolls and custom duties. Some of the important taxes were as follows:

- Custom Duty (*Sulka*), which consisted of import duty (*praveshya*), export duty (*nishkramya*) and gate tolls / octroi (*dwarabahirikadeya*).
- Transaction tax (*vyaji*), which included *manavyaji* (transaction tax for Crown goods)
- Share of Production (*Bhaga*) which included 1/6th share called (*Shadbhaga*)
- Tax in cash called (*Kara*)
- Taxes in Kind (*Pratikara*), which included Labour (*vishti*), for military (*Ayudhiya*)
- Counterveiling duties (*Vaidharana*)
- Road Cess (*Vartani*)
- Monopoly Tax (*Parigha*)
- Royalty (*Prakriya*)
- Taxes paid in kind by villages (*Pindakara*)
- Army Maintenance Tax (*Senabhaktham*)
- Surcharges (*Parsvam*)

The *basic premise of Kautilya's taxation doctrine was that public should not be exploited by imposing tax more than their competence to pay*. People should be willing to pay so that the receipts can be effectively used to build social and physical infrastructure.

Kautilya's System of Tax Administration and Present Day Tax System

There are many similarities between the current day tax system and the Kautilya's system of Tax administration prevalent more than two thousand years ago. For example, Kautilya had specifically laid down the terms for taxation, without any scope for arbitrariness. Further, he fixed a time table for payment of taxes and also what share of the produce or product value is to be paid as tax. Further, the stance of Kautilya on a kind of progressive taxation and ability to pay principle are followed in modern day practice also. Further, the personnel responsible for collection of the tax needed to keep proper record of the entire collection as done today. There were additional taxes for emergency situation (such as tax on liquor levied during war or emergencies).

Merits and Demerits of Direct Taxes

There are different types of direct taxes such as Income Tax, Corporate Tax, Inheritance Tax, Property Tax, Wealth Tax (abolished now in India), Capital Gains Tax etc.

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Merits

The key merits of the direct taxes are as follows:

Progressive Tax

The direct taxes follow the principle of 'ability to pay' because they are levied on the basis of individual's income and wealth. Since ability to pay can be measured, the direct taxes are imposed at progressive rate whereby richer persons pay higher taxes in comparison to the poor persons.

Reduction in Inequality

Due to their progressive nature, the direct taxes help in reduction of the inequalities because the revenues collected from the rich man can be used for the good of poor man.

Economical in collection

In comparison to indirect taxes, the direct taxes are easy to collect because a tax payer makes his own payments.

Elasticity

Direct taxes can be manipulated / altered as per requirements of the government, change in the income of the people and economic status of the nation as a whole.

Taxpayer Consciousness

The taxpayers are conscious of their payments and are aware or make efforts to be aware where their money is being spent. It develops a national and civic consciousness among themselves. The role of RTI in recent years has become much more important in recent times towards increased awareness among tax payers.

Demerits

There are several demerits of the direct taxes. Since the burden of tax payment is on individuals, it is most disliked tax. It is generally paid as large amount and sometimes involves too much personal information, direct tax gets unpopular. Further, tax burden of one person cannot be transferred to another person; so direct tax does not differentiate between ways of earning. One might be working hard while another might be earning without hard labour; but direct tax liability of both are similar so sounds unjust. Further, since there is no scientific principle of defining the degree of progression, the direct taxes are fixed arbitrarily. Since, large number of taxpayers make self declaration, the honest tax payers end up paying more than those who involve in tax evasion by falsifying the accounts.

Merits and Demerits of Indirect Taxes

Indirect taxes are levied on the production or consumption of goods and services or on transaction, including imports and exports. In case of indirect taxes, it is said that the person who is hit does not bleed; someone else bleeds. Still, there are key merits of Indirect taxes as follows:

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Elasticity

Akin to direct taxes, the indirect taxes are elastic because they can be adjusted to the changing economic environment. Further, the burden of the tax is on to the consumers of goods and services, so any change in the rates increases the revenue of the government in bulk. For example, the recent change in service tax rates from 12.5% to 14% has increased government revenue to great extent.

Broad-based

Indirect taxes are charged on a large number of goods and services so they are broad based. Due to wider coverage and broad base, the governments end up collecting more revenues as the taxes cover almost every goods.

Progressive

To some extent, the indirect taxes can be made progressive, for example imposing such taxes on items of luxury while exempting the essential commodities.

Leveller

Indirect taxes spare none. Rich or poor, all have to pay indirect taxes. This makes the lower income groups share the burden of the government while not paying the direct taxes.

Low Tax evasion

Since the indirect taxes are collected on sundry items and are a part of the price of commodities; these taxes are not evadable generally. However, they can be evaded by falsifying accounts or smuggling activities.

Sin Tax to promote social welfare

Sin Tax refers to a tax levied on all products and consumer goods known as vices or unhealthy for social growth and consumption of which may cause negative externalities. Sin Tax is thus a subtle way to discourage people from participating in such activities without implementing as complete ban on them. The tax forms a huge source of revenue to the government.

Easy to Pay

The indirect taxes are paid in small amounts while purchasing the goods and services and due to this, it's easier to pay them.

Environment Protection

This is relatively new concept. The governments would use indirect taxes to modify the behaviour of the individuals to achieve goals related to environment protection. For example, increased taxation on goods produced via polluting industries can modify the demand. Similarly, increase cost of fossil fuel may promote public transport.

Demerits

There are several demerits of the indirect taxes. Firstly, the cost of collection is very high. The government needs to establish network throughout the territory to enable indirect tax collection. Secondly, since the taxes are on expenditure, they affect only the consumers, the revenue generation

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is uncertain and is subject to price elasticity of demand / supply of the goods. Thirdly, indirect taxes need to be paid by all whether rich or poor, they are termed regressive, though they can be artificially made progressive to some extent. Fourthly, since the indirect prices are paid concealed in the price, they don't bring on civic awareness among the taxpayers in contrast to the direct taxes. Fifthly, since indirect taxes inflate the price of the goods, they lead to inflation. To reduce inflationary pressure, government reduces indirect taxes from time to time on concerned commodities. Sixthly, being regressive in nature, the indirect taxes impose heavier burden on poorer sections of society.

Comparative Analysis of Direct and Indirect Taxes

There are several parameters on which the direct and indirect taxes can be compared. *Firstly,* direct taxes are progressive and they help to reduce inequalities but indirect taxes are regressive and they widen the gap of inequalities. Thus, direct taxes result in more equitable distribution of income and wealth, though it might not be always true. Secondly, direct taxes are narrow based so their collection is easier; but indirect taxes are broad based, so administration costs to collect them is comparatively higher. Thirdly, in comparison to direct taxes, the indirect taxes affect the purchasing power of the people more. In other words, direct taxes only remove the enhanced purchasing power of the tax payers. On the other hand, the indirect taxes affect poor people more brutally. Fourthly, in terms of the economic growth, indirect taxes are more growth oriented in comparison to direct taxes. Direct taxes are progressive and they reduce savings and investments. When saving and investments are discouraged, economic growth is more likely to be affected. In contrast, the indirect taxes discourage consumption and increase savings. The sin taxes for example discourage consumption of inconspicuous items and promote health, which has indirect effect on economic growth.

Tax Avoidance and Evasion

There are three different concepts viz. tax avoidance, tax evasion and tax planning. Tax Avoidance means an attempt to reduce tax liability through legal means, i.e. to regulate one's financial affairs in such a way that one pays the minimum tax imposed by the law. This can be understood with a simple example. Tax Evasion and Tax avoidance are two different things. While Avoidance is legal management to avoid tax, tax evasion is illegal means to reduce tax liabilities, i.e. falsification of books, suppression of income, overstatement of deductions, etc.

Similarly, Tax planning is an accepted practice, whereby the taxpayer uses provisions of law to minimize his tax liability.

Methods of Tax avoidances

Tax Havens

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This implies to route profits through subsidiaries located in tax havens. Tax havens refers to the countries or territories where either very low tax is levied on certain items or not taken at all. Switzerland, Luxembourg, Isle of Man, British Overseas Territory, Bermuda, British Virgin Islands, Cayman Islands, Puerto Rico etc. are some of the popular tax havens around the world.

Treaty Shopping

Treaty shopping refers to taking undue advantage of a tax treaty between two countries by a resident of a third country.

Round Tripping

India Round Tripping, money is routed back into the country by local investors through tax havens like Mauritius. In this, money from home country goes out through illegal channels and invested back in the same country via a second country with whom India has a tax treaty. For example, it was suspected that many Indians used round tripping method and invested the money back in India via Mauritius. Such problem is countered by including relevant clauses and rules in the taxation law. For example in India, the domestic companies routing their investments through Mauritius need to pay capital gains tax.

Transfer Pricing

Transfer Price is the price of the goods and services sold between related entities such as – parent company and daughter (subsidiary) company. The companies artificially keep pricing of goods and services between related entities to avoid taxation via so called Base Erosion and Profit Sharing (BEPS).

Thin Capitalization

Thin capitalization is when most part of company's capital is made of debt instead of equity. When most of the capital is debt, the company has solvency risk. For tax avoidance purpose some companies indulge in artificial thin capitalization if there are tax benefits on receiving debt or loan. To counter this menace, governments need to introduce rules to disallow interest payments beyond certain limits.

Methods of Tax Evasion

Tax evasion involves illegal and unfair ways to get away without paying. Evasion of tax takes place when the people report dishonest tax. Falsifying the accounts, smuggling, false invoicing etc. are common methods of tax evasion.

Treaty Shopping

Treaty shopping is considered to be a means of tax avoidance. The bilateral tax treaties are done to reciprocate the benefits between the residents of two countries but when someone from a third country invests in any of them just for the sake of avoiding tax and derives the benefits of low

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taxation, this is termed as treaty shopping. Countries use anti-treaty-shopping provisions such as Limitation of Benefit (LOB) clause and/or beneficial ownership provisions to counter the treaty shopping. For example, India included such LOB clause in relation to bilateral tax treaty with Singapore.

Limitation Of Benefit (LOB)

Limitation Of Benefit (LOB) refers to the rules that are put in place to counter the menace of treaty-shopping/ Such rules restrict availing of the treaty benefits by a conduit (compromised) entity formed for the purposes of treaty-shopping {*they call it a letterbox entity*}. It also restricts entities who attempt to claim double non-taxation; for example, LOB clause under India-Singapore tax treaty.

Transfer Pricing

Transfer Price is the price of the goods and services sold between related entities such as – parent company and daughter (subsidiary) company; or between branches of same entity. The fixing of price of goods and services between parent-subsidiary is called Transfer Pricing.

Tax Avoidance Using Transfer Pricing

Transfer pricing itself is not a means of tax avoidance if transfer price matches what the seller entity would charge to an unrelated customer (called customer at arm's length). However, since lowering or increasing the prices between parent-daughter entities don't affect the whole organization, the companies artificially increase or decrease the transfer price to avoid corporate tax. This processing of using unusual transfer pricing to avoid tax is called *Base Erosion and Profit Sharing (BEPS).*

Transfer Pricing Case Study

In 2009-10, TCS (Tata Consultancy Services) ad shown a net profit per employee of Rs 4.3 lakh. At the same time, Capgemini, a foreign IT firm with operations in India, recorded a net profit per employee of Rs 1.5 lakh. Thus, Capgemini showed a net profit per employee one third of TCS. Despite of similar business, similar in contract pricing and similar in salaries and other expenses, why the foreign IT firms repo profitability numbers that are a fraction of their Indian peers? *Moreover, the same difference went* on the same lines on other scales such as revenue per employee, operating profit margin, net profit margin. This was **due to the menace of Transfer pricing** as per experts.

How it is done?

The subsidiaries of the foreign companies in India use transfer pricing to allocate most expenses / loss to India and most profits to their high-tax home country thus produce low taxable income or excessive loss on transactions. The Transfer Pricing has been under tough scrutiny by the authorities

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in India, which look for a better share in the tax from the companies. However, sometimes the companies claim and insist that they have done transfer pricing correctly. Due to this, Transfer pricing has been a key issue for both multinational corporations and tax authorities for a long time. Most of the countries in the western world have their own rules regarding the transfer pricing. Indian Government also has took some proactive measures to resolve the disputes arising due to the transfer pricing.

Government Efforts in this Direction

The Government had introduced Transfer Pricing Regulations (TPR) through the Finance Act, 2001 on the basis of OECD guidelines. Currently, the transfer pricing rules are part of section 92 and 92F of the Income Tax Act. Basic premise of these rules is that the related party transactions should involve an arm's length principle and the pricing should be such as if it would have been charged from an independent buyer. The rules postulate several methods of defining an arm's length price such as Comparable uncontrolled price (CUP) method; Resale price method (RPM); Cost plus method (CPM); Profit split method (PSM); Transactional net margin method (TNMM) etc.

To handle the dispute in calculation of tax liabilities, government established a Dispute Resolution Panel (DRP) under Income Tax Act via the Finance Act 2009.

Dispute Resolution Panels

DRPs had been constituted at Delhi, Mumbai, Ahmedabad, Kolkata, Chennai, Hyderabad, Bengaluru and Pune. DRP consists of three commissioners or directors of income tax appointed by the Central Board of Direct Taxes (CBDT). Any foreign company, or any domestic company with transfer pricing issues, in whose case the income-tax assessing officer proposes to make any variation in the income or loss returned, may apply within a month of receiving the draft assessment order before the DRP for appropriate remedy by way of direction to the assessing officer.

Further, via the Finance Act 2012, the government extended these rules to domestic related party transactions exceeding Rs. 5 Crore also.

G20- OECD's BEPS Action Plan

Base Erosion and Profit Sharing (BEPS) has emerged as one of the most important challenges for the governments across the world today. The globalization, privatization and liberalization has resulted into free movement of capital and labour, shift of manufacturing base from high cost to low cost locations, gradual removal of the trade barriers and rise of digital economy. LPG has boosted trade and foreign investments in many countries thereby supporting growth, employment generation, innovation and removal of poverty. LPG has led to flourishing of multinational corporations with

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their presence in many countries.

As early as 1920s, it was recognized that the interaction of the foreign companies with domestic tax system in host country might lead to double taxation which might result in adverse impacts on the growth and global prosperity.

To eliminate double taxation countries started entering into Double Tax Avoiding Treaties. The bilateral tax treaties are effective in preventing double taxation, but they often fail to prevent double non-taxation that results from interactions among more than two countries. This led to an increased number of *sophisticated tax planners* around the world. These professionals would *identify and exploit the loopholes in the tax treaties* thereby allowing the MNCs to do aggressive treaty shopping and go for Base Erosion and Profit Shifting (BEPS) to reduce their tax burden. This has harmed governments because they need to cope with less revenue and incur heavy cost to ensure tax compliance. This is a critical issue around the world.

What is BEPS?

Base Erosion and Profit Shifting (BEPS) refers to those instances where gaps between different tax rules leads to tax avoidance causing harm to the government. It refers to all those artificial arrangements where:

- Due to gaps in application of the bilateral tax treaties, cross border activities may go untaxed in any of the two countries.
- No or low tax is paid by shifting profits to low tax jurisdictions and shifting losses and high expenditures to high tax jurisdictions.

Further, the spread of the digital economy has also posed challenges for international taxation.

Over the years, the MNCs have artificially reduced their corporate tax outgo by shifting to lower tax jurisdictions. As per OECD estimates, the base erosion and profit shifting has resulted in a loss of $100-240 billion every year to countries which is around 4-10% of global corporate income tax revenue.

OECD Action Plan on BEPS

Originally, OECD had started the BEPS project in response to the 2008 financial crisis in order to create sustainable economic growth. It was formally launched in 2012 by the G-20 Finance Ministers who in turn called on OECD to develop an action plan to address BEPS issues in a co-ordinated and comprehensive manner and develop an action plan with inter alia, following points:

- There is a need to effectively prevent the double non-taxation and low taxation by checking the artificial arrangements to reduce tax liability.
- Countries should adopt new consensus-based anti-abuse provisions and new international

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standards to ensure the coherence of corporate income taxation at international level to complement the existing standards.

- Rise of digital economy has furthered the problem.

In 2013, the OECD came up with an action plan to address the Base Erosion and Profit Shifting menace. This action plan has 15 actions points. In summary, the 15 OECD action points seek to develop a more coherent international system to address the problems of digital economy taxation, treaty abuse, transfer pricing, aggressive tax planning and disputes related to such problems. The document says that countries should build consensus on how to effectively address the tax compliance of digital products and services and effective collection of VAT/GST with respect to cross border supply of digital products and services. It talks about neutralising the effects of hybrid mismatch arrangements and strengthening the CFC (controlled foreign company) rules. It aims to improve transparency both for business and governments by introducing commonly agreed minimum standards for tax administration across countries.

Hybrid mismatch arrangements

Hybrid entity refers to the companies which might be treated differently in two tax jurisdictions. A hybrid instrument is one which is treated differently in two tax jurisdiction i.e. debt in one and equity in other. The tax planners exploit the asymmetries between different tax jurisdictions through the use of a hybrid entity or a hybrid instrument. The OECD action plan calls for developing model treaty provisions regarding domestic rule to neutralize the effect of hybrid mismatch arrangements.

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The BEPS Timeline

June 2012
- G20 Summit launches BEPS Project

February 2013
- OECD publishes BEPs background report
- Public comments and stakeholder discussions continue on a parallel track since June 2013 over issues like transfer pricing, treaty abuse, permanent establishment status, taxing the digital economy

July 2013
- OECD Action plan delivered to G20

September 2013
- G20 leader's declaration at St Petersburg endorsing the project, making it a joint project between OECD and G20

September 2014
- OECD presents G20 leaders with draft proposals to tackle tax evasion
- Push for greater role of developing countries to curb corporate tax avoidance

October 2014
- OECD issues revised calender for stakeholder consultation

February 2015
- OECD gets the mandate to launch negotiations on a multilateral instrument, an implementation package for country-by-country reporting, among others

October 2015
- G20 Finance Ministers discuss OECD/G20 final BEPS reports

Current Status

The G20-OECD led project on base erosion and profit sharing (BEPS) is currently taking a firm shape. It aims to fulfil the 15 points of the G20-OECD on the multifarious aspects of international tax policy by December 2015. On October 5, 2015, OECD has released a Base Erosion and Profit Shifting (BEPS) package containing final reports on 15 identified focus areas. This report includes recommendations for significant changes in the key elements of international tax architecture. In

2016, OECD is expected to come out with a multilateral convention to prevent the treaty abuses.

India's Stance on multilateral / Bilateral Tax Regime

India has also responded positively to the G20-OECD led BEPS project. For a developing country like India, any such regime which effectively addresses the treaty shopping would result in more tax revenues. Further, India is also in the process of making tax treaties sustainable with its bilateral partners such as Mauritius. India also has become a signatory of the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information on 3rd June, 2015. These new global standards on automatic exchange of information, known as Common Reporting Standards (CRS), once implemented, will facilitate automatic exchange of taxpayers' information between treaty partner countries for speedy dispute resolution and reducing instance of base erosion through use of dubious structures/financing instruments in cross-border transactions.

Further, India has also signed the Inter-Government Agreement (IGA) on Foreign Account Tax Compliance Act (FATCA) with United States.

India and BEPS

It was recently reported that the Budget 2016-17 might take some recommendations from the BEPS measures and make domestic anti-abuse provisions such as rules to block thin capitalization, Controlled Foreign Corporation (CFC) Regulations etc.

General Anti Avoidance Rules (GAAR)

General Anti-Avoidance Rules (GAAR) are general rules that target any transaction of business arrangement that is done for aggressive tax planning, tax avoidance or tax evasion. GAAR were introduced in Australia in 1981, Canada in 1988, South Africa in 2006 and China in 2008.

GAAR in India

In India, GAAR is still at proposed stage and current government has deferred implementation till April 2016.

Key Proposals in GAAR

The objective of GAAR is to check tax avoidance by giving additional powers to the Income Tax Department. The department will have powers to deny tax benefit if a transaction was carried out exclusively for the purpose of avoiding tax. It will be able to go deeper into ownership structures, beneficial ownerships, voting rights, transactions, etc. and lift the corporate veil if there is any artificial arrangement made just for the sake of avoiding taxation. The key proposals are as follows:

Minimum threshold for invoking GAAR

As per the proposals, GAAR can be invoked only if artificial arrangements have been done to avoid tax value of at least Rs. 3 Crore in a particular assessment year.

Applicability of GAAR to foreign institutional investors (FIIs)

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GAAR provisions are not applicable to those SEBI-registered Foreign Institutional Investors (FIIs) which do not take any benefit under Double Taxation Avoidance Agreements (DTAA) entered by India with other countries. GAAR would also not apply to investment made by FIIs by way of offshore derivative instruments

'Grandfathering' of investments

This implies that the GAAR provisions will not apply in case of income from transfer of investments made before August 30, 2010

Consequence of impermissible arrangement in a transaction

Applicability of GAAR will be restricted to only that part of the arrangement which is regarded as an 'impermissible avoidance arrangement' by tax authorities, and not to the entire transaction

Powers of Income Tax Commissioner

The Income Tax Commissioner will be empowered to declare an arrangement as an Impermissible Avoidance Arrangement (IAA) if:

- The whole, a step or a part of the arrangement has been entered with the objective of obtaining tax benefit, and
- The arrangement creates rights and an obligation not normally created in arm's length transactions or results in direct or indirect misuse or abuse of the provisions of the code or lack commercial substance in whole or part, or is not bonafide.

This is so far reaching in nature that almost each and every transaction, which results in saving tax could be regarded as an IAA.

This means that GAAR enables tax authorities to declare any arrangement entered into by a taxpayer as an IAA. If it is so declared, then the tax authorities can disregard, combine or re-characterize any step of such arrangement or the entire arrangement, disregard any accommodating party involved in such arrangement, treat the transaction as if it had not been entered into or carried out, reallocate any income or expenditure, look through any arrangement by disregarding any corporate structure, re-characterize debt as equity or vice-versa and so on.

In effect, for tax purposes, any transaction can be treated in a manner different from the manner in which it is carried out if it is regarded as an IAA.

Key concerns of Industry

The industry in one voice raised several concerns. The basic issue here is the trust deficit between the investors / corporate and the income tax department. The real fear was that overarching powers to the Income Tax department would create an environment of deterrence and would make doing business further difficult in India.

To draw the final guidelines, to bring tax clarity and to address the concerns of foreign investors in

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relation to GAAR, the UPA government in 2012 had set up the Parthasarathy Shome panel. This panel made the following important recommendations:

- The implementation of GAAR shall be deferred by three years.
- GAAR should be made applicable only if the monetary threshold of tax benefit is Rs.3 crore and more.
- GAAR should not be invoked to examine the genuineness of the residency FII from Mauritius.
- GAAR should apply "only in cases of abusive, contrived and artificial arrangements".
- Short-term capital gains tax should be abolished and transaction tax should be increased.

Current Status

The UPA Government in 2013 had deferred GAAR for two years accepting recommendations of the Shome Panel. In the budget for 2015-16, FMM Jaitley proposed postponing the implementation of GAAR by two more years. There are several questions that remain unanswered as follows:

- There are already some Special Anti-Avoidance Rules (SAARs) in the Income Tax Act. Will GAAR apply when these rules exist.
- What are the cases which would fall within and outside purview of GAAR; government should clarify this.
- Remove retrospective taxation.
- Government should create a special cadre of GAAR-trained tax administrators

The above extension is likely to be the last extension.

Conclusion

Tax avoidance is an international concern and comes heavy on the Government exchequer. Several countries have already codified GAAR laws or are in the process of doing so. India is no different and must codify the laws that check misuse of the tax treaties and legal loopholes to avoid taxes. While the carefully drafted GAAR rules should not deter the genuine investors, GAAR must be in place to show the world that India is not a tax haven.

Tax Reforms

Prior to the liberalization of Economy, India's tax regime was marred with numerous problems. In terms of direct taxes, there was a high degree of progressiveness in 1960s and 1970s that led to adverse effect on tax collection efficiency. Further, there were large number of exemptions eroded the already narrow tax base in the country. Then, the poor enforcement of direct taxes led to tax evasion at vogue. In terms of corporation tax, there were numerous discriminations between different kinds of the companies that discouraged the investments. Further, double taxation of

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dividends was also common in those days. In terms of Indirect taxes, the high rates of custom / excise duties were prevalent. There was no VAT, there was no service sector within the purview of tax.

The efforts to reform India's tax system began in mid 1980s when the government announced a Long Term Fiscal Policy 1985. This policy recognized that the fiscal position of the country is going downhill and there was a need to make changes in the taxation system. In that decade, a technical group to review and rationalize the central excise duties was established and this led to introduction of Modified System of Value-Added Tax (MODVAT) in 1986. To rationalize the custom duties, the harmonized system (HS) of the classification of goods was introduced.

Raja Chelliah Committee

The Government appointed a Tax Reforms Committee under Prof Raja Chelliah to lay out agenda for reforming India's tax system. This TRC came up with three reports in 1991, 1992 and 1993 with several measures, which can be summarized in these points:

1. Reforming the personal taxation system by reducing the marginal tax rates.
2. Reduction in the corporate tax rates.
3. Reducing the cost of imported inputs
4. by lowering the customs duties.
5. Reduction in the number of Customs tariff rates and its rationalization.
6. Simplifying the excise duties and its integration with a Value-Added Tax (VAT) system.
7. Bringing the services sector in the tax net within a VAT system.
8. Broadening of the tax base.
9. Building a tax information and computerization.
10. Improving the quality of tax administration.

The tax reforms that began with the Chelliah Committee recommendations are still going on. Later on, government appointed the Vijay Kelkar Committee in 2002 which further provided direction to the tax reforms in the country. Below is the crisp summary of tax changes made in India since 1991.

The DTC and GST have been so far biggest reforms initiated by the Government in direct and indirect tax regime respectively. However, while DTC has lapsed and the government had decided to not to pursue it further, GST remains entangled into India's murky politics.

Direct Tax Reforms

Impetus to direct tax reforms in India, came with the recommendations of the Task Force on Direct & Indirect Taxes under the chairmanship of Vijay Kelkar in 2002. The main recommendations of this task force related to the direct taxes related to increasing the income tax exemption limit,

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rationalization of exemptions, abolition of long term capital gains tax, abolition of wealth tax etc. Its key recommendations were as follows:

Administration of Direct Tax

- The taxpayer services should be extended both in quality and quantity and taxpayers should get easy access through internet and email.
- PAN (Permanent Account Number) should be expanded and it should cover all citizens.
- Block assessment of search and seizure cases should be abolished.
- To clear the backlog, the department should outsource the data entry work.
- All returns and issue of refunds should be completed in a four month period. Dispatch of refunds should be outsourced.
- Government should establish a Tax Information Network to modernize, simplify and rationalize tax collection, particular TDS and TCS.
- Abolish the requirement of Tax Clearance Certificate on leaving the country.
- Empower CBDT with appropriate administrative and financial powers.

Personal income tax

- Increase in exemption limit to Rs.1 lakh for the general categories of taxpayers and further exemption for senior citizens and widows.
- Rationalize income tax slabs, eliminate surcharge on personal income tax.
- Incentivise home loans by providing interest subsidy on home loans @2%.
- Increase deduction under Section 80CCC for contribution to pension funds.

Corporation Tax

- Reduce the Corporate tax to 30% for domestic companies and 35% for foreign companies.
- The listed companies should be exempted from tax on dividends and capital gains.
- Increase rate of depreciation for plant and machinery.
- Abolish Minimum Alternate Tax.

Wealth Tax

- Abolition of wealth tax.

The above recommendations were made 13 years ago. Today, we see that many of them have been implemented. The current status of various tax reforms done in these years is as follows:

Tax Information Network (TIN)

On behalf of the Income Tax Department, the National Securities Depository Limited (NSDL) established Tax Information Network (TIN). This is a source of the countrywide tax related data. The basic idea behind establishing TIN was to modernise collection, processing, monitoring and accounting of direct taxes using information technology. TIN has three subsystems viz. ERACS,

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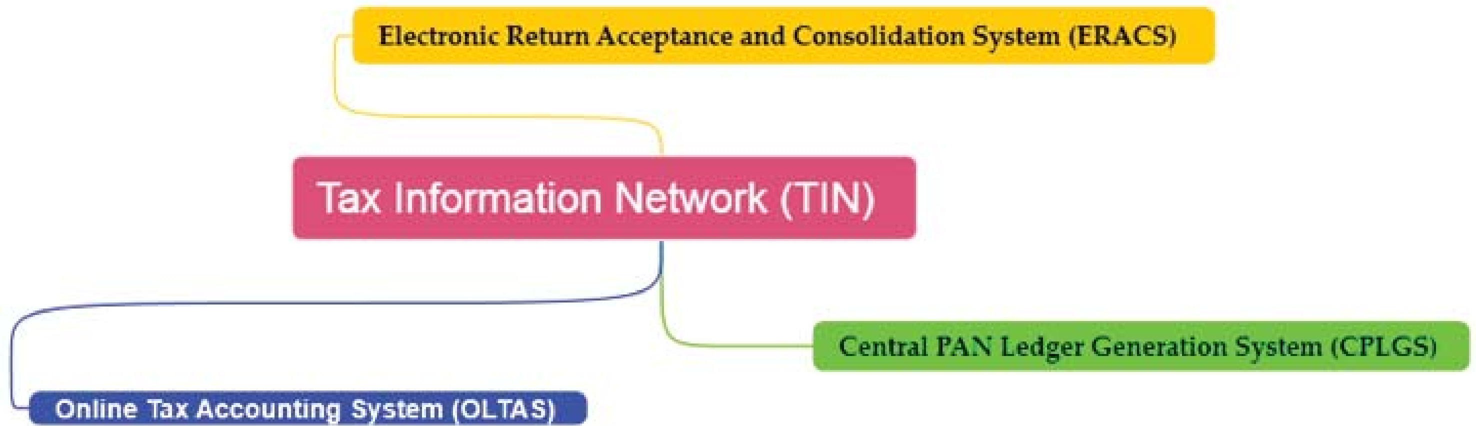
OLTAS and CPLGS.



Electronic Return Acceptance and Consolidation System (ERACS)

ERACS consists of a system for interface with the taxpayers (TIN Facilitation Centres that is TIN-FC) and an internet supported system for upload of electronic returns of Tax Deduction at Source (TDS) and Tax Collection at Source (TCS) and Annual Information Return (AIR) to the central system of TIN.

Online Tax Accounting System (OLTAS)

OLTAS is used for upload to the central system the details of tax deposited in numerous tax collecting branches across the country every day.

Central PAN Ledger Generation System (CPLGS)

It is the central system that merges the details of TDS/TCS and advance tax into the PAN.

e-TDS & e-TCS

TDS refers to Tax Deduction at Source. The third parties deduct tax at source and then deposits it at pre-determined bank branches. Since 2004–2005, it has been made mandatory to file TDS returns electronically for both the operators, the Government as well as corporate sector. Further, the Income Tax Act, 1961 states that when tax is collected at source by the seller from the buyer, it is named TCS (Tax Collected at Source). Under the scheme named 'Electronic Filing of Returns of Tax Collected at Source Scheme, 2005', the corporate and Government deductors have to pay electronically or physically to NSDL.

eSahyog initiative : Paperless Assessments

Information Technology has made the life of tax payers easy as they don't need physically go to banks to deposit bank challans and present the case and documents to assessing officers. To make further simple, the CBDT recently came up with a proposal paperless income tax assessment over emails. This would save the taxpayer to pay a visit to IT office, particularly in case of small amounts. Pilot projects in this direction have been launched in Mumbai, Delhi, Chennai, Bengaluru and Ahmedabad.

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Sevottam: Efficient grievance redressal

To bring new life to the sluggish grievance redressal system, the department is using 'Sevottam' platform that connects all income tax offices in the country. The idea is to address the queries and grievances in real time.

Faster refunds

The IT department is working towards processing and sending tax refunds within 10 working days. The initiative to verify Income Tax Return (ITR) by Aadhaar or bank database has been taken.

Pre-filled ITR forms

Despite of online forms, many people still use offline downloaded forms for tax purpose. The Department is now taking an initiative to offer pre-filled forms which automatically populated with user / taxpayer data and are downloaded with most information filled already.

PAN camps

To increase coverage of the PAN, the government has been conducting PAN camps across India. There is also a proposals to launch Income Tax Business Application-Permanent Account Number (ITBA-PAN) portal, through which anyone can apply for PAN online and get it within 48 hours.

Income Tax Rates

The personal income tax rates have been rationalized, however, currently the minimum taxable income is Rs. 2.50 Lakh.

Corporate Tax Rates

Despite of the demand to bring down the corporation tax rate to 25%, the current effective tax rate is around 34% and 42% for Indian and foreign companies. Further, Indian companies still need to pay 12% Dividend Distribution Tax, which is regressive.

Wealth Tax

Wealth Tax in India was introduced in 1957 and was levied @1% on Individuals, HUF's and Companies if the Net Wealth of such person / entity exceeds Rs. 30 Lakhs. This tax is now abolished from April 1, 2015. The loss of the revenue is to be compensated with additional surcharge on super rich tax payer earning more than Rs. 1 crore.

Direct Taxes Code

Direct Taxes Code (DTC), which was first released in 2009, sought to replace the existing Income Tax Act 1961 and Wealth Tax Act 1957 through a single legislation, with consolidation and improvements in the way taxes are collected in India. It sought to consolidate all direct taxes. The current NDA Government has put it in cold storage and will not pursue it. As per finance minister, most of its proposals have already been incorporated in the Income Tax Act, there is not merit in pursuing it.

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Indirect Tax Reforms

First Indirect Tax Reform occurred in India when the Modified Value Added Tax (MODVAT) was introduced for selected commodities in 1986 to replace the Central Excise Duty. It was gradually extended to all commodities through Central Value Added Tax (CENVAT). The states also followed the suit and enacted the VAT acts to replace the sales tax with Value Added Tax. Following are the key indirect tax reforms done.

Reduction in Custom Duties

In 1990, the custom duty on non-agricultural products was around 128%. It was brought down gradually. Currently, the average custom duties are 11-12%, however, they range from 0 to 150%.

Central Excise

Central Excise duties were first replaced with MODVAT and now CENVAT is applicable. The number of different types of duties was cut down.

Service Tax

Service tax was first introduced on some limited services in 1994-95 at 7%. The rate was gradually increased and so was the number of taxable services. Currently, we pay 14% service tax on around 100 services.

Direct Tax Code and Goods and Services Tax

The Goods and Services Tax (GST) is so far the biggest tax reform in the country. It is currently entangled into the murky politics in parliament.

Goods and Services Tax

Goods and Services Tax is a comprehensive indirect tax which is to be levied on the manufacture, sale and consumption of goods and services at a national level. This is so far the biggest tax reform in the country. France was the first country to introduce GST system in 1954. More than 140 countries have implemented the GST. Most of the countries have a unified GST system. Brazil and Canada follow a dual system where GST is levied by both the Union and the State governments.

Background

Genesis of the GST occurred during the previous NDA Government under Atal Bihari Vajpayee Government when it set up the Asim Dasgupta committee to design a model for GST. The UPA Government took the matter further and announced in 2006 that this tax would be introduced from April 1, 2010. However, so far it has not been introduced. It is now proposed to be introduced from April 1, 2016.

Rationale

The indirect taxes such as excise duty, sales tax, service tax, octroi, customs duty etc. are currently imposed on goods and services and are levied by both centre and states. There are multiple

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incidences on taxes and cascading impact on the cost of finished goods. For example, prior to MODVAT and VAT reforms, the excise duty was imposed on both inputs used and output produced as well as each intermediate product. This led to multiple taxation incidents and that would have a cascading effect on the prices of the goods. The Sales tax was also incident upon for multiple times in the entire distribution chain.

VAT regime solved this problem to a great extent but several problems still remain. Many central and state taxes and few sectors such as real estate, oil/gas sector remained out of VAT. Further, each state levied VAT differently making it a very complex matter.

The problem is compounded in the interstate transport and trade of the goods. Currently, different forms are needed to be kept in different states during the entire logistics operations. The first problem is getting these forms as they are maintained in serial numbers. Second problem is of these forms to be presented as each of the check posts, if the trucker is not able to do so, the truck is detained. The checking of these documents itself is cumbersome so we can see long lines on the check posts. The result is a drastic increase in the transit time from the source to destination. It is said that in India, the transit time is 50% higher than other countries. The direct implication of this is the decrease in the return on investment per truck.

Many of these problems are addressed by the Goods and Services Tax.

Need for Constitutional Amendment

Article 264 & 293 are related to the financial relations between the Union and the State Governments. Since, the state Governments have their interests in GST, the implementation of GST cannot take place without amendment of the Indian Constitution For this purpose, Constitution (122nd Amendment) Bill, 2014 is currently pending in the parliament. The bill was passed in Lok Sabha on May 06, 2015 and currently needs to be passed in Rajya Sabha where ruling coalition is in minority.

Proposed New Articles in Constitution

Article 246A

This articles provides that both parliament and state legislatures shall have concurrent powers to make laws with respect to goods and services tax (GST). The Parliament will retain exclusive power to legislate on inter-state trade or commerce.

Article 269A

In case of the inter-state trade, the tax will be levied and collected by the Government of India and shared between the Union and States as per recommendation of the GST Council.

Article 279A

This article provides for constitution of a GST council by president within sixty days from this act

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coming into force.

Proposed important amendments in existing articles

- The residuary power of legislation of Parliament vi article 248 wll be made subject to article 246A.
- Article 249 will be changed so that if 2/3rd majority resolution is passed by Rajya Sabha, the Parliament will have powers to make necessary laws with respect to GST in national interest.
- Article 250 would be amended so that parliament will have powers to make laws related to GST during emergency period.
- Article 268 would be amended so that excise duty on medicinal and toilet preparation will be omitted from the state list and will be subsumed in GST.
- Article 268A will be repealed / modified so that service tax is subsumed in GST.
- Article 269 would empower the parliament to make GST related laws for inter-state trade / commerce.

Scope of GST

- GST is one tax applicable to both goods or services. There will be no service tax once GST is implemented. There will be no cesses either in indirect taxes. Exports are zero-rated.
- Alcoholic liquor for human consumption is exempted. Further, GST will not be applicable to crude oil, high speed diesel, petrol, natural gas, aviation turbine fuel as of now. When the GST will apply to these items- is to be decided by GST council later on.
- Tobacco and tobacco products will be subject to GST. The centre may also impose excise duty on tobacco.

Levy of GST

- The power to make laws on taxation of goods and services would be vested in both Parliament and state legislatures. Further, a law made by Parliament on GST will *not override a state law* on GST.
- In case of inter-state trade / commerce, an Integrated GST (IGST) will be levied and collected by the Central Government.
- Parliament will by law prescribe how the IGST will be shared between centre and states on recommendation of GST council.
- The central government will also imposed 1% tax on supply of goods in case of inter-state trade or commerce. This tax is to be collected by centre and to be assigned to state from where the supply of good originated. This tax is to be levied for 2 years or for a longer period as recommended by GST council.

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GST Council

GST Council will be a constitutional body established by president of India. It's composition will be as follows:

- Chairman – Union Finance Minister
- Minister of State (Finance)
- Finance Minister as member from each state
- The meetings of the GST Council can proceed with a quorum of 50 percent and decisions will be taken with a at least three-fourth weighted majority voting for a resolution. All decisions of the GST Council will be made by three-fourth majority of the votes cast; the centre shall have one-third of the votes cast, and the states together shall have two-third of the votes cast.

Functions of GST Council

The functions of the GST council would be to make recommendation on

- What taxes, cesses, and surcharges to be subsumed under the GST?
- What goods and services are subject to, or exempted from GST?
- The threshold limit of turnover for application of GST
- Rates of GST
- Model GST laws, principles of levy, apportionment of IGST and principles related to place of supply
- Special provisions with respect to the eight north eastern states, Himachal Pradesh, Jammu and Kashmir, and Uttarakhand
- Other related matters

Compensation to states

The proposed bill says that the parliament would enact law for compensation to states for revenue losses arising out of the implementation of GST. This will be done on the basis of recommendations of the GST Council. Such compensation could be for a maximum of five years.

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General Knowledge Today

Government Budgeting-3: GST, Fiscal Policy, FRBM, Investments

Target 2016: Integrated IAS General Studies

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Model Questions

Prelims Topics for MCQs

Special Majority, Fiscal Policy versus Monetary Policy, Components of Fiscal Policy, Constitution articles related to India's Fiscal Policy, FRBM documents that need to be placed with budget, Financial Investment and Real Investment, Induced and Autonomous Investment, Impact of monetary and fiscal policies on Investments, Types of Growth Models.

Mains Model Questions

1. To what extent the proposed Goods & Services Tax has potential to alleviate the tax-on-tax problem? Substantiate your answer.
2. Discuss the concerns of the states with respect to the Goods and Services Tax. To what extent, these concerns have been addressed in the current GST model as proposed in Constitution 122nd amendment Bill.
3. The demand for an independent GST Dispute Settlement Authority seems to be more logical in comparison to GST Council. Analyze.
4. The proposed 1% additional levy on supply of goods under GST will contradicts the actual purpose of GST introduction. Comment.
5. Explain the concept destination-based taxation? How the GST proposes to implement the destination-based taxation system and what are the implications of it?
6. "The success of a GST system is largely dependent on the width of its coverage." Comment.
7. Critically examine the potential implications for small sector business and consumers.
8. Discuss the impact of the GST implementation on inflationand GDP with special reference to the Make in India campaign?
9. Discuss the key elements of fiscal policy of the government.
10. "The overarching framework for India's fiscal policy is provided by the constitution." Amplify.
11. "It appears that the FRBM act and the rules framed for fiscal discipline was an exercise in futility.". Discuss suggesting steps towards fiscal dicipline with reference to FRBM Act 2003.
12. Differentiate between Induced and Autonomous Investments. Why governments try to boost the autonomous investment?
13. Objectively differentiate between Demand-led, Investment-led and Consumption-led Economic Growth models. Which model suits to Indian Economy. Discuss.

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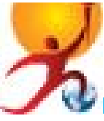

14. Why the Investment led growth is not considered to be sustainable? Examine citing examples.
15. Discuss various factors that influence the Foreign Investment Decisions.

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In this document, we continue our discussion on GST from Government Budgeting-2 document.

Analysis: Key Issues with GST

GST will come into effect by enactment of constitution 122nd amendment bill. This bill is the current and slightly modified version of Constitution 115th amendment bill, which was proposed by the UPA Government in 2011 but failed to get it passed. The 122nd amendment bill was cleared in Lok Sabha on May 6, 2015 but is currently stalled in Rajya Sabha where ruling dispensation is in minority.

To become a law, the bill needs to be passed by *special majority in* both Houses, and ratified by 50% of states. Special majority is the majority of the total membership of that House and by a majority of not less than two-thirds of the members of the House "present and voting".

GST and its impact on cascading effect of taxes

There are three important elements of GST:

- First, it is a unified tax taking the form of a dual GST to be levied concurrently by both levels of governments and would comprise of a Central GST and a State GST. It would combine the taxes such as excise, sales and services. It is going to replace 17 taxes and it is argued that it would lead to ease of doing business.
- Second, GST is essentially a Value Added Tax This implies that it would be calculated on value addition and not only the value of the goods or service.
- Third, GST has to remove the cascading effect of the tax-on-tax problem and profit on tax problem. It is argued that this would lead to a fall in prices.

There is no doubt that GST would be simplifying the indirect tax regime however, it appears overhyped. Even under GST, there are going to be three taxes viz. *CGST to be collected by Centre, SGST to be collected by States and the IGST to be collected by centre on inter-state sales of the goods.* Thus, it appears that the CGST, SGST and IGST are nothing but new names for existing Central Excise/Service Tax, VAT and CST.

This apart, it is likely that *alcohol, tobacco and petroleum products* would be left out of purview of GST mainly because of pressure from states. Further, electricity and real estate is also being left out of the GST net and thus they would be taxed separately. In summary, the cascading effect of some taxes is going to stay and not to be alleviated completely.

Issue of Revenue Neutral Rate (RNR)

Because GST removes the problem of tax on tax and cascading effect of various taxes; and because GST is a value added tax, it is expected that tax collection would fall when it comes into effect. This

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implies that government tax revenue will come down when India moves to the GST regime. If the government wishes to collect the same amount of tax as in earlier tax regime, it needs to raise tax rate to make adjustments. This increased tax rate has been called the Revenue Neutral Rate (RNR).

What should be the revenue neutral rate? This has been a contentious issue. The government had set up several committees to arrive at such rate. The initial panels (including 13FC) recommended that RNR should be slightly above 12%. However, states called this rate too low and objected because they would be bearing the brunt of low tax revenue collection.

Subsequently, a Delhi based think tank National Institute of Public Finance and Policy (NIPFP) was asked to compute the RNR. This think tank proposed a 26.68% RNR (12.77% CGST and 13.91% SGST). This rate is practically very high because globally, the average GST or VAT rate is around 16%. Thus, this number was neither politically not practically satisfactory. Currently, the deliberations are on to identify the most appropriate number which can be around 23 to 25%. The Congress party had asked the Rajya Sabha select committee for capping the GST rate at 18 per cent.

A possible implication of high RNR is inflation, which reduces the demand in economy and will affect rate of growth. The government cannot give up RNR because if it does so, its revenue would fall and states would suffer. This is the main worry of the states. We note here that the Centre has been proposing to compensate the states for their revenue losses but then, it will increase deficit of the centre.

In June 2015, a panel headed by Chief Economic Adviser Arvind Subramanian, was set up to prescribe a RNR which strikes a balance so that the rate is not too high for industry and simultaneously high enough, so that states do not suffer any revenue loss. The committee will also suggest the impact of GST rollout on inflation. The Committee is expected to submit its report in December this year.

Concerns of the States

The state governments have the following issues:

- A lower GST rate might mar their existing revenues and they may need to look up to the centre for compensation.
- They are not ready with the information technology systems and the administrative infrastructure.

Various state Governments have sought assurances that their existing revenues will be protected, fearing that if the uniform tax rate is lower than their existing rates, it will hit their tax kitty. The centre believes that dual GST will lead to better revenue collection for States.

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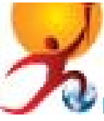

IT Infrastructure for the GST: GSTN

A robust IT infrastructure is prerequisite to successful implementation of GST. The current status is as follows:

- For central taxes, the IT infrastructure is managed by the NIC and all the returns are filed through the ACES site.
- For states, the tax infrastructure is managed by the tax departments of respective states. *There is a huge inequality in the IT infrastructure among the states.*

In the proposed GST, government would be consolidating the returns to be filed and a new infrastructure has to be created from scratch. For this, a new entity*Goods and Service Tax Network (GSTN*) in the form of a *non-government private limited company* was created in March 2013.

In September 2015, Infosys had bagged Rs. 1380 Crore contract from central government to build the technology infrastructure for Goods and Services Tax Network (GSTN). Infosys will work as managed service provider (MSP) for GSTN and the contract is for five years.

The GSTN company would provide IT infrastructure and services to the Central and State governments, tax payers and other stakeholders for implementation of the Goods and Services Tax (GST).

The Issues around GST Council

The GST bill seeks to set up a GST Council. The GST Council aims to develop a harmonized national market of goods and services. According the GST Bill, the President must constitute a GST Council within sixty days of this Act coming into force. The composition of the GST Council includes:

- The Union Finance Minister (as Chairman),
- The Union Minister of State in charge of Revenue or Finance, and
- The Minister in charge of Finance or Taxation or any other Minister, nominated by each state government.

The decisions of the GST Council will be made by three-fourth majority of the votes cast. The centre shall have one-third of the votes cast, and the states together shall have two-third of the votes cast.

The GST Council will make recommendations on:

- taxes, cesses, and surcharges to be subsumed under the GST;
- goods and services which may be subject to, or exempt from GST;
- the threshold limit of turnover for application of GST;
- rates of GST;
- model GST laws, principles of levy, apportionment of IGST and principles related to place of

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supply;

- special provisions with respect to the eight north eastern states, Himachal Pradesh, Jammu and Kashmir, and Uttarakhand; and
- other related matters.

The GST Council may decide the system of resolving disputes arising out of its recommendations. The GST Council will also decide when the GST would be levied on petroleum crude, natural gas, high speed diesel, aviation turbine fuel and motor spirit (petrol).

The Congress Party has opposed the composition of the council which gives the one-third weightage to the central government. It is demanding for the one-fourth of representation to the Central government. The Congress Party has also proposed for an independent dispute settlement mechanism.

GST and Issue of Dispute Resolution

The current GST bill seeks to entrust the power of dispute resolution to the GST Council, comprising the Centre and states, instead of an independent body like *GST Dispute Settlement Authority* as proposed in UPA government draft. A dispute redressal mechanism is needed as issues are bound to come up between states, or the Centre and states, or even with local bodies.*The proposed GST Council as the dispute resolution body is criticised on the ground that how can it resolve the disputes arising out of its own recommendations.*

The GST Council provides veto power to centre along with state governments. The GST Council will give the Centre one-third voting power and the states two-thirds. Any decision will need three-fourth of the votes. Thus, neither the states together nor the Centre alone can change the GST. However, the dispute resolution body cannot work on this principle. Because any dispute resolution mechanism would need a judicial member. The authority was supposed to have a former Supreme Court judge or chief justice of a high court as its chairman. In GST Council each state, whether big such as Uttar Pradesh or Madhya Pradesh or small such as Uttarakhand or Chhattisgarh, will have the same voting percentage with it. The weak states may sometimes become orphan as they cannot woo the stronger states to support them.

Any dispute resolution mechanism whether it is independent or other way should resolve the issues in an amicable manner by giving due say to each of the parties to the dispute.

Issue of GST being a Destination based Tax

Indirect taxes can be either origin based or destination based. Origin based tax (also known as production tax) is levied where goods or services are produced. Destination based tax (consumption tax) are levied where goods and services are consumed. In destination-based taxation, exports are

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allowed with zero taxes whereas imports are taxed on par with the domestic production.

In case of the inter-state trade of goods and services, there may be two undesirable instances of *double taxation* or *tax avoidance* due to origin and destination based taxes. Firstly, some goods might be taxed in both the states of origin and destination, leading to double taxation. Secondly, the goods might skip tax in both the states thus leading to tax evasion. The first instance of double taxation in India is so high that importing goods from abroad is cheaper than importing it from other state.

The 13th finance commission had recommended that GST may be*either origin based or destination based.* If it is destination based, revenue should belong to the states where the goods are finally consumed and not to the State where the goods are produced. If its origin based tax, should accrue to state, where the goods or services are produced and not to the State where they are consumed. As per current proposals, the GST will be a destination-based tax. This implies that all SGST collected will generally accrue to the State where the consumer of the goods or services sold resides. This simply means that the producing state gets nothing if produced goods are sold outside that state.

There are several implications of this, discussed as below:

- Firstly, destination based GST would be very much beneficial for the states which consume more goods / services than they produce. The more they consume the more revenue they get from inter-state trade but such benefits that *come via increased consumption* are not good for overall economy of the state.
- Secondly, the destination based tax may not be very encouraging for the states which produce these goods because nothing will accrue to them.
- Thirdly, to discourage consumption, some states might put restriction on inter-state movement of goods. Such move might adversely affect the economy.

The move from origin based to destination based indirect tax regime would lead to drop in revenues of some states. This was the reason that some states such as Gujarat have opposed GST, which is a destination based tax. The central government has promised to compensate such states for a period of five years.

There are counter arguments to the revenue loss concept of producer states. The increased exports will increase the income of the producer state and the increased income may increase the consumption and thereby the revenue of the state will improve.

GST and the concept of ' Supply of Goods"

Under GST, the definition of goods has been replaced with the "supply of goods". Under the present indirect tax regime in India various central and state levies are triggered by distinct taxes like service tax provision of services, VAT on sale of goods and excise duty on manufacture of goods. The GST

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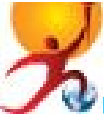

proposes to subsume all these taxes into a single tax trigger – "supply".

Taxable event

GST is a tax on the supply of goods and services. Though 'supply' has not been defined, it is not restricted by the traditional terms such as 'sale' and 'manufacture'. Under GST, all goods and services transactions will be taxed, unless they are specifically excluded. Therefore, we can expect a wide range of activities (which are not taxable under present regime) to become liable to GST, given that a supply will subsume multiple taxable events. For example, the manufacture and sale of goods currently attracts two separate levies (excise duty and VAT), will attract a single levy as a supply under the GST regime (central GST and state GST).

The important outcome of 'supply' being the tax trigger is the *elimination of the potential for dual taxes.*

GST will likely be levied on supplies of both goods and services at same rate. Under the GST bill, the term 'services' has been defined as "anything other than goods". This mutual exclusivity will be followed in various GST laws enacted by the states and central government. This will solve various longstanding disputes in relation to the duality of taxes.

With the introduction of the concept of 'supply'- even supplies of personal goods or supplies of goods to agents could attract GST. This would ensure the continuity of the tax chain, allowing credit to flow freely.

Place of supply

The rules governing the place of supply are closely linked to the taxable event. The rules of place of supply will determine not only whether a given transaction is subject to GST, but also determine which state can claim to the state GST component built into central GST. As GST is a destination-based consumption tax, the rules for the place of supply should be aligned with this principle. As per the destination-based principle, the default rule for determining place of supply is the location of the recipient. The supply rules for the services will be more complex as the place of supply cannot be determined in some cases like telecom services and supply of fuels through dedicated pipelines. The place of supply rules must be simple and clear to address the issues related to place of supply of services– particularly given the growth in e-commerce and electronic delivery of services. Any ambiguity in rules may result in endless disputes not only between taxpayers and the revenue authorities, but also between states that assert jurisdiction over the supply of goods and services.

Issue of Proposed 1% levy on Supply of Goods

The proposed GST is a destination-based consumption tax. The taxes will accrue to the state where consumption of goods happens. This is opposed by the producer states as they have spent on infrastructure and now they won't get any benefit under the GST model.

To allay the problems of those manufacturing states, the*NDA government has provided for an*

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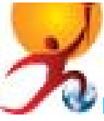

*additional levy of 1% over the GST for supply of goods for a two year time period.*However it is criticised on the grounds that it could make the intra-sate movement of goods more expensive and it will hurt the Make in India campaign. For example, if a good is going form Gujarat to Tamil Nadu, crossing four states, the good would embody an additional tax of about four-five percent, because it is 1% for each state. This makes it easier to import the good from Thailand to Tamil Nadu. The 1% levy will burden the individuals in the consumption state and so is opposed by the northern and eastern states. Many economists are also argued that there is no point implementing the GST in this manner and it should be delayed till it can be launched as a single tier levy. The 1% additional levy also creates the distinction between the manufacture of goods and provision of services. The GST Council has the power to extend the levy beyond the proposed interim period of 2 years. This presents a major concern of the additional levy remaining over a long period of time. The proposed levy also violates the principle of "Supply of goods". The solution to the issue is the centre should drop the 1% additional levy and compensate the states directly for a two year time period.

GST Possible Implications

Till now, introduction of Value Added Tax (VAT) at the state level and CENVAT at central level are considered to be largest indirect tax reforms in the country and GST is the next logical step towards making India a unified market. The biggest advantage of GST is economic unification of India. It has potential to end the long-standing distortions arising out of the differential treatment of the manufacturing and service sectors. Further, it would also improve tax compliance by making it easier for businesses to return files, pay taxes and get refunds. For importers, the input tax credit would be available for countervailing duty of customs (CVD) and additional customs duty (ACD) and thus would help them. GST would substantially enhance the competitive edge of both the manufacturing and services industry by removing the disability that domestic producers suffer from. The following are specific implications of GST on various stakeholders.

Impact of GST on Consumers and businessmen

The several types of taxes that currently exist such as excise, octroi, sales tax, CENVAT, Service tax, turnover tax etc. would come under the GST umbrella. Since this would eliminate double taxation, it might result into fall of prices; thus relieving consumers.

This is also because the GST provides tax credit at every stage of taxation from manufacturing to consumption. Currently, margin is added at every stage and tax is paid on the amount including margins. These taxes on profit and taxes on tax add to the cost of goods and services whose burden is to be borne by the final consumer. GST would provide a continuous chain of set- off from the producer's point to the retailer's point and would result in fall in prices. The chain of set offs would

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also result in better tax compliance of industry, trades and businessmen.

For businesses, the GST would make life easy because of easier compliance (due to absence of multiple taxes) and easier return filing, tax payment and refund process due to robust IT infrastructure.

Impact of GST on Services

Currently, central government levies service tax for more than 100 services. No sales tax / VAT are levied by the states on services. However, once GST is in place, the service providers would need to pay the SGST to the states. Further, there will be a common tax rate on all services. This implies that services might become costly when GST is in place.

Impact of GST on Small Businesses and Unorganized sector

The GST is not applicable until gross annual turnover crosses Rs. 10 Lakh. A few states, which have lower VAT threshold, will be at loss and the Central Government promises to compensate them. The GST is unlikely to benefit the unorganized sector because it would not get any tax credit for purchases that it makes from organized sector. Further, if a business from unorganized sector sells the goods to unorganized sector, it would not be able to pass on the benefits of setoff. Due to this, it can be expected that unorganized sector might become less competitive and may face decline. Any such decline might further aggravate the unemployment in the country.

Implications of GST

1. Abolition of multiple taxes
2. Increase in voluntary tax compliance
3. Removes distortion in economy
4. Removes cascading effects of taxation
5. Enhances manufacturing and distribution efficiency
6. Widening tax base

Impact of GST on Inflation Management and GDP

The GST with its uniform taxation structure can be one of the most important steps towards achieving the task of inflation management and GDP growth. The current indirect tax regime suffers from significant cascading which leads to higher cost of goods and services consumed in the country. There are also numerous examples where the tax payers or consumers have to pay both Centre and

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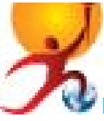

State taxes on a single sale which adds to increased tax costs for business and consumers. Such increase costs add to the inflationary pressure in the economy.
In the GST regime, a free flow of credits across transactions decrease the tax cost for businesses. Given that both Centre and State taxes would be levied simultaneously on all supplies, the issue relating to dual taxation on certain products would also come to rest. The decrease in tax costs would boost the exports in the country. The reduction of costs in India would make our products more competitive in the international market thereby not only increasing the GDP of the country but also inflow of foreign currency. There are also estimates that GST can add 2% to GDP.

Impact of GST on Make-in-India

The 'Make in India' campaign is proposes to make India a world-class manufacturing hub. The tax reforms through GST will play a crucial role to attract large scale investment. The impending Goods and Service Tax (GST) promises a progressive tax system which avoids tax cascades and helps establish India as a true common market. GST will reduce the cost of production and allows the hassle free supply of goods. This can increase the ease of doing business India.

Key current challenges to GST

Currently, challenges to implementation of GST are as follows:

- Enactment of Constitution amendment bill needs consensus among ruling and opposition parties because ruling party is in minority in Rajya Sabha.
- Setting up IT infrastructure and an enabled centralised agency to settle the IGST claims and work as a clearing house.
- To estimate and formulate a Revenue Neutral Rate (RNR) of the tax, although centre has taken lead to comfort the states by promising compensation for five years.
- The estimation of the tax base in each of the states and since the threshold for the centre and states are different, of the tax base of the centre as well
- How the 'hard to tax' sectors will be dealt with. Such sectors include financial services, real estate and housing. As of now, real estate is left out of purview but later, its inclusion would be warranted.
- The training of tax personnel at both at the Central and state levels.
- To create a permanent institutional arrangement to negotiate, harmonise and monitor the reform process as well as the working of the new tax system.

Success of a GST Width of its coverage

The success of a GST system will dependent on the width of its coverage. All items in the tax chain must ideally be included in the GST system to achieve the best results. That will eliminate the

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incidence of paying tax on taxes, reduces the cascading effect of a tax system and enables producers of goods and services to enjoy the set-off benefits on the taxes they may have paid at various intermediate stages. But the proposed GST regime excluded potable alcohol, tobacco and petroleum products. Taken together, they account for a large chunk of the indirect taxes base in the country. This exclusion is largely triggered by some of the state governments desire to preserve their revenue. Added to this the real estate sector will not be covered under the proposed GST. Thus, all construction activities and the expenditure incurred on them would be outside the GST chain. The new GST regime with all these imperfections may perpetuate the barriers. However, it would be good to make a beginning even with an imperfect GST, with all its flaws, as long as the government is committed to addressing the concerns that arise over time.

Fiscal Policy

Objectives and Components of Fiscal Policy in India

The word *fiscal* comes from a French word *Fisc*, which means *treasure of Government.* All the *taxation and expenditure decisions* of the government comprise the Fiscal Policy.

Fiscal Policy is different from monetary policy in the sense that monetary policy deals with the supply of money and rate of interest. The government and RBI use these two policies to steer the broad aspects of the Indian Economy. *While government is conducts Fiscal Policy, RBI is responsible for monetary policy.* RBI also helps the government in implementing its fiscal policy decisions.

Conducting fiscal policy is one of the main duties of the government. Via fiscal policy, the government collects money from different resources and utilizes it for different expenditures. Since all welfare projects are carried out under public expenditures, fiscal policy is closely related to the development policy.

Objectives of Fiscal Policy

The objectives of the fiscal policy of the government are as follows:

Resource Mobilization

Fiscal policy allows the government to mobilize resources for public expenditure and development. There are three ways of resource mobilization viz. taxation, public savings and private savings through issue of bonds and securities.

Resource Allocation

The funds mobilized under fiscal policy are further allocated for development of social and physical infrastructure. For example, the government collected tax revenues are allocated to various ministries to carry out their schemes for development.

Redistribution of Income

The taxes collected from rich people are spent on social upliftment of the poor and this fiscal policy

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in a welfare state tried to reduce inequalities of income using resource allocation.

Price stability, control of Inflation, Employment generation

Government uses fiscal measures such as taxation and public expenditure to stabilize the prices and control inflation. Government also generates employment by speeding infrastructure development.

Balanced Regional Development

A large part of the government tax revenues are given out to less developed states as statutory and discretionary grant. This helps in the balanced regional development of the country.

Balance of Payments

Using fiscal policy measures government tries to promote exports to earn foreign exchange. This helps in maintaining favourable balance of trade and balance of payments.

Capital Formation and National Income

Fiscal policy measures help in increasing the capital formation and economic growth. Increased capital formation leads to increase in national income al

Components of Fiscal Policy

There are four key components of Fiscal Policy are as follows:

- Taxation Policy
- Expenditure Policy
- Investment & Disinvestment policy
- Debt / surplus management.

Taxation Policy

We have already discussed in detail about the taxation policy in previous module. The government gets revenue from direct and indirect taxes. Via its fiscal policy, government aims to keep the taxes as much progressive as possible. Further, judicious taxation decisions are very important for economy because of two reasons:

- Higher than usual tax rate will reduce the purchasing power of people and will lead to an decrease in investment and production.
- Lower than usual tax rates would leave more money with people to spend and this would lead to inflation.

Thus, the government has to make a balance and impose correct tax rate for the economy.

Expenditure Policy

Expenditure policy of the government deals with revenue and capital expenditures. These expenditures are done on areas of development like education, health, infrastructure etc. and to pay internal and external debt and interest on those debts. Government budget is the most important instrument embodying expenditure policy of the government. The budget is also used for deficit financing i.e. filling the gap between Government spending and income.

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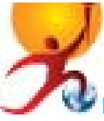

Investment and Disinvestment Policy

Optimum levels of domestic as well as foreign investment are needed to maintain the economic growth. In recent years, the importance of FDI has increased dramatically and has become an instrument of integrating the domestic economies with global economy.

Debt / Surplus Management

If the government received more than it spends, it is called surplus. If government spends more than income, then it is called deficit. To fund the deficit, the government has to borrow from domestic or foreign sources. It can also print money for deficit financing.

India's Fiscal Policy Framework

The overarching framework for India's fiscal policy is provided by the constitution. This framework is made of:

- Article 246, Article 248 (residuary power of taxation) and Seventh Schedule
- Article 280 provision for Finance Commission
- Article 112 and other articles related to Budget
- Part IX and IX-A (local administration)
- Article 360 (Financial Emergency)

Article 246 and Seventh Schedule clearly divide the powers of taxation between Central and the State governments. Article 248 makes provision for enabling parliament to exercise residual power of taxation when a particular subject of taxation is not available in any of the Union, State or Concurrent list of the constitution. Further, there are provisions for financial powers of local administration in part IX and IXA.

Since the tax powers of states is not equal to the centre, the constitution makes provision for a finance commission via article 280 which recommends allocation of some resources of centre to states via statutory grants and discretionary grants. The constitution also mandates the central government to prepare budget or annual financial statement of its proposed taxation and expenditure for Legislative debate and approval in the parliament under article 112.

Fiscal Responsibility and Budget Management Act, 2003

In 1980s, India saw a sharp deterioration of the fiscal situation, which ultimately culminated in the balance of payments crisis of 1991. Within a decade of economic liberalisation, the fiscal deficit and debt situation again seemed to head towards unsustainable levels around 2000. At that time, a need to *institutionalize a new fiscal discipline framework*. The FRBM Bill 2000 was introduced by previous NDA government in the parliament to institutionalize the fiscal discipline at both the centre and state level. However, the bill took three years to become an act and during this process, it lost most of

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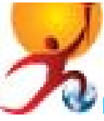

its teeth.

Under the Fiscal Responsibility and Budget Management Act (FRBMA) 2003, both the Centre and States were supposed to wipe out revenue deficit and cut fiscal deficit to 3% of GDP by 2008-09, thus bringing much needed fiscal discipline. Originally, the FRBM bill had given annual numerical targets as well. But in the process of making it a law, the annual targets were dissolved and the act simply said that the Centre will take appropriate measures to eliminate revenue deficit by March 31, 2008. The act left the annual numerical targets to be formulated by the Central Government in the form of FRBM rules under the FRBM Act 2000.

However, the NDA government (which passed this act) was replaced by UPA in 2004. The UPA-I Government notified the FRBM Rules in July 2004. As Parliament is the supreme legislative body, the Act and the Rules legally bind the Finance Ministers and Governments. The key provisions of the Act as well as FRBM rules are as follows:

- Every year the government will bring down revenue deficit by 0.5% and eliminate it by 2007-08.
- Every year, the government will bring down fiscal deficit by 0.3% and bring it down to 3% by 2007-08.
- Total liabilities of the Union Government should not rise by more than 9% a year.
- Union Government would not give guarantee to loans raised by PSUs and State governments for more than 0.5% of the GDP in aggregate.
- Union Government would place three more documents along with the budget documents viz. Macroeconomic Framework Statement, Medium Term Fiscal Policy Statement and the Fiscal Policy Strategy Statement.
- At the end of second quarter, the Finance Minister would make a statement on the trend of fiscal indicators and corrective measures taken thereof.

However, due to the 2007 international financial crisis, the deadlines for the implementation of the targets in the act was initially postponed and subsequently suspended in 2009. In last few years, the act has been largely neglected.

> Central Government is required to lay before both Houses of Parliament the following documents: (1) Medium Term Fiscal Policy Statement (2) Fiscal Policy Strategy Statement and (3) Macro Economic Framework Statement along with Annual Financial Statement and Demand for Grants.

Critical Analysis of the FRBM Act

The act was passed to make the central government and finance minister accountable to parliament

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for fiscal discipline. However, due to lack of an autonomous Fiscal Management Review Committee (as proposed originally) the act more or less became like a Directive Principle of State policy which is not enforceable via courts. Its mandate was diluted and even today we find both revenue deficit and fiscal deficits in budget documents.

Why Government deviated from path of fiscal correction?

The government deviated from the path of fiscal correction in the wake of the global financial crisis and unanticipated changes in the prices of oil and fertilizers in 2008-09. In those days, the subsidy bill shot up and government needed to issue fertilizer and oil bonds to raise money from market. Further, in 2008-09, the government also included a fiscal stimulus package to revive the economy and this led India's fiscal deficit to go up to 6.5%.

A huge fiscal deficit forced the government to relax the FRBM targets and subsequently ask the 13th finance commission to rewrite the whole plan for fiscal consolidation.

In 2010-11, Government gave further blow to this act by including the concept of*Effective Revenue Deficit* in the budget documents. In Budget 2012-13, the finance act changed the FRBM act and dumped the centre's commitment to eliminate the revenue deficit. Instead, it brought in a new commitment of eliminating the effective revenue deficit rather. The amended rules extended the time for elimination of Effective revenue deficit by March 2015 and bringing down fiscal deficit to 3% by March 2017. Currently we have 2.9% revenue deficit and 4.1% fiscal deficit.

From the above discussion, it appears that the FRBM act and the rules framed for fiscal discipline was an exercise in futility. The government wants fiscal consolidation but is not ready to pay the short term costs. Increasing taxes to raise revenue is painful, while cutting subsidy has political costs to the ruling parties. In summary, the experience with FRBM has been of shifting goalposts and bypassing the spirit to achieve fiscal consolidation.

Where is the problem?

The problem lies in the act itself. The FRBM rules can be simply amended by gazette notification. They lack transparency and adequate monitoring and compliance by the government. The Economic Survey 2013-14 had recommended for a new FRBM act with teeth. Further, there are some other approaches which can help:

- Move the annual numerical targets from FRBM rules (which are framed and amended by central Government at whim by gazette notification) to the FRBM act itself (so that at least a parliamentary approval is needed to make changes)
- Do away with the ambiguous concept of the Effective Revenue Deficit which is nothing but a jugglery to rewrite revenue expenditure as capital expenditure.

The FRBM Committee Report of 2000 had recommended an autonomous Fiscal Management

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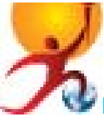

Review Committee (FMRC) which would conduct an annual independent and public review of FRBM compliance. The current act lacks that, and there is a need to institute an independent review and monitoring of implementation of the FRBM law.

Investment Models

Basic Concepts

Financial Investment and Real Investment

The meaning of the term "**investment**" is different for economists than the rest of the world. When we ask our banker for investment, he / she would probably start taking about stocks, mutual funds, some deposit accounts or insurance products. But, for an economist, these purchases of financial assets are **NOT investment** simply for the reason that financial assets do not represent real net wealth for the economy as a whole. Rather, when somebody purchases a financial asset, it would reflect the credit relationship within the economy. For example,

- Loans and bank accounts represent contracts to pay interest and repay principal on borrowed money.
- Stocks represent partial ownership of a corporation, or right to receive dividends etc.

In these cases, the financial asset of one party in the economy would be offset by a financial liability of another party. Thus, when we aggregate the wealth of all members of the economy, these assets and liabilities cancel and financial assets disappear. This implies that when I am investing in an asset, somebody is disinvesting at the same time. *By my investment in a financial asset, the aggregate or social investment doesn't increase. Such an investment only signifies change of ownership. This kind of investment has significance only from individual point of view; it has no importance from social point of view.*

An economist would reserve the term investment for those transactions that *increase the magnitude of real aggregate wealth in the economy*. This implies that investment refers to creation / purchase of new durable assets such as factories and machines, which are used for production. Here please note that resale of the assets is not counted in such investments.

In the expenditure side computation of the National Income, the GDP is represented by a formula **GDP = C + I + G + NX,** where C is consumption, I is investment G is government spending, and NX is net exports, given by the difference between the exports and imports, X – M. By this, we can arrive at

I=GDP-G-NX

This means *investment is everything that remains of total expenditure after consumption, government spending, and net exports are subtracted. This kind of investment results in* ***net addition to the total capital***

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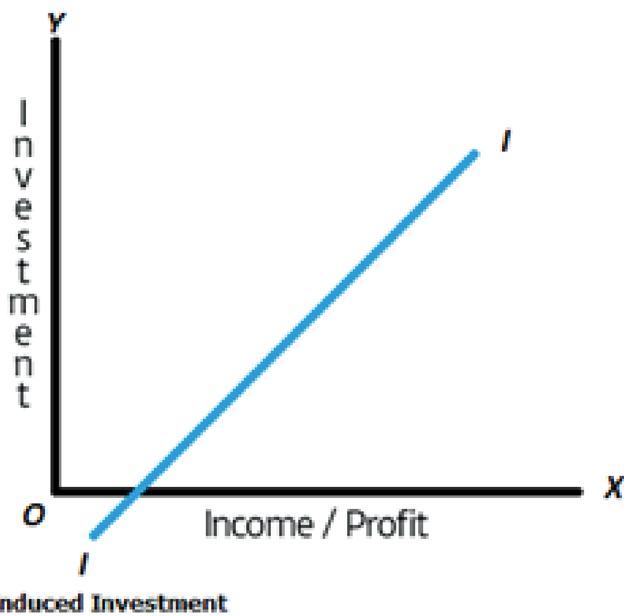
stock of the society, *causing increase in employment. This is called* ***Real Investment.***

Notable points: Real Investment

- Real Investment results in increment of capital equipment
- By real investment, we don't mean to purchase the existing paper securities, bonds, debentures or equities, but the purchase of new factories, machines, railroads etc.
- Investment expenditure is a related concept, which refers to the expenditures which are done for producer's durable equipments, new construction and the change in inventories.

Induced and Autonomous Investment

Induced investment is that investment which is governed by income and amount of profit. The inducing factors are changes in income and profit. Where there is a possibility of increase in income and profit, the induced investment increases and when there is a decreased possibility of income and profit, the induced investment decreases. This implies that the induced investment is profit and income elastic. In simple language, when increase in investment is due to the increase in current level of income and production, it is known as induced investment. The relations of the income/ profit and investment are shown by the below graph.



Induced Investment

The graph shows that at very low level of income / profit, the induced investment may be negative also. Autonomous investment is that investment which is independent of the level of income or profit. Thus, it is not induced by any changes in the income. The investments which are made with the aim of introducing new techniques, new inventions etc. or enhance the level of effective demand during the period of depression and unemployment are kept in the category of autonomous investments. Thus, the autonomous investment is generally associated with:

- Introduction of new techniques of production

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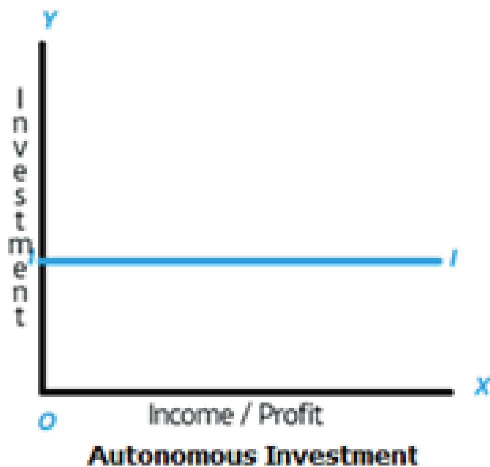
- Development of new resources
- Growth of population
- Depression or recession.

In the graphical representation, the autonomous investment remains parallel to the Income/ profit axis as shown in the below graph.



Autonomous Investment

There will be no change in investment whether the income increases or decreases. Please note that autonomous investment does not vary with variation in income. It does not mean that autonomous investment does not change at all. The autonomous investment **can be increased and decreased** any time, notwithstanding the changes in income or profit. Thus, in such changes, the I-I curve in the above graph will shift either upward or downward.

The above discussion also leads us to conclude that the autonomous investment is not determined by consideration of profit. Instead, it is determined by consideration of the social welfare. In the times of economic depressions, the governments **try to boost the autonomous investment**. Thus, autonomous investment is ***one of the key concepts in welfare economics.***

Private Investment and Public Investment

Investment can be divided into two factions on the basis of ownership of investment viz. Private Investment and Public Investment.

Private Investment

Private Investment is the investment which is made by the private individuals with the *sole objective of earning profit.* According to classical economist Keynes, there are two factors which decide the Private Investment viz. *Marginal Efficiency of Capital (MEC)* and *Rate of Investment*. It can be simply understood by the fact that the output in an economy depends upon the stock of capital. If there is an increase in stock of capital, the output increases. But, how much increase in investment in capital would raise the output, this would depend upon the productivity of new capital i.e. on the

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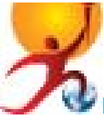

marginal efficiency of capital. The marginal efficiency of capital (MEC) is that rate of discount which would equate the price of a fixed capital asset with its present discounted value of expected income.
A businessman while investing in a new capital asset examines the expected profit on it during its lifetime against the supply price of capital asset (interest). If the Marginal Efficiency of Capital (MEC) is greater than the rate of interest, more private investment will be made.

Public Investment

Public Investment is that investment which is made by the central, provincial or local self government of a country. This investment is made for social welfare, defense and economic development. Profit does not motivate such investment.

Gross Investment versus Net Investment

Investment is closely related to Economic growth. One of the important reasons for making investments is **Capital Consumption,** which is another technical term used for **depreciation**. By capital consumption, we mean to replace worn out, or failing machinery, equipment or buildings. Capital consumption arises from the continuous depreciation of fixed capital assets. The other obvious reason is to undertake purchase of a new machinery, equipment, railroad, buildings and factories to increase the productive capacity. The long term objective of such investments is to increase competitiveness, reduce long term costs and raise profits.
The investment made for both *new acquires* and *Capital Consumption* is called **Gross Investment.** However, *net investment only measures new assets* rather than replacement assets. This relationship is expressed as follows:
Net investment = gross investment – depreciation
We take an example here. We suppose that a shipping company replaces five worn out ships with identical new ships. At the same time, it also purchases two new ships for increasing the traffic capacity. In this case, the gross investment is seven ships but net investment is only two ships. Here, the net investment is what attracts the economists as a basis for economic growth.

Factors affecting Investments

Investment in public sector is induced by objectives like defence of the country, economic development and social welfare. Investment in this sector is independent of income or profit motive. Investment must be made, if deemed necessary for the defence of the country or the welfare of the people irrespective of any profit or income.
Deficiency of private investment also calls for public investment. However, it should not be construed that government does not undertake any public investment for profit motive. Under normal conditions, many a time, government also makes investment to earn profit. But the purpose

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is not to compete out private sector. There are several industries of public interest wherein private sector does not want to invest. Government makes investment in these sectors. For example, in India, construction of roads and running of air, traffic etc. are done largely by government itself. Often government makes investment even at a loss. Volume of this kind of investment increases mostly during war or depression.

The major factors are discussed below:

Technological Advance and Innovation

- The technological challenges influence the investment decisions. The investment in labour saving and capital saving machines and other facilities are an example. *In other words, a rapid rate of innovation is conducive to high level of investment.*

Discovery of resources

- Discovery of new natural resources such as metals, minerals and oil induce investment.

Government Policy

- The monetary and fiscal policies of the government affect investment mainly in three ways:
    - Firstly, when the government pursues expansionary (cheap money) policy, the investment increases because of easy availability of the credit. Reverse happens when the government pursues tight policy.
    - Secondly, taxation, which is a part of business cost, affects investment. Higher taxes reduce the expectations of the profit and lower the investments. Reverse happens in lower taxations.
    - Thirdly, the government expenditure also affects investment in a big way. When the government initiates new projects and spends huge funds on them, the investment increases.

Foreign Trade

- When there is a possibility of increase in a country's foreign trade, it will have a favourable effect on investment, i.e., more investment will take place.

Political Environment

- Peaceful and stable political environment favour investments.

Business Expectations

- Business investments are very much dependent on expected profit, so favourable business expectations induce investment.

Rate of Population Growth

- More and more population will need more new houses, schools, public services, roads, motor vehicles and consumer goods, so investment will increase. Rapid population growth also increases supply of labour which results in fall in wages, further increasing profit expectations

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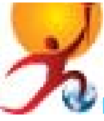

and investments.

Price Levels

- When there is a tendency for the price level to rise, it will increase the possibility of the profits of investors and so they will go on for more investment.

Other Factors

- Availability of finance, stock of capital goods, aggregate demand and conditions of labour market are other factors.

Measures to stimulate Private Investments

Various measures to stimulate the Private Investments in an economy include reduction in interest rates, reduction in taxes, adopting a policy of wage cut, increase in government expenditure and pump pricing. They are discussed below:

Reduction in rate of Interest

- During depression period, monetary authorities should deliberately lower the rate of interest with a view to stimulate investment. This policy was propounded by Keynes. However there are two problems with this policy.
    - Firstly, the rate of interest can not be made below a particular limit because it depends on **liquidity preference.** This in simple language means that the interest rate can not go below the **liquidity preference** (**demand for money**).
    - Secondly, Investment is influenced by marginal efficiency of capital than rate of interest that is why during the period of depression, despite fall in in the rate of interest there is no increase in investment. Ordinarily, lowering the interest rate can induce investment in some sectors of economy.

Reduction in Taxes

- Taxation system should be such that the investor is not much burdened. Here, the problem is that if the taxation is generally low, the government revenues will fall and it will badly affect public investments.
- The economists say that the people who spend their income on consumption and not investment can be taxed more. This further implies that the government should impose more indirect taxes and luxury taxes and rationalize the direct taxes such as Income Tax and Corporation Tax.

Policy of wage cut

- This was propounded by the classical economists. It says that reduction in money wages would lead to fall in cost of production and thereby increase investment. This theory was not approved by Keynes though.

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Increase in Government Expenditure

- Government expenditure proves to be very effective in stimulating investment.

Other measures:

- **Price Support Policy** by the government under which some essential goods are bought and sold by the government in the open market to keep the prices in equilibrium*Monopolistic hold of big firms on the production of a commodity should be abolished*, so that new firms can enter to make fresh investments.
- Government should government should enhance its expenditure on research and development. **The R&D** findings will attract investments from the private investors. During the depression, **Pump Priming** stimulates the private investments.
- During depression period, private investment is at its lowest ebb. In order to stimulate it, increase in public investment is quite necessary. The policy of increasing public investment with a view to stimulating private investment is caused Pump Priming

Types of Growth Models

There are several drivers of Economic Growth. The main cause of increased output in the short run is increase in the aggregate demand, thus known as**Demand-led Growth**. The increase may be caused by rise in investment, Government spending, expenditure, exports or a combination of any of them. The higher investment increases the productive capacity of the economy and thereby raises the potential output of capital and consumer goods. Such a growth in the economy is called **Investment-led growth**. Here we note that the investment and output are closely related as increase in investment raises the output which further stimulates more investment.*The Economic growth model of China in recent decades is most suitable example of Investment-led growth model.*

Similarly, the USA is best example of**Consumption-led Economic Growth**. This model is based upon the fact that the well of people are able to consume the goods and services in such a way that there is an increase in aggregate demand thereby leading to increased output to satisfy that demand. Rises in government spending on education, training, research & development, infrastructure etc. are likely to have more impact on long lasting influence on economic growth than spending on welfare benefits such as subsidies. The economic growth led by such spending is called **Government Expenditure led growth**. Finally, the exports also cause the economic growth because some of the exports proceeds can be used to fund imports which may lead to increase the productivity and output to a great extent. Such economic growth is called**Export-led growth**. In countries like India, the growth tends to be more driven by the savings and is thus called **Savings driven growth.**

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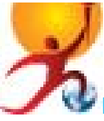

Shanghai Model

India and China as large economies of Asia hold development lessons for each other. The growth models of these two economies are essentially different from each other.

The Investment-led growth model of China has given birth to the so called **Ghost Towns** whereby 64 million vacant homes lie without occupants.

Today, China is world's second largest economy after United States. The seeds of China's rapid economic growth since the 1990s were first planted back in 1978 when the Communist Party started to introduce capitalist market principles, initially in the agricultural sector. While, in 1980s, the country was powered by the bottom-up enterprises, especially in the rural areas; the economic expansion accelerated dramatically in the 1990s as a result of mass privatisations, and the opening up of the country to foreign investment.

Overseas firms rushed to build factories in China to take advantage of its low labour costs. In this rush, China had changed its development strategy by placing greater emphasis on big cities like Shanghai and Beijing. This was the so called **Shanghai Model**. The Shanghai Model is an **extreme version of investment led growth** model.

Implication of the Investment-led Growth Model

- The So called Shanghai model was effective in building up production but not in ramping up the consumption base.
- It is alleged that China has been successful in generating GDP growth, but far less successful in generating household income growth.
- Almost half of China's GDP comes from Investment, which has a huge multiplier effect on GDP. However, maintaining a high growth rate is not sustainable for an economy which is

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heavily relied on investment and subsequent manufacturing and export cycle.

- Most of the experts agreed that the fast GDP growth in China powered by investment is a time bomb. In terms of household income and small asset base, China is poor, indeed poorer than India. The *Consumption-to-GDP Ratio* of China is lower than India. The Household savings rate in China is not as high as that of India.

The impact of this investment-led growth model was that ***China witnessed over-investing***, which led to over-capacity that resulted in wastage of resources.

However, it does not mean that China has no savings at all. In fact, China has persistent Current Account Surplus and has generated excessive savings, but, despite their exceptionally high levels, savings have not been absorbed in domestic investment, and have to be exported.

Why Investment led growth is not sustainable?

One way to assess the impact of investment on growth is to examine whether investment adds value to the capital stock. If investment does not add value in terms of creating a future flow of goods and services (i.e., the value added concept of national accounts), then that part of investment will not contribute to the productive capital stock. It will initially be captured as excess capacity and then, once depreciation sets in, as wasted. Such investment will contribute to GDP growth only at the time it is implemented, reduce the marginal product of capital, and lead to deadweight loss.

The Shift in China's strategy

In recent times, China has decided to take a pause from the investment-export led growth and focus *its attention on the consumption side*. The Chinese government is trying to increase domestic consumption; however, they're trying that within the existing level of the income rather than thinking of growing the income.

Some of the important measures being taken are summarized as below:

- The government is emphasising on rebuilding the social safety nets and narrowing the income gaps between the rural and urban areas.
- Eliminate the operational taxes on small businesses so that small businesses which provide employment to millions can thrive
- Tax exemptions so that people see more disposable income to spend off.

Overall, the Chinese seems to be convinced that the Economic Growth should not be investment led growth, but consumption led growth; the latter being much more sustainable and least susceptible to external shocks. The experts say that as China moves into consumption led growth, there may be a slowdown of temporary nature, which may indeed help India.

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India's Growth Model: Saving-led growth

India's growth model is quite distinct from other rapidly growing Asian economies. India has a growth model that is quite distinct from the Investment-export-oriented strategy adopted by China. Here are a few points for comparison.

- While China has derived a predominant part of its growth from the external sources both in terms of foreign investments and export markets, India's growth has mostly come from its internal sources. India's net exports to GDP ratio has been significantly lower than that of China.
- India has a large trade deficit, yet, India has managed to grow at reasonably high rates. The role that services exports, principally software exports, have played in maintaining an external sector balance for India and in sustaining high GDP growth rates as well is evident from the surplus in the invisibles account.
- The domestic savings investment gap in India has been kept at low levels and India has managed to finance a predominant part of its capital formation from domestic savings. Unlike China, India has not generated excessive savings. Till recent rise in CAD, India had a comparatively small current account deficit, a modest level of foreign exchange reserves and limited inflow of foreign capital. The foreign investments in India were hardly a fraction of the investments made in China, but small investments gave India ample insurance against external shocks.

Further, India's economic growth has been a services-led growth. The post-1991 high GDP growth has largely been attributed to the spectacular performance of the services sector, especially the software and IT-enabled services sector, in India.

Sources of Investment

There are three main sources of investments viz. **Internal funding** using accumulated profits of a firm; **Borrowing** either from banks or through the issue of financial assets such as bonds (long term debt) or Commercial Papers (short-term) and **Issuing new shares of stock** i.e. new equity.

Each of the above funding methods imposes explicit and/or implicit costs. For example, if the firm borrows in order to fund an investment, it pays interest cost. If the internal funds are used, it is forgoing other uses of those funds. Had the firm not used the internal funds for new capital, it could have earned interest on the funds by lending them or purchasing financial assets. This means that *implicit cost of each rupee of internally funded investment is the interest of forgone lending*

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Foreign Investments- Basics and Models

Any investment in India which has its source any other country than India is Foreign Investment. The foreign money can be invested in India by *Foreign Corporate* and *nationals* or *Non Resident Indians*. The money can be invested in shares, properties, ownership / management or collaboration. On the basis of this, the Government of India classifies the Foreign Investment into the following forms:

- Foreign Direct Investment (FDI)
- Foreign Institutional investment (FII)
- Non-resident Indian (NRI) investment

FDI

The Foreign Direct Investment refers to the direct investment into the production and management. This can be one by either buying a company or by expanding operations of an existing business. One example is Unilever which has its own subsidiary and long term investment here via its subsidiary Hindustan Unilever. This means that FDI brings foreign capital, technology & management.

FII

FII (Foreign Institutional Investment) and FPI (Foreign Portfolio Investment) are same things. The foreign institutions invest in a capital / money market which is not their home country. Such kinds of investments are seen in the Mutual Funds, Investment Companies, Pension Funds and Insurance Houses. This means that FII/ FPI brings only capital. FII is also called Foreign Indirect Investment.

QFI

QFI (Qualified Foreign Investor) is an individual, group or association, resident in a foreign country that is compliant with Financial Action Task Force (FATF) standard and that is a signatory to International Organization of Securities Commission's Multilateral Memorandum of Understanding. Though, QFI are also portfolio investors, yet in context with India, QFIs do not include Foreign Institutional Investors or Sub-accounts as per the regulations.

Differences between FDI and FII

The first notable difference is that while FDI brings foreign capital, technology & management, FII brings only foreign Capital.

Second difference we can understand with an example. Suppose, Wal-Mart comes to India and opens up stores here, this means that the investment made by Wal-Mart would come with a long term commitment. Thus, FDI brings in funds with long term commitments. On the other hand, if the company of Warren Buffett buys shares of an Indian company, they can sell it any time (as per regulations). This means that FII does not come with long term commitment. This also means that the money invested in India via FII can be taken back more easily than FDI. Thus, there is always a risk of flight of capital in terms of FII outflows but not generally in FDIs.

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Why Foreign Investors go for FDI?

Foreign direct investment is done for many reasons including to take advantage of cheaper wages in the country, special investment privileges such as tax exemptions offered by the country as an incentive to gain tariff-free access to the markets of the country. FDI can be done to acquire lasting interest in enterprises operating in the target country.

Why Foreign Investors go for FII?

A portfolio investment does not entail active management or control of the target organization. This is done by the investors if they are not interested in involvement in the management of a company. The objective of the indirect investment is to financial gain only and does not create a lasting interest in or effective management control over an enterprise.

How a Foreign Company can enter in India?

A foreign company planning to set up business operations in India need to set up a company under the Companies Act, 1956. For example, Hindustan Unilever is the Indian subsidiary of Unilever, British–Dutch multinational consumer goods company. The incorporation of the company can be done via a Joint Venture or Wholly owned Subsidiary. Foreign equity in such Indian companies can be up to 100% depending on the requirements of the investor, subject to equity caps in respect of the sector/area of activities under the FDI policy.

These companies enter into India via an office or representation in India which is known as Liaison Office/Representative Office or Project Office or even Branch Office. Such offices can undertake activities permitted under the Foreign Exchange Management Regulations, 2000 (Establishment in India of branch or office of other place of business).

What attracts Foreign Direct Investment?

The growth rate of the source economy is an important determinant of FDI into the country. The political and economic stability of the target region attracts FDI. Any FDI investment into the target country depends upon how 'open' the economy is towards foreign trade (both imports and exports). Apart from that, the policies, rule, regulations and loopholes incidental thereto also affect the flow of FDI. For example, Mauritius has been top FDI source for India due to the later reasons.

What is the impact of FDI on Inflation?

FDI has been generally touted as a measure to dampen inflation. But this can NOT be concluded in all situations. The FDI's impact on dampening the inflation is based upon the assumption that FDI would result in the developing of country's back-end infrastructure and crack the supply bottlenecks. Practically, it may or may not happen. Economics has no rule to link FDI and Inflation because Inflation may have many reasons behind it rather than only infrastructure and supply bottlenecks. Generally the FDI's role in containing inflation is supported by the facts that:

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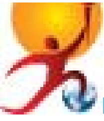

- It improves Infrastructure
- It improves supply chain
- It brings permanent investment

What is the impact of FII on Inflation or vice-versa?

The FII impact inflation indirectly rather than directly. If there an excess inflow of FII, it may shoot the prices of stocks very high. When stocks become costly, there would be a huge demand for Indian rupees. To fulfil that demand, RBI would need to print more money and pump this money to economy. All of a sudden, if FII withdraw the funds, there would be an excess of liquidity in the markets. This would lead to a situation of too much money chasing too few goods and thus things would become costlier. *Thus, unchecked FII inflow and outflow can bring into demand pull inflation.*

When there is a high inflation in the country, it repels FII. Rising inflation in India makes the investors bothering.

What are benefits of FII?

Controlled FII helps in improving the local environment. When huge FII comes in, there is much availability of fund for local companies to increase their capacity. The sufficient FII inflow in the country means that the need to borrow from international sources seldom arrives. This helps in those countries where domestic saving is not sufficient for funding the expansion plans.

Why FII inflows are volatile?

FII inflows are aimed at making money on the invested capital i.e. Capital gains. The capital gains are linked to the interest rates and stock market environment. If the interest rates / potential gains in one country go down in comparison to other target country, the FII inflow may halt or outflow may begun. That is why FII money is called hot money sometimes. In summary, the most suitable conditions for FII are as follows:

- Attractive Interest Rates
- Adequate money supply and stable rate of inflation
- Stable exchange rates
- Low deficit in Balance of payments.

Key factors that influence the Foreign Investment Decisions

Trade barriers

Government may impose tariffs, quotas, embargo and other restrictions on export and imports goods and services hindering the free flow of these products across national boundaries.

Sometimes governments may even impose complete bans in the international trade of certain products. Foreign investors can circumvent these restricitons by establishing production facilities in foreign countries.

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Imperfect labor market

Labor is immobile because of immigration barriers, firm themselves should move the workers in order to benefit from the underpriced labor services.

This one reasons MNCs are making FDIs is less developed countries such as Mexico, China, India and Southeast Asian countries like Thailand, Malaysia and Indonesia, where the labor services are underpriced relative to their productivity.

Intangible assets

MNCs often enjoy comparative advantages due to special intangible assets they posses. Example including technological, managerial and marketing know-how, superior R&D capabilities and brand names.

These intangible assets are often hard to packages and sell to foreigners.

In addition the property rights in intangible assets are difficult to establish and protect, especially in foreign countries where legal resources may not be readily available.

As a result, firms may find it more profitable to establish foreign subsidiaries and capture returns directly by internalizing transactions in these assets.

The theory internalization of FDI, stated that the firms have intangible assets with a public good property tend to invest directly in foreign countries in order to use these assets on a larger scale and at the same time avoid the misappropriations of intangible assets that may occur while transacting in foreign markets.

Vertical integration

- MNCs may undertake FDI in countries where inputs are available in order to secure the supply of inputs at a stable price.
- MNCs with monopolistic / oligopolistic control over the input market, this can be served as a barrier to entry to the industry.
- Many MNCs often find it profitable to locate their manufacturing / processing facilities near the natural resources (oil fields, mine deposits and forest) in order to save transportation costs.
- Backward vertical FDI – an industry abroad that produces inputs for MNCs.
- Forward vertical FDI can take an example where they involve industry abroad that sells a MNC's output.

Product life cycle (Raymond Vernon Model)

Raymond Vernon (1966) firm undertake FDI at a particular stage in the life cycle of the product that they initially introduced. This can be understood by an example. The personal computers (PCs) were first developed by US firms (such as IBM and Apple Computer) and exported to overseas markets.

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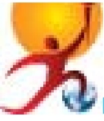

As PC's became a standardized commodity, however, the US became a net importer of PCs from foreign producers based in such countries as Japan, Korea and Taiwan as well as foreign subsidiaries of US firms.

Shareholder diversification services

If investors cannot effectively diversify their portfolio holdings internationally because of barrier to cross border capital flows, firms may be able to provide their shareholders with indirect diversification services by making their direct investments in foreign countries.

When a firm holds assets in many countries, the firm's cash flows are internationally diversified.

Thus, shareholders of the firm can indirectly benefit international diversification even if they are not directly holding foreign shares.

Important Terms Related to FDI

Inward FDI

When a foreign country invests in the country in question.

Outward FDI

When the home country invests abroad.

Green field investment

Building new production facilities in a foreign country.

It refers to investment in a manufacturing, office, or other physical company-related structure or group of structures in an area where no previous facilities exist.

Brownfield investment

Used for purchasing or leasing existing production facilities to launch a new production activity.

Backward Vertical FDI

Where an industry abroad provides inputs for a firm's domestic production process.

Forward Vertical FDI

Where an industry abroad sells the outputs of a firm's domestic production.

Five Models of Foreign Direct Investments

There are five major types of Foreign Direct Investments viz. Access to Intangible assets, Access to cheaper factors of production, Mutual Investment Model, Host Country Market Model and Regional Integration. These have been discussed below:

Access to Intangible Assets

The first type of FDI is taken to gain access to intangible assets, e.g. resources, technical knowledge, material know-how, patent or brand names, owned by a company in the host country.

Access to Cheaper Factors of Production

According to this model the company shall invest in order to gain access to cheaper factors of production, e.g. low-cost labour. The government of the host country may encourage this type of FDI if it is pursuing an export-oriented development strategy. Since it may provide some form of

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investment incentive to the foreign company, in form of subsidies, grants and tax concessions.
If the government is using an import-substitution policy instead, foreign companies may only be allowed to participate in the host economy if they possess technical or managerial know-how that is not available to domestic industry. Such know-how may be transferred through licensing. It can also result in a joint venture with a local partner.

Mutual Investment Model

This model involves international competitors undertaking mutual investment in one another, e.g. through cross-shareholdings or through establishment of joint venture, in order to gain access to each other's product ranges. As a result of increased competition among similar products and R&D-induced specialisation this type of FDI emerged.
Both companies often find it difficult to compete in each other's home market or in third-country markets for each other's products. If none of the products gain the dominant advantage, the two companies can invest in each other's area of knowledge and promote sub-product specialisation in production.

Host country market Model

This concerns the access to customers in the host country market. In this type of FDI there are not observed any underlying shift in comparative advantage either to or from the host country.
Export from the companies' home base may be impossible, e.g. certain services, or the capability to request immediate design modifications. The limited tradability of many services has been an important factor explaining the growth of FDI in these sectors.

Regional Integration

This related to trade diversionary aspect of regional integration. This type occurs when there are location advantages for foreign companies in their home country but the existence of tariffs or other barriers of trade prevent the companies from exporting to the host country.
The foreign companies therefore jump the barriers by establishing a local presence within the host economy in order to gain access to the local market. The local manufacturing presence need only be sufficient to circumvent the trade barriers, since the foreign company wants to maintain as much of the value-added in its home economy.

Disinvestment and Related Issues

Disinvestment and Privatization are two different terms in technical sense, though both involve the sale of Government's share in the Public Sector Undertakings. The term privatization is used for a stake sell in which there is a transfer of 51% or more equity to the private players. In disinvestment, the government sells only a part of the equity which is essentially less than 51% so that ownership and management rights can be hold by the Government itself.

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Rationale behind Disinvestment

The rationale behind the disinvestment and privatization are as follows:

- It is believed that the **private ownership leads to better use of resources** and their more efficient allocation.
- The **proliferation of market based economy resulted in the fact that State could no longer meet the growing demands of the economy.** It was believed that the government can deliver better results when it responds according to the market driven forces.
- **Globalization and WTO commitments need quick restructuring of the Public Sector Undertakings**. If they are not able to adapt to this, they would not be able to survive. Public enterprises, because of the nature of their ownership, can restructure slowly and hence the logic of privatization gets stronger. Besides, techniques are now available to control public monopolies by regulation/competition, and investment of public money to ensure protection of consumer interests is no longer a convincing argument.

Objective of Disinvestment

The Industrial Policy Statement of 1991 had envisaged the disinvestment of a part of Government holdings in select Private sector companies. This became necessary because of the withdrawal of the budgetary support of 60 percent by the government to the loss making units in those times. The disinvestment policy in July 1991 had outlined the following objectives:

- To meet the budgetary needs
- To improve overall economic efficiency
- To reduce fiscal deficit
- To diversify the ownership of PSU for enhancing efficiency of individual enterprise
- To raise funds for technological upgradation, modernization and expansion of PSUs
- To raise funds for golden handshake (VRS)

The Rangarajan Committee on disinvestment 1993

The Rangarajan Committee of 1993 was constituted by the government for makin recommendations in context with the disinvestment. The committee said that

- The units to be disinvested should be identified and disinvestment could be made upto any level, except in defence and atomic energy where the government should retain the majority holding in equity.
- Disinvestment should be a transparent process duly protecting the right of the workers.
- An autonomous body for the smooth functioning and monitoring of the disinvestment programme should be established. *This recommendation led to the Disinvestment Commission in*

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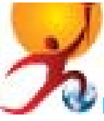

1996 as an advisory body having a full time chairman and four part-time members. The Commission was required to advise the government on the extent, made, timing and princing of disinvestment.

- It suggested **four modes of disinvestment viz. Trade sale, Strategic Sale, Offer of shares and Closure or sale of Assets.**

In its budget speech of 2000-01, the government emphasized that more emphasis would now be paid on the strategic sale of public sector enterprises.

Strategic Sale : Major Route for disinvestment in India

In Strategic sale, the disinvestment / privatization take place by auctioning a state-owned enterprise to the highest bidder. It is in contrast with the minority sale where shares in an enterprise are sold as public offers. The emphasis on strategic sale in Indian privatisation is relatively recent in origin. From 1991 until 2000, the general policy was to sell minority shares in public sector companies. In March 2000, the the finance minister's budget speech spoke of a "fresh impetus to privatization programme that will emphasise increasingly on strategic sales of identified PSUs." The f important strategic sale in India was of Modern Foods to the multinational subsidiary, Hindustan Lever during times of NDA Government. The strategic sale invited lesser criticism from political parties mainly because the process is aimed at maximizing revenues to the government. Today, strategic sale is the most important route of disinvestment of Indian PSUs.

Later Developments

Up to November 1999, the Disinvestment commission had submitted 12 reports to the government covering 58 public sector enterprises. On 30th November 1999, the term of the Commission expired. However, it was reconstituted in July 2001. Initially the Department of Disinvestment was constituted which was later on upgraded as the ministry of disinvestment in order to streamline and speed up the process of disinvestment including restructuring.

- The Disinvestment Commission also recommended creation of **separate disinvestment fund** in which the disinvestment proceeds would be placed to be used for the purpose of financial restructuring of the concerned unit before disinvestment and for carrying out voluntary retirement schemes. It also suggested merger of National Renewal Fund with the disinvestment fund.

Current Issues

As we read above, post 2000, the focus of the disinvestment has shifted to strategic sale of the identified public sector units. For the period 1991-2012, the progress of disinvestment has been a

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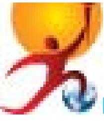

normal and Government could seldom collect more than what it had targeted. The pace of disinvestment has been largely restricted due to political opposition.

Does we disinvest only loss making companies?

The policy at privatization pursued by the NDA regime was disinvestment of the profit making CPSUs. However, later UPA Government declared that no profit making PEs will be disinvested. However, currently, it is not a policy of the Government to disinvest or privatize only profit making or only loss making companies.

What is the Philosophy of the Government?

The Government says that as long as the it retains control over the PE, and its public sector character is not affected, the government may dilute its equity and raise resources to meet the social needs at the people. Thus, the government takes the Disinvestment and privatization as useful economic tools and wishes to use them selectively.

Examples of companies in which disinvestment has taken place:

- Shipping Credit and Investment Corporation of India
- Container Corporation of India Ltd.
- Videsh Sanchar Nigam Ltd. (VSNL)
- Oil and Natural Gas Corporation (ONGC)
- Gas Authority of India Ltd. (GAIL)
- Steel Authority of India Ltd. (SAIL)
- Mahanagar Telephone Nigam Ltd. (MTNL)
- Indian Petrochemicals Corporation Ltd. (IPCL)
- Power Grid Corporation
- Shipping Corporation of India
- National Aluminum Company (NALCO)
- National Fertilisers Ltd. (NFL)
- Indian Airlines
- Dredging Corporation
- LNG Petro Net
- Madras Refineries Ltd.
- Hindustan Zinc Ltd.
- Maruti Udyog Ltd.
- Modern Food Industries (India) Ltd.
- Indian Tourism Development Corporation (10 Hotels)
- Hotel Corporation of India etc

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Challenges before disinvestment

- Process of disinvestment is not favoured socially as it is against the interest of socially disadvantageous people.
- Political pressure from left and opposition
- Loss making units don't attract investment so easily.
- Lack of well defined investment policy

The disinvestment process needs to be taken up more seriously by the government. The Government should try to come out with a time bound programme to conduct the process with transparency in all the activities need to reach. Some consensus is very essential. Only then the real benefits can be reaped.

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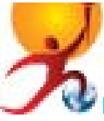

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General Knowledge Today

Land Reforms in India

[Target 2016: Integrated IAS General Studies]

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Model Questions

Prelims Topics

Bali and Shadbhaga, Meaning of Land Grants, Earliest Land Grants, Iqta System, Khuts and Muqaddams, Mustkharaj, Mustkharaj, Revenue systems of Alauddin Khilji and Shershah, Patta and Kabuliyat, Polaj and Paruti, Dahsala system, Galla-bakhshi, Kankut, Nasaq, new land ownership policy of the British, Izaredar System, Features of Permanent Settlement, Ryotwari System, Mahalwari System, Commercialization of Agriculture during British Era, Constitutional Provisions Towards Land.

1. Critically examine the implications of the Indian Feudalism on polity of early medieval India.
2. "Shershah Suri had laid the foundation of administration on which Akbar raised the superstructure." Explain.
3. What improvement were done by Todarmal / Akbar in the existing land revenue system created by Sher Shah Suri? Discuss their impact on peasants.
4. Write a critical note on Akbar's land revenue system. To what extent a shift from annual system of assessment to Dahsala system helped the royal exchequer or the peasants. Discuss.
5. "The position of Zamindars had undergone a paradigm change from Mughal era to British Era.". Amplify.
6. "In the 18th and 19th centuries free countries of Europe and America, more and more people shifted from agriculture to industry and service. Ironically, exactly reverse happened in India." Discuss critically.
7. Discuss the salient features of Permanent Settlement. Why some historians call it a bold step and a wise measure adopted by company while some others called it a sad blunder? Substantiate.
8. Critically examine the social, economical and political outcome of Permanent Settlement of Bengal, Bihar and Odisha.
9. Make a comparative account of Zamindari, Mahalwari and Ryotwari system.
10. Critically examine the impact of the commercialization of agriculture on the peasant classes during 18th and 19th century India.
11. Critically examine the circumstances in which Zamindari Abolition Acts were passed in newly independent India throwing light on the outcomes of the enactments.
12. Discuss the tenancy reforms in independent India throwing light on their achievements.
13. "The Bhoodan and Gramdan movements led by Vinoba Bhave attempted to bring about a "nonviolent revolution" in India's land reforms programme." Discuss.

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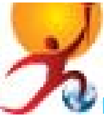

14. Critically examine the performance of Land Ceiling acts / reforms in Independent India.

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Land Revenue in Ancient India

Land Revenue in Ancient India

Land revenue system in ancient India was based upon income from land, thus rated according to the productivity and kind of soil. Manu fixed it between 1/6, 1/8 or 1/12 according to the quality of the soil. Gautama raises the lower limit to 1/10. Sukra's schedule gives 1/6, 1/4, 1/3 and 1/2 according to the nature of soil, rainfall and irrigation facilities .

The Arthashstra mentions that the upland or*Sthala* and lowland i.e. *Kedara* should be entered differently in the land revenue books. The tax rate is 1/10 as per Arthashashtra initially, but later Kautilya mentioned about two taxes viz. **Bali** and ***Shadbhaga or Sadbhaga*** which is 1/6th.

In summary, the assessment of land varied as per the quality of the land and nature of the crop in ancient India. The King's share did not necessarily mean a fixed share. It was determined by consideration of fertility of the soil and by the needs of the State or of the cultivator. The system of measurement and survey and differentiation of soil according to productivity also indicate that land revenue assessment was not permanent but revised at intervals although a constant revision was not necessary.

Megasthenes states that Maurya officers were most likely concerned with the measurement and supervision of alluvial deposits for revenue purposes.

Indian Feudalism and Land Grants

From the post-Maurya period, and especially from Gupta times, India's political and administrative developments tended to feudalise the state apparatus.

What is feudalism?

In Europeans sense, feudalism describes a set of reciprocal legal and military obligations among the warrior nobility, revolving around the three key concepts of lords, vassals, and fiefs. However, in context with ancient India, the system gradually**developed from the beginning of the land grants**.

The practice of making land grants to the Brahmanas was a custom, sanctified by the injunctions laid down in the Dharmashashtras, Epics and Puranas. The**Anusasana Parva** of the Mahabharata devotes a whole chapter to the praise of making gifts of land (*Bhumidanaprasamsa*).

The Land Grants & Administrative Rights

The early Pali texts of the pre-Maurya period refer to the villages granted to the Brahmanas by the rulers of Kosala and Magadha. A term used for such grants was "**Brahamdeyya**".

Earliest Land Grants

The earliest land grants belonging to the first century BC were given to the Buddhist priests and Brahmanas and other religious establishments. However, in the post-Guptas period even

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administrative officials were granted land. The landed beneficiaries were given both powers of taxation and coercion, leading to the disintegration of the central authority. The secular recipients of the grants and the autonomous holders of land are generally termed as fief holders and free holders. The major outcome was decentralization.

However, the Earliest epigraphic record of a land grants in India is a Saatavahana inscription of the first century BC, which refers to the grant of a village as a gift in the *Ashvamedha Sacrifice*. However, it is not clear, whether the administrative or revenue rights of these lands were also given to those priests or not. It has been guessed that the administrative rights were perhaps given up for the first time in the grants made to Buddhist monks by the Satavahana ruler – Gautamiputra Satakarni in the second century AD. Such a land grant included the rights that :

- The royal troops could not enter such land granted
- The government officials and district police was not supposed to disturb such lands.

Changes in Land Grants

From the period of later Mauryas, the land grants included the transfer of all sources of revenue, and the surrender of police and administrative functions. The grants of the second century AD mention that the *transfer of the king's control only over salt,* which implies that he retained certain other sources of revenue. But in some other grants, it was recorded that the donor (King) **gave up his control over almost all sources of revenue**, including pastures, **mines including hidden treasures and deposits.**

Then, the donor not only abandoned his revenues but also the right to govern the inhabitants of the villages that were granted. This practice became more prevalent in the Gupta period. There are many instances of grants of apparently settled villages made to the Brahmanas during the Gupta era. In such grants, the residents, including the cultivators and artisans, were expressly asked by their respective rulers not only to pay the customary taxes to the donees, but also to obey their commands. All this **provides clear evidence of the surrender of the administrative power of the state**.

One of the important aspect of the Kings sovereignty was that he used to retain the rights of the punishing the culprits. In the Post-Gupta times, the king made over to the Brahmanas not only this right, but also his right to punish all offences against family, property, person, etc.

Implications of Land Grants

We see that, by giving such privileges, the state was bound to disintegrate. Out of the seven organs of the state power mentioned in literary and epigraphic sources, taxation system and coercive power based on the army are rightly regarded as two vital elements. If they are abandoned, the state power disintegrates. This was the system created by the grants made to the Brahmins. The land was granted for as long as the existence of the sun and the moon, which implies the permanent break-up of the

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integrity of the state.

The above discussion makes it clear that in the Post-Gupta period, the Brahamdeyya carried **freedom from taxes**, Administrative freedom and also the freedom from punishments (**Abhayantarasiddhi**). The widespread practice of making land grants in the Gupta period paved the way for the rise of Brahmin feudatories, who performed administrative functions not under the authority of the royal officers but almost independently. What was implicit in earlier grants became explicit in grants from about 1000AD; and well recognised in the administrative systems of the Turks.

The implications were many but themajor implication was the creation of powerful intermediatories wielding considerable economic and political power.As the number of the land-owning Brahmins went up, some of them gradually shed their priestly functions and turned their chief attention to the management of land. Thus, their case secular functions became more important than religious functions. The comprehensive competence based on centralised control', which was the hallmark of the Maurya state gave way to**decentralisation in the post-Maurya and Gupta periods**. The functions of the collection of taxes, levy of forced labour, regulation of mines, agriculture, etc., together with those of the maintenance of law and order, and defence which w re hitherto performed by the state officials, were now systematically abandoned, first to the priestly class and later to the warrior class.

Thus, the main implications of the Indian Feudalism in early medieval period are as follows:

- **Political decentralization:** The seed of decentralization that was sown in the form of Land grants turned into a vividly branched political organization made up semi-autonomous rulers, Samantas, Mahasamantas and others such as Rajpurushas.
- **Emergence of new landed intermediatories:** The emergence of landed intermediaries- a dominant landholding social group absent in the early historical period- is linked to the practice of land grants which began with the Saatavahana.
- **Changes in agrarian relations:** Free vaishya peasants dominated the agrarian structure in early historical India and labour services provided by the Shudra. But, from the sixth century AD onwards the peasants stuck to the land granted to the beneficiaries because they were asked not to leave the village granted to the beneficiaries or migrate to tax-free village. This resulted in the immobility of the population and isolation from the rest of the world. Its implication was very profound such as development of localized customs, languages and rituals.

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Land Revenue in Medieval India

Sultanate Era

The conquest of Mohammad Ghori and establishment of the Sultanate brought major changes in the land revenue system in India. The Governments in those times made all attempts to increase the revenue by collecting taxes as per those in Islamic nations. The new taxes were imposed upon people and government's share in produce increased. However, till that time, the original form of Hindu system of Land tenure as per ancient Manu's laws survived with some modifications done by some of the greedy sultans and their officials.

The agricultural and land revenue system of the early Turkish Sultans rested on two foundations viz. the **Iqta** (assignment of land revenue) and **Kharaj** (Land Revenue).

The Iqta system provided an agrarian system to the country while the members of the ruling class attained income without any permanent attachment to any territory. The Iqta system was provided institutional status by Iltutmish and later this system became the mainstay of the sultanate administration under slave dynasty.

Iqta System

Under Iqta System, the land of the empire was divided into several large and small tracts called Iqta and assigned these Iqtas to his soldiers, officers and nobles. In the beginning, an Iqta was based upon salary. Later, under Firoz Shah Tughlaq it became hereditary.

Literally, Iqta means land or land revenue assigned to an individual *on certain conditions.* The holders of these Iqtas were the trustful agents of the Sultan. There were two kinds of Iqtas viz. **Large Iqtas** and **Small Iqtas**. The holders of large Iqta were the provincial governors, who had some administrative responsibilities also. On the other hand, the holders of the small Iqtas were the small troops holders who had no administrative responsibilities.

The small Iqta holders held and appropriated all the income obtained from the cultivators but as a *quid pro quid*, they were bound to present themselves with horses and arms whenever called upon by the Central Government. These small Iqta holders were called *Khuts* and *Muqaddams*. Amir Khusarau, for the first time, referred to Khuts as Zamindars.

The Khuts and Muqaddams became fond of luxurious living over the period of time, later, Alauddin Khilji suddenly abolished the system of small Iqtas with a stroke of pen and brought them under the central Government (thus called Khalsa land). This was regarded as one of the most important agrarian reforms of Alauddin Khilji.

Alauddin Khilji

Under Alauddin Khilji, India saw one of the most harsh land revenue system in India. His land and

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revenue reforms are notable for two measures viz. abolition of small Iqtas and Land Measurement (Paimaish)

Abolition of small Iqtas

With a stroke of pen, Alauddin abolished almost all small Iqtas and brought these lands under Khalsa or Crown lands. Almost entire land of Doab was brought under Khalsa*In the Khalsa lands, the revenue was collected directly by the state.* The Sultan deprived the Khuts, Maqaddams and Chaudhuris of their privileges. They were forced to pay arrears of land revenue in a newly established department of arrears called *Mustkharaj*. This Mustkharaj reduced these Khuts and Muqaddams to beggars literally.

Land Measurement and Tax rates

Alauddin Khilji made several sweeping reforms in the field of revenue system. He was the *first Sultan who paid attention to measurement*(paimaish) of the cultivable land, which he called *zabita*, and estimated *yield per Biswa was fixed as unit of revenue collection* (currently, Biswa is 20th part of Bigha).

The ancient Hindu terminology of taxes viz. Bhaga, Bhoga and Kara were still in operation in those times but their meaning and demand had changed. Bhaga now meant Land revenue, Bhoga meant cess and Kar meant other taxes. These three were basis of assignment of land to nobles under Khilji. As far as state demand is concerned, Alauddin made the harshest possible hike in tax demand till that time. He fixed state demand to be *half of the produce per Biswa yield*. This scale of agrarian tax at 50% was the highest under Khilji among all other sultans and kings so far in India. Not only this, he also imposed house tax (Ghari) and pasture tax (Charai or Chari) on the agrarian population.

But these harsh measures were not sustainable. As soon as Alauddin died, the system lost into oblivion. Later, Mohammad Tughlaq somehow tried to return to the Khilji's system and he tried to implement such a pilot project in a local area in Doab, but this pilot project failed like many of his other adventures.

Shershah Suri

Shershah Suri had laid the foundation of administration on which Akbar raised the superstructure. Todarmal, who later carried out most reforms under Akbar had gained considerable experience under former master Shershah Suri.

Shershah is known to have made *a systematic survey and measurement of the entire cultivable land* of his empire using a unit called *Sikandari Gaj*. {Sikandari Gaj was introduced by Sikandar Lodi and it was equivalent to 39 inches). He introduced the so called *Patta and Kabuliyat* (or Qabuliyat) system of land deeds.

> Under Patta system, the area sown, types of crops cultivated and revenue share was

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duly written on paper. The Qabuliyat system involved a deed agreement between the peasant and the government. Qabuliyat system aimed at discouraging the Jagir system.

Shershah had also established the per Bigha land (Rai) for the lands under continuous cultivation (Polaj) and the lands which kept out of cultivation temporarily (Parauti). Rai was average of three rates representing good, middle and low yields. This rai system was later adopted by Akbar.

Shershah also introduced direct remittances of the taxes to the government so that the taxpayers are saved from any exploitation by the middle officers. He also placed a survey charge of 2.5% called *Jaribana* and collection charge of 5% called *Muhasilans*.

But Shershah died soon and much of his work was destroyed by the anarchy that followed his death.

Land Revenue System of Akbar

There was no Mughal land revenue system before Akbar. His father Humayun and grandfather Babur did not introduce any changes because they were the first conquerors of their dynasty and remained pre-occupied with subduing rebellions, consolidating empires and maintaining order.

A proper land revenue system was founded by Akbar. However, the system of Akbar was itself based on what Shershah Suri implemented during his short tenure. Thus, the land revenue system of Akbar was neither an innovation nor an invention. His indebtedness to the earlier rulers is immense but this has not diminished his fame as far as land revenue system is concerned. He followed the policy of Shershah with greater precision and correctness and then extended it to various*subah* or provinces of his empire. But this correction or precision did not came overnight. Initially was tortuous enough to turn peasants into beggars, and forcing them to sell their wives and children. But it was revised several times.

The first question is – what were the corrections and precisions Akbar did in the existing system created by Shershah? The corrections done by Akbar in land revenue system can be mainly divided into three heads as follows:

- Standardization of measurement of land
- Ascertaining the produce per Bigha of Land
- Fixation of state's share in that produce

Standardization of measurement of the land

In Akbar's administration, we find so many territorial divisions and sub-divisions for the first time in medieval history. For political as well as fiscal purposes Akbar had divided his empire into 15 *Subahs* (originally there were 12 Subahs, but by the time Akbar died, the number stood at 15), 187 Sarkars and 3367 Mahals. He ordered a standardization of measurement unit and the so called *Ilahi Gaj* was made the definite unit of land measurement. This *Ilahi Gaj* was equivalent to some 41 fingers (29-32

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inches), and was shorter than the Sikandari Gaj (approx 39 inches) used by Shershah. The Gaj as measurement of land finds its origin during Sikandar Lodi's times.

Standardization of land measurement was adopted to brush aside all kinds of vagueness in defining extent of land and to reduce extortion / corruption by officials.

For land measurement (*Paimaish*), a rope called *Tenab* was used in those days. Since, this rope was subject to variation in its length due to seasonal dryness or humidity, Akbar made reforms in Tenab also. Instead of an ordinary rope, Akbar ordered the Tenab to be made of pieces of Bamboo joined together with iron rings. This made sure that the length of Tenab varies little during different seasons of a year.

A further change done by Akbar was to fix definite measurement to *Bigha* of land. A Bigha was made of 3600 Ilahi Gaj, which is roughly half of modern acre. Several Bighas made a *Mahal*. Several *Mahals* were grouped into *Dasturs*.

Ascertainment of produce per Bigha

After the standardization of land measurement, Akbar turned towards ascertainment of the amount of produce per Bigha and the state's share in it. Shershah Suri had already divided land into four different categories. Akbar followed the system and to make a comparative estimate of the produce of lands and fixed different revenues for each of them. These four types were as follows:

Polaj

Polaj was the ideal and best type of land throughout the empire. This land was cultivated always and was never allowed to lie fallow.

Parati or Parauti

This was the land kept out of cultivation temporarily in order to recoup its lost fertility.

Chachar

Chachar was a kind of land allowed to lie fallow for three or four years and then resumed under cultivation.

Banjar

Banjar was the worst kind of land that was left out of cultivation for five years or upwards.

Fixation of state's share in produce

The best lands viz. Polaj and Parauti were subdivided into three categories viz. good, middle and bad. Average produce of these three categories, called *Mahsul* was taken as a normal produce per Bigha. One third of this *Mahsul* (average produce) was fixed as state's share. The Parauti land also was liable to pay the Polaj rate (one third of*Mahsul*) when cultivated. Chachar land was allowed to pay a concessional rate until it was cultivated again to be liable to pay the Polaj rate. Banjar lands were also not totally neglected.

Further, the peasants were given option to pay either in cash or kind, whichever was convenient to

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them.

It's worth note here that during British Era, the land was divided on the basis of natural or artificial qualities of soil in clay, loam, irrigated, unirrigated and so on. However, the basis of land classification by Akbar was on the continuity or discontinuity of the cultivation. Akbar's vazirs had not taken account the soil qualities for ascertaining the produce.

Fixing Rate of Assessment

Once the land was measured and state's share in produce was fixed per Bigha of land, Akbar next proceeded to fix the rate of assessment. This was the *most contentious part* and in fact several changes were done in the system till 1585. Firstly, Akbar adopted Shershah's Rai system in which cultivated area was measured, and a central schedule was created fixing the dues of peasants crop wise on the basis of the productivity of the land. The state's share was fixed one-third of the produce under the schedule (*Dastur-i-amal*) to be paid in cash. The peasant's tax was based on annual system of collecting prices and settlements of revenues for the previous years. But there were several problems with this arrangement. Firstly, the prices of crops could not reasonably be applied to the whole empire. Prices were lower in rural areas which were far away from the urban centres. Secondly, the cultivators found it difficult to pay in cash at the official rate. Thirdly, this system was affected by corruption of the revenue collectors, particularly the ***Karoris*** appointed in 1573-74. Fourthly, fixing prices every year and doing settlements of revenues of previous years was a cumbersome practice. Akbar ordered that the settlement should be concluded for past 10 years. An aggregate of the rate of revenues from 1570 to 1579 was made and a decennial average was fixed as demand of the revenue. This brought certainty to collections and alleviated the problem of peasants to great extent. This was the so called **Dahsala system** or **Zabti System**, that was implemented by Raja Todarmal. This remained a standard system of revenue assessment during the greater part of the Mughal empire. During Shahjahan's era, it was introduced in the Deccan by Murshid Quli khan.

Assessment of Karori / Crori System

The determination of current prices and rates of collection was one of the most arduous task for Akbar because the extent of empire was big and administrative machinery was new. However despite the difficulties, entire land – whether dry or irrigated; whether in towns or hills or deserts or jungle; was measured in all the Parganas. {Pargana: Fiscal Union of Akbar's administration}

To make the collection of revenue efficient, every piece of land large enough to give revenue of Once Crore *Tanka* was divided off and put under an special officer called Karori / Crori.

Tanka & Tanki

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Kindly note that in Sultanate era *Tanka* referred to a Silver coin. In Shershah's time, the place of the silver *Tanka* was taken by Rupiah, which was as it is adopted by Akbar and remained India's currency unit till date. However, Akbar had transferred the names of *Tanka* to copper coins coined during his rule. One *Tanka* was equal to 2 Dams. Akbar also struck a coin called Tanki that was equal to 1/10th of *Tanka*)

The Crori was selected for his trustworthiness and not acquaintance with the revenue matters. The measurement of the land was started at Fatehpur Sikri and first Crore was named Adampur, next as Sethpur and so on after the patriarchs of those areas or names of prophets etc.

Critical Assessment of Akbar's Land Revenue System

The assessment of Akbar's land revenue system must be done on two accounts viz. annual system and Dahsala system.

Annual System

The annual system was another name of uncertainty in assessment and appointment of Karoris was disastrous for the peasants. The Karoris turned rapacious and system of paying previous years taxes in current years led the peasants to sell their wives and children. Badauni writes that by the time Karoris were made accountable to Raja Todarmal, lots of damage to life of people had been already done. The uncertainty and confusion regarding taxation rendered cultivation without any incentives.

Dahsala System

Under the Dahsala system, the peasants were relieved from the uncertainty of the taxes they would be paying. Since amount due from the peasant to government treasury was fixed, the farmers had hope to enjoy some greater profits if they improve or extend their cultivation.

Apart from this, we can also examine Akbar's land revenue system vis-a-vis ancient system. In ancient India, the share of the government was 1/6th, however, by the time of Akbar, this share had gone up to 1/3rd. This was an excessive demand because even in Akbar's times, the other Hindu sovereigns were taking 1/6th of the produce. Various historians justify this 1/3rd share arguing that Akbar reduced or abolished as many as 29 taxes including Jehat (Manufacturing tax).

Other Systems of Mughal Era

During the reign of Akbar and his successors three more systems of revenue assessment were prevalent viz. Batai or Gallabakshi System, Kankut System and Nasaq System.

Batai or Galla-bakhshi

Batai or Galla-bakhshi was a very old system which continued during the Mughal period. This was a simple method of crop-sharing in which the produce was arranged into heaps and divided into three shares, one of which was taken by the state. Under this system the peasant had the choice to pay in cash or kind.

Kankut System

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Kankut system was also an old prevalent method in which, instead of actually dividing the grain (kan), an estimate (kut) was made on the basis of an actual inspection on the spot and one-third of the estimated produce was fixed as the state demand. *So, it was a rough estimate of produce on the basis of actual inspection and past experience.*

Nasaq System

Nasaq System was widely prevalent in the Mughal Empire, particularly in Bengal. In this system a rough calculation was made on the basis of the past revenue receipts of the peasants. It required no actual measurement, but the area was ascertained from the records.

Position of Zamindars during Mughal Era

Zamindars during the Mughal era were petty landholders in the villages, descendants of old ruling families who retained small portions of their ancestral lands. These also include the rajput and other chiefs who exercised autonomous administrative authority in their principalities. They had hereditary rights of collecting land revenues which could go up to 25 percent of the revenue. They generally made collection from the individual peasants at rates fixed by custom or by themselves and paid a fixed tax to the Government. The difference between his collections and the amount he paid to the state was his personal income.

If the state demand reached the maximum that the peasant could pay, a deduction of 10 percent was made from the total amount of revenue and paid to the Zamindars as *malikana* .

> Please note that in Mughal Era, the Zamindar was not the owner of the land and the peasants could not be dispossessed of land as long as they paid land revenue. Only later Zamidars became prominent and some of them had militaries and forces. Sometimes the state had to use military force against recalcitrant Zamindars for the realization of revenue.

In some respects of Zamindars and the peasants were natural allies in any struggle against the Mughal government. Hereditary succession to Zamindari was the general rule. Zamindari was divisible among legal heirs and could also be freely bought and sold. Normally in the Mughal empire villages were divided into zamindari and raiyati (non-zamindari) areas.

Land Revenue During British Era

India's land revenue system was radically changed under British due to several factors such as agricuituralisation and de-industrialization; change in land ownership; methods of assessment; and collection of land revenue.

In the 18th and 19th centuries free countries of Europe and America, more and more people shifted from agriculture to industry and service. Ironically, exactly reverse happened in India. When

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England was undergoing Industrial Revolution, India was undergoing increased *agricuituralisation and de-industrialization.* The coordination between Indian Industry and Indian Agriculture was destroyed and a new bond of Indian agriculture and Britain's industry was developed which shifted the entire wealth of India to that European country.

Destruction of rural and cottage industries, allied trades and commerce ruined all supportive vocations of the bulk of population and the people thus thrown out from their vocations crowded in the agriculture sector.

Coupled with new land ownership policy of the British, even the peasants started getting uprooted from land ownership. *Land was never a mortgagable commodity in India earlier to British. It was rarely transferable as a matter of right. The laws enacted around 1835 A.D. and in the following years by the British conferred unrestricted rights of transfer of land on occupants of all classes.* It could be mortgaged now and could be recovered through the British court of law.

In the pre-British India, land had no exchange value and labour was costly. During British rule all those who were deprived of their vocations and trade, flocked to agricultural land and labour became cheap. These things are evident by the repeated famines during the early British rule in India. This has been endorsed by the famine commission appointed in 1878.

Another blow to the whole system of agriculture was given by introducing Zamindari in India in the British style. These changes in land policy and revenue system literally shattered the whole system of agriculture and trade in the country.

In conclusion, within 50 years of British Rule, the pattern of ownership, the method of assessment and the collection of land revenue introduced by the British in India had destroyed the self sufficiency of the Indian economy.

Post Plassey changes in Land Revenue System

Izaredar System

After the battle of Plassey, the British secured the Diwani rights (rights to collect revenue). When Robert Clive obtained the Diwani of Bengal, there used to be annual settlements of the Land revenue. Izaredari system was introduced in 1773 by Warren Hastings in Bengal whereby he assumed that all land belongs to State. This was the first land tenure system implemented in India by British. Under this system, right of collecting revenue of a particular area was auctioned to the highest bidder. The Peasants, shopkeepers and merchants had to pay their taxes to the **Izaredar** who eventually was also the highest bidder to the company. Hastings first made the assessment from annual to 5 years and then back to annual.

Implications of Izaredar System

So far, the Zamindars had the customary hereditary rights of revenue collection and formed two way

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links to the Government and the peasants. But the auctioning of Land made many of those old settled Zamindars lose their job and thus the two way links were broken. The **Izaredar** was essentially a contractor who squeezed the poor peasants and then paid to the company saving his profit. They had no interest in the welfare of the peasants.

From Company's point of view also, the Izaredari system was no good because there was a frequent change in the assessment period and no fix revenue generation. The Ijaredar system ended when Lord Cornwallis introduced the Permanent Settlement in Bengal, Bihar, Odisha and some parts of Carnatic (parts of northern Karnataka).

Permanent Settlement : Zamindari System

Permanent settlement was introduced in 1793 by Lord Cornwallis and covered around one fifth of British territory in India, including Bengal, Bihar, Orissa, parts of Northern Karnataka, Varanasi and some other areas. With the permanent settlement, the auctioning of land (Izaredar system in Bengal) came to at an end.

Salient Features of Permanent Settlement

- The previous experiment of Izaredar system was based on annual assessment of revenue. To streamline the revenues of the company, Cornwallis changed the settlement schedule from annual to decennial (10 years).
- Zamindars were hitherto only collectors of revenue and had no ownership rights over land. In the permanent settlement, the company recognized them as owners of soil. They were given permanent hereditary rights to collect revenue.
- The Zamindars needed to pay a fixed amount of land revenue on a fixed date every year. This amount could not be increased later, however, if the Zamindar failed to pay the amount on fixed date, the Company could sell their land via public auction. This made sure that Zamindars were strict enough to collect revenues from peasants and pay it to company at fixed time.
- Zamindars were allowed to keep force and maintain order in their districts. They were expected to improve the conditions of the tenants but the company would not interfere in their internal dealings with the tenants so long they paid the fixed land revenue.

Assessment of Permanent Settlement

Some historians called permanent settlement a bold step and a wise measure adopted by company while some others called it a sad blunder.

The assessment of the Permanent Settlement of Bengal, Bihar and Odisha should be done in the light of following points.

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Position of Zamindars

The permanent settlement was mainly done to make the amount of land revenue permanent, certain and fixed. The ownership of land had undergone paradigm shift. In Mughal era, Zamindar was not owner of the land but only a collector of revenue. With permanent settlement vesting ownership rights in Zamindar, he assumed a position that never been his before. The Zamindars became wealthier.

Further, Zamindars were not the same old hereditary landholders, but anyone could become a Zamindar provided he had good connection in East India Company or some other hackMany servants of old Zamindars, petty clerks, agents, traders and merchants became the so called new Zamindars. They all became petty capitalists and they invested in trade, commerce thus some positive impact on other segments of economy was seen. This class of new capitalists was called "*Mushroom gentlemen*".

For East India Company, this system secured the British Dominion in India. In Zamindars, it created a faithful class of Indians who proved to be a great instrument for the security of the British interests in India. This settlement was the reason that during the 1857 mutiny, the Zamindars remained loyal to the company and did not provide any help to the rebels.

However at the same time, company retained the ultimate ownership and was able to sell the land via public auction if the fixed rent was not paid on due date by Zamindar. The Zamindar had to deposit the collected revenue on a day fixed before sunset, if not done, he would lost part or full of estate and then the estate would be sold in open auction. No excuses were entertained.

This so called "sunset law" on rigidity of the sale later became a prestige issue and its brunt was borne was the peasants. The land revenue was fixed high and it was not very convenient to pay it on time. Many Zamindars turned defaulters and it created problems.

Revenues of Company

By this settlement, the company was sure of getting fixed revenues. It also facilitated the easier method of collection of revenue through Zamindars. Before this settlement, the company needed large establishment / officials to make annual / five yearly assessments. The permanent settlement saved the company from these expenses. The officials could be engaged in judicial or other works. However, the permanent settlement could not enhance the amount of land revenue because*it was inherent in the settlement that it was permanent in terms of revenue* also and company could not increase a single pie even if there was rise in the produce or prices of the produce. This was one of the reason that some British authors called the settlement a blunder as it resulted in loss of enhanced land revenue in times to come.

Impact on Peasants and Productivity

Since the permanent settlement made Zamindars owners of land, peasants were left at their mercy.

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The Peasants had no right over land and could be kicked out any time.

In 1799, the East India Company passed some notorious regulations which gave arbitrary powers to the Zamindars to eject the cultivator and forfeit the agriculture stock for non-payment. This was probably the lowest point in Indian Peasantry.

Since any increase land productivity was not subject to increase taxes, it was expected that Zamindars would make efforts to improve the conditions of the tenants. This system was that what company would levy from the Zamindars was fixed as 10 parts out of 11 parts. The 11th part was the remuneration of the Zamindar. However, what the Zamindar would levy from the Peasants was left unsettled. This implies that more the value of 11 parts, more is the remuneration of Zamindar's 11th part. Thus, it was clear that if the productivity of land is improved, company will have no right to demand anything in excess of what was already settled. But this belief of Cornwallis was belied later because unfortunately, the increased earnings were not spent on peasants. Instead this led to increased luxuries and pleasures of the Zamindars.

Pressure on land and Absentee Landlords

The same time was of increasing pressure on lands due to many reasons. Since work of Zamindars was to collect and pay revenues at time, they started doing sub-feudalization of their estate to some unofficial middlemen. Thus, a new crop of unofficial middlemen also grew between the Zamindars and Peasants. A Zamindar would sublet the land to a middlemen and would relocate to big cities like Calcutta to live a luxurious life. Zamindars thus turned into Absentee landlords due to permanent settlement. This was exact opposite to the hitherto Zamindari system prevailing since Mughal era. old rural based zamindars were replaced by many new urban landlords, who obtained Zamindari by hook or by crook to earn money as well as social distinction. The urban Zamindars left their servants and agents to collect revenue from peasants. This furthered the exploitation of the peasantry because agents / middlemen would extort almost all a peasant produced.

Impact on rural society of Bengal.

The social outcome of permanent settlement in Bengal was that the society was divided into two mutually hostile classes of Zamindars and Tenants. While Zamindars were favourite children of British Imperialism, they were few in numbers in comparison to the other class of tenants. British won loyalty of a few at cost of many.

Assessment : Changes in Zamindari System from Mughal to British Era

During reigns of Shershah Suri and Akbar, the system was that land revenue was collected directly by the officers of the state and could be paid either in cash or in kind, though cash payments were encouraged. Thus, the peasant called *ryot* held his land directly from the crown. But in the eighteenth century, with the growing clout of British, the tax collectors tended to be hereditary and the right of collection of revenue from the cultivator (which was hitherto a duty) came to be

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considered as a right and a possession. Via the permanent settlement in Bengal, Bihar and Odisha, the Zamindars were recognized as proprietors of the land on condition that they would pay the government rent on a fix date. The peasants had no proprietary rights and were subject to ejection from the land unless they purchased it by paying the zamindar a special additional fee and price. This system continued till India became independent.

Ryotwari System

Ryotwari System was initially introduced by Shershah Suri. He had surveyed the entire land under cultivation of his territory and fixed per bigha due on the basis of average of three rates representing good, middle and low soils under continuous cultivation (Polaj) and temporary out of cultivation (Parauti). This average rate was called "Rai" and the cultivator was called Ryot. The Rai system was initially adopted by Akbar.

In the East India Company territories, the Ryotwari system was introduced by Thomas Munroe and Captain Reed first in Madras presidency. It was later extended to Bombay, Parts of Bengal, Assam, Coorg etc. This system was exactly opposite to the Zamindari system. In this system, peasants were given the ownership and proprietorship and they would make direct payment to state as 55% of produce. But the system was such that whatever government calculated was faulty and exploitive. Thus, excessive rate of revenue made the agriculture unprofitable. Then, the ways of collecting revenue were so harsh and rigid that the peasants would like to handover their ryots to some money lenders.

It is not that uniformly all the tillers were recognized as proprietors. Under the Ryotwari settlement system, the company recognized *mirasidars* as the sole proprietors of land, dismissing tenants' rights completely. Only in villages where no mirasidars system existed, were the villagers holding permanent occupancy rights recognized as landholders responsible for the payment of land revenue. The impacts were more visible such as

- the supply side of land increased and land prices fell
- Interest rates increased. The rates were so high that the cultivator was at best could pay only interest.

Assessment of Ryotwari System

Ryotwari system of land tenure was introduced early in the nineteenth century in Presidencies of Bombay and Madras. Under this system the settlement was made by the government directly with the cultivator (ryot) who thus was the proprietor, but only for a period of time. This time was fixed for thirty years after which it was subject to re-assessment and re-settlement on new terms. The government share was fixed at 55% of the produce, which was highest ever share. Though the cultivator got security of tenure but was subject to a very heavy duty, thus leaving no motivation for

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cultivation.

Mahalwari System

The Zamindari as well as the Ryotwari System could not fulfil the expectations of the policymakers. A third type of system called Mahalwari system was introduced in Agra, Awadh (Oudh), Central parts of India, Punjab, parts of Gangetic valley etc during regime of Lord Hastings.

Mahal refers to an estate with many cultivators. The term Mahal referred to the fiscal unit / revenue division into which the whole land was divided by Akbar. In Mahalwari system, all the proprieties of a Mahal were jointly and severally responsible, in their persons and property, for the sum assessed by the government on that Mahal. If the number of the proprietors was large, some of them were made representatives of all. The ownership and occupancy right was reserved for individual peasants. Even cultivation was to be dome individually. But for the payment of the land revenue, the peasants were jointly responsible. Usually the village as a whole would be designated a Mahal and it paid the revenue via its headman called Lambardar. Thus, Lambardars worked as a link between the individual tillers and the government, but they were not given rights like those of Zamindars. The issues with the Mahalwari system were as follows:

- In actual practice, only some big families could take the land rights not all villagers.
- The stable revenue dream of the government could not be fulfilled.
- Mahalwari was a limited reform in area as well as duration. It was a temporary settlement.

Talukdar System

Side by side with the Mahalwari system there existed Talukdar system which recognised the Talukdar as the proprietor and gave him full control over the ryot. It differed from the zamindari or permanent system of Bengal only in as much as it was not permanent. This system prevailed in some parts of current states of Uttar Pradesh, Madhya Pradesh and Punjab.

Commercialization of Agriculture during British Era

The British Era is also known as a period of commercial revolution in the agricultural sector. Commercialization of agriculture was coincident with Industrial revolution and became prominent around 1860 A.D. This brought about a change from cultivation for home consumption to cultivation for the market. Cash transactions become the basis of exchange and largely replaced the barter system. The major reason of commercialization of agriculture was that India was now reduced to the supplier of raw materials and food grains to Britain and importer of British manufactured goods. This era saw the introduction and proliferation of many crops as cash crops such as Indigo, cotton, jute, tea, tobacco. The Land revenue payments were also monetized and India saw emergence of grain merchants. The increasing demand for some of the commercial crops in other foreign countries gave impetus to commercialization of agriculture.

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Impact of Commercialization

- The commercialization of agriculture should have increased productivity but in reality it did not happen because of poor agricultural organization, obsolete technology, and lack of resources among most peasants. Rich farmers benefited and this accelerated the inequalities of income in the rural society.
- The commercial non-food crops substituted the food grains. This had a devastating effect on the rural economy and showed its impact in famines.
- one more outcome of the commercialization of agriculture was the crop production got regional specialization based upon the climatic conditions. This was the outcome of the commercial revolution in agriculture. The peasants of Bombay presidency grew cotton, Bengal grew jute and Indigo, Bihar grew opium, Assam grew tea, Punjab grew wheat.
- The agriculture sector of India was linked to the world market. Price movements and business fluctuations in the world markets began to affect the fortunes of the Indian farmer to a greater degree. The crop selection became dependent upon the market demand and price.

Thus we can conclude that the commercialization of agriculture assisted the industrial revolution in Britain, it broke the economic self-sufficiency of villages in India.

Increased population of Landless Labourers

In ancient India there were no wage earners in agriculture. The situation in British Era was reverse with an ever high population of the landless labours. Landless agricultural labourers were as high as 20 percent of the agricultural population in Dinajpur in 1808. Those who either owned land or had customary rights to cultivate it were not homogeneous in the early decades of the nineteenth century.

Further, the impact of the commercialization of agriculture on the peasant classes was complex. It sometimes strengthened small peasants by providing a higher income, but often the growing fluctuation in prices led them to disintegrate into a group of richer peasants, who benefited from the fluctuation, and others who came under the grip of moneylenders and merchants. In general, it contributed to the expansion of landed property by the non-agricultural population, though the extent of such transfer differed by region.

Land Reforms In India

Before discussing about current and recent past issues in land reforms, we should understand the three different terms that are used frequently while discussing about land reforms. These three terms are land reform, agrarian reform and land rights.

Land Reforms

Land reforms refers to a wide variety of specific programmes and measures to bring about more

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effective control and use of land for the benefit of the community as a whole. *Land reforms generally comprise the takeover of land by state from big land lords with partial compensation and transfer it to small farmers and landless workers.*

Land reforms are aimed at changing the agrarian structure to *bring equity and to increase productivity.* The structure includes both the man-land relationship and man-man relationship (tenant and landlord). In India, the land reforms aim to follow the ideal of socialistic and democratic society. The land reforms in India are envisaged to bring reforms through abolition of intermediaries, tenancy reforms, ceiling on land holdings, and consolidation and encouragement of co-operatives.

Agrarian Reforms

Agrarian reform is a broader term. Along with land reforms it also includes measures to modernize the agricultural practices and improving the living conditions of entire agrarian population. It also covers the establishment of co-operatives; development of institutions to provide agricultural credit and other inputs; processing and marketing of agricultural produce; and establishment of ago-based industries etc.

Land Right

Land right is defined as legally and socially recognized claims on land enforceable by a legitimized authority like state government. Land rights can be in the form of ownership, different degrees of freedom to lease out, mortgage, or sell.

Constitutional Provisions Towards Land and Land Reforms in India

The constitution of India has included the Land reform in State subjects. The Entry 18 of the State List is related to land and rights over the land. The state governments are given the power to enact laws over matters related to land.

Part IV of the Directive Principles of State Policy also indirectly mandates the government to take measures for land reforms to achieve an egalitarian society.

The Entry 20 in the concurrent list also mandates the Central Government to fulfil its role in Social and Economic Planning. The Planning Commission was established for suggestion of measures for land reforms in the country. The specific articles of the constitution that pertain to land reforms are as follows:

- Article 23 under fundamental rights abolished Begar or forced unpaid labour in India.
- Article 38 under Directive principles directed the state to minimize inequality of income, status and opportunities.
- Article 39 under the Directive Principles directed the state to work for equitable distribution of the material resources of the community for common good.
- Article 48 directed the state to organize agriculture and animal husbandry on modern-

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scientific lines.

Further, immediately after the independence, the state government enacted laws to abolish the Zamindari, Jotedari, Ryotwari etc. systems. But soon, these laws were dragged into the court on the basis that they violated the fundamental rights to property of the Zamindars under article 19 and 31. Consequently, the first amendment of the constitution was passed that amended the constitution and secured the constitutional validity of zamindari abolition laws passed by states.

Objectives of land reforms

The main objective of the land reforms programme is to *do away with the existing inequalities in the system of landholding* and *to increase the agricultural productivity.* The Five Year Plans aimed to remove the impediments for increase in agricultural production and elimination of exploitation and social injustice within the agrarian system so as to achieve equality and providing opportunities for all sections of the rural society.

The other objectives of land reforms are *abolition of intermediaries* and their exploitative practices on real tillers of the land. The measures sought to enable the *redistribution of lands from the hands of middlemen to the tillers themselves.* Ceiling on agricultural holdings aimed to ensure that ownership of land does not get concentrated in a few hands. Tenancy reforms seek to give rights to tenants or *complete abolition of tenancy.*

Efforts in Land Reforms

Changing the man-land relations and the man-man relations on land has been a concern for decision-makers and people of a country. Whenever there is exploitation of landlords or the government's failure to frame the policies, peasants and people's movements targeted the oppressors and policy makers. The efforts in land reforms can be categorised under four heads.

- Governmental action (top-down): This is related to enactment of various laws related to land.
- Peasants or people's movements (Bottom-up): Protest movements from disadvantaged sections. These movements have often turned militant.
- Initiatives by individuals, charismatic leaders or non-governmental organizations. Such voluntary efforts aims to bring the change through non-violent and consensus based decisions. Bhoodan and Gramdan movements are glaring examples of this.
- Based on efforts of two or more of the above three categories above.

Government Action Towards Land Reforms

In India, governmental efforts in land reform are basically centred around the following five measures:

- Abolition of intermediaries;
- Tenancy reforms;

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- Ceiling on land holdings;
- Consolidation of land holdings;
- Legislations and their Implementation.

Abolition of Zamindari and other such systems

The major objective of land reforms in free India was to abolish intermediaries and to bring changes in the revenue system that would be favourable to cultivators. The process of abolition of Zamindari, Jagirdari, Ryotwari etc. system had started even before the constitution of India came into effect.

Position of the intermediaries at the time of independence

On the eve of the independence, there were two extremes in India. On one extreme, there were landless labourers and tenants-at-will while on the other end, there were big landlords having huge estates. However, various tenancy systems had undergone vast transformation in 150 years of their practice. The coexistence of Zamindari, Mahalwari and Ryotwari led to intermixing of their characteristics, which led to drastic problems at the time of enactment of Zamindari abolition laws. The intermixing of the various systems made it difficult to know who was the rentier. This problem was made further complex due to land sub-letting, absentee landlords, absence of proper records etc. The most harassing feature was absence of proper revenue records which made the task of abolition of intermediaries very difficult. Thus, there was a need felt for complete census of land holdings.

Zamindari Abolition Acts

The first important agrarian reform after independence was the abolition of the Zamindari system. The process of passing Zamindari abolition bills had started even when the constitution of India was not enacted. A number of provinces such as United Provinces (UP), Central Provinces, Bihar, Madras, Assam, Bombay had introduced such bills on the basis of a Zamindari Abolition committee, chaired by G.B. Pant. However, there was a widespread concern that he Zamindars would make every effort to cause delay in acquisition of their lands. When constitution was passed, right to property was enshrined as fundamental right under article 19 and 31. The provinces passed the Zamindari Abolition Acts but all these acts were challenged in the court on account of their constitutional validity. The supreme court upheld the rights of Zamindars. To secure the constitutional validity of these state acts, the parliament passed first amendment (1951) within 15 months of enactment of the constitution and second amendment in 1955. By 1956, Zamindari abolition act was passed in many provinces. Due to conferment of land rights, around 30 lakh tenants and share-croppers were able to acquire the ownership rights over a total cultivated area of 62 lakh acres throughout the country due to these acts. On the other hand, the compensation paid to Zamindars was generally small and varied from state to states.

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Tenancy Reforms

After passing the Zamindari Abolition Acts, the next major problem was of tenancy regulation. Tenancy reforms aim to regulation of rent, provide security of tenure and conferring ownership to tenants. The tenancy reforms laws provide the provisions for registration of tenants, or giving ownership rights to the former tenants to bring them directly under the state.

Regulation of Rent

The rent paid by the tenants during the pre-independence period was exorbitant. It was anything between the 35 and 75 percent of gross produce throughout India. With the enactment of legislation for regulating the rent payable by the cultivators in the early 1950s, fair rent was fixed at 20 to 25 percent of the gross produce level in all the states except Punjab, Haryana, Jammu and Kashmir, Tamil Nadu, and some parts of Andhra Pradesh. In these states, the rent payable by the tenants varied between 25 percent and 40 percent, depending on the available irrigation facilities.

Security of tenure

Providing security of tenure was the second important reforms brought about during the first three five-year plans via tenancy acts. Legislation for security of tenure had three essential elements:

- Ejection could not take place except in accordance with the provision of the law;
- Land could be resumed by an owner, but only for personal cultivation;
- and in the event of resumption, the tenant was assured of a prescribed minimum area.

Tenancy laws were enacted in all states though their implementation varied widely across the states.

Conferment of ownership rights to tenants

The third important component of tenancy legislations was the conferment of ownership rights to tenants.

At national level, a tenancy regulation policy was announced. As per this policy, large landowners were allowed to evict their tenants and to bring the land under personal cultivation up to a ceiling limit to be prescribed by each state. At that time, the term "personal cultivation" was defined as cultivation by the owner of the land and other members of his family.

The tenants of those lands which were not resumable (i.e. without landowners) were given occupancy rights on payment of a price to be fixed as a multiple of the rental value of the land.

The owners of land not exceeding a family holding were defined as small owners. Land belonging to small and middle owners was divided into two categories viz. land under personal cultivation, and land leased to tenants at will. If the land posses was below a ceiling restriction, tenants of such land owners were given limited protection, provided that it should be renewed for five to ten years and should be renewable, and that the maximum rent payable should not exceed 20 to 25 percent of the gross produce. However, in second five year plan, the definition of "personal cultivation" was

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amended with three elements viz. risk of cultivation, personal supervision, and personal labor. This further narrowed down to define who was eligible for the ownership rights on land. In the third five year plan, the final goal was fixed to confer rights of ownership to as many tenants as possible. The policy suggested that the states should study the problem and determine the suitable action in light of prevailing conditions. In the fourth plan, the tenancies were suggested to be declared non-resumable and permanent except in the case of landowners working in defence services or with any disability." Thus, the lands where cultivators, agricultural labourers, and artisans had constructed their houses, was now to be their own land.

All these efforts were partially successful in reversing the conditions of the British Era. But still, there were issues of tenants being forced to sell the lands due to poverty. The government was suggested to make efforts to bring them within the institutional credit regime.

In the sixth five year plan, a time bound schedule was given to the states to implement the measures of land reforms. It further recommended that the states in which legislative provisions for conferment of ownership rights on all tenants did not exist should immediately introduce appropriate legislative measures within one year (by 1981–1982). However, it was not achieved in all states.

Critical Assessment of Tenancy Reforms in Independent India

Despite repeated emphasis in the plan documents, some states could not pass legislation to confer rights of ownership to tenants. Few states in India have completely abolished tenancy while others states have given clearly spelt out rights to recognized tenants and sharecroppers. The tenancy reforms led to only a small percentage of tenants acquiring ownership rights, but undoubtedly it has reduced the area under tenancy.

Impact of Tenancy reforms on productivity

Further, since the tenancy reforms coincided with green revolution, it was difficult to define, how exactly it helped in productivity. However, some studies attempted to separate all the other effects and concluded that: –

- There was a positive correlation between the growth in production and the progress of tenancy.
- It led to changes such as greater social equity and self-confidence among the poor tenants.
- However, some studies criticise it and say that due to poor resource base, tenancy reforms could not led to growth in productivity.

The proportion of landless agricultural households in the rural area had stabilized. However, at the same time, there has been an increase in the marginal and small holdings. However, the increase in smaller holdings is also due to increase in population and lack of alternative employment in rural

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areas.

Land Ceiling & Consolidation of Landholdings

The land ceiling acts define the size of land that an individual/family can own. In India, by 1961-62, all the state governments have passed the land ceiling acts. But the ceiling limits varied from state to state. To bring uniformity across states, a new land ceiling policy was evolved in 1971. In 1972, national guidelines were issued with ceiling limits as 10-18 acres for best land, 18-27 acres for second class land and for the rest with 27-54 acres with a slightly higher limit in the hill and desert areas. Before 1972, the basis of land ceiling was an individual as a unit instead of family. Since 1972, family is considered as the unit of application for land ceilings. And also certain exemptions were allowed for plantations of crops like tea and coffee, Bhoodan Yagya Committees, registered cooperatives, and other bodies.

The land ceiling also deals with the acquisition of surplus land and its redistribution among the small farmers and landless workers. But the progress of redistribution of surplus land has been unsatisfactory.

A number of factors such as separate ceilings for major sons, exemptions for religious and charitable institutions, benami transfers, falsification of land deeds, judicial interventions, loopholes in ceiling laws, non-availability of land records, inefficient administration and lack of political-will etc. account for the failure of the land ceiling. Other reasons include the generally poor quality of surplus lands and lack of financial and institutional support to bring these lands under cultivation.

Consolidation of Landholdings

The fragmentation of land implies a single farm consists of numerous discrete parcels, often scattered over a large area. It results in inefficient use of soil, capital, and labour in the form of boundary lands and boundary disputes and litigation costs. Efficiency of cultivation is considerably reduced and also prevents land improvement. Consolidation refers to reorganization of fragmented holdings into one plot. Of all the land reform measures, this has received the least critical appreciation. The land consolidation was resisted by the small and marginal landowners because of the fear of displacement among tenants and sharecroppers and lack of updated land records; the perceived advantage of having land in fragmented parcels in the event of floods and other natural calamities or acquisition for public purposes.

Conclusion

After independence, most of the major legislations with far-reaching consequences to land reforms have been passed. The main features of the laws relating to land reforms are:

1. All states passed the laws to abolish intermediaries, with varying provisions for resumption for self-cultivation.

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2. Ceiling laws showed wide variations in their actual ceilings.
3. All laws provided heritable rights to the tenants. Eviction is possible only if tenants violates the conditions of the agreement or if the landowner wants the land back for self-cultivation.
4. In all states the provisions for redistribution gave preference to SC caste for allocation of surplus land.
5. Provisions with respect to tribal lands were made in every state with sizeable tribal populations.

Implementing these laws has been an uneven process in all the States. These differences were both in the timing of the laws as well as in their implementation.

Peasant Movements and Land Reforms

The peasant movements for agrarian reforms in India have always been centred on the issue of land ownership and land distribution. The term 'peasant' includes tenant, sharecropper, small farmer not regularly employed, hired labour, and landless labourers. Several peasant movements rose over economic questions all through the British period but with limited results. The 20th century saw some of the most violent and widespread peasant movements with far-reaching consequences. The main demands of these movements centred on reduction of excessive rent or revenue on produce and land redistribution from the rich to the poor. Many of these movements have provided the stimulus necessary for land legislation in India.

Some of the major movements of 20th century are discussed below:

Peasant Movements in Bihar

After the Champaran Satyagraha in 1917, Bihar became an important centre for peasant movements. These activities had addressed the problems of share croppers such as abolition of customary non-rent payments, regulation of eviction, and fixation of fair rent. The main centre of the movements was north Bihar. The Bihar Kisan Sabha, started in 1927, developed as an extensive organization under the leadership of Swami Sahajanand Saraswati. It was the strongest section of the All-India Kisan Sabha. With passage of Zamindari Abolition Act,1949, the movements disappeared. In 1978, the peasants in Bihar, under the leadership of the Yuva Chhatra Sangharsh Samity, organized a long drawn out struggle in Bodhgaya to secure land rights from the Shankar Math. The mahants (religious heads) of the Buddhist monasteries in the area had amassed huge tracts of land under the exemption given to religious and charitable institutions in the ceiling laws of the state. The situation erupted in violence. After the Supreme Court's directive to the effect that the land is handed over to the tillers, the struggle was considered to be successful.

Kisan Sabha and Khet Mazdoor Sabha in Uttar Pradesh

Kisan sabhas were started in U.P. in 1926-27. Their main demands centred on problems of tenants,

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such as giving tenants occupancy rights, abolishing non-rent extraction and forced labour, cancelling all rent arrears, reducing rent and water rates. These movements did not show much interest in problems of agricultural labourers. This led to the establishment of the Khet Mazdoor Sabha in 1959.

Tebhaga Movement in Bengal

Despite repeated famines in the Bengal region, the tenants were forced to surrender half of their produce to the landlords. The famine was worsened when the jotedar (landlord) class were indulged in hoarding and black marketing of food grains. In 1946, the *All India Kisan Sabha* started the Tebhaga movement, demanding that tenants be allowed to keep two-thirds of the produce. The movement received the massive support from agricultural labourers. The movement declined in 1947 due to crackdowns by the police, and the divisions that developed within the movement along religious lines.

Telangana Movement

One of the most politically effective peasant movements was seen in the erstwhile State of Hyderabad. In Telangana region, the land ownership was in the hands of very few ruling class people. The actual cultivators of the land were subjected to high rent, increasing indebtedness and a system of free labour (also known as the *vetti system*). The Communist Party of India took up these issues as the basis for a peasant's struggle against feudalism in the period 1946-48. The objectives of this armed struggle were land grabbing and redistribution, abolition of compulsory levy to the government, and stopping eviction of tenants under any pretext. The struggle turned in to violent with police retaliation against the Gram Raj Committees that were set up by the peasant groups to work as defence squads and institutions for self-governance. Laterthe A.P. (Telangana Area) Tenancy and Agricultural Lands Act, 1950, was passed when the Indian Government took over from the Nizam's rule.

Naxalbari Movement in West Bengal

In 1967, the Communist Party of India (Marxist-Leninist) had started a liberation movement by imitating Chinese Model, in the village of Naxalbari, Darjeeling district in north Bengal. The main issue of the movement was to secure rights for the marginalized sections of the agricultural community. In the course of the movement, several peasant committees were set up and land was redistributed. Several landlords were put on trial and executed. Village defence squads were established with agricultural labourers as its leaders. Later the revolution was quickly liquidated. The Naxalbari movement is one of the most widespread movements of the present times. Now, it no longer confines its issues to land reforms, but also on larger issues of corruption, exploitation, maladministration.

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Voluntary Efforts Towards Land Reforms

Traditionally, voluntary efforts in India were confined to educational and welfare-related activities to benefit the disadvantaged sections of society. Gandhiji had introduced the voluntary efforts initially in promotion of village and cottage industries, animal husbandry and agriculture. It is only after independence, the voluntary efforts started focusing on economic issues. Since then the voluntary organisations focussed on larger issues of poverty alleviation, income generation, watershed management, etc.

Voluntary efforts can be initiated either by individuals or by organizations, both formal and informal.

Individual Efforts : Bhoodan and Gramdan

The Bhoodan and Gramdan movements led by Vinoba Bhave attempted to bring about a “non-violent revolution” in India’s land reforms programme. These integrated movements were an attempted to implement land reforms by urging the landed classes to voluntarily surrender a part of their land to the landless. The Bhoodan was started in 1951. The problems faced by the landless harijans were presented to Vinoba Bhave in Pochampalli, Telangana.

In response to appeal by Vinoba Bhave, some land owing class agreed to voluntary donation of their some part of land. This led to the birth of Bhoodan Movement. Central and State governments had provided the necessary assistance to Vinoba Bhave. Later, Bhoodan gave way to the Gramdan movement which began in 1952. The objective of the Gramdan movement was to persuade landowners and leaseholders in each village to renounce their land rights and all the lands would become the property of a village association for egalitarian redistribution and joint cultivation. A village is declared as Gramdan when at least 75 per cent of its residents with 51 per cent of the land signify their approval in writing for Gramdan. The first village to come under Gramdan, was Magroth, Haripur, Uttar Pradesh.

The movement received widespread political patronage. Several state government passed laws by aimed at Gramdan and Bhoodan. The movement reached their peak around 1969. After 1969 Gramdan and Bhoodan lost its importance due to the shift from being a purely voluntary movement to a government supported programme. In 1967, after the withdrawal of Vinoba Bhave from the movement, it lost its mass base. In the later period, landlords had mostly donated land under dispute or unfit for cultivation. The whole movement was treated as something different from the general scheme of development rather than combining with the existing institutional means. This separation from the mainstream scheme seriously affected its continuation as a policy.

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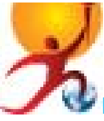

Organizational Efforts

Voluntary efforts by organisations were initially focussed on poverty alleviation. After the Bhoodan and Gramdan movements, voluntary organisations took up the issue of land reforms. They started working for the voluntary donation of land and its redistribution to the landless. The voluntary organisations have realized that land reforms core around which the whole issue of poverty removal and equality should revolve. This realization was confined to a minority, and did not gain general acceptance. After the passage of ceiling acts, acquiring land for redistribution was removed from the agenda issue for voluntary organisations. Instead, the focus shifted to securing rights to the tenants and landless by promoting the causes of land consolidation, identifying the beneficiaries for the programmes.

Other activities of the voluntary agencies are:

- Awareness generation among the peasants about the importance of the land reform and motivating them to initiate action against the violators of the laws.
- Distribution of pattas among the landless workers, who have not been covered under formal ownership rights.
- Providing legal assistance to the rural poor to deal with the legalities of land rights.
- Identification of the landless for purposes of redistribution of surplus land.
- Provision of training in agriculture and supplying of inputs like seeds, fertilizers and technology.

Combined Efforts

Whenever the government tries to initiate and implement a programme with the active cooperation of the peasants and voluntary organisations, such efforts be largely successful.

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General Knowledge Today

Population, Census & Unemployment Fundamentals

Target 2016: Integrated IAS General Studies

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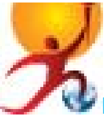

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Model Questions

Prelims MCQ Topics

Dependency Ratio, Demographic Transition Theory, Age Sex Pyramids, Push Pull Factors of Migration, Birth Rate, Death Rate, Total Fertility Rate, Demographic Dividend & Longevity Dividend, Census Act Provisions, Canvasser method and 'householder' method of enumeration, Population Extremes (highest, lowest states, districts), SECC Objectives, data, angle of deprivation, Labour Force versus Workers Force, Labour Force Participation Rate, Types of Unemployment, Employment Elasticity, Trend in Female Labour Force Participation Rate.

Mains Model Questions

1. What do you mean by 'disguised unemployment'? Do you think that it can be used as a source of capital formation? Examine its limitations.
2. "Poverty and unemployment are inseparable twins". An effective anti-poverty programme should aim at solving the unemployment problem. Elucidate
3. "Migration, fertility and mortality are the basic fundamental elements determining population growth and demographic structure of a country." Elucidate.
4. "Economists in India have put forward the reasons for and against the question of whether India is over-populated." Discuss presenting your view.
5. "The growing population problem calls for a definite population policy and its effective implementation."Discuss.
6. "India's national population policies have failed to achieve their objectives as we remain world's second largest populated country." What are the shortcomings? Discuss.
7. "The recently released religious data in Census 2011 had stripped up a controversy with respect to the growth of the minority population in India." Critically examine the issue.
8. "The key rationale behind conducting a socio-economic and caste census was to assess the population that is actually below the poverty line (BPL)." To what extent the methodology adopted has been successful in SECC-2011 objectives? Discuss critically.
9. "Despite of so many committees formed over the last many decades, there has never been a correct insight into who are the legitimate beneficiaries of the welfare schemes." Critically examine.
10. "Economic Development must bring some notable changes in the structural, institutional and technical set up." Throw light.
11. What do you understand by Employment Elasticity? Discuss the Employment Elasticity

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trends in India in different sectors over there recent years.

12. Critically examine the recent trends in labour force and workforce participation rates of women in India.

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Part: A: Fundamentals in Population

Dependency Ratio

Dependency ratio refers to the ratio of persons of ages under 15 years and over 64 years to the persons of ages 15-64 years. The persons below 15 years and above 64 years are defined dependent while persons between 15-64 years age are defined as economically productive.

$$Dependency\,ratio = \frac{(number\ of\ people\ aged\ 0-14\ and\ those\ aged\ 65\ and\ over)}{number\ of\ people\ aged\ 15-64} \times 100$$

Dependency Ratio is also sometimes called Total Dependency Ratio. It is made up of two different ratio viz. Child Dependency Ratio and Age Dependency Ratio.

Child Dependency Ratio

Child dependency ratio is the ratio of persons under age 15 to number of people aged 15-64.

$$Child\ dependency\ ratio = \frac{number\ of\ people\ aged\ 0-14}{number\ of\ people\ aged\ 15-64} \times 100$$

Aged Dependency Ratio

Age dependency ratio is the ratio of persons above age 65 to number of people aged 15-64.

$$Aged\ dependency\ ratio = \frac{number\ of\ people\ aged\ 65\ and\ over}{number\ of\ people\ aged\ 15-64} \times 100$$

Important notes on Dependency Ratio

- A higher dependency ratio means that more and more people (children and aged) are dependent on the working population of a country.
- The higher dependency ratio necessitates the government to spend more on health, education, social security, age related pensions, disability pension etc.
- Higher dependency ratio is a feature of aging populations and populations with higher birth rate in comparison to death rates.
- The developing and least developed countries have tendency to show a higher dependency ration.

Thus, increasing **dependency ratio** brings more economic pressure on working population. As the ratio increases there may be an increased burden on the productive part of the population to maintain the means of livelihood of the economically dependent. This results in direct impacts on financial expenditures on things like social security, as well as many indirect consequences.

Demographic Transition Theory

The demographic transition theory studies the relationship between economic development and population growth. It discusses about changes in birth rate and death rate and consequently growth

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rate of population in assonance with the process of growth and development. It is also used to describe and predict the future population of any area. The theory tells us that population of any region changes from high births and high deaths to low births and low deaths as society progresses from rural agrarian and illiterate to urban industrial and literate society. These changes occu**in stages** which are collectively known as the demographic cycle. There are four stages of demographic transition related to the state of economic development.

First Stage or Stage of High Birth Rate and High Death Rate

In first stage, the country is at low level of economic development. Agriculture is the main occupation of the people. Standard of living of the people is low. Death rate is high because of lack of medical facilities, epidemics, famines and illiteracy. Birth rate is high because of social and economic reasons. The key notable features of this stage are as follows:

- *Population Pyramid in the first stage is Expanding at the bottom*
- Stable population
- High birth rate, High infant mortality and High death rate = low life expectancy
- Many young people, very few older people
- High fertility rate (8+)

The first stage has high fertility and high mortality because people reproduce more to compensate for the deaths due to epidemics and variable food supply. The population growth is slow and most of the people are engaged in agriculture where large families are an asset. Life expectancy is low, people are mostly illiterate and have low levels of technology. Two hundred years ago all the countries of the world were in this stage.

Second Stage or Stage of High Birth Rate and Low Death Rate or Stage of Population Explosion

In this stage, birth-rate is high but death rate is low. It results in high growth rate of population. In this stage, income begins to rise and economic activities expand. On account of better health facilities and nourishing diet, death rate falls rapidly. Birth rate remains high due to social backwardness and limited access to contraceptives. The key notable features of this stage are as follows:

- Population Pyramid in this stage is Rapidly Expanding
- Very rapid increase in population (population explosion)
- Rapid decline in death rate but death rate remains below the birth rate
- Fertility rate remains high
- High birth rate
- High rate of natural increase
- Decline in infant mortality
- Many young people

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Fertility remains high in the beginning of second stage but it declines with time. This is accompanied by **reduced mortality rate**. Improvements in sanitation and health conditions lead to decline in mortality. Because of this gap the net addition to population is high.

Third Stage or Stage of Declining Birth Rate and Low Death Rate

In the third stage, a declining birth rate and low death rate lead to low population growth. Along with economic development of the country, structural changes in the economy begin to take place. Large population begins to reside in urban areas. People start considering large families as liability. Consequently, birth rate begins to fall. Death rate continues to be low. Growth rate of population declines. India is passing through this stage of demographic transition. The key notable features of this stage are as follows:

- The Population Pyramid in third stage is Stationary
- Population growth slows down
- Birth rate declining rapidly
- Decline in fertility rate
- Death rate declining slowly
- Birth rate approaching death rate
- High life expectancy
- Increasing number of older people

Fourth Stage or Stage of Low Birth Rate and Low Death Rate

In the fourth stage, low birth rate and low death rate lead to Population stabilisation. In this stage, because of rapid economic development, standard of living of the people becomes very high. Quality of life is given a priority to the size of the family. The key notable features of this stage are as follows:

- Population Pyramid is Contracting
- Stable or slow population increase
- Low birth rate
- Low death rate
- High life expectancy
- Birth rate is approximately the same as the death rate
- Fertility rate is close to or below 2.1
- Many older people

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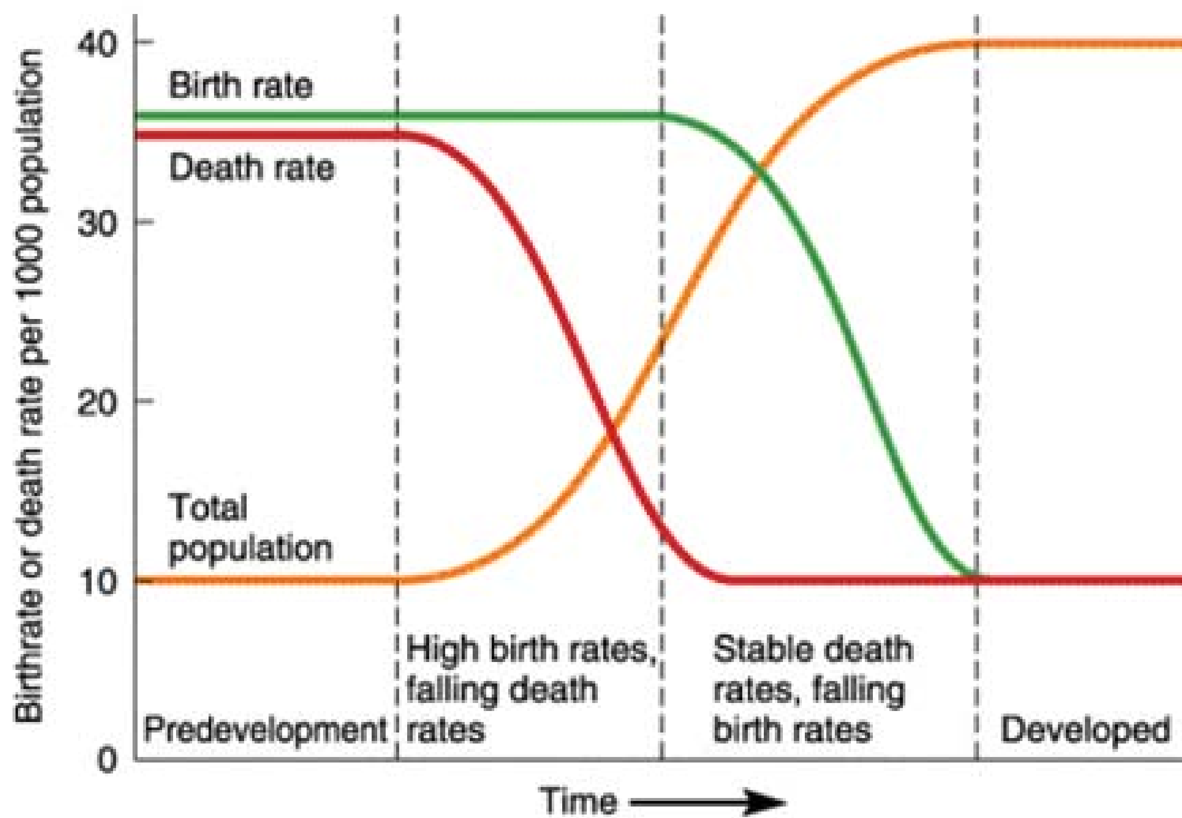

In the last stage, both fertility and mortality decline considerably. The population is either stable or grows slowly. The population becomes urbanised, literate and has high technical knowhow and deliberately controls the family size. This shows that human beings are extremely flexible and are able to adjust their fertility. In the present day, different countries are at different stages of demographic transition.

Age Sex Pyramids

The age-sex structure of a population refers to the number of females and males in different age groups. An age sex pyramid or population pyramid is used to show the age-sex structure of the population. The shape of the population pyramid reflects the characteristics of the population and also indicates whether the population is experiencing growth or decline or stability.

In an age sex pyramid, the left side shows the percentage of males while the right side shows the percentage of women in each age group. By convention, the younger ages are at the bottom.

Triangle Shaped Pyramid

A Triangle shaped pyramid with a wide base reflects that the number of people with lower age groups is larger and thus there would be high birth rates.

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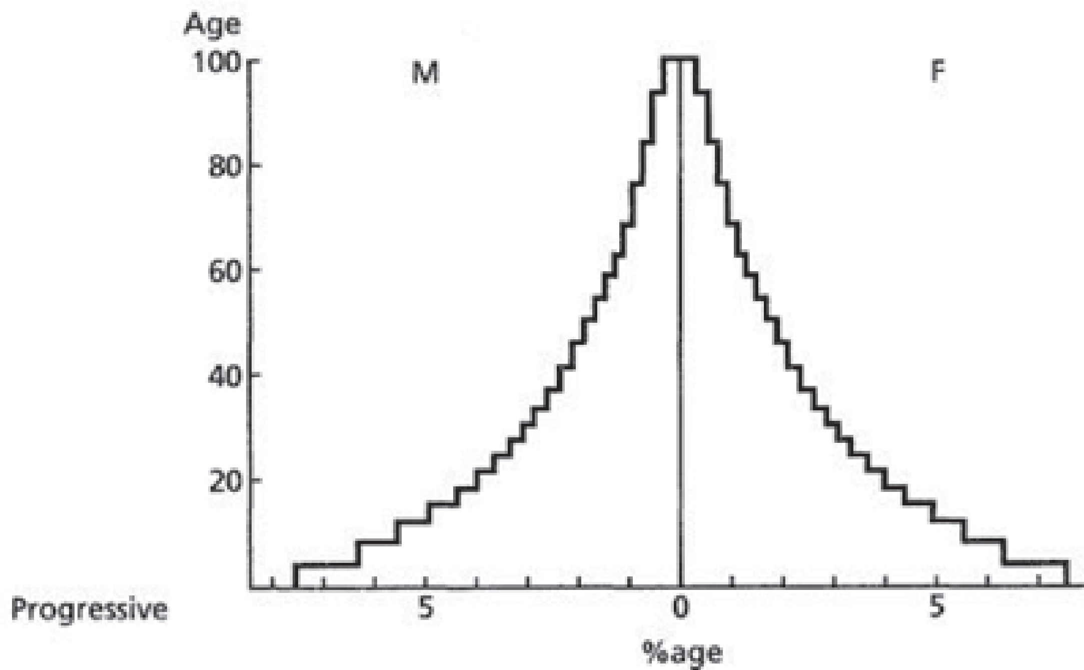

This kind of age sex pyramid is typical for Nigeria, Bangladesh or Mexico or such less developed countries. These have larger populations in lower age groups due to high birth rates.

Bell shaped Pyramid tapered at top

Australia's age-sex pyramid is bell shaped and tapered towards the top. This shows birth and death rates are almost equal leading to a near constant population.

Bell shaped Pyramid tapered at top and bottom

The Japan pyramid has a narrow base and a tapered top showing low birth and death rates. The population growth in developed countries is usually zero or negative.

India's Age Sex Pyramid

India's population is to grow by just over 57% between 2000 and 2050. This overall growth will, in part, be due to increased life expectancy and, therefore, a larger elderly population – around 10 million aged 80 years and over in 2005 to grow to around 50 million in 2050. However, the population is expected to begin to decline beyond 2050, with the 0-4 year old group falling from over 110 million in 2005 to just over 105 million. This means that India's Age Sex Pyramid was on stage 1 in past and expected to be at stage 4 in 2050. Since 1981, India has been passing through the**Third Stage** of demographic transition. Few states and union territories of India already reached the fourth stage.

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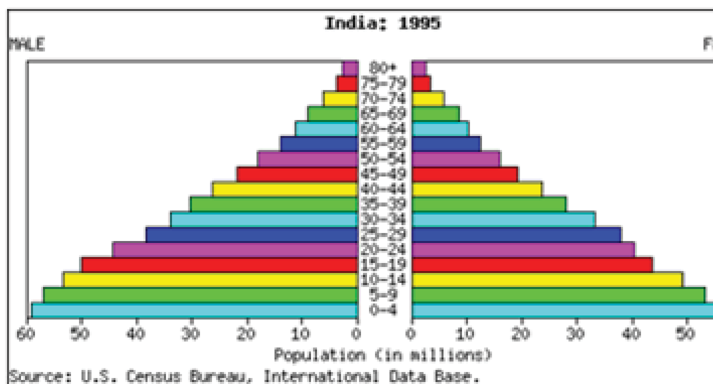

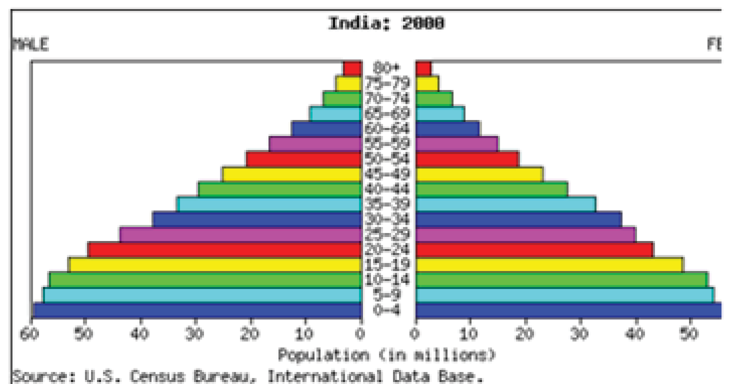

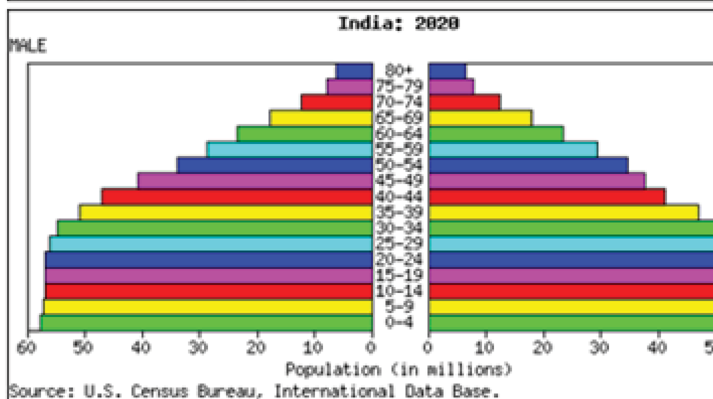

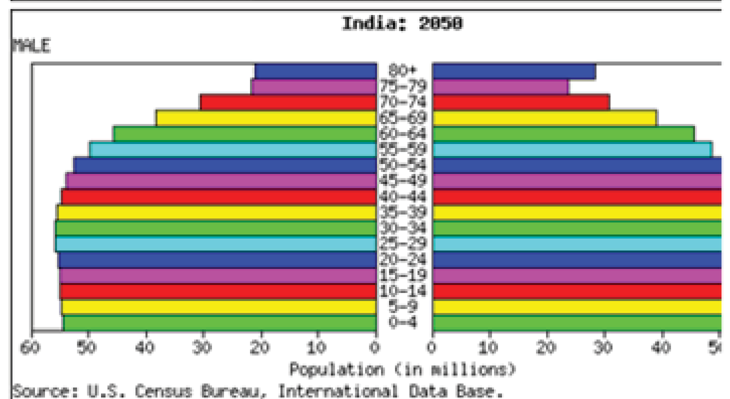

Migration

Migration, fertility and mortality are the basic fundamental elements determining population growth and demographic structure of a country.

Migration is permanent or semi-permanent change of residence of an individual or group of people over a significant distance. It can be international, intra-national, interregional, intra-urban, rural-to-urban or urban-to-rural. On the basis of distance, it may be long or short distance. On the basis of number, it may be individual or mass; it may be politically sponsored or voluntary. On the basis of social organisation, migration may be that of family, community, clan, or individual. On the basis of causes, migration may be economic, social, cultural, religious or political. Migration may be stepwise or direct from the place of origin to the destination.

There can be various causes of migration such as over population, economic causes, technology, political causes, socio-religious causes, demographic causes and wars.

Factors Affecting Migration

People migrate for a better economic and social life. There are two sets of factors that influence migration.

- The **Push factors** make the place of origin seem less attractive for reasons like unemployment, poor living conditions, political turmoil, unpleasant climate, natural disasters, epidemics and socio-economic backwardness.
- The **Pull factors** make the place of destination seem more attractive than the place of origin

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for reasons like better job opportunities and living conditions, peace and stability, security of life and property and pleasant climate

Consequences of Migration

Migration has a direct and indirect consequence on society, demography, economy, and environment. Some of the main consequences of migration are:

Reallocation of resources

- Generally, people from the crowded and overpopulated areas emigrate to the areas of sparse population with better re-source base, which helps in maintaining a balance between population and physical resources.

Change in demographic characteristics

- Migration brings tangible change in demographic characteristics of place of origin and place of destination. The absolute number of population, the density of population, age composition, and literacy rates are either favourably or adversely affected.

Change in sex ratio

- The sex ratio at the place of destination drops as the male members have been added while the sex ratio at the place of origin increases.

Economic gains

- There is more intensive and judicious utilisation of physical resources at the place of destination, leading to higher agricultural and industrial production. The migrants send money back to home to their families which brings prosperity to the place of origin of migration also.

Transformation of ethnic characteristics

- The physical and marital contacts of people belonging to different ethnic groups may change the biological characteristic of the migrants and that of the host population.

Transformation of cultural values

- When large scale migration takes place, the cultural values of the people undergo radical transformation. The dietary habits of the people are also significantly transformed.

Crude Birth Rate

Crude Birth Rate

The Crude Birth Rate (CBR) is expressed as number of live births in a year per thousand of population. It is calculated as:

$$CBR = \frac{Bi}{P} X\ 1000$$

Where *Bi* is the number of live births during the year and P is the mid-year population. This implies that A country with a population of 2 million and has 40,000 live births per year; it has a **crude birth rate** of 20.

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India's Crude Birth Rate

The Crude Birth Rate (CBR) at the national level during 2013 stands at 21.4, a decline of 0.2 points over 2012. The maximum CBR has been reported in Bihar (27.6) and the minimum in Kerala (14.7).

Crude Death Rate

Death rate plays an active role in population change. Population growth occurs not only by increasing births rate but also due to decreasing death rate. Crude Death Rate (CDR) is a simple method of measuring mortality of any area. CDR is expressed in terms of number of deaths in a particular year per thousand of population in a particular region

$$CDR = \frac{D}{P} X\ 1000$$

Where D is the number of deaths and P is mid-year population.

Rate of Natural Increase (RNI)

Crude Birth Rate minus Crude Death Rate is called Rate of natural increase (RNI). The RNI does not take into account the immigration and emigration of people, so it does not show population growth rate. Generally, the developing countries have high RNI while developed countries have low RNI.

Infant Mortality Rate & Maternal Mortality Rate

Infant Mortality Rate refers to the deaths of infants under age of one year per 1,000 live births. Infant Mortality Rate include Perinatal mortality, Neonatal mortality and Post-Neonatal mortality. *Perinatal mortality* only includes deaths from 22 weeks of pregnancy onward till 7th day after delivery. *Neonatal mortality* includes deaths in the first 28 days of life.*Postneonatal mortality* only includes deaths after 28 days of life but before one year. IMR is different from Child mortality, which refers to death of children below 5 years per 1000 live births.

Currently Highest IMR is found in Afghanistan, followed by African countries such as Mali, Somalia etc.

Maternal Mortality Rate

Maternal mortality Rate refers to number of women who die as a result of pregnancy and childbirth complications per *100,000 live births in a given year*.

Total Fertility Rate

Total Fertility Rate is the average number of children that a woman bears over her reproductive span. The reproductive age span of women taken for statistical purpose is between 15-49 years. A Total Fertility Rate of 2.1 is considered to be aReplacement Rate, i.e. the rate at which a given population is able to produce enough offspring to replace itself. This ratio ideally should be 2 (two parents produce 2 children) but taking into account for possible premature deaths, the replacement rate is considered to be 2.1 TFR. A TFR of above 2.1 shows increasing population, while below 2.1

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shows decreasing population.

India's TFR

India's TFR is around 2.6. Most of the states in India have above 2.1 replacement Total Fertility Rate. Highest TFR in India is in Bihar and Uttar Pradesh.

Demographic Dividend & Longevity Dividend

India is a nation of young people – out of a population of above 1.1 billion, 672 million people are in the age-group 15 to 59 years, – which is usually treated as the "working age population".

A few years back, it was proposed that India in near future (30 years) will see a sharp **decline in the dependency ratio** over, which will constitute a major 'demographic dividend' for India. In 2001, 11% of population of the country was in age group of 18-24 years which is expected to rise to 12% by the end of XI Five Year Plan.

However, recent data says that India's old age dependency ratio is increasing consistently:

Longevity Dividend

When people live longer, it offers society a chance to reap a 'longevity' dividend. This implies that the elderly continue to contribute significantly for an unprecedented period of time. However, in order to reap that benefit, it is necessary that the challenges of an ageing population and understood and effective policy are made in time.

Zero Population Growth

Zero population growth is an ideal condition when the birth rate equals death rate and the replacement level is 2. Zero population growth is often a goal of demographic planners and environmentalists who believe that reducing population growth is essential for the health of the ecosystem. Preserving cultural traditions and ethnic diversity is a factor for not allowing human populations levels or rates to fall too low. Zero population growth is seen with increase in elderly population which is opposite to demographic dividend.

Size and Trends of Growth of India's Population

India is the second largest populated country in the world. India's share in the world population is 17.5%. The population of India, at 121 crore, is almost equal to combined population of USA, Indonesia, Brazil, Pakistan, Bangladesh and Japan. In 1991, population of India was 84.64 crore and in 2001 it was 102.87 crore. Thus, during 1991 to 2001 we added 18.23 crore people and during 2001 to 2011 we added another 18.14 crore people. Thus, decade after decade, the size of our population is growing at explosive rates. But the average annual growth rate has recorded a decline from 1.97 percent in 2001 to 1.64 percent in 2011. But this decline is very modest and we are still in the danger zone as far as growth rate of population is concerned. The addition of 1.8 crore population every year will end up India being the most populated country in the world. According to the United

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Nations, India is set to replace China as the most populated country by 2022.

Census Year	Population (in crores)	Decadal growth (%)	Average Annual growth rate (%)
1901	23.83	–	–
1911	25.2	5.75	0.56
1921	25.13	-0.31	-0.03
1931	27.89	11.1	1.04
1941	31.86	14.22	1.33
1951	36.1	13.31	1.25
1961	43.92	21.64	1.96
1971	54.81	24.8	2.2
1981	68.33	24.66	2.22
1991	84.64	23.87	2.16
2001	102.87	21.54	1.97
2011	121.01	17.64	1.64

The growth rate of population started rising till 1951 though it was not a cause of concern. But after 1951, there was an alarming rise in the population. It continued till 1981. Since 1981, though population has been growing in absolute numbers, growth rate has been declining, offering a slight relief to the policy makers of the country. The growth of India's population can be divided into four periods.

Period of Stable Population (1891-1921)

During the period from 1891 to 1921, growth of Indian population was very slow and it was almost stable. During this period, only 1.27 crore persons were added to the total population. The size of the population increased from 23.87 crore in 1891 to 25.14 crore in 1921. The decades of 1891-1901 and 1911-1921 witnessed negative growth of population because of famines. During the decade of 1901-1911, there was positive growth of population.

Period of Steady Rise in Population (1921-1951)

The year 1921 was referred as the year of 'Great Divide.' From 1921 onwards India's population started rising steadily. The average annual growth rate of population during this 30 years period

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increased to 1.22 percent. In absolute number, population of India increased by 10.96 crore during this period.

Decade	Increase in population (in crores)	Population growth rate (%)
1921-1931	2.76	1.1
1931-1941	3.96	1.4
1941-1951	4.24	1.3

Period of Population Explosion (1951-1981)

Population Explosion is a situation in which size of population tends to become enormous owing to a widening gulf between birth rate and death rate. During the phase of 1951-1981, India witnessed population explosion. Growth rate of population reached to 2.2% by 1981. Average annual growth rate of the population during this period reached to 2.15%.

Period of Declining Growth Rate of Population (1981 Onwards)

From 1981 onwards, India's population is growing consistently but growth rate of population has been falling. Average annual growth rate of population was 1.64 percent in 2011. It was 2.16 in 1991 and 1.97 in 2001.But in its absolute size, population continues to rise. From 1981 to 201153 crore people were added to our population.

Causes of Population Explosion

There two main causes of high increase in population in India viz. High Birth Rate, and Low Death Rate. Birth rate refers to the number of children born per thousand persons in a year. Death rate refers to the number of persons who die per thousand persons in a year.

Improvement in health and medical facilities and proper distribution of food grains in the country brought down the death rate and increased the birth rate.

Causes of High Birth Rate

There are several causes of high birth rate in India.*Firstly*, poverty is main cause as poor people consider children as assets who help them to supplement family income even at the tender age. Secondly, illiteracy among the rural people has been traditionally an important reason. Due to high infant mortality rate, people were encouraged to have more children in last century. *Thirdly*, attitude towards having a male child resulted in high birth rate. *Fourthly*, early marriage results in long child bearing capacity and causes high birth rate. Universality of marriage in India also supplements this reason.

Causes of Decline in Death Rate

The death rate in past used to be very high due to epidemics and famines. Most of the epidemics have been controlled and mass destruction of human life does not take place due to epidemics. The spread

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of medical facilities in rural areas has reduced the occurrence of epidemics and communicable diseases like cholera and smallpox. Easy availability of life-saving drugs have saved lives of millions of people. The spread of institutional delivery, female education, urbanization etc. have resulted in decline of the death rates.

The Overpopulation Debate

There is no particular criterion to judge whether a country is over-populated or not. Economists in India have put forward the reasons for and against the question of whether India is over-populated.

Argument against the perception that India is over populated

Some economists argue that there are ample natural resources in the country. Output can be sufficiently increased by exploiting and utilising the natural resources judiciously. There is also rising per-capita income which proved that India is not over-populated. Population density in India is low compared to many other countries.

Argument favouring the perception that India is overpopulated

The standard of living in India is very low. Further increase in the population of poor families will prove to be fatal. The economic growth of the country is not able to create enough employment opportunities for the rising population.

Population Control in India – Remedial Measures

Large size of population is a challenge for India's economic development and is needs to be addressed. The growing population problem calls for a definite population policy and its effective implementation. There are several remedial measures to control population. *Firstly*, the late marriages should be encouraged to reduce the period of reproduction among the females, bringing down the birth rate. *Secondly,* self restraint due to spread of awareness and education can help in combating high rise in population. Increased consciousness towards better standard of life comes due to education and awareness and induces people to reduce their family size. *Thirdly*, Infant Mortality Rate should be brought down. People produce many children when Infant Mortality Rate is high, so that they can offset the loss due to premature death of their offspring. *Fourthly*, women should be treated on par with their male counterparts. Education among women should be encouraged to make them financially independent. Working women prefer small size families. *Fifthly*, more planned families should be covered under social security schemes. Children are born in India in a hope that they would take care of parents in old age. An increased social security net will lessen the desire to produce children as old age insurance. *Sixthly*, the availability of cheap devices of birth control should be in place.

National Population Policy

Government of India introduced first National Population Policy in 1976, which focussed on reducing birth rate, lowering infant mortality rate and improving standard of life. The policy was

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revised in 1977 which focussed on:

- No coercion for family planning
- Minimum marriage age 18 years for females and 21 years for males.
- Emphasis on awareness through education and media
- Mandatory registration of marriages
- Use of media for spreading the awareness about family planning among the rural masses.
- Monetary compensation to those who opt for permanent measures of birth control (sterilisation and tubectomy).

The National Population Policy 2000 provided a comprehensive framework to provide the reproductive and health needs of the people of India for the next ten years. It has fixed short term, medium term and long term goals as follows:

- Short term goal: Addressing the un-fulfilled needs of contraception and health care infrastructure. Provision ofintegrated service for basic reproductive and child health care.
- Medium term goal: Bring down the Total Fertility rate.
- Long term goal: To achieve a stable population by 2045.

The government implemented the policy with involvement of local level bodies and voluntary sector with funds from central government.

Critical Assessment of India's Population Policy

India's national population policies have failed to achieve their objectives as we remain world's second largest populated country. The population of India in 1951 was 35 crore, but by 2011, it had increased to 121 crore. There have been few shortcomings*Firstly,* the NPP have a narrow perspective, give much importance to contraception and sterilisation. The basic prerequisite of meaningfully controlling population include poverty alleviation, improving the standards of living and the spread of education. *Secondly*, on national scale the policy was not publicised and failed to generate mass support in favour of population control. *Thirdly*, we have insufficient infrastructure owing to the lack of trained staff, lack of adequate aptitude among the staff and limited use or misuse of the equipment for population control resulted in failure of the policy.*Lastly,* the use of coercion during the Emergency (1976-77) caused a serious resentment among the masses. This made the very NPP itself very unpopular.

Part-B: Census Information

Basic Information About Census

Earliest reference to Census in India comes from Kautilya's Arthashashtra. In Mughal period, writings of Abul Fazal in Ain-e-Akbari also give reference to the census.

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First Census

- During British Era, first census was conducted non-synchronously in 1965, the efforts culminated in 1872 and thus, the 1872 Census is called first Census of India. First synchronous census was carried out in 1881. Since then, Census in India is carried out every 10 years. Census 2011 was the latest and fifteenth Census in this continuous series from 1872. It was *seventh* since Independence.
- Indian population census organisation is considered as the largest administrative network in the world.

Census Act Provisions

In India, the population census is a Union subject (Article 246) and is listed at serial number 69 of the seventh schedule of the constitution. The Census Act 1948 forms the legal basis for conduct of census in independent India. Although the Census Act is an instrument of Central legislation, in the scheme of its execution, state hierarchy is setup at all levels by State Governments for the purpose of carrying out census.

- Census Act 1948 gives necessary authority to the Census Organization to access to households and canvass the prescribed questionnaires and to expect the people to answer truthfully. This act empowers Central Government to notify the date for the census and to appoint a Census Commissioner and Superintendents of Census Operations in States.
- The Act enjoins upon every citizen to assist in the taking of census. The law makes it obligatory on the part of every citizen to answer the census question truthfully.
- The Act provides penalties for giving false answer or not giving answers at all to the census questionnaire.
- The law calls upon the census officers to discharge their duties faithfully and warns them against putting any question to a person which is not covered by the questionnaire and they are required to record the answers as given by the person enumerated.
- One of the most important provision of the Census Act 1948 is that it makes provisions for the maintenance of secrecy of the information collected at the census of each individual.
- The Act requires strict secrecy to be maintained about the individual's record which *should not be used for any purpose against the individual except for an offence in connection with the census itself.*
- The *census records are not open to inspection and also not admissible in evidence.* The answers ascertained at the census can be used only for statistical purposes in which the individual data get submerged.
- Services of teachers can be used for works of national importance like Census, disaster relief, elections etc. (as per RTE section 27)

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- Section 27 of the Right to Education makes it obligatory for the teachers to be deployed in Census, disaster relief duties etc.
- Census Records Can NOT be used as evidence in any civil proceeding or criminal proceeding other than a prosecution under the Census act itself.

Operational Unit of enumeration is Household on individual

- The Census aims at enumerating every individual. But the operational unit is not the Individual but the household. A household is generally understood as a group of persons commonly living together and partaking of food from the same kitchen. There may be one or more than one households sharing one house. The census officers are trained and mandated to clearly locate every house and household(s) therein.
- For the census purpose, the country is divided into states and sub-divided into districts and further sub-divided into sub-districts, sub-divisions, taluks etc. The smallest unit of administration will ultimately be a village or a town.

Census Organization

- Census Organisation under the Union Home Ministry has been functioning on permanent footing ever since 1961 and provides a vital continuity to conceive, plan and implement the programme of census taking in country. The Organisation headed by the Registrar General and Census Commissioner, India has field offices in thirty three States and Union territories. These are permanent Directorates headed by the Directors of Census Operations, who are mainly responsible for the conduct of census in their respective jurisdiction.
- The states appoint State Co-ordinators for furthering co-ordination between the Directorate, Government of India and the State Government. Deputy Commissioners under the guidance of Divisional Commissioners function as Divisional Census Officers at the Division level in states. District Collectors as Principal Census Officers are responsible for the census work in their respective districts.

Objective of conducting a Census

- India is a welfare State. Since independence, Five Year Plans, Annual Plans and various welfare schemes have been launched for the benefit of the common man. All these require information at the grass root level. This information is provided by the Census. Census is the basis of how the number of seats in Parliamentary/Assembly Constituencies, Panchayats and other local bodies are determined. Similarly, Census helps on how the boundaries of such constituencies are demarcated. Census provides information on a large number of areas.
- House listing and Housing Census has immense utility as it provides comprehensive data on the conditions of human settlements, housing deficit and consequently a wide range of data on amenities and assets available to the households, information much needed by various

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departments of the Union and State Governments and other non Governmental agencies for development and planning at the local level as well as the State level. This would also provide the base for Population Enumeration.

Canvasser method and 'householder' method of enumeration

'Canvasser' and the 'Householder' methods are the two recognised methods of census enumeration.

- Under the 'Canvasser' method the enumerator approaches every household and records the answer on the schedules himself after ascertaining the particulars from the head of the household or other knowledgeable persons in the This is followed in India.
- Under the 'householder' method the enumerator distributes the census schedules to each household in his jurisdiction and the head of the household is expected to fill the answer for all members of his household and the enumerator later collects back the answered schedules soon after the census day is over.
- *Since literacy is still low, the 'canvasser' method is the only practical method in India.*

The Census of India is conducted once in a decade, following an extended de facto canvasser method. Under this approach, data is collected from every individual by visiting the household and canvassing the questionnaire all over the country, over a period of three weeks. The count is then updated to the reference date and time by conducting a Revisional Round. In the Revisional Round, changes in the entries that arise on account of births, deaths and migration between the time of the enumerator's visit and the reference date/time are noted down and the record is updated.

De-facto and De-jure enumeration

An important question pertaining to enumeration that always arises at a Population Census is whether the population should be counted on a de-facto basis i.e. at the place where a person is actually found on the reference date of the census or on a de-jure basis i.e., count a person only according to the place of normal residence.

- Of these, the enumeration on *de-jure basis is more difficult to achieve without the risks of omission or double count* Enumeration of de-facto population though may appear simple will be difficult unless the movement of population is restricted on the census day and the entire enumeration is got through on a single night which is operationally difficult specifically when large population has to be covered by canvasser method.
- In practice, therefore, enumeration on a 100 per cent de-facto or de-jure basis is impossible and often times a variation or even a combination of the two is resorted to. The census instructions should clearly lay down who are the persons who should be enumerated during the census enumeration period.

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Census 2011: Key Data

The Census of India 2011 was conducted in two phases as follows House listing and Housing Census and Population Enumeration. The population of India, at 1210.2 million, is almost equal to the combined population of U.S.A., Indonesia, Brazil, Pakistan, Bangladesh and Japan put together (1214.3 million). The population of India has increased by more than 181 million during the decade 2001-2011. The absolute addition is slightly lower than the population of Brazil, the fifth most populous 10 country in the world. 2001-2011 is the first decade (with the exception of 1911- 1921) which has actually added lesser population compared to the previous decade. The percentage decadal growth 14 during 2001-2011 has registered the sharpest decline since Independence – a decrease of 3.90 percentage points from 21.54 to 17.64 percent.

Top 10 States with highest population

Rank	State	Population (2011 Census)
1	Uttar Pradesh	19,95,81,477
2	Maharashtra	11,23,72,972
3	Bihar	10,38,04,637
4	West Bengal	9,13,47,736
5	Andhra Pradesh	8,46,65,533
6	Madhya Pradesh	7,25,97,565
7	Tamil Nadu	7,21,38,958
8	Rajasthan	6,86,21,012
9	Karnataka	6,11,30,704
10	Gujarat	6,03,83,628

Uttar Pradesh (200 million) is the most populous State in the country – population is more than the population of Brazil. The combined population of Uttar Pradesh and Maharashtra (312 million) is greater than the population of USA.

All top populated states show decline in decadal growth rate in 2001-2011 in comparison to 1991-2001.

Bottom 10 States with Lowest Population

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Rank	State	Population(2011 Census)
18	Jammu and Kashmir	1,25,48,926
19	Uttarakhand	1,01,16,752
20	Himachal Pradesh	68,56,509
21	Tripura	36,71,032
22	Meghalaya	29,64,007
23	Manipur	27,21,756
24	Nagaland	19,80,602
25	Goa	14,57,723
26	Arunachal Pradesh	13,82,611
27	Mizoram	10,91,014
28	Sikkim	6,07,688

Highest populated Districts of India

Thane with population of 1.1 Crore is the most populated district of India. North Twenty Fourth Pargana in West Bengal is the second most populous district of India with a population of 1.08 Crore.

Lowest Populated Districts of India

With a population of 7948, Dibang Valley in Arunachal Pradesh is the lowest populated district of India. Second lowest populated district of India is Anjaw which is also in Arunachal Pradesh. It had a population of 21089 in Census 2011.

States with Highest Decadal Growth Rate 2001-2011

According to Census 2011, Meghalaya has registered the highest decadal growth rate during 2001-11. Top ten states with highest decadal growth rate in India are as follows:

State	% Growth (2001-2011)
Meghalaya	27.80%
Arunachal Pradesh	25.90%
Bihar	25.10%

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State	% Growth (2001-2011)
Jammu and Kashmir	23.70%
Mizoram	22.80%
Chhattisgarh	22.60%
Jharkhand	22.30%
Rajasthan	21.40%
Madhya Pradesh	20.30%

However, if we compare all states and UTs, then the highest decadal growth is registered by Dadra and Nagar Haveli that is 55.50% . Lowest Growth Rate has been of Nagaland – Negative .47%, followed by Kerala – 4.86%.

Union Territory	% Growth 2001-2011
Dadra and Nagar Haveli	55.50%
Daman and Diu	53.50%
Pondicherry	27.70%
Delhi	21%
Chandigarh	17.10%
Andaman and Nicobar Islands	6.70%
Lakshadweep	6.20%

Districts with highest and lowest Decadal Growth Rate

District with highest decadal growth rate was Kurung Kumey in Arunachal Pradesh that registered 111% growth rate. District with lowest decadal growth rate was Longleng in Nagaland which registered -58.39% Growth rate.

Population of 0-6 Years

The total number of children in the age-group 0-6 is 158.8 million (-5 million since 2001). Highest population in this age group is in Uttar Pradesh. The 158.8 million children in age group 0-6 make 13.1 percent population of India. This figure was 15.9 percent in 2001 census. The decline in child population in the age group of 0-6 years to total Population is *indicative of fall in fertility*.

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Gender Composition of India's population

India Sex ratio is 940 as per Census 2011. The sex ratio was 933 as per 2001 population. The sex ratio at 940 is highest Sex Ratio recorded since Census 1971. However, so far highest sex ratio in India was recorded in Census 1961. Kerala has highest sex ratio (1084) while Daman & Diu has lowest sex ratio (618). Mahe district of Puducherry is the district in India with highest sex ratio (1176), while Daman district in Daman & Diu has lowest sex ratio (533). India's child sex ratio (0-6 years) is 914, which is lowest since independence. Further, the three major States (J&K, Bihar & Gujarat) have shown decline in Sex Ratio as compared to Census 2001.

Literacy in census 2011

India's literacy rates stands at 74.04 % for age 7 and above. The literacy has increased by 9.2% from 2001 Census. Male literacy stands at 82.14 and female literacy stands at 65.46. The gap of 21.59 percentage points recorded between male and female literacy rates in 2001 Census has reduced to 16.68 percentage points in 2011.

Population density

As per the provisional data of Census 2011, population density of India stands at 382, which is 17.5% more than 325 in Census 2001. NCT of Delhi with 11297 is has highest density in India, followed by Chandigarh where population density stands at 9252. Population density of Arunachal Pradesh is 17. Lowest among all states and Uts in India. Lowest Population density among Uts is of Andaman & Nicobar Islands (46).

Religious Data in Census

The data on Religious population was released in August 2015. Following table shows the religious population of India:

Religion	Numbers (Per cent of the population)
Hindu	96.63 crore (79.8 %)
Muslim	17.22 crore (14.2%)
Christian	2.78 crore (2.3%)
Sikh	2.08 crore (1.7%)
Buddhist	0.84 crore (0.7%)
Jain	0.45 crore (0.4%)
Other Religions & Persuasions (ORP)	0.79 crore (0.7%)
Religion Not Stated	0.29 crore (0.2%)

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Controversy over Religious Data in Census 2011

The data had stirred up a controversy (in media) with respect to the growth of the minority (Muslim) population. The data revealed that the share of Hindus in India's population had fallen very slightly from 80% to 79.8%. At the same time, the share of Muslims rose slightly from 13.4% in 2001 to 14.2% in 2011. But the data reveals that the rate of growth for Muslims is considerably lower than in previous decades. We note here that 2004 also similar controversies had erupted when the government released the Census 2001 data on religion. In 2005, the union government had set *Rajinder Sachar committee* to find out the social, economic and educational status of the Muslims. That report had discussed about the Muslim population growth in India and had thrown light on some of the misconceptions about the population growth of Muslims in India.

After the government released data, some went to extent of saying that the increased growth of Muslim population is a part of conspiracy to take over India demographically. However, such rhetoric throws further misgivings only. The demographic changes should be analyzed in not only short period context but also in context of structural socio-economic changes. The relatively faster growth rate in Muslim population is due to younger median age (22 in Muslims, 26 in Hindus) and relatively high Total Fertility Rate in Muslims (3.1) in comparison to Hindus (2.7) and Christians (2.3). The higher fertility rate is mainly because of low female literacy rates, poverty and backwardness. The Muslim women in India, particularly rural women live in stranglehold of the harsh customs and unable to act on their own to obtain family planning services to regulate their childbearing. However, fortunately, there is a growing awareness among the new generation for women. Muslim women are also challenging patriarchy that all women experience around unequal power hierarchies in society.

Socio-Economic Caste Census 2011

The 1st ever post independence Socio-Economic and Caste Census (SECC) 2011 began on 29 June 2011 from the Sankhola village of Hazemara block in West Tripura District. Government released the results of SECC-2011 in July 2015. SECC-2011 was first caste based census of Independent India. Earlier, caste based data was collected in 1931 Census. It was also SECC-2011 was also India's first paperless Census conducted on handheld devices by the government in 640 districts of the country. Government would use SECC-2011 data in all programmes such as NFSM, MGNREGA, Deen Dayal Upadhyaya Grameen Kaushalya Yojana etc and to identify the beneficiaries of direct benefit transfer (DBT) under the JAM (Jan Dhan-Aadhaar-Mobile) Trinity.

Objectives

The key rationale behind conducting a socio-economic and caste census was to assess the population that is actually below the poverty line (BPL).

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Methodology

The SECC-2011 was based on exclusion criteria under which *households possessing specified assets are automatically excluded from the list*. The crucial difference between past BPL censuses (as the SECC is also called) and the current one, apart from the methodology, is that caste was analysed for the first time on a nationwide scale. The SECC data included:

- households without shelter
- destitute/living on alms
- manual scavengers
- Primitive Tribal Groups
- legally released bonded labourers.

The above households would be given highest priority for inclusion in the BPL list. Rest households are identified as poor from the *angle of deprivation* to which they are subjected to. The Angle of Deprivation is based on several deprivation factors such as: the households which have only one room with kacha walls and kacha roof; there is no adult member in the household between 16-59 age; female headed households with no adult male member between age 16 to 59; households without able bodied adult members, households without literacy; landless households earning via only manual causal labour.

The government had fixed a formula to rank the households on the basis of *deprivation score* on the basis of seven criteria. The order of priority for inclusion of households in the BPL list is the largest number of deprivations to smallest number of deprivations.

Further, there was a provision to automatically exclude the people from BPL list if they have certain assets, for example- two/three vehicles, motorized boats, tractors and other farming machines, Kisan card with credit limit above Rs. 50000, households with any member as government employee (except honorarium based workers like ASHA, Anganwadi workers), households with some registered enterprises, households with any family member earning more than Rs. 10000 per month, income tax payees, households with pukka houses, having a refrigerator or landline phones, having 2.5 acre or more land with at least one tube well etc.

Key Findings

- Out of the 24.4 crore households in India, 17.9 crore live in villages, which is 73.3% of all households in India. Out of these, 10.7 Crore households are deprived.
- Close to 30% rural households are landless and do the manual causal labour for bread winning; 13% live in one room huts (with kacha walls or roof) and 22% of them are from SC/ST category. More than half (56%) rural households in India are landless.
- 36% rural people are illiterate in India. This figure was recorded 32% in Census 2011. Out of

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the remaining 64% literate, around 20% have not completed primary school.

- 35% of urban Indian households qualify as poor
- Around 1.80 Lakh households are still engaged in manual scavenging for livelihood. Largest number of manual scavengers in India are in Maharashtra state. Close to 64 thousand out of 1.80 Lakh households in entire country are engaged in manual scavenging in Maharashtra for living. Maharashtra (63,713) is followed by Madhya Pradesh (23,093), Uttar Pradesh (17,619), Tripura (17,332) and Karnataka (15,375) and Punjab.
- India's 0.1% population is comprised of transgender. Highest proportion of transgenders is in Andaman & Nicobar Islands, West Bengal, Gujarat, Odisha and Mizoram.

Important Trivia

- *The SECC-2011 was NOT conducted under the Census Act 1948*, which implies that the information collection was done on self-declaration model of the respondents.
- SECC 2011 has three census components which were conducted by three separate authorities as follows:
    - Census in Rural Area was conducted by the Department of Rural Development.
    - Census in Urban areas was done under the administrative jurisdiction of the Ministry of Housing and Urban Poverty Alleviation.
    - Caste Census was done under the administrative control of Ministry of Home Affairs (Registrar General and Census Commissioner of India)
- The paperless Census was done via handheld devices manufactured by Bharat Electronics Ltd. Management of Information System (MIS) for the management of the database of Socio Economic Census 2011 and to facilitate its subsequent use by the MORD, other ministries and State Governments to be facilitated by National Informatics Centre (NIC).
- The methodology for conducting the Census in Rural areas is based upon suggestion of Expert Group chaired by Dr NC Saxena and a Pilot Study carried out in 29 States/Union Territories, thereafter.

Analysis

Our country has always struggled to define who is poor. Despite of so many committees formed over the last many decades, there has never been a correct insight into who are the legitimate beneficiaries of the welfare schemes. Further, the official estimates of the poor have always tended to underestimate the number of poor in comparison to the estimates done by international organizations such as World Bank. In this context, the SECC data seems to quite enlightening and innovative. The use of various deprivation factors and automatic exclusion make it free from controversy. Further, its finding are different from what official estimations of rural as well as urban

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poor by different committees had been so far.

Extent of Rural Poverty

The *key finding of the SECC-2011 is that rural India is poor.* The main breadwinner of the 74.5% rural households in India earns less than Rs. 5000 per month. This ratio is even higher in states such as West Bengal (82.4%), Madhya Pradesh (83.52%) and Chhattisgarh (90.79%). However, SECC data needs to be adjusted for tendency of the rural people to not to tell correct income in fear of losing some entitlement benefits. However, despite we do all adjustment, there is no doubt that deprivation levels in rural India are still far too high.

Extent of Urban Poverty

According to SECC-2011, 35% of urban households are poor (below BPL). This figure is in striking contrast with the earlier estimates that ranged from 13.7% as per Tendulkar committee methodology, while 26.4% as per Rangarajan formula. Here, we should note that SECC numbers have greater credibility as the data has been collected via door-to-door enumeration. However, in urban areas also, there may be a tendency to understate income and asset ownership.

How SECC can help?

The decadal Census focuses on individuals while SECC has focussed on households. The data would be helpful for states and centre to target the most needy of the DBT and other schemes. Since SECC has also included the homeless, there is a chance that a large number of hitherto excluded people are brought into the welfare schemes of the government. Further, the caste data might be helpful on if the policy of reservation has really helped the most downtrodden of India.

Further, with SECC data, the writing on the wall is clear. The SECC makes case for a paradigm shift in the economic policy making and budget allocation both by central and union governments. At the core of it, the policy making needs to be decentralized and include the most downtrodden people.

Part-C: Unemployment Fundamentals

Concepts related to Labour Force

Labour Force refers to the number of persons *actually working or willing to work.* However, workforce refers to the number of persons *actually working.* Thus, workforce does not account for those who are willing to work. The difference between labour force and workforce is the total number of unemployed persons.

Number of Persons unemployed = Labour Force – Workforce

Workforce does not takes into account the wage rates. On the other hand, labour supply refers to supply of labour *corresponding to different wage rates.*

Labour Force Participation Rate

Labour Force Participation Rate (LFPR) is defined as the number of persons in the labour force per

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1000 persons.

$$LFPR = \frac{no.of\ employed + no.of\ unemployed\ persons}{Total\ population}\ X\ 1000$$

For example, if population is 1000, and there are 400 people actually working while 300 people willing to work; then, LBPR would be 700. LBPR can also be shown in percentage, whereby the above figure would become 70%.

Worker Population Ratio

Worker Population Ratio (WPR) is defined as the number of persons employed per 1000 persons.

$$WPR = \frac{no.of\ employed\ persons}{Total\ population}\ X\ 1000$$

As per NSSO 68th round, India's worker population ratio is 537.

Usual approach

A main worker is the person who has worked more than 183 days in a year. Marginal worker is the person who has worked less than 183 days in a calendar year. The major time spent by a person (183 days or more) is used to determine whether the person is in the labour force or out of labour force. This is called Usual approach in determining the participation rate.

Other Facts

- Unemployment is an economic situation marked by the fact that individuals actively seeking jobs remain unhired. Unemployment may be voluntary in nature also as individuals sometimes not interested to work at the prevailing wage rate due to various reasons. They are not included among the job seekers.
- As ability to work is one of the important indicator in calculation of unemployment, people of the age 15 – 60 excluding sick people are included in the workforce.
- In India, a person working 8 hours a day for 273 days in a year is considered as employed on a standard person year basis. An employed person should contribute to the growth of GDP of the country. Employment can be either self-employment or hired employment. Hired employment is either on casual basis or regular basis.

Types of Unemployment

There are several kinds of unemployment rate as follows.

Open Unemployment

Open unemployment is a condition in which people have no work to do. They are able to work and are also willing to work but there is no work for them. They are found partly in villages, but very

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largely in cities. Most of them come from villages in search of jobs, many 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. Naked unemployment is another term used for open unemployment.

Structural Unemployment

It occurs due to structural changes in the economy. Structural changes can be due to change in technology (from labour intensive technology to capital intensive technology) or change in the pattern of demand. In a developing country like India, structural unemployment exists both in the rural and the urban areas.

Frictional Unemployment

It occurs when a worker is shifting from one job to the other. During the mobility period, he may unemployed for some time. It is a temporary phenomenon. In other words, Frictional unemployment is the time period between jobs when a worker is searching for, or transitioning from one job to another. It is sometimes called*search engine* and can be voluntary based on the circumstances of the unemployed individual.

Cyclical Unemployment

It occurs because of cyclical fluctuations in the economy. Phases of boom, recession, depression and recovery are typical characteristics of a capitalist economy. In boom phase, high level of economic activity results in high level of employment whereas recession and depression phases marked with low demand results in more unemployment and during the recovery phase unemployment is slowly reduced.

Under-employment

It is a situation under which employed people are contributing to production less than they are capable of. It can be in terms of time (visible under-employment) or type of work (invisible under-employment). Part-time workers come under this category.

Disguised Unemployment

A disguisedly unemployed person is the one who seems to be employed but actually he is not. His contribution to the total output is zero or negligible. When more people are engaged in a job than actually required, a state of disguised unemployment is created. It is mostly seen in rural areas.

Seasonal Unemployment

It occurs only during seasonal months of the year. In India, it is very common in agriculture sector. In certain type of industries also this type of unemployment is found. Disguised unemployment and seasonal unemployment are two most common types of unemployments found in rural India particularly in farm sector.

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Unemployment Trends in India

There are five sources of employment / unemployment statistics in India viz. NSSO, Economic Census, Employment Market Information Programme of DGET, Registrar General of India and Labour Bureau. The NSSO (National Sample Survey Office) releases its survey-based employment results every five years. It includes both organised and unorganised sector employment. Central Statistics Office (CSO) releases the 'Economic Census' every five years, which also provides survey-based data on employment but only with respect to establishments in the organised and unorganised sectors. Labour Bureau, Ministry of Labour and Employment, releases the 'Annual Survey of Industries (ASI)', covering employment in the organised sector as well as the 'Quarterly Report on Changes in Employment in Select Sectors'. While the NSSO, Economic Census and ASI offer state-level data, the quarterly publication releases sector-wise details.

Extent of Unemployment

The latest available data / trends on unemployment in India is from Employment & Unemployment Survey (2011-12) conducted by Labour Ministry and Economic surveys of last few years. According former report, all-India unemployment rate is 3.8 percent. This figure is in contrast with ILO (International Labour Organisation) data of 2011 which said that India's 6% population is unemployed. Out of this 3.8, male unemployment stands at 2.9% while female stands at 6.9%. Highest unemployment rate is in Goa (17.9%) followed by 14.1% in Tripura, 12.6% in Sikkim, 9.9% in Kerala, 8.3% in Bihar and 7.8% in West Bengal.

Labour Force Participation Rate

At All India level the Labour Force Participation Rate (LFPR) based on usual principal status approach is estimated at 529 persons out of 1000 persons. The male and female LFPR is estimated to be 774 and 254 persons respectively per
1000 persons each.

Worker Population Ratio

The WPR at All India level based on usual principal status is estimated at 508 persons out of 1000 persons; which signifies that about 51 per cent of the population of age 15 years & above is employed.

Self-employed and Hired Workers

The ratio of self-employed and hired workers is another important feature of employment which indicates the nature of employment in the country. Nearly 48 percent of workforce is hired and 52 percent of it is self-employed.

Factors Accounting for Unemployment

Several factors account for the variation in the degree of Unemployment in different states. Normally, Unemployment is high in areas having the following characteristics:

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- Larger proportion of agricultural Labourers
- more urbanisation
- More pressure of population on agriculture.
- High rate of illiteracy.

Regarding unemployment in India, we need to note that since poor cannot afford to remain unemployed, unemployment rate among the poor is very low as compared to educated youth who are from the relatively better of economic family background. Higher the level of education attainment, higher is the rate of unemployment in India. This is partly because of the fact that they can afford to remain unemployed to search for better employment opportunities. This is also a reason that there is increase in proportion of "Non workers" among Youth since 2001. Further, in recent years, the proportion of Non-workers has also increased among rural youth.

Employment in Organised and Unorganised Sectors

Employment may broadly be classified as:

- Organised or formal sector employment and
- Unorganised or informal sector employment.

Organised or formal sector employment means employment which is offered by public and private sector establishmentswith10 or more workers. Unorganised or informal sector employment means employment offered by private enterprises hiring less than 10 workers, besides employment in farming and self-employment ventures. Workers in organised sectors are entitled for social security benefits.

Employment Growth Rate

There has been a slowdown in the growth of employment. For the last 14-15 years, the approximate growth rate in employment has been ranging between 3.0 to 3.3 percent annually.

Share of Major Sectors in Total Employment (per cent)

	1999-2000	2004-05	2011-12
Agriculture & allied	59.9	58.5	48.9
Industry	16.4	18.2	24.3
Services	23.7	23.3	26.9

Source: Rangarajan, Seema, and Vibeesh (2014).

According to Economic Survey 2013-14, there has been a decline in the workforce in agricultural and allied sector, while there is an increase in industry and service sector. In 2011-12, almost half of total workforce was employed in farm related activities while remaining half in industry and services.

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Need of Investment growth for creation of Jobs

Defining challenge in India today is that of *generating employment and growth*. Jobs are created by firms when firms invest and grow. Hence it is important to create environment conducive for firms to invest.

Reforms are needed on three fronts

- Creating a framework for sustained low and stable inflation
- Setting public finances on a sustainable path by tax and expenditure reform
- Creating the legal and regulatory framework for a well-functioning market economy.

Economic Development and structural shift in employment

The Economic Development must bring some notable changes in the structural, institutional and technical set up. For example a shift from the dominance of primary sector to that of the secondary and tertiary sector is one of the important structural changes. Then, the change from labour intensive to capital intensive technology is a technological change. The shift in the ownership of land from the absentee landlords to actual tillers is institutional change.

Thus, on path of development, there is a decline in farm employment and surge in non-farm employment.

This is evident from the data presented in the economic survey 2013 that growth of India's service sector is second fastest in the world only after china. In the services sector, the survey noted that largest growth of employment was registered by "**Construction**" sector, registering an increase of nearly 2.5 crore between 2004-05 and 2011-12.

Employment Elasticity

It is an irony that a few years back, when India was on high growth trajectory, its growth was **jobless growth.** Jobless growth means that the high growth in GDP did not accompany a similar growth in employment, resulting in a *low Employment Elasticity*.

Employment elasticity is a measure of how employment varies with economic output. An employment elasticity of 1 implies that with every 1 percentage point growth in GDP, employment increases by 1%. As a missed opportunity, the extraordinary growth during yesteryears didn't lead to any employment growth at all. For example, between 2004–05 to 2009–10, employment elasticity of India was as low as 0.01, which implies that with every 1 percentage point growth in GDP, employment increased by just one basis point.

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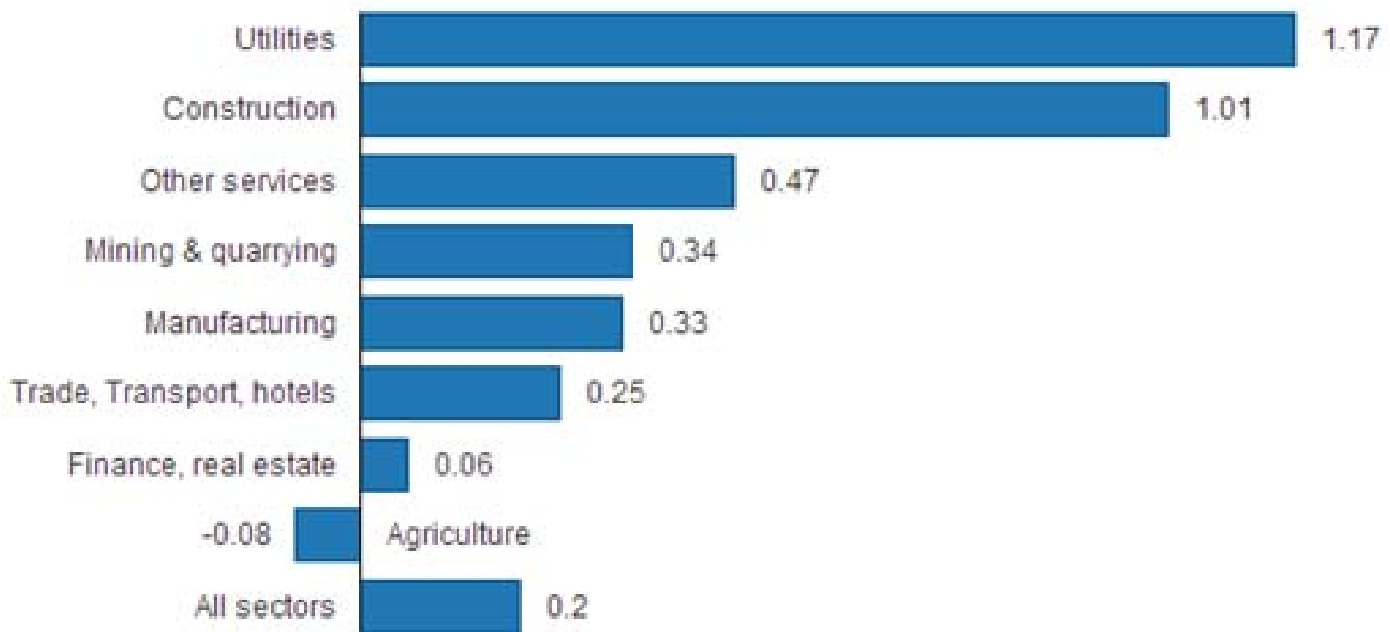

Employment Elasticity of various sectors in 2009-10 (Source RBI)

In recent years, the highest employment elasticity has been shown by the Construction and utilities sector (which includes energy, water and waste management). These are the biggest job generators in our country. Further, the graphics above shows that *farm sector in India has shown negative employment elasticity*. This simply indicates that growth in farm sector is accompanied by reduction in farm employment as more and more people leave this sector and go out for jobs in non-farm sector. This indicates a daunting task for the government. On the one hand, it has to revive growth; on other hand, it has to provide new and better-paying jobs for a growing workforce.

Decreasing women participation in labor force and workforce

In recent years there has also been a decline in the labour force and workforce participation rates of women. A large number of analysts have ascribed this to a rapid increase in female participation in education, both in the rural and urban areas.

We note here that very low and stagnating female labor force participation rates in urban India over the past 25 years. This stagnation is surprising given that it took place at a time of high GDP and earnings growth, a sizable fertility decline, a rapid expansion of female education, and rising returns to education. A combination of demand and supply side effects have played a role in accounting for this stagnation. On the supply side rising male incomes and education have reduced female labor force participation. Second, as the survey noted, there is a rapid increase in female participation in education, both in the rural and urban areas. This in part is driven by the preferences of educated women for white-collar service employment and stigmas attached with working in other sectors.

Causes of Unemployment in India

Problem of unemployment in India is not very grave in comparison to countries like Spain, Greece

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etc. However, the problems is of Under-employment, whereby people do the jobs worth less than their capacity to do. The growth of Indian Economy has been jobless. Since 1990's, Indian economic growth is mainly based on manufacturing and services sector. The use of efficient technology in these sectors resulted in low level of employment opportunities creation. The low level of economic growth in primary sector curtailed the job opportunities at rural level. Thus it resulted in jobless growth. Further, rapid population growth adds more labour force to the market. More population means more consumption and less saving, less saving implies less capital formation and less production which finally leads to less employment. Some other reasons are as follows:

Agriculture – A Seasonal Occupation

- Being a seasonal activity, agriculture largely offers seasonal employment. Those engaged in farming remain idle for three to four months in a year.

Decline of Small Scale and Cottage Industries

- Industrial policy of British government curtailed the growth of small scale and cottage industries. Independent India's preference to large scale industry and new industrial policy of 1990's resulted in decline of small scale industries.

Joint Family System

- It encourages disguised unemployment. In big families having large business establishments, many such persons are found who do not do any work and depend on the joint income of the family. Joint family system is more prevalent in rural areas; hence a high degree of disguised unemployment there.

System of Education

- Prevailing educational system failed to produce trained and efficient labour force capable of self-employment. Country is producing a large number of graduates and post-graduates capable of white collar jobs only. Since the supply of such jobs is less than their demand, unemployment is the obvious outcome.

Mobility of Labour

- Labour mobility is very low in India. Because of their family loyalty, people generally avoid migrating to far-off areas of work. Factors like diversity of language, religion and customs also contribute to low mobility. Lower mobility causes greater unemployment.

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